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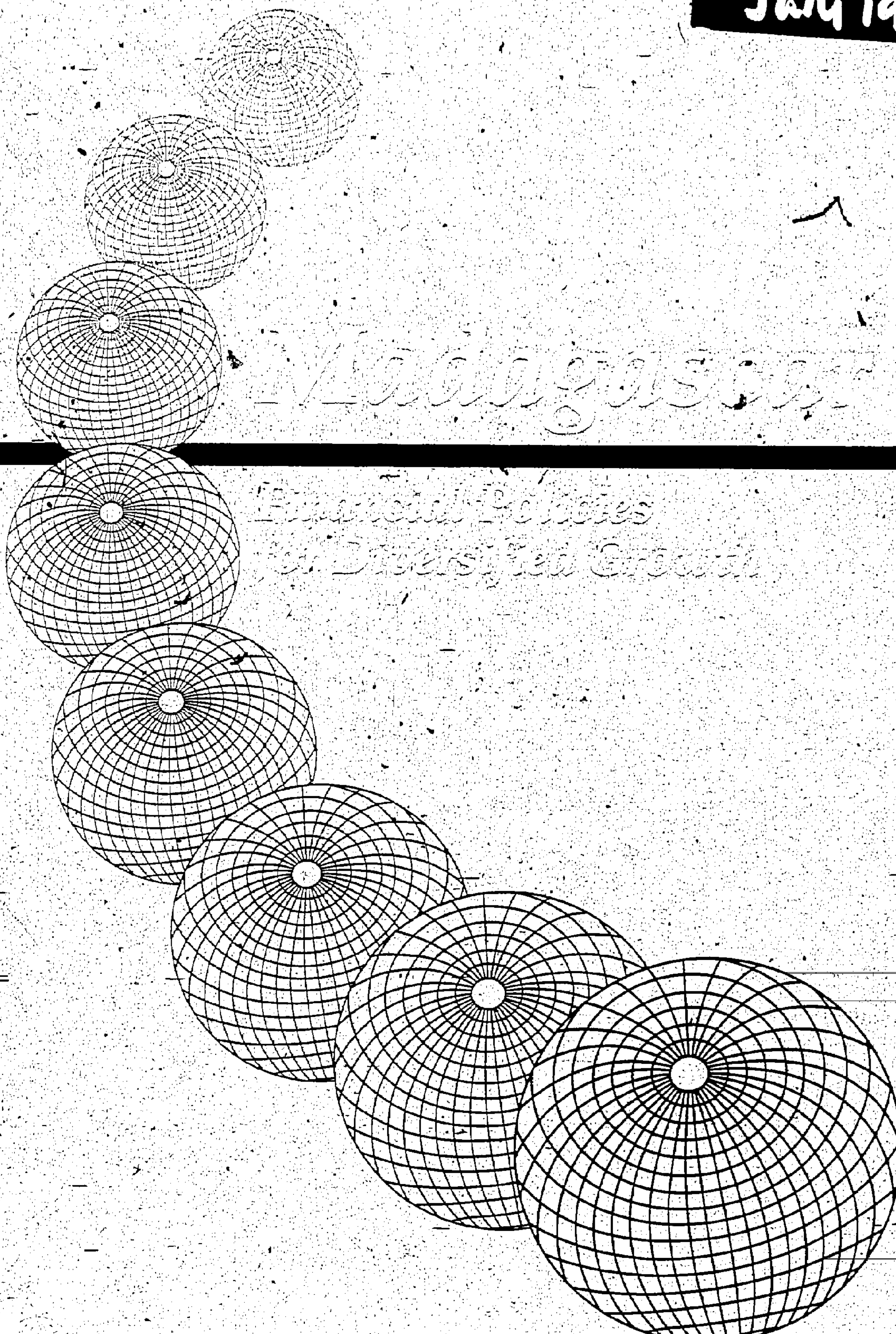

Madagascar

Financial Policies for Diversified Growth

A WORLD BANK COUNTRY STUDY

Madagascar

Financial Policies for Diversified Growth

The World Bank
Washington, D.C.

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PREFACE

This study is the product of close collaboration between the World Bank and the Government of Madagascar to formulate a strategy for the development of the country's financial sector. The analysis in this study is based on two missions to Madagascar led by Govindan Nair (task manager) and comprising: R. Karaoglan and P. Popiel (AFTEF), Bernd Balkenhol (ILO), and Bernard Connen (consultant) in January/February 1991; as well as A. Op de Beke (IMF), P. Berglund and L. Lindroth (consultants) in May 1991. The completed study was discussed with the Government in January 1992. The support of the Government of Madagascar is gratefully acknowledged. The Bank missions express their thanks especially to the many staff members of the Central Bank of Madagascar and the Treasury who collaborated in this study.

Notwithstanding the collaborative nature of this study, the conclusions are ultimately the responsibility of the Bank team. In addition to Govindan Nair, principal author of the study, and the members of both missions, the following individuals in the Bank provided substantial advice, comments and input: Michael Sarris, Philippe Le Houerou, Gerard Caprio, and Edgardo Barandiaran. The conclusions are also the result of close collaboration of the IMF. Ms. Judite Fernandes provided secretarial and production support.

The study has not been updated since its completion in October 1991. However, in recognition of the usefulness of the study to on-going thinking on financial sector reforms in Madagascar, the Government has requested its publication in its present form with a view to its wider dissemination.

CURRENCY EQUIVALENTS

Currency Unit	=	Malagasy franc (FMG)
US$1	=	1800 FMG (end 1991)

WEIGHTS AND MEASURES

Metric International Standard System

1 meter (me)	=	3.3 feet
1 hectare (ha)	=	2.47 acres
1 kilometer (km)	=	0.62 mile
1 sq kilometer	=	0.39 sq mile (sq mi)
1 kilogram (kg)	=	2.2 pounds (lb)
1 liter (1)	=	0.26 US gallon (gal)
1 metric ton (m ton)	=	2, 204 lb

LIST OF ABBREVIATIONS

AON	=	Appels d'Offres Négatives
AOP	=	Appels d'Offres Positives
APB	=	Association Professionnelle des Banques
BA	=	Bankers' Acceptances
BCEAO	=	Banques Centrales des Etats de l'Afrique de l'Ouest
BCRM	=	Banque Centrale de Madagascar
BFV	=	Banky Fampandrosoana ny Varotra
BMOI	=	Banque Malgache de l'Océan Indien
BNI	=	Bankin'ny Indostria
BTA	=	Bon du Trésor par Adjudication
BTC	=	Bon du Trésor Classique
BTM	=	Bankin'ny Tantsana Mpamokatra
CCBEF	=	Commission de Contrôle des Banques et d'Etablissements Financiers
CCP	=	Compte des Chéques Postaux
CD	=	Certificates of deposits
CEM	=	Caisse d'Epargne de Madagascar
CNAPS	=	Caisse Nationale de Prévoyance Sociale
CPI	=	Consumer Price Index
ECGS	=	Export Credit Guarantee Scheme
EPZ	=	Export Processing Zone
FIARO	=	Financière ARO
FMG	=	Franc Malgache
IOC	=	Indian Ocean Commission
NGO	=	Non-governmental Organization
PTA	=	Preferential Trading Agreement
PTT	=	Postal and Telecommunications Services
SA	=	Sociétés Anonymes
SARL	=	Sociétés à Responsabilité Limitée
SILI	=	Système d'Importations Libéralisées
SME	=	Small and Medium Enterprises

GOVERNMENT OF MADAGASCAR FISCAL YEAR

January 1 to December 31

GLOSSARY OF FINANCIAL TERMS

Average Cost of Funds: A weighted average of the interest cost of a bank's deposits and own funds, based on the composition of its deposits at a point in time.

Capital Market: The market in which long-term financial instruments, such as equities and bonds, are issued and traded.

Clearing: In the context of the payments system, refers to the transfer and recording of payment instructions made by a payor to a financial institution. Clearing can be done on a gross basis i.e. transaction by transaction or, if channelled through a specialized clearing organization such as a clearinghouse, on a net basis where total receipts of one institution are offset against payments to be made by that institution.

Commercial Bills: Short-term debt instruments that are used mainly to finance trade. Examples are promissory notes, by which debtors commit themselves to pay to creditors or to their order a stated sum at a specified date, and bills of exchange, which are drawn up by creditors and accepted by debtors. Commercial bills that are also accepted by banks are known as bank acceptances. Promissory notes issued by large corporations to meet their general financial needs are known as commercial paper.

Contractual Savings Institutions: Occupational pension funds, national provident funds, life insurance plans, and similar institutions that collect financial savings on the basis of long-term financial contracts.

Direct instruments: In connection with monetary policy, refers to actions affecting monetary conditions which directly force banks into portfolio positions they would not voluntarily accept such as aggregate and individual bank credit ceilings, interest rate controls and directed credit policies.

Discount: A reduction from the face value of a financial contract.

Disintermediation: Usually it refers to the removal of funds from interest-bearing time accounts in savings institutions and commercial banks for the purpose of reinvesting the funds at higher rates in market instruments. In other cases, ordinary sight and saving deposits are removed to increase the demand for durable (e.g., land, gold) or consumption goods, or to be lent directly by surplus agents (households) to enterprises, bypassing financial intermediaries.

Equity Finance: The provision of finance in a form that entitles its owner to share in the profits and net worth of the enterprise.

Financial Depth: The extent to which savings in an economy is channelled through the financial system. Usually measured as the ratio of broad money (M2) to GDP.

Financial Distress: Usually refers to the sharp deterioration of a group of financial indicators resulting in changes in the behavior of the agent before its restructuring or bankruptcy.; When such distress reaches crisis proportions and is widespread, it usually leads to a rush out of real or financial assets into cash.

Financial infrastructure: The framework of laws, regulations and accounting practices governing financial transactions and the logistics and practices of the payments system.

__Financial sector__: The structure of arrangements in an economy which facilitates the conduct and growth of real economic transactions through the use of money for payments, savings and investment. This structure of arrangements include monetary and regulatory policies, infrastructure, institutions, instruments and markets which are intended to enable the transfer of financial resources with minimal possible risk and cost from payers to recipients of funds and from savers to borrowers.

__Financial system__: The institutions, instruments and markets in the financial sector.

__Financial Savings__: The portion of total wealth held in the form of financial assets.

__Fiscal Deficit__: Defined on a cash basis as the difference between total Government cash outlays, including interest outlays but excluding amortization payments on the outstanding stock of public debt, and total cash receipts, including tax and nontax revenue and grants but excluding borrowing proceeds.

__Girobank__: An institution for handling financial payments and transfers. It receives payments from individual payers which aggregate several payment obligations (eg. utility and tax bills) or from a firm or public entity making payroll transfers. The girobank then re-aggregates all these payments by individual payees who receive a lump sum settlement from the girobank for obligations due from a group of a group of clients (eg. the utility company).

__Hedging__: The acquisition of a financial contract designed to protect the purchaser or the seller against a future change in the price of a commodity or security in which the purchaser or the seller has an interest.

__Indexation__: A mechanism for periodically adjusting the nominal value of contracts in line with movements in a specified price index.

__Indirect instruments__: In connection with monetary policy, refers to policy actions affecting monetary conditions such as interest rates and price levels through use of market forces and financial markets.

__Liquid liabilities__: Money plus highly liquid money substitutes, such as savings deposits.

__Liquidity Management__: In connection with monetary policy, refers to actions taken by a central bank to ensure that the banking system can flexibly provide in the short-run for the cash and payment needs of society.

__Monetary policy__: Refers to actions taken by central banks to affect monetary and other financial conditions in pursuit of the broader objectives of sustainable growth of real output, high employment and price stability. Distinguished from fiscal policy which affects these broader objectives through Government expenditures and taxes (see direct instruments and indirect instruments).

__Money__: Currency and other liquid assets. Narrow definitions such as M1 refer to money used as a medium of exchange. Broader definitions such as M2 or M3 add to M1 money used as a store of value.

__Money markets__: Markets in which financial instruments with a term of one year or less are issued and traded. These instruments usually include enterprise bills, commercial paper, bankers acceptances, Treasury bills, and negotiable certificates of deposits.

__Nonperforming Loans__: A loan on which contractual obligations (for example, interest or amortization payments) are not being met.

Open market operations: A tool of monetary policy through which a central bank can affect reserve money through purchase or sale of securities.

Payments system: The system of logistics and practices involved in settling economic obligations and transferring resources through financial payments. Clearing and settlement are the two major steps in the payments process. The institutional elements of this process include, for example, the system of checks, clearinghouses, girobanks and automatic deposit and payment orders executed by financial institutions including the postal system. (see **clearing, girobank, and settlement**)

Prudential Regulation: Refers to the set of laws, rules and regulations which are designed to minimize the risks banks assume and to ensure the safety and soundness of both individual institutions and the system as a whole. Examples include lending limits, minimum capital adequacy guidelines, liquidity ratios, etc.

Quasi-fiscal Activities: Refers to activities undertaken by the central bank that are outside the strict ambit of monetary policy and which are normally undertaken by the Government; these activities can affect the profit and loss account of the central bank or initially show up only as a change in composition of central bank assets.

Quasi-fiscal Deficit: Refers to the losses of the central bank that arise from activities not specifically related to monetary policy and that would be normally undertaken by the Government (see **fiscal deficit, quasi-fiscal activities, monetary policy**).

Reserve Money: Currency in circulation plus deposits (of banks and other residents but not the Government) with the monetary authorities.

Securities: Financial instruments which can be readily transferred through sale from one owner to another either directly or through the intermediary of specialized institutions and markets. The term generally refers to shares and bonds specifically.

Securitization: The process of conferring the tradeable characteristics of securities to a financial instrument.

Seignorage: The net revenue derived from money issue.

Settlement: In the context of the payments system, refers to the actual transfer of value based on payments instruction through the use of account balances at a financial institution which can be bank balances or on the books of the central bank.

Term Finance: Equity or medium- and long-term debt finance.

Write-Offs: The act of removing an asset from the books of a company or bank, acknowledging and charging the loss against loan-loss provisions or capital.

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CHAPTER 1

FINANCE IN THE CHANGING MALAGASY ECONOMY

Objectives and Organization of the Report

1.1 Objectives of the Report: This Report has three objectives: (i) to identify strengths and weaknesses of Madagascar's financial system; (ii) to formulate policy options which could enable the financial system to better serve the country's objectives of sustainable and diversified growth; and (iii) to recommend an appropriately sequenced strategy for financial system development that could be implemented within the 1990s. As in most low-income countries, Madagascar's financial system is narrow and shallow, comprising a small range of institutions and instruments for mobilizing financial savings and channeling credit. Financial deepening and broadening can facilitate the economic transition from the adjustment and stabilization policies of the 1980s to a period of self-sustained growth. This would entail making existing financial institutions, instruments and markets more efficient and developing new ones as needed to progressively respond to the growing needs of an increasingly market-oriented economy. What constitutes an appropriate financial system for Madagascar and how to develop such a system is the subject of analysis of this Report.

1.2 Importance of Finance to the Economic Transition: An appropriate financial system is essential to Madagascar for several reasons. First, an efficient financial system can play a major role in expansion of domestic and foreign trade, stimulation of domestic savings and appropriate channeling of available resources to productive uses - functions essential to the increasingly market-oriented Malagasy economy. Second, a system of appropriate financial institutions, instruments and markets enables economic agents to pool, price and trade the risks associated with various economic activities which individual entrepreneurs may not wish to bear entirely - a key issue which will emerge with increasing economic diversification. Third, a well-developed financial system with adequate depth and range of financial instruments can over time help address the concern of Malagasy policy makers to more effectively conduct macroeconomic policy and adjust to internal and external shocks.

1.3 Overall Organization of the Report: This first chapter of the Report introduces the financial sector in Madagascar in the context of recent developments both in the domestic and external sectors of the economy. It then focusses on the key economic challenge of resource mobilization and allocation in which the financial sector is assuming an increasingly important role. After reviewing the general structure and salient characteristics of the existing financial system in Madagascar, the first chapter concludes with an outline of how the remainder of this Report identifies improvements in research mobilization and allocation through the financial system. To develop the analytical underpinnings of a financial sector strategy in Madagascar, the financial sector is viewed in this Report as comprising three sets of elements which are successively analyzed in Chapters 2 through 7. These three sets of elements of the financial sector are the framework of (i) financial policies and (ii) financial infrastructure which supports (iii) the financial system. Chapters 2 and 3 of the Report respectively examine the framework of macro-financial policies and the regulatory, legal, accounting and payments mechanisms which provide the basic infrastructure for financial transactions. Subsequently, Chapters 4 through 7 examine the core elements of the financial system: institutions, instruments and markets. These chapters cover recent developments and future challenges of the banking system (Chapter 4); issues in term finance, particularly in regards to contractual savings institutions and housing finance (Chapter 5); the special issues pertaining to small-scale depositors and entrepreneurs (Chapter 6); and the scope of new instruments, institutions and markets to meet specialized trade and investment needs (Chapter 7). The concluding chapter of this Report outlines a financial sector development strategy based on the analysis of the preceding chapters.

Economic Growth And Recent Policy Developments

1.4 Patterns in Growth: Madagascar's post-independence economic record is mixed and can be roughly characterized by four periods: modest growth from independence in 1960 to 1970; stagnation from 1970 to 1980; sharp deterioration between 1980 and 1982 -- during which period real GDP contracted by 10.0 percent; and almost a decade of stabilization and adjustment beginning in 1981 and with signs of real per capita growth emerging towards the end of the 1980s for the first time in decades.

1.5 Policy Shifts in the 1970s: During the 1970s, the country followed an inward-looking development strategy which resulted in declining growth and ultimately in large current account and fiscal imbalances. This strategy emphasized a predominant role for the public sector, with industrialization as the central objective and agriculture in a supporting role. Nevertheless, until 1978, the authorities also pursued cautious financial policies that kept the fiscal deficit low, held the balance of payments close to equilibrium and resulted in a debt service ratio of only 4.0 percent. Between 1978 and 1980 however, the Malagasy authorities embarked on a policy of massive public investment. It was poorly coordinated, concentrated on economically inviable projects, and financed mainly with external borrowing on commercial terms. This policy, combined with declining terms of trade and stagnant domestic revenues increased considerably the fiscal deficit, fueled inflation and resulted in a large external debt burden that subsequently constrained economic growth.

1.6 Stabilization in the Early 1980s: Beginning in 1981 and until 1986, the Government embarked on a policy of financial stabilization centered on demand adjustment. During this period, the fiscal deficit was reduced substantially mainly by curtailing public expenditures, notably in investment. Largely as a result, the annual expansion of domestic credit fell sharply and annual inflation dropped from about 30% in 1981-82 to about 13% in 1983-86. On the external side, the current account deficit was reduced in half, with the brunt of adjustment falling on imports.

1.7 Structural Adjustment in the 1980s: While financial stabilization measures helped alleviate immediate macroeconomic imbalances, a number of structural rigidities and price distortions remained embedded in Madagascar's economy. From 1985, as stabilization measures implemented in the first part of the decade were showing steadying results, the authorities turned their attention to adjustment efforts on the supply side. These efforts comprised some early adjustment measures followed by the first large-scale macroeconomic structural adjustment program launched in 1987. This first stage of adjustments focussed on quantitative and price controls. Under this program, a large devaluation of the Malagasy franc brought the real effective exchange rate to less than half its 1978 level, protective import quotas were replaced by tariffs and a non-discretionary "open general license" system of foreign exchange allocation for merchandise imports was established. These reforms were extended to administrative export restrictions and state agricultural export monopolies which were eliminated and to remaining price controls which were lifted. In the next phase of adjustment, from 1988 onwards, reforms were broadened to public sector management where strengthening of the public investment and budgetary formulation was initiated along with reforms of the public enterprise sector. At the same time, financial sector reforms were undertaken entailing the clean-up of loan portfolios of state-owned banks and the entry of private capital into the banking system for the first time since nationalization of banks in the 1970s. At this stage, some systematic attention also began to be given to the social aspects of the adjustment process.

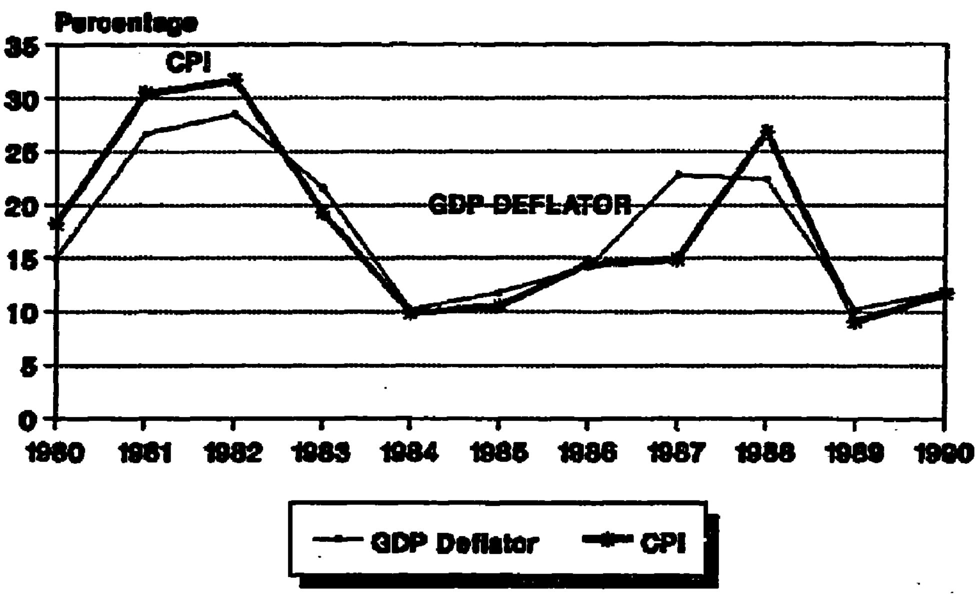
1.8 Evolution of Prices in the 1980s: Until 1982, Madagascar maintained a comprehensive system of price controls at both producer and consumer levels. Under the stabilization, and later the adjustment programs virtually all domestic price controls were eliminated beginning with agricultural producer prices in 1983 and ending with retail prices of goods in 1989. Recent analyses conclude that the impact of price deregulation upon the evolution of the price level was positive and contributed to the decreasing of the inflation rate. During the 1980s' inflation showed a "camel-back" pattern with two major bumps in 1980-82 and 1987-88 (see Fig. 1.1). As measured by the yearly average of the combined CPI, the rate of inflation increased from 18 percent in 1980 to peak at 31.0 percent in 1982 and decline sharply to a low 9.0 percent in 1985. It rose again in 1986-1988, reaching a second peak of 26.3 percent and dropped thereafter. For 1990, inflation was estimated to be nearly 12 percent.

1.9 Effects of Money Supply and Exchange Rate on Inflation: Regression analysis shows that throughout the 1980s', prices in Madagascar were very sensitive to variations in money supply and the exchange rate 1/. The consumer price index lagged by one-quarter showed an elasticity of almost unity to money supply. In contrast to this general pattern whereby money supply led inflation, during the 1987-1988 period of high inflation triggered by the large devaluation of the FMG, money supply lagged behind prices.

1.10 Inflation and Disintermediation: Macroeconomic instability and high inflation led to disintermediation in the first part of the 1980s. From 21.9 percent in terms of the GDP in 1980, M1 dropped to 15.4 percent in 1985 and M2 from 24.6 percent to 18.8 percent. The stabilization and adjustment programs initiated in the first half of the decade steadied the macroeconomic environment and brought inflation down with the result disintermediation was arrested and the financial system began to deepen again. In terms of the GDP in 1990, M1 was about 19.0 percent and M2, 22.7 percent. The experience of the first part of the 1980s appears to have significantly affected the "depth" of the financial system in Madagascar compared to other countries (para 1.38)

1/ Regressing quarterly CPI data on quarterly broad money (M2) data, an X coefficient of 0.9 and R-squared of 0.95 are obtained with 40 observations.

Figure 1.1: Madagascar
Inflation Rate 1980-1990



Source: Government Data

Note: The CPI is based on a 1972 consumption basket for traditional households and modern ones. The relative weights of the combined CPI are 75.0 percent for traditional households and 25.0 percent for modern households. The CPI covers prices in Antananarivo only.

1.11 <u>Results of Policy Reversals in the 1980s</u>: The implementation of Madagascar's adjustment programs in the 1980s reflects a fundamental choice by the Government to reorient the economy towards market signals rather than mandated allocation of resources. Retrenchment of the public sector role in ownership and productive activities has been underway; key prices including exchange and interest rates have been substantially or completely liberalized; and the internal and external macroeconomic imbalances of the early 1980s have been significantly redressed. This choice led to a notable improvement in economic performance although still falling short of generating a broad based and durable supply response. Real GDP grew by 3.8 percent for 1988 and by 4.9 percent in 1989; growth for the year 1990 however slowed to 3.5%. Terms of trade deterioration have kept domestic demand sluggish and per capita consumption continues to fall. In the last years of the 1980's, private aggregate consumption stabilized, whereas public consumption continued to decline. As a result, total domestic saving began to grow reaching 8.0 percent of the GDP in 1989. 2/ The fragility of the recovery however became evident in 1990 when decline in traditional exports and stagnation of non-traditional exports coupled with a dramatic surge in credit-financed imports led to a rise in inflation and a sharp fall in external reserves. The economy still remains highly vulnerable to external shocks which put the path to sustainable growth at risk.

<u>External Sector Developments 1970-1990</u>

1.12 <u>Exchange Rate Overvaluation</u>: Although, Madagascar left the franc zone in 1973, the Malagasy franc (FMG) remained fixed at 50 FMG per French franc until 1982. *During the 1970s' Madagascar allowed its exchange rate to appreciate considerably in real terms:* the real exchange rate appreciated by about 26 percent between 1977 and 1982. A similar course was followed by many developing countries and was enabled by availability of foreign finance to cover resulting current account deficits and in some cases, by relatively favorable terms of trade. This real appreciation of the exchange rate favored production of nontraded over traded goods and encouraged reliance on imported inputs. Financial institutions, accordingly, tended to allocate a larger share of financial resources to firms in the non traded goods sector. In Madagascar, public enterprises accounted for much of the activity in nontraded goods during the period of exchange rate overvaluation. Their substantial borrowings from the financial system posed, later in the 1980s' a major risk for commercial banks portfolios as the Government initiated macroeconomic adjustment and trade liberalization measures which confronted public enterprises with a much more competitive environment than the one they were facing formerly.

1.13 <u>Exchange Rate Adjustments</u>: In 1982, the Malagasy franc was devalued and pegged to a basket of currencies trade-weighted according to the distribution of Madagascar trade during the period 1973 - 1980. Starting in 1984, the authorities adopted a flexible exchange rate policy, whereby the exchange rate relative to the basket was indexed to the domestic prices index, ensuring in the subsequent years a gradual depreciation in real terms. As a result the nominal effective exchange rate depreciated cumulatively by 73.5 percent between 1984 and 1990 and the corresponding real effective exchange rate by 59 percent, with one fourth of this total devaluation occurring in the period 1987 to 1988.

1.14 <u>Impact of Exchange Rate Changes</u>: The successive devaluations that took place principally in the second part of the 1980s' are reflected in the financial system in two ways. Directly, the balance sheet of the central bank showed increasing accumulated exchange rate losses through its "revaluation account", placing the financial structure of this institution on an unsound footing, contributing to money creation and constraining the conduct of monetary

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2/ Domestic savings are substantially higher than national savings because of a large negative net factor income from abroad with external interest payments absorbing more than one half of domestic savings.

policies (see Chapter 2). In contrast, Malagasy publicly owned commercial banks had few liabilities in foreign exchange and where not affected directly by the devaluations. However, they were affected indirectly through the financial situation of many of their borrowers. The devaluations affected Malagasy enterprises which had liabilities in foreign exchange. These enterprises were mostly parastatals which had no or little foreign exchange assets or revenue. As a result their financial situation deteriorated and this deterioration affected in turn the commercial banks which, as mentioned above, had a large credit exposure to parastatals. This contributed to the financial distress experienced later by these banks (see Chapter 4).

1.15 New System of Foreign Exchange Allocation: In 1988, a new, liberal system of foreign exchange allocation for foreign trade operations was set in place, while control of capital account transactions was maintained.Under the new system, the Liberalized Import System (SILI) introduced in July 1988, all economic agents may import and receive the total amount of foreign exchange requested for merchandise transactions at the prevailing exchange rate. No restrictions apply to the opening of credit or the means of financing imports; importers may freely use their own resources, borrow from the banking system, or avail themselves of external loans, including supplier's credits, to finance imports. Services and the capital account transactions, however remain controlled. Under this control, the Treasury authorizes and supervises all payments for invisibles and borrowing and lending abroad by residents and outward and inward investments. Commercial banks are not authorized to maintain an exchange rate position in any foreign currency although they may hold trade bills as foreign assets. There are no arrangements for forward cover against exchange risk operating in the official or banking sector. There is scope for the financial system to help stimulate capital flows from abroad and facilitate trade , by developing new mechanisms for servicing foreign loans, paying suppliers, providing for dividend and capital recovery for non resident risk and managing external financial risk (see Chapter 7).

1.16 The external payment crisis of the early 1980s, although stemming from the 1979-1980 public investment boom, was precipitated by a marked deterioration of terms of trade and a sharp increase in international interest rates. To meet the crisis, the Malagasy authorities tightened fiscal and monetary policies in addition to the series of devaluations discussed previously.

1.17 Balance of Payments: Despite a prudent demand management policy in the later part of the 1980s', Madagascar's balance of payment has remained under considerable pressure. 1990 was the fourth consecutive year of deterioration in the external terms of trade(see figure 1.2). Also, in the second half of the 1980s, a number of measures aimed at trade liberalization released a pent-up demand for imports, further deepening the trade deficit. At the same time, the current account remained burdened by heavy interest payments related to the large external borrowings on non-concessional terms in the 1970s. The performance of the external sector was also hurt by a cyclone in 1986 and a drought in 1987-1988. Against these constraints, a major positive factor was a substantial increase in the levels of grants and concessional loans which gradually strengthened the country's external position, even allowing for a modest buildup in the level of net international reserves towards the end of the 1980s before this began eroding in 1990. However, a 38 percent increase in imports combined with a 12 percent decline in export earnings shifted the small trade account surplus in 1989 into a deficit of 2.5% of GDP in 1990 which was unprecedented since the early 1980s.

Table 1.1: SUMMARY INTERNATIONAL ACCOUNTS
(in percent of the GDP)

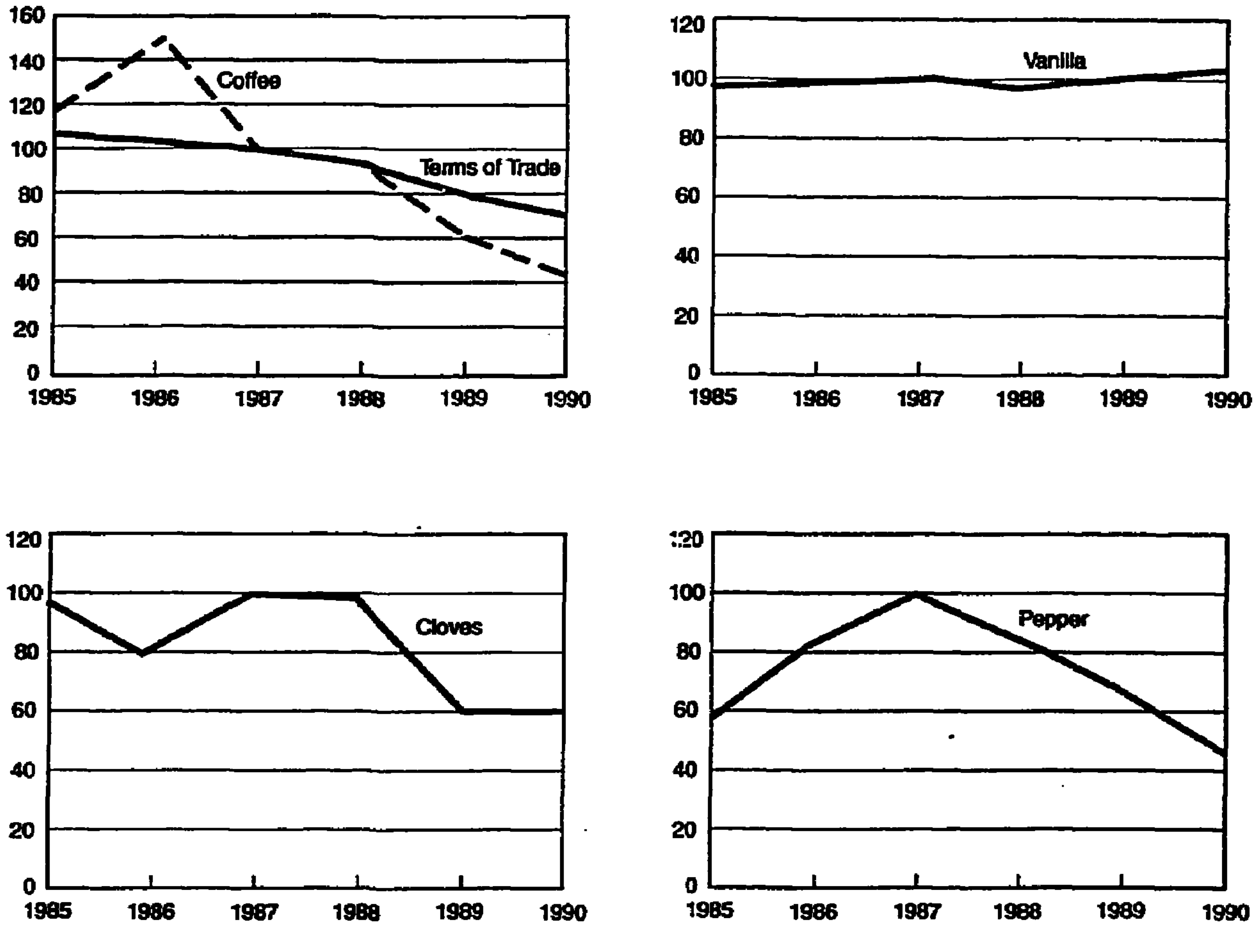
	1981-1983	1984-1988	1988	1989 4/	1990 4/
Current Account 1/	-12.6	-10.9	-14.2	-13.2	-13.5
Trade Balance	-4.4	-0.7	-1.8	-	-2.5
Interest 2/	-5.1	-6.8	-9.3	-11.0	-7.6
Other Current Account 3/	-3.1	-3.4	-3.1	-2.2	-3.4
Capital Inflow	0.6	5.5	6.1	4.5	5.9
Arrears(-decrease)	2.5	-0.5	-0.9	-1.4	-1.5
Reserves(-increase)	-	1.6	2.1	0.9	1.0

1/ Including net official transfers.
2/ Including moratorium interest on rescheduled debt.
3/ Non factor services royalties, remittances.
4/ Provisional.

Sources: World Bank and IMF Data.

1.18 Shifting Structure and Continuing Burden of External Debt: Madagascar borrowed mostly on concessional terms during the 1980s, in contrast with the 1970s. However, owing to the difficult balance of payments situation, the outstanding debt inherited from the past and contracted on non-concessional terms, had to be rescheduled. Therefore, the overall debt continued to rise, reflecting concomitantly the substantial depreciation of the Malagasy franc. At the same time, the stock of external debt as a ratio to GDP increased from 90.0 percent in 1984 to 142 percent in 1989. The composition of the outstanding stock of external debt changed, however, considerably during the second part of the 1980s. Debt rescheduling with official creditors and positive net capital inflows from multilateral organizations led to increased outstanding external debt from these sources while the outstanding external debt to commercial banks and outstanding external payments arrears decreased on account of net repayment by Madagascar. Since 1981, Madagascar has signed seven rescheduling agreements with the Paris Club and four with the London Club; the country also benefitted from a US$516 million debt cancellation from France in 1989. Despite the highly concessional terms of debt contracted after 1982 and the succession of debt relief agreements, debt service continues to seriously burden the economy. In 1989, debt service after rescheduling and cancellations represented 59% of exports of goods and non-factor services. Unless this burden is substantially eased, the economic future will continue to be mortgaged and resources that could be mobilized for growth will instead be preempted by debt payments.

Figure 1.2: Madagascar: Merchandise Terms of Trade and Price Indices of Traditional Exports 1985-1990



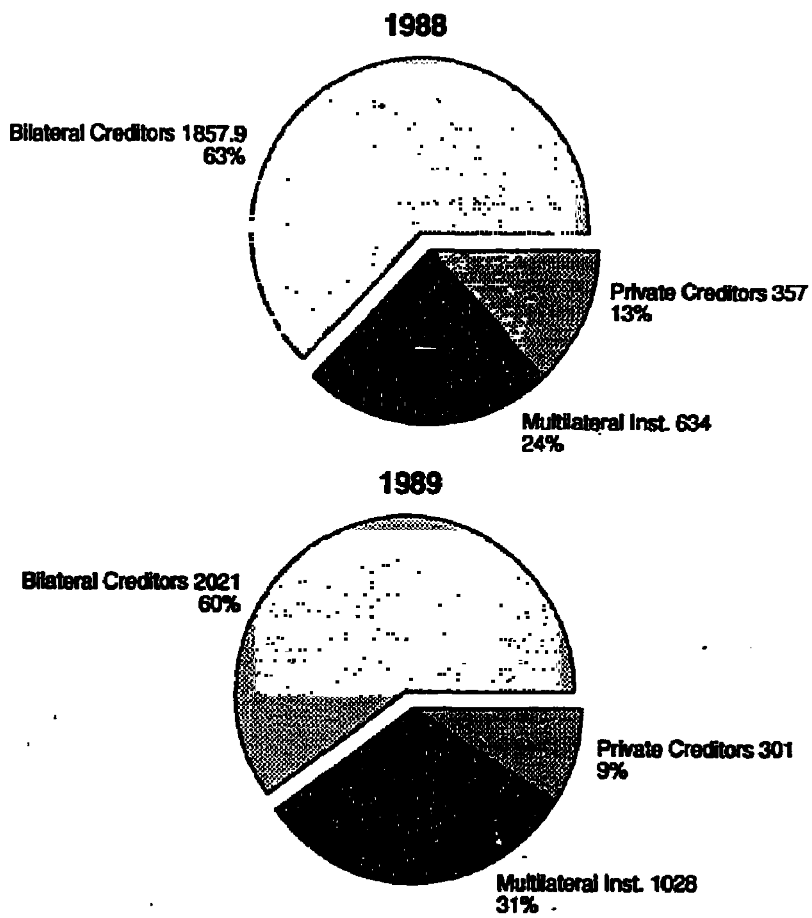
Source: Government Data

The base year is 1987 (=100)

EX/W540608

Note: The traditional exports referred to accounted for about 55% of Malagasy exports in value during 1985-1990.

Figure 1.3: External Debt by Type of Creditors
Millions US$



Source: Government Data

Future Challenges In Resource Mobilization And Allocation

1.19 Madagascar's Economic Potential: Owing to both domestic and external developments, economic performance in Madagascar has historically not been commensurate with its human and physical endowments. Today, with a population of 11.6 million growing at 3% per year and a per capita income of $230 in 1989, Madagascar remains one of the poorest countries in the world. Reliance on a narrow export base has been associated with a secular decline in terms of trade (see Figure 1.2) and has led to a pattern of economic growth which is sluggish and vulnerable to external developments. Yet, Madagascar's physical and human resources afford unusually promising economic potential particularly in comparison to a majority of countries in Sub-Saharan Africa. Its exceptional ecological and climatic diversity allow cultivation of a variety of tropical and temperate crops. This agricultural potential coupled with the availability of a significant variety of mineral deposits and of an industrious, relatively well-trained and competitively-priced labor force offer a strong basis for a diversified economy including a variety of non-traditional economic activities and exports. In the services sector, considerable potential exists in tourism for which Madagascar's unique environment, culture and coastline constitute valuable assets. Most of this potential however has been unexploited.

1.20 Challenges in a New Economic Environment: The shift in policies during the 1980s, particularly since 1985, has begun to profoundly alter the domestic economic environment and the incentive structure in which the Malagasy private sector operates. These reforms have helped lay the base for revitalizing traditional economic activities and stimulating new ones. Nonetheless, the supply response to these reforms to date have been limited and are evident mainly in the highlands of the country. Traditional activities such as rice production have been revived while some new activities have been stimulated in non-traditional areas as textiles, agro-industries, aquaculture and seafood processing, and gemstone cutting and polishing. Yet, while the domestic incentive structure appears more favorable for sustainable growth in the 1990s than anytime in the previous two decades, outstanding domestic constraints are now compounded by the challenges of an increasingly competitive international economy. These external challenges include the emergence of rapidly growing newly industrializing countries (NICs) notably in East Asia; greater difficulties than in the past in attracting foreign capital; and greater demand in world markets for rapid technological adaptation and timely delivery which in turn requires more flexibility and responsiveness in production and greater attention to marketing and transport logistics. These factors leave the Malagasy economy today at crossroads as it faces the challenge of restructuring and diversifying in order to survive in the new market-oriented system.

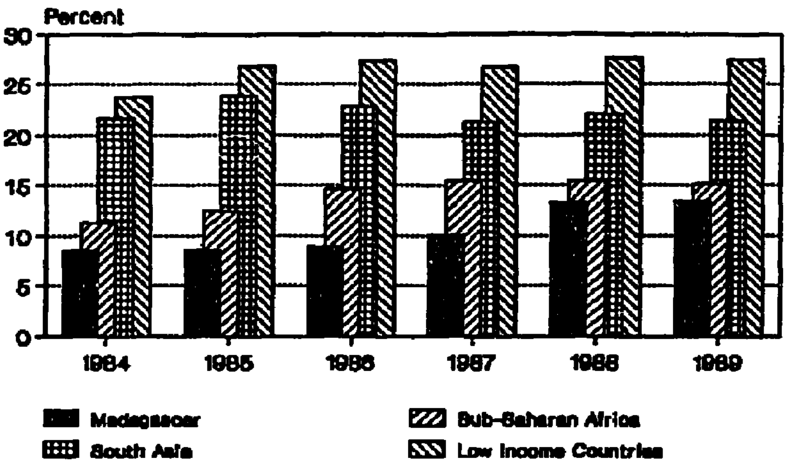
1.21 Importance of Resource Mobilization and Allocation: Ensuring sustainable growth in the 1990s requires several constraints to be overcome. Among the most fundamental of these constraints is the maintenance and deepening of the stock of physical and human capital. Given the need for increased exports to sustain growth, Malagasy businesses, which in the past refrained from investing in certain activities partly because of the small domestic market and unfavorable policy environment, must now begin to invest and increasingly produce for global markets. A necessary element for an increased investment rate is the availability of both domestic and foreign resources to ensure that the existing capital stock is adequately replaced, maintained or expanded. To ensure that these resources are used as efficiently as possible, the traditionally preponderant role of public investment must be reoriented to allow proper private sector response to market signals.

1.22 Public and Private Sector Roles: Mobilizing and efficiently allocating resources for future growth is a twofold challenge in which there are important and complementary public and private sector roles. On one hand, more efficient public sector management and fiscal policy should ensure that tax and other public revenues are raised in the least distortionary manner and that public investment is based on well-defined priorities and carefully appraised projects that themselves facilitate and induce further economic activity. At the same time, resource mobilization and allocation through the financial system has to be improved to facilitate enhanced private sector roles in the economy. In contrast to the government which mobilizes and allocates resources through its taxing and spending authority, the financial system, particularly deposit-taking institutions, depends on voluntary decisions by private savers and borrowers to place and use financial resources. The efficiency of resource mobilization and allocation crucially depends on how well financial institutions, instruments and markets address the joint needs of savers and borrowers.

1.23 Maintaining Investment for Growth: An adequate overall rate of investment is a critical although not a sufficient condition for sustained growth. Madagascar's investment rate in recent years lies below the average for Sub-Saharan Africa. Gross domestic investment averaged 10.6 % of GDP during 1985-89 against 14.6 % for Sub-Saharan Africa. This level of investment however is unlikely to be adequate for sustained and significant real per capita growth in income. For example, among Sub-Saharan African countries, the minimum investment needed to replace depreciated capital alone is estimated at about 13 percent of GDP. It is also estimated that the investment rate in these countries has to be in the region of 25% of GDP in future years if a minimum growth rate of 5-6% is to be attained.

1.24 Efficiency of Aggregate Investment: As Madagascar's experience with the crash public investment program of the late 1970s has shown, a high rate of investment alone does not ensure economic growth. An adequate aggregate investment rate must also be matched by efficiency in investment. Empirical studies confirm that less than half the growth in output can be attributed to increases in labor and capital; higher productivity explains the rest. Accordingly, increases in labor and capital inputs must be accompanied, for example, by improved health, education and work effort which increase labor productivity while capital productivity is increased by technical progress and more efficient allocation of investible resources. Efficient investment in the aggregate requires that all economic agents be able to make sound investment decisions in response to undistorted market signals. Overall investment encompasses a wide range of decisions including, for example, government investment in infrastructure, enterprise investment in productive capital, household investment in shelter, and investment by individual farmers to build fences and improve pasture. Individual economic agents tend not to make their investment decisions in isolation from investment decisions by others, notably that of the public sector. Therefore, notwithstanding the increasing market-orientation of the Malagasy economy, the role of public investment will remain crucial.

Figure 1.4: Comparative Gross Domestic Investment Rates (% of GDP)

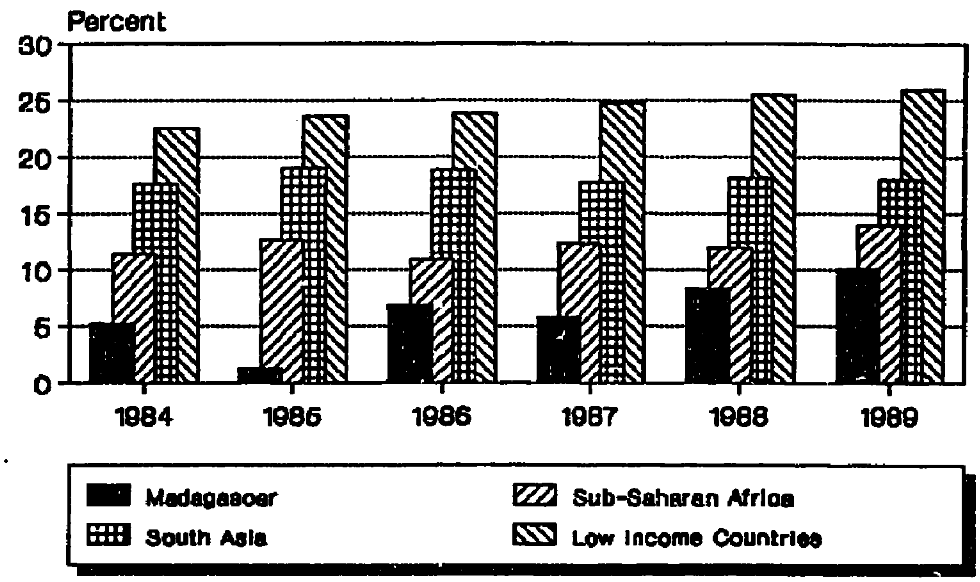


Source: World Bank Data

1.25 Raising Aggregate Savings: A major constraint in increasing the level of investment in Madagascar, particularly the level of private investment, is the low level of domestic savings. Despite its recent increase to 10% of GDP in 1989, Madagascar's gross domestic savings rate is below the average for Sub-Saharan Africa (12.4%). Aggregate savings can be raised from domestic sources consisting of public and private savings (which interact in important ways) as well as savings from abroad. Until now, concessional (and essentially public sector) capital inflows from abroad have provided the bulk of resources for (largely public) investment. While such public capital inflows will remain necessary and are likely to continue in the near term, it will be crucial for domestic sources of savings and private foreign capital to increase their absolute and relative contributions to financing aggregate investment. Each of the sources of savings that are alternatives to foreign public capital inflows is discussed below.

Figure 1.5: Comparative Gross Domestic Savings Rates

(% of GDP)



Source: World Bank Data

1.26 Public and Private Sector Roles in Savings: In parallel with an appropriate public/private mix, in investment the public and private sectors have complementary roles in savings. The most immediate way to raise domestic saving is to increase savings of the public sector (comprehensively defined to encompass central and local governments as well as public enterprises and the central bank). Government's ability to mobilize large amounts of resources through its powers to tax and create money make it a key source of investment finance, whether or not it undertakes this investment directly or channels resources to other entities. Changes in public savings however result not only from the discretionary and direct effects of tax and expenditure policies but also from the impact of exchange rate changes on foreign-denominated revenues and expenditures. Notwithstanding the importance of public savings, it is the private sector in Madagascar, as in most countries, which undertakes the greater part of domestic saving. Government resource mobilization efforts aimed at improving tax yield should therefore not discourage private incentives for savings, investment and production. At the same time, although government policy can readily alter the disposable income of the private sector mainly through tax policies, in a market economy it has only limited influence on the share of disposable income that the private sector saves. Increasing the private savings rate usually takes longer than the public sector and depends mainly on growth in household incomes through economic growth.

1.27 Mobilizing Household Savings: The most important source of private savings are households, the basic economic unit of any society. The principal motivations to save among households include: to invest in children's education; to meet large unanticipated expenses such as weddings and funerals; to enable consumption after retirement from the work force; and accumulate funds for a major purchase such as a house. The fundamental determinant of the savings of a household is its level of income. On one hand, given that Madagascar's per capita income stands among the fifteen lowest in the world, there are limitations on increases in the average level of private savings in the immediate term. Yet, the significant disparities in income distribution in Madagascar also suggests scope for mobilizing additional savings from better-off segments of society. Additional factors can influence the household saving rate depending on what margin its income provides over and above basic subsistence needs. These include the objectives of savings and alternative ways of satisfying them which are in part influenced by the security and terms of available financial instruments. A major source of private savings in Madagascar's predominantly agricultural economy is the rural sector which is typically a net saver albeit not necessarily in financial assets. While transforming unmonetized wealth into financial savings alone does not increase aggregate savings, it can generate more efficient use of resources.

1.28 Enhancing Enterprise Savings: The other source of domestic private savings is the enterprise sector. After earning incomes from sale of outputs and paying for capital, labor and intermediate inputs, enterprises generate profits which are partly paid out as taxes and incomes to their owners (thus contributing to household incomes). The residual constitutes gross savings of an enterprise which can help finance an enterprise's own investment, form a reserve against possible future losses, acquire financial assets (thereby transferring savings to other economic entities) or provide for depreciation of existing machinery, equipment and buildings. The savings level of the enterprise sector depends on overall profits and in turn on overall growth of the economy. Given the limitations of the domestic market, one crucial determinant of enterprise profits is the competitiveness of Malagasy enterprises in export markets as the economy restructures and diversifies. Given this profit level, the savings decision of an enterprise depends on the rate of return on available investments, uncertainty of future income, volume of existing accumulated reserves, and the quality of available financial assets.

1.29 Demographic Factors and Savings: The future evolution of savings in Madagascar will also depend on a combination of demographic as well as growth factors. In any given country, the larger the active population (conventionally defined as the proportion of individuals above fifteen and below sixty-five years old), the higher the potential savings rate. In 1989, about 52% of the Malagasy population was estimated to be in the "active" age group; this proportion, which is comparable to other developing countries, is expected to rise throughout the 1990's, especially among the rural population. Faster growth in Madagascar in the 1990's can lead to a higher aggregate savings rate given macroeconomic stability and confidence of savers in the economy. This is because the aggregate savings rate would move closer to the savings rate of active workers, widening the gap between the lifetime income of active and retired workers. Therefore, if economic policies in coming years succeed in providing productive employment to new job seekers, this should favorably influence the level of overall savings in Madagascar.

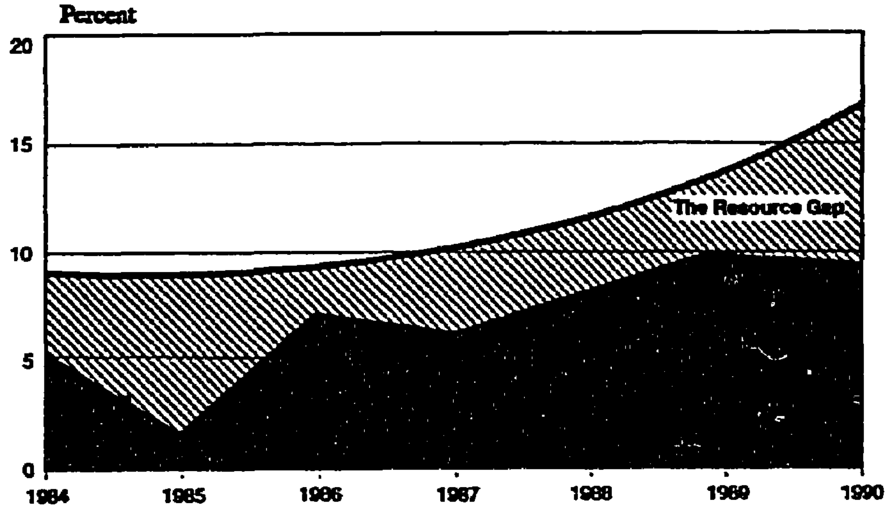
However, the impact on financial savings could be negligible unless the financial system is further developed in order to capture these resources, particularly in rural areas.

1.30 __Attracting Savings from Abroad__: In addition to domestic sources of private savings, savings from abroad can be an important source of finance for investment. One such source for Madagascar is the repatriation of flight capital held abroad by Malagasy residents. The other source is the direct investment provided by foreign enterprises in Madagascar. On one hand, growing internationalization of world production coupled with advances in technology, particularly telecommunications, is likely to lead to higher direct investment from industrial countries to developing countries in the 1990s. However, most of this investment is likely to be concentrated in middle-income developing countries with good infrastructure - between 1981 and 1990, for example, 90 per cent of these flows went to just twenty developing economies, mainly in Asia and Latin America. Nevertheless, for small, reforming economies such as Madagascar, even modest increases in direct foreign investment can have a measurable impact on growth. Whereas large captive domestic markets used to underpin much of foreign direct investment in developing countries, these capital flows are now increasingly driven by an outward-looking incentive structure within individual countries. Both repatriation of flight capital and direct foreign investment depend primarily on perceptions of economic uncertainty, political stability and the regulatory environment. The strength of domestic public and private institutions, including the financial system, in providing supporting infrastructure and services for productive activities can also provide a stimulus to such capital flows from abroad.

1.31 __The Role of the Financial Sector__: The financial system, particularly financial institutions within the formal legal and regulatory framework, is generally not directly involved in the major part of private savings and investment, especially in economies dominated by rural households and family-owned enterprises. In most developing countries in particular, firms and households rely significantly on self-finance, using their own savings to finance their investment. However, the investment opportunities of a household or a firm may not be matched by its resources and may be inefficiently limited by them. Therefore, in order for an economy to develop and diversify, the role of the financial system can be expected to grow relative to those of self-finance, relatives, friends and moneylenders. At any given point in time, surplus resources are generated by certain economic units that can be most efficiently used by other economic units. The role of the financial system is to ensure that savings from surplus economic units are efficiently mobilized and shifted to high-yielding investments in deficit economic units with an appropriate balance of risk and return.

1.32 Smoothly functioning financial systems lower the cost of transferring resources from savers to borrowers, which raises the rates paid to savers and lowers the cost to borrowers. The adequacy of financial institutions, instruments and markets can affect the volume of financial savings mobilized and the efficiency with which they are allocated to productive uses. In the medium term and long-term, the financial system should develop confidence among savers and investors alike. The gap between domestic savings and investment (see Fig. 1.4) should be increasingly financed by foreign private inflows. In recent years, the bulk of the current account deficit has been financed by loans and grants from foreign bilateral and multilateral donors with non-concessional private inflows (loans and direct investment) playing a relatively minor role. Although concessional public inflows are likely to remain important in the foreseeable future, the base for substantial inflows of private resources should begin to be established. This would require adequate legal protection for providers of foreign capital, whether in the form of debt or equity. Growth in Madagascar could be sustained if there are also appropriate policies to deepen and develop the financial sector in order to service the growing needs of an increasingly diversified real economy.

Figure 1.6: Madagascar The Resource Gap
(% of GDP)



Note: In Madagascar, the resource gap is less than the current account balance because of the substantial factor payments related to external debt servicing.

Overview of the Malagasy Financial Sector

1.33 Structure of the Financial Sector: As previously mentioned, the financial sector in Madagascar can be viewed as consisting of financial policies and financial infrastructure which support the financial system. Financial policies relate mainly to money supply, interest rates, public deficit financing and the provision of financial services. These policies are therefore key aspects of monetary, fiscal and exchange rate management as well various regulatory and sectoral policies. Financial infrastructure consists of the institutional support for the financial system found in the legal and regulatory framework governing financial transactions, the practices surrounding audit, accounting and financial disclosure and the operations of the payments system. Both these aspects of the financial system are examined in the subsequent two chapters of this Report. As in any country, the core of the financial sector in Madagascar consists of the three basic elements of the financial system: institutions, instruments and markets. These elements of the financial system, which are summarily reviewed below, are examined in the fourth through seventh chapters of this Report.

1.34 Financial institutions cover a variety of entities including deposit-taking institutions (banks, postal savings, informal savings schemes), contractual savings institutions (insurance and social security) and specialized institutions (eg. venture capital, leasing). These institutions provide vital services for economic growth and development. Besides the important function of serving as a payments mechanism for economic transactions, these institutions are an important although not exclusive channel through which financial savings are transferred to borrowers. In Madagascar, financial institutions in the formal sector are presently limited to the Central Bank, four banks, a postal checking and savings system, two insurance companies, the Social Security Fund, and two venture capital firms.

1.35 Financial instruments represent claims to real resources. The claims are against financial institutions or against borrowers of these institutions or (in the case of equity) to the residual value of an enterprise. The holdings of financial assets in Madagascar must be viewed in the context of other forms of wealth. Given its predominantly smallholder agrarian economy, livestock and land loom large as prevalent forms of wealth, possibly along with home ownership. Financial instruments provide an alternative to real assets as a store of wealth and are important vehicles for helping allocate surplus resources into their most efficient use. In Madagascar, the main instruments for financial savings are currency and demand and time bank deposits; insurance, social security and pension fund claims as well as a small volume of local shares and Treasury bills make up the remainder of financial claims held against residents in Madagascar. Financial resources are mainly transferred through a range of bank credit products and the small Treasury bill market.

1.36 Financial markets facilitate the voluntary transfer of resources from savers to investors, both individual and institutional, by pooling and pricing financial resources according to criteria of risk, return and liquidity. They comprise primary markets for issuing negotiable debt securities or equities and secondary markets for trading these instruments. The only formal financial markets in Madagascar are: an embryonic money market restricted to commercial banks and comprising an inter-bank market and a recently-launched liquidity window operated at the Central Bank; and a small monthly auction of Treasury bills.

1.37 The financial system of Madagascar is still at an early stage of development. Financial institutions are dominated by the banking sector and their transactions are substantially focussed on the formal, urban segments of the economy and population. A range of specialized institutions found in developed financial systems do not exist in Madagascar, for example, in housing finance, leasing or discounting of trade bills. Financial instruments in Madagascar are also rudimentary - the share of financial assets held by private savers in forms other than currency and deposits is minimal while small-scale savings in the rural and informal sectors are substantially unmonetized. Like most low-income countries, Madagascar lacks financial instruments such as mutual funds, quasi-equity instruments or corporate bonds. Financial markets are largely undeveloped: the money market is embryonic and a well organized and active capital market does not yet exist. Besides the formal financial system, an informal financial system exists that largely operates outside the ambit of formal financial sector regulation. Little is known about the importance of this informal system nor the efficiency of its operations.

1.38 **Depth of the Malagasy Financial System**: One of the basic indices used to gauge financial sector development in a country is financial depth. Empirical evidence suggests a strong correlation between financial depth, efficiency of investment, and economic growth. Investment productivity, as measured by the ratio of the change in GDP to investment, is significantly higher in countries which have deeper financial systems. Financial deepening, through higher financial savings, should figure as a top priority for the Malagasy authorities as the experience of fast developing countries suggests a strong link between financial development and growth. However, the depth of Madagascar's financial system has not been significantly different since its early post-independence history. The M2/GDP ratio, one of the leading indicators of financial depth, has hardly changed over a twenty-year period (1968-1988), remaining below the 25% of GDP. Table 1.2 compares Madagascar's financial depth with that of a number of industrial and developing countries.

Table 1.2: FINANCIAL DEPTH AND FINANCIAL PRICE INDICATORS (1985-1988 average)

	M2/GDP Ratio	GDP Deflator(%)	Per Capita Income(US$)
Industrial Countries			
-United States	69	3	18.190
-France	73	3	12,813
-Japan	175	1	15,245
-United Kingdom	67	5.2	10,230
Developing Countries			
-India	46	7.1	308
-Mauritius	54	6.8	1,410
-Nigeria	29	16	575
-Ethiopia	43	1	120
-Malawi	26	13.4	158
Madagascar	22.5	16	215

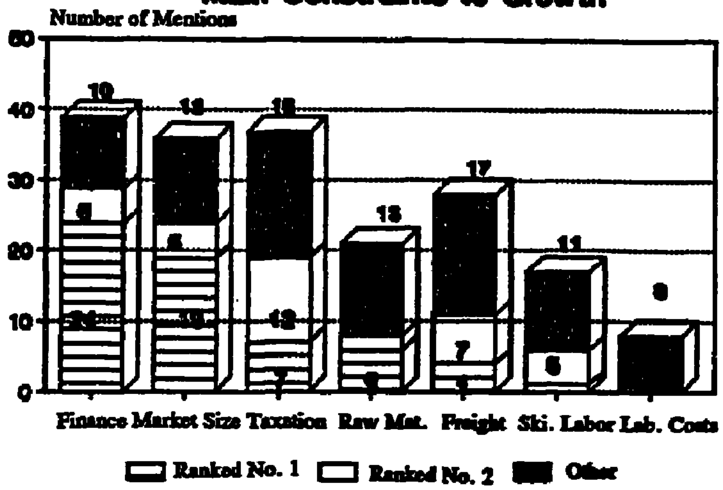
Source: World Bank Data

1.39 __Reasons for low financial depth__: Several factors may explain the low M2/GDP ratio for Madagascar as compared to other developing countries like Mauritius and India. First, Madagascar's GNP per capita stands among the lowest in Sub-Saharan Africa and has been on the decline since 1980, when it reached its peak of $350. Second, high inflation, particularly double-digit inflation as recently as the mid-1980s, has been a major disincentive which has adversely affected people's willingness to hold financial assets. The experience of other countries shows that positive real interest rates favor financial saving over other forms of saving and therefore promote financial deepening. Reducing inflation and maintaining a stable price level is as an essential precondition for increasing the size of a country's financial system and thus promote the economic efficiencies associated with bank financial intermediation. Third, Madagascar's financial network is mainly concentrated in the urban areas, thereby failing to capture the surplus resources of the rural areas. Financial deepening will require a decentralization of financial activities from the urban areas to the rural areas.

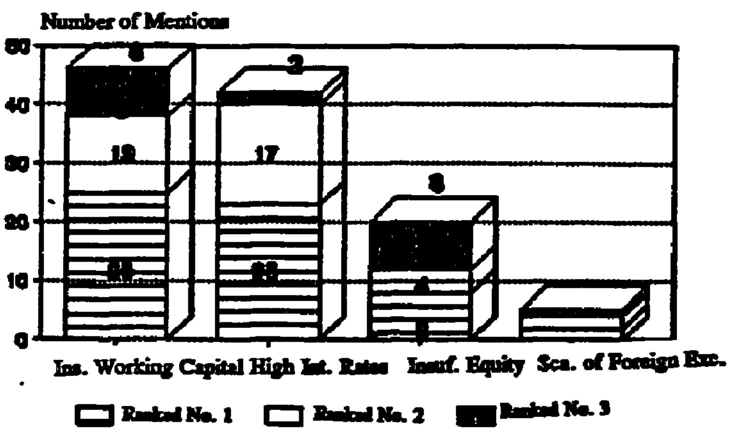
1.40 __Perceived Importance of Finance__: In addition to theoretical insights on the importance of finance to growth, the importance of the financial system can be directly assessed by investigating the perceptions of Malagasy enterprises. The latter perspective has been examined in this Report partly through in-depth interviews with a sample of 104 Malagasy enterprises of varying sizes and representing a range of agricultural, industrial, and commercial activities (see Annex 1.2 for a detailed description of the enterprise survey and results). When asked to rank the relative importance of finance, generally speaking, to their growth compared to seven other constraints (including market size, access to raw materials and labor, and taxation), 44 % of these enterprises ranked finance as the predominant constraint. Finance was especially seen as the major constraint to growth among small and medium-scale enterprises. In addition, Figure 1.7 shows how the enterprises ranked the relative importance of four types of financial constraints - high interest rates; inadequate working capital; insufficient equity; and scarcity of foreign exchange.

1.41 __Inadequacies in Servicing Financial Needs of the Real Economy__: The analysis of the Malagasy financial system which is developed throughout the rest of this Report points to at least five major interrelated inadequacies within the financial system as a whole emanating from both the supply and demand side. First, the overall financial system is heavily biased towards short-term finance with very little medium and long-term finance available either as debt or equity. Second, the attractiveness of holding financial assets as a primary form of wealth has until recently been eroding because of uncertainty among economic agents with regard to inflation and the real exchange rate. Third, many economic agents find it difficult to get access to the resources of the formal financial system because of their small size (small and medium-scale industries and smallholder peasants) or the nature of their activities (notably, in agriculture and to some extent in construction). Fourth, the financial system is not widely regarded as an effective mechanism for discharging financial obligations and transferring resources in a timely and secure manner; partly as a result, basic payments instruments such as checks have not acquired universal acceptance. Fifth, both suppliers and users of financial services suffer from a lack of adequate financial information such as lending terms and credit risks which is compounded by various inadequacies in either obtaining or adequately enforce legal protection necessary to ensure confidence among lenders and borrowers. This has contributed to a pattern of finance in which transactions tend to be limited to short maturities and to borrowers either personally known to the lender or able to provide easily attachable collateral.

Figure 1.7: Entrepreneurs' Ranking of the Main Constraints to Growth



Entrepreneurs' ranking of Financial Constraints



Note: 104 Malagasy entrepreneurs were asked to rank the general constraints to growth and the specific financial constraints. The above graphs indicate the number of times a particular ranking of a given constraint was expressed.

Raw Mat.: Raw Materials
Ins. Working Capital: Insufficient Working Capital
Ski. Labor: Skilled Labor
High Int. Rates: High Interest Rates
Lab. Costs: Labor Costs
Ins. Equity: Insufficient Equity
Sca. of Foreign Exc.: Scarcity of Foreign Exchange

1.42 Potential of the Malagasy financial system: To varying degrees, virtually all low-income countries share the above-mentioned inadequacies in Madagascar's financial systems. At the same time, the range of available financial institutions appears more narrow in Madagascar than several Sub-Saharan African countries which have, for example, leasing companies, housing finance institutions, a large network of informal grassroots-level savings institutions and embryonic capital markets. Furthermore, a narrow and shallow financial system is, in one sense, even more constraining in a large island such as Madagascar than it would be a smaller island economy such as Mauritius. Owing to its unusually large size - the world's fourth largest island with an area larger than France - weaknesses in the financial system tend to perpetuate the poor linkages among product markets in various regions of the country by not affording adequate payments services. Realization of the full potential of developing an export-oriented economy is thus constrained. Yet, at the same time Madagascar's economy shows promising potential in areas such as agriculture, mining, manufacturing and tourism as a result of its human and physical endowments coupled with its unique flora, fauna and range of climates. The scope therefore exists for developing among the most dynamic export-oriented economies and financial systems in the Africa and Indian Ocean region. The absence of certain financial institutions that may exist elsewhere can also be seen as an opportunity to avoid the mistakes of financial policies since many of these institutions in Sub-Saharan Africa are themselves riddled with problems. Notwithstanding the increasing market-orientation of the economy, government policies will have a key role to play in financial sector development as discussed below.

1.43 Shifting State Involvement in the Financial Sector: Although the role of the state in ownership of financial institutions generally makes a dubious contribution to financial sector development, appropriate state roles in macroeconomic management and regulatory policies are essential to financial sector development. Government has an important role to play in the financial sector in providing a sound macroeconomic framework which maintains positive real interest rates, does not unduly pre-empt investible resources for public expenditure and ensures that the borrowers of financial institutions operate in an undistorted economic environment. Government also needs to provide a regulatory framework which balances efficiency in the financial system, which requires freedom of financial managers to act, with prudent management of financial institutions and safety of depositor and investor funds, which in turn requires some degree of government regulation. The emerging shift away from government ownership in institutions must now be matched by a strengthened government role in appropriate macroeconomic management, financial sector regulation and prudential supervision.

1.44 Towards a Financial Sector Strategy: A strategy for future financial sector development in Madagascar must determine how the policy and institutional framework affecting financial transactions can provide appropriate stimuli for strengthening existing and developing new financial institutions, instruments and markets. This strategy must also be grounded in an assessment of the needs of real sector activities. At the same time, a review of the experience of financial development elsewhere - in both developing and industrial countries - can provide useful lessons for Madagascar (including an appreciation of pitfalls of certain policies). Especially useful insights can be gleaned from neighboring countries such as Mauritius which has undergone a significant evolution of its financial system in the last decade together with a dramatic transformation of its economy. All these perspectives are developed in the chapters which follow which provide the analytical underpinnings for identifying options and priorities for a financial sector strategy in Madagascar.

1.45 The attached Table 1.3 summarizes how the discussions in Chapter 2 through 7 are aimed at identifying improvements in three closely related areas:

(i) increasing the level of financial savings: Measures to increase confidence of savers in the value and safety of financial assets can increase the share of savings in Madagascar, (much of which is unmonetized), that is channeled through the financial system. Furthermore, there appears to be promising potential in two areas to encourage savings through financial assets : (a) among the vast majority of small-scale economic agents who have not yet accessed the existing financial system; and (b) through long-term financial contracts such as insurance and social security.

(ii) increasing the efficiency of investment: As the key ingredient for increasing efficiency of investment and promoting rapid economic diversification in Madagascar, increased private investment requires that financial savings be effectively channeled to its most productive uses. A well functioning financial system will help promote high-yielding projects by : (a) fostering competition among lending institutions which disciplines their lending decisions on which their profits and survival depend; and (b) ensuring that risks and returns of investments are appropriately balanced through financial markets which help price the cost of capital and distribute the risks of investment; and

(iii) lowering the costs and risks of financial transactions: Effective intermediation of savings and investment through the financial system in Madagascar depends fundamentally on reducing the costs and risks of transferring resources from savers to borrowers and from payers of financial obligations to recipients of funds. Improvements in the legal, accounting and payments system are needed to lower these costs and risks, thereby encouraging use of the financial system to settle economic obligations, to channel savings and to finance investment.

Following the above analysis, Chapter 8 outlines the basic elements of an approach for implementing the various proposed measures and institution building measures.

Table 1.3 Proposed Financial Sector Strategy

KEY OBJECTIVE	KEY MEASURES	DETAILED RECOMMENDATIONS
INCREASING FINANCIAL SAVINGS **Operational goals:** Increase real returns on financial assets and confidence of depositors Small-scale savings mobilization Boosting contractual savings	Increased credibility and effectiveness of Central Bank monetary policy Strengthened supervision and regulation of financial institutions Revamping postal checking and savings system Improving operating incentives and regulatory framework of insurance and social security	Chapter 2 (para 2.48-2.53) Chapter 4 (para 4.36-4.42) Chapter 6 (para 6.26-6.34) Chapter 5 (para 5.26-5.28)
ENHANCING EFFICIENCY OF INVESTMENT **Operational goals:** Increase share and level of private investment Promoting high-yield investments Improving pricing of capital	Averting crowding out of private investment from Central Bank losses Enhancing competition within financial sector including divestiture of remaining government shareholdings Building money and capital markets to price and distribute financial risk	Chapter 2 (para 2.54-2.56) Chapter 7 (para 7.44) Chapter 4 (para 4.28-4.30) Chapter 7 (para 7.29-7.46)
LOWERING COSTS AND RISKS OF FINANCIAL TRANSACTIONS **Operational goals:** Improving financial intermediation and payment services	Strengthening legal framework to protect financial contracts Improving accounting, auditing and financial disclosure Increasing speed, accuracy and reliability of financial payments and transfers	Chapter 3 (para 3.3-3.37) Chapter 3 (para 3.28-3.35) Chapter 3 (para 3.42-3.54) Annexes 3.3-3.5

CHAPTER 2

STRENGTHENING MONETARY MANAGEMENT OF THE CENTRAL BANK

2.1 In developing and industrial countries alike, the main function of central banks is to ensure the integrity of the national currency and a stable price level. To this end, central banks are entrusted with management of money and liquidity in the economy. As such, the central bank is a pivotal point of the financial system. To effectively undertake its functions, it should be financially sound and independent and have well trained staff at its disposal. This chapter is primarily concerned with the existing role of the central bank in Madagascar (BCRM) in monetary policy and the means for improving this role in a market-oriented economy. Monetary policy generally has two aspects—economic management and liquidity management. The economic management aspect involves price stability. This aspect of monetary policy is operationally constrained by available foreign reserves, external debt and inflows of foreign capital. At the same time, and within a shorter time horizon, the central bank has to assure that the banking system can provide flexibly for cash and payment needs of society. Both these aspects of monetary policy interact closely with the outcomes of public finance policies which are also reviewed in this chapter. The other crucial function usually attributed to central banks is prudential regulation and supervision of banking institutions which is discussed in Chapter 4.

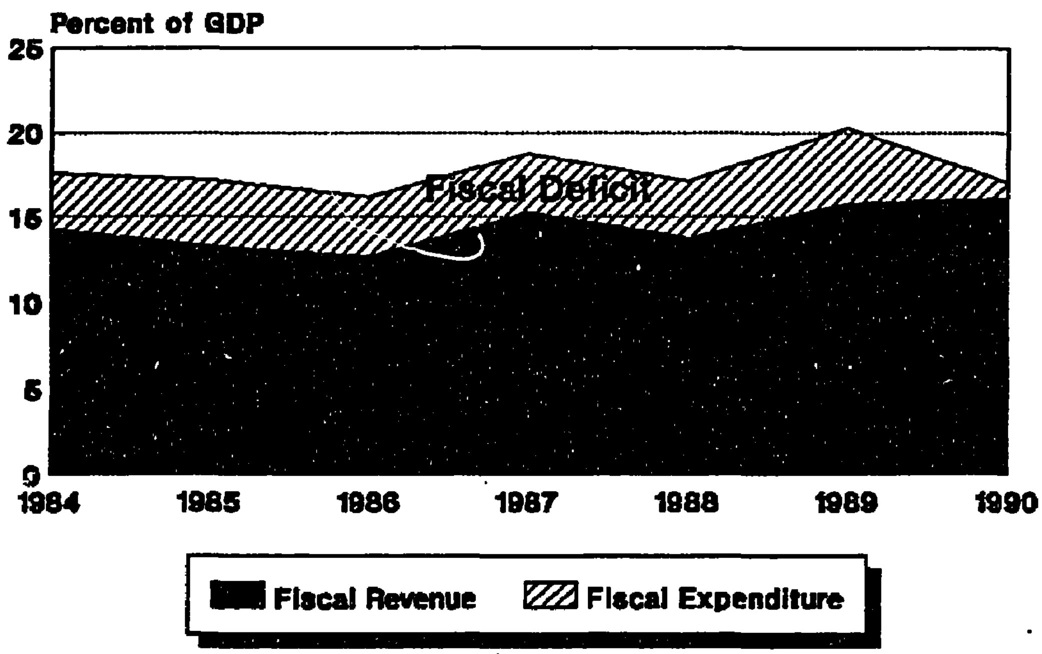
2.2 This chapter is organized as follows. Government finance policies are first reviewed to provide a context in which to situate certain activities of BCRM. These "quasi-fiscal" activities of BCRM are not strictly related to monetary management. These activities are analyzed in depth because they have serious implications for BCRM in terms of its ability to effectively play its role in monetary management. Subsequently, the various instruments of monetary policy are reviewed. The conclusions of this chapter suggest broad directions for future changes in BCRM to enable it to become a more effective player in the financial system in Madagascar.

Government Finance: Fiscal Deficit and Quasi-Fiscal Operations

2.3 Government finance can influence the financial sector through its impact on money supply, credit and interest rates. The main impact comes through the means by which the deficit is financed. In analyzing the impact of deficit financing on the Malagasy financial system, the particular definition of the fiscal deficit must be clarified. The fiscal deficit is conventionally defined as the central government financing gap that is covered by net government borrowing, including borrowing from the central bank. The financing gap results from the excess of total government cash outlays, including interest payments but excluding amortization on public debt, over total cash receipts, including tax and non-tax proceeds but excluding borrowing. At the same time, in Madagascar as in many other developing countries, certain government finance activities that are usually undertaken by the central government have been instead assigned to the central bank. These operations which are not strictly carried out with the purpose of implementing monetary policy, are referred to as quasi-fiscal operations of the central bank. The consolidation of the conventional fiscal deficit and quasi fiscal deficit produces a broader measure of government financing needs which for the purposes of this analysis is called the overall fiscal deficit.

2.4 Conventional Fiscal Deficits in the 1980s: Following the fiscal imbalances in 1978 - 1980, caused by a massive increase in public expenditure, the Malagasy authorities implemented a program of fiscal austerity. As a result, fiscal performance improved significantly during the period 1981-83, during which the fiscal deficit which had peaked at 18.4 percent of the GDP in 1980, was reduced sharply to 6.7 percent of the GDP. This reduction was effected mainly through a reduction in expenditure. During the period 1984 to 1988, the authorities consolidated this substantial fiscal adjustment effort. Fiscal deficit during the 1984-89 period was kept within the 3-4 percent range of GDP and it was brought down to only 0.9 percent of GDP in 1990 (see Figure 2.1). The increase in the deficit during 1988-1989 resulted primarily from a number of once-and-for-all expenditures, including those associated with rehabilitation costs of the public enterprise sector, the partial write-off of doubtful and litigious loans of the commercial banks to public enterprises and from the impact of a sharp deterioration in the terms of trade on export-related tax revenues.

Figure 2.1: Fiscal Expenditure, Revenue and Deficit, 1984-1990



Source: Government Data

Note: Fiscal deficit refers to central government financial operations during the 1984-1990 period. These cover the general budget, extrabudgetary capital outlays financed by external resources, revenues and expenditures of the former crop stabilization fund (FNUP), other extrabudgetary current expenditures financed by the treasury and rice imports financed by BCRM. Fiscal deficit is defined on a cash basis which equals total government revenue less total government expenditure plus payment delays and arrears.

2.5 Financing the Fiscal Deficit: Table 2.1 shows that during the 1980s the share of the central government budget deficit was financed to a decreasing degree from domestic sources which mainly consisted of central bank financing. Net external financing of this deficit assumed increasing importance as a proportion of the fiscal deficit, rising from 55.5 percent in 1984 to 225 percent in 1990 and covered, on the average, more than five sixth of the total fiscal deficit over the 1984 - 1990 period. This contrasted with the period 1980 to 1983, when its share of deficit financing was declining. In turn, domestic financing fell continuously from 1984 onwards, corresponding to the cumulative government repayment to the domestic banking system of approximately FMG 110 billion by the end of 1990.

Table 2.1 : Central Government Budget Deficit and Financing
(in percent of the GDP)

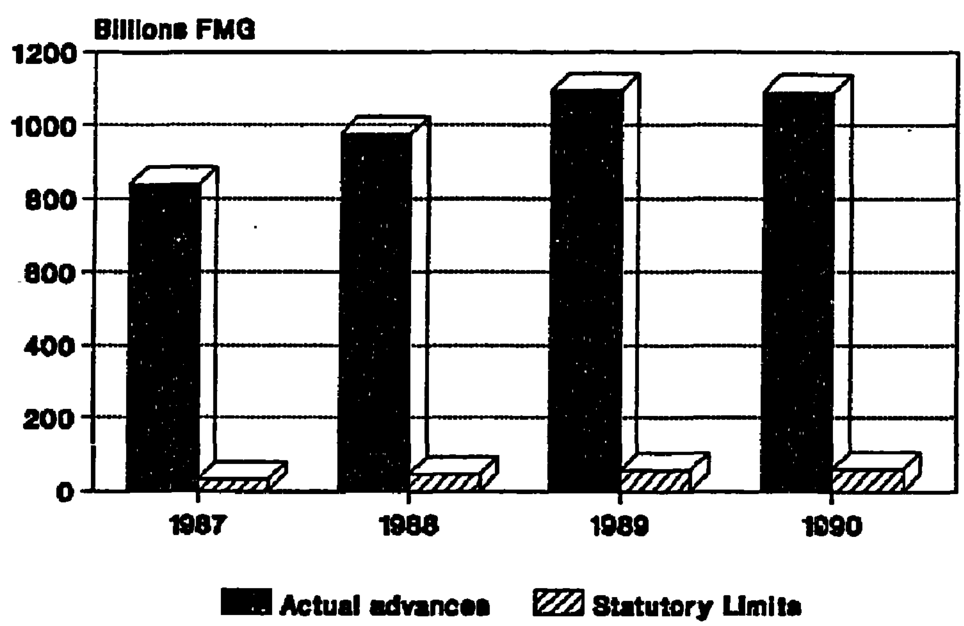
	Overall Cash Deficit	Financing Domestic	Financing Foreign
1981-83	10.1	4.6	5.5
1984-88	3.6	0.5	3.1
1988	3.5	-0.4	3.9
1989	4.1	-0.5	4.6
1990	.9	-1.2	2.1

Source: Government Data.

2.6 Assessment of Fiscal Performance: Having redressed previous major fiscal imbalances, fiscal stabilization efforts in Madagascar in the 1980s' appear on the whole quite impressive. Notwithstanding the success achieved hitherto, a more qualified assessment is necessary in examining both the developmental impact and sustainability of this fiscal performance as well as attendant pressures on seeking government financing outside the general budget. Lacking the appropriate margin of manoeuvre and institutional structures to tailor government revenues and expenditures to changing economic circumstances, the authorities were forced in the 1980s' to slash to varying degrees all categories of non-interest current expenditures. Consequently, civil service salaries gradually eroded in real terms to well below their levels of the early 1970s with adverse implications for the motivation and efficiency of government employees. Furthermore, as the principal category of discretionary spending, goods and services bore the brunt of the cuts, with adverse consequences for the functioning of public institutions across the board and the profitability of private enterprise. Moreover, tax to GDP ratios in Madagascar, already low by international standards, have steadily diminished during the 1980s reaching a low 9.4 percent of GDP in 1990. It is therefore not surprisingly that in Madagascar, as in many developing countries which have maintained severe fiscal austerity drives for long periods of time without improving fiscal revenues, fiscal pressures have led to various modes of government financing outside of the budget. In the case of Madagascar, in addition to the financing of the conventional fiscal deficit, other financing of Treasury has occurred through quasi-fiscal activities of the central bank described below.

2.7 BCRM Quasi-Fiscal Operations: As is the case for most central banks around the world, BCRM performs a number of banking and agency services for the Treasury which would be generally accepted as proper roles for a central bank. For example, BCRM has a statutory role in maintaining accounts for the Treasury, keeping deposits (including "counterpart funds" described in para 2.18) and making advances to the Treasury. At the same time, BCRM has engaged in a number of "quasi-fiscal" activities which entail explicit or implicit financing of Government. Like BCRM, central banks in many other developing countries have gone beyond their strictly monetary functions by undertaking such quasi-fiscal activities which tend to eventually create central bank losses. These losses either alone or together with other central bank financing of the deficit often end up being monetized. Central bank quasi-fiscal activities have a potential for adverse effects on liquidity and money supply. Moreover, such monetization may quickly get out of hand and undermine the ability of the central bank to control money supply, with threatening consequences for macroeconomic stability and credit availability to the private sector. Such quasi-fiscal activities include negative real returns on financial operations related to the net financing of the Treasury and public enterprises, subsidized credit, rescue of distressed financial institutions, financing of the servicing of the external debt and assuming the accounting and cash losses resulting from foreign exchange operations. It appears that losses of BCRM which have been chronic and substantial since 1980 can be principally, although perhaps not exclusively, traced to the two last type of operations. These principal quasi fiscal activities of BCRM are analyzed in greater detail below.

Figure 2.2 : BCRM Advances to Treasury and Statutory Limits



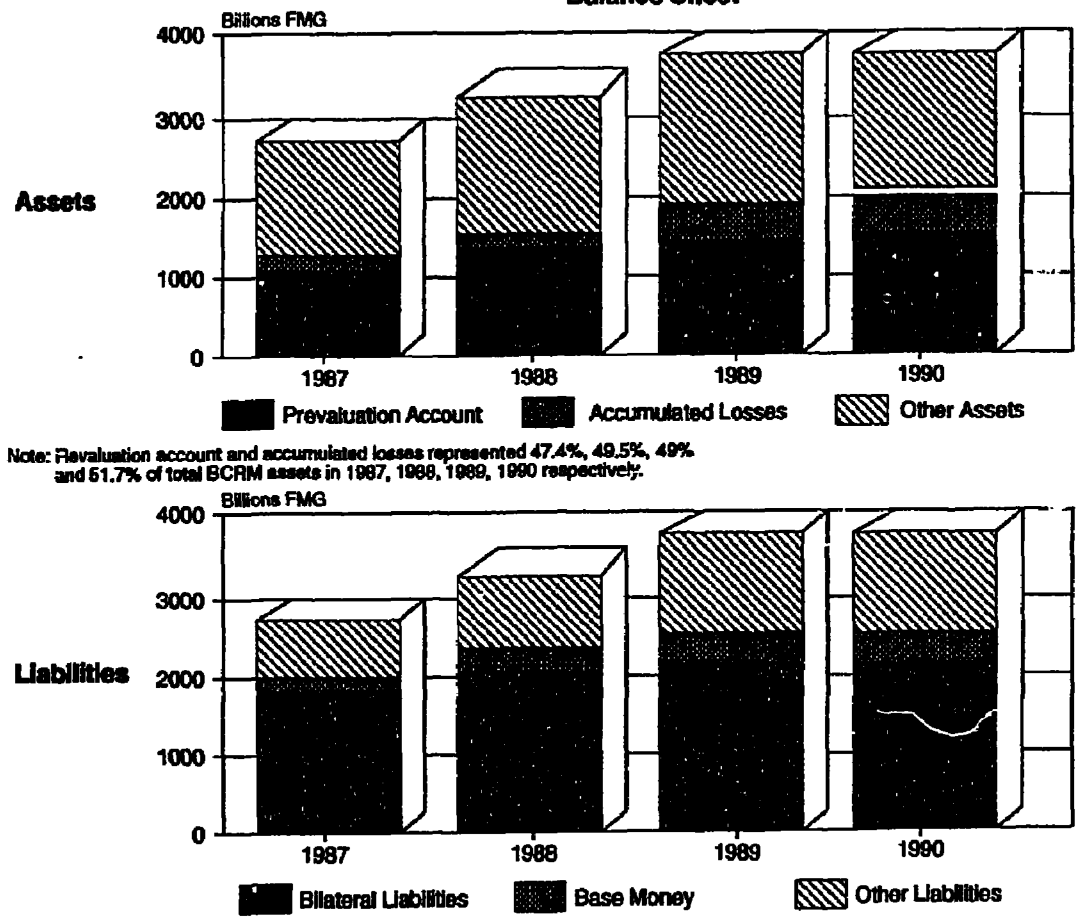
Note: Under article 54 of the BCRM Statutes, advances to the Treasury are limited to 15 percent of ordinary budget revenue of the previous fiscal year.

Source: Government Data

2.8 <u>BCRM Advances to the Treasury</u>: Under Chapter 3 of its statutes, BCRM can extend advances to the Treasury. These advances are statutorily limited to a ceiling equivalent to 15 percent of ordinary budget revenues of the previous fiscal year and should be statutorily reimbursed within six months of the closing of fiscal year in which these advances are made. In practice, as Figure 2.2 shows, these statutory provisions have been consistently violated as the volume of BCRM advances to the Treasury has well exceeded the prescribed 15 per cent limit. The actual ratio at the end of 1990, for example, was about 291 per cent of ordinary budget revenues of the previous year; even net of government deposits, the ratio of advances was 78 per cent of previous year's ordinary budgetary receipts.

2.9 At the same time, until 1991, BCRM paid virtually no interest on Treasury deposits, while also receiving about one half per cent on its advances to the Treasury, an interest rate that was markedly below market rates. In other words, BCRM lending to the Treasury (net of government deposits) has been heavily subsidized over time. In October 1990, the Treasury showed an overdraft position of approximately FMG 275 billion (approximately 5.9 percent of the GDP). To the extent that the cost of funds of the central bank is higher than the rate paid on the Treasury overdraft, provision of banking services to the Treasury and the Government could result in a loss. It should be noted that the Government and BCRM have decided with effect from 1991 to remunerate both Treasury deposits and borrowing with BCRM at money market rates (the former at one percentage point below the borrowing rate).

Figure 2.3: Evolution of BCRM's Balance Sheet

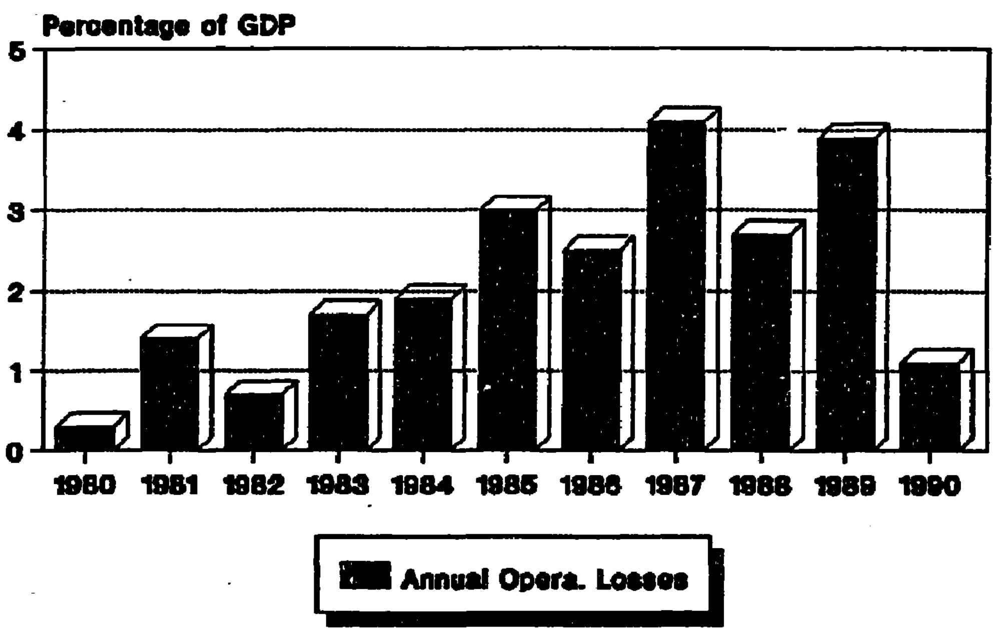


2.10 __Central Bank's Foreign Exchange-Related Quasi-Fiscal Activities__: Another quasi-fiscal function of the central bank is the performance of foreign exchange operations and transactions on behalf of the government and the servicing of the external debt without full compensation by the Treasury. This function became very important during the 1980s after BCRM assumed external liabilities from the Government and the private sector in the context of Paris and London Club debt rescheduling agreements. As Figure 2.3 shows, the financial repercussions of this quasi-fiscal activity have dramatically reshaped the central bank's balance sheet and income account. The accounting and financial results of these operations are reflected in the "revaluation" account and accumulated losses accounts of the central bank balance sheet which are discussed more fully below. The evolution of these two accounts shown in Figure 2.3 result from a fundamental mismatch within the balance sheet of BCRM. On the liabilities side are foreign currency denominated liabilities against which there is the domestic currency denominated "revaluation account" on the asset side which is in practice unremunerated by the Government. Every time there is a devaluation, there is initially an equal increase in the domestic currency value of both accounts on the liability and asset side. The discussion below however shows that there have subsequently been asymmetric movements in both sides on the balance sheet leading to BCRM operating losses.

2.11 __The Revaluation Account of BCRM__: The revaluation account originated from the need to account for the changes in value of net foreign assets following devaluations. Since, net foreign assets (including medium and long term ones), as shown on the central bank's balance sheet, have been increasingly negative during the 1980s, their increased value in domestic currency consequent to devaluations had to be reflected on the assets side of the central bank's balance sheet by an offsetting entry called the "revaluation account". Over time, this "revaluation account" began to record other foreign exchange operations and transactions. Today it records a mix of accrued and cash results from servicing of external debt and sundry operations and transactions. Under normal accounting practices however, only losses on an accrued basis should be included in this account; once these losses are realized, they should be moved to the profit and loss account and be set off yearly against net worth. The revaluation account also records differences in posted values resulting from time value mismatch between outflows of foreign exchange and corresponding domestic currency inflows from the Treasury. This mismatch arises in payments from the Treasury to BCRM in domestic currency equivalent to debt servicing on the original maturity schedule and out payments by BCRM to service external debt according to the maturity profile of rescheduling agreements. Under the 1983 amendment to BCRM statutes which was related to its assumption of new external debt servicing functions, the Government was to guarantee any resulting valuation losses that have now been recorded in the revaluation account. In practice, no Government compensation on this account has occurred. Hence, the revaluation account which now reflects the yearly total value of a number of both accrual and cash foreign exchange operations and transactions, represented in 1990, 40.2 percent of the assets of BCRM in 1990 without generating any income for BCRM.

2.12 __The accumulated losses of BCRM__: BCRM has consistently incurred substantial operating losses throughout the 1980s as shown in Figure 2.4. It appears that the foreign exchange operations and transactions described above are by far the main source of Central Bank losses. The changes in the revaluation account described above can remain unrealized and not have any impact on BCRM income statement. It is only when BCRM has to purchase foreign exchange at a new devalued rate to service old debts acquired at an overvalued rate that an impact occurs in terms of BCRM operating losses. This is because payments from the Treasury do not fully compensate BCRM for valuation losses, leading to operating losses as the valuation charges are realized. Since 1985, these operating losses have averaged 3 percent of the GDP a year and have accumulated to the equivalent to 9.6 percent of the GDP in 1990. According to BCRM statutes, the Government is to fully compensate BCRM for such losses. Since the central bank considers that these losses represent a claim on the Government, it accounts for them in its balance sheet under "other assets" rather than on the liability side as a reduction in net worth.

Figure 2.4: BCRM Annual Operating Losses
% of GDP



Source: BCRM Data

2.13 Aggregate result of quasi-fiscal activities: When including the claims on Government represented by the revaluation account with BCRM's operating account and BCRM advances to the Treasury at the end of 1990, the resulting claims on Government represented about 607 per cent of ordinary budget revenue estimated for 1990. This percentage is about forty times the actual percentage limit of 15 percent prescribed by BCRM statutes (see para 2.8) for BCRM credit to the Treasury. A more careful study is needed to fully clarify the origins, accounting practices and magnitude of the quasi-fiscal activities of BCRM described here. Although the quasi-fiscal operations of the central bank merit further investigation, the available information suggests that these operations, particularly as reflected in the revaluation and "other assets" accounts, have a major impact on money base creation and the financial stability of the Central Bank. The monetary significance of central bank operating losses is that they lead to reserve money creation. Depending on the size of these losses, they may seriously interfere with monetary policy.

2.14 In Madagascar, these losses have become very large, amounting in 1990 to 60.5 per cent of the stock of reserve money at the end of 1990. In other words, BCRM in its reserve money management had to compensate for a 60.5 per cent autonomous increase of reserve money or accept the inflationary consequences. However, as discussed below, such compensation did not occur by design between 1984 and 1990 but rather inadvertently. As the discussion below points out, during this period the potentially inflationary consequences of BCRM losses were compensated by large net inflows from the Treasury to BCRM arising from the mismatch of debt servicing under the original and rescheduled payment profiles and the substantial accumulation of counterpart fund deposits. This situation underscores the precarious position of monetary management if and when such offsetting factors cease to compensate for the inflationary impact of BCRM operating losses. As the discussion below shows, continuation of existing external debt servicing arrangements into the 1990s is likely to result in increased inflation or crowding out of the private sector if BCRM is to attain its targets for monetary growth. In addition to operating losses, there are the accrued losses found in the revaluation account which, as noted above, will eventually be realized as operating losses. The monetary impact of these quasi-fiscal activities are reviewed in depth below. A side issue, but also an important one, is that these quasi-fiscal activities should be of concern from a fiscal standpoint. By obscuring the full magnitude of government financing needs, the importance of these activities cannot be properly weighed against that of other activities competing for limited resources. Accounting for these quasi-fiscal operations significantly changes the picture of fiscal performance and monetary stability and raises a number of key issues with regard to both fiscal and monetary policies.

Monetary Developments and Sources of Money Creation

2.15 During the period 1984 to 1988, the main objective of monetary policy was to limit the increase in M2 or broad money in line with that of projected nominal GDP so as to avoid inflationary pressures and strengthen the external position. As explained above, a number of developments, some of which reflected direct credit and monetary controls, restrained excessive money supply with the result that broad money increased in line with nominal GDP; the latter increasing at 18.6 per annum during the period and the former at 18.5 percent, thus implying an almost constant velocity during the period. In 1989, financing of the quasi fiscal deficit increased sharply which led to an increase in base money and accordingly broad money grew by 29.8 percent against 15.4 percent for the GDP. This monetary slip caused in turn, a dramatic decrease in foreign reserves -- as trade policies and foreign exchange allocation had been liberalized -- forcing the authorities to tighten anew credit ceilings and limit drastically import financing.

2.16 Impact on Base Money Creation: A central bank creates liabilities in the form of currency and reserves against its assets. Together currency and reserve form base money. Base money is intermediated by the banking system. This intermediation produces a multiplier effect and adds to bank deposits and to currency in the hands of the public. To analyze the proximate origins of changes in the money base using central bank balance sheet, the movements in international reserves can be viewed as a residual variable. Table 2.2 below shows the five main sources that influenced changes in the money base in the 1980s: medium- and long-term liabilities; revaluation account; losses of the central bank; net claims on Government; and net short term foreign assets. Figure 2.5 graphically depicts the major sources of change in the money base in Madagascar during 1988-90. These influences on the money base and their significance are discussed below.

Table 2.2 : Sources of Expansion of the Monetary Base
(in billion of FMG)

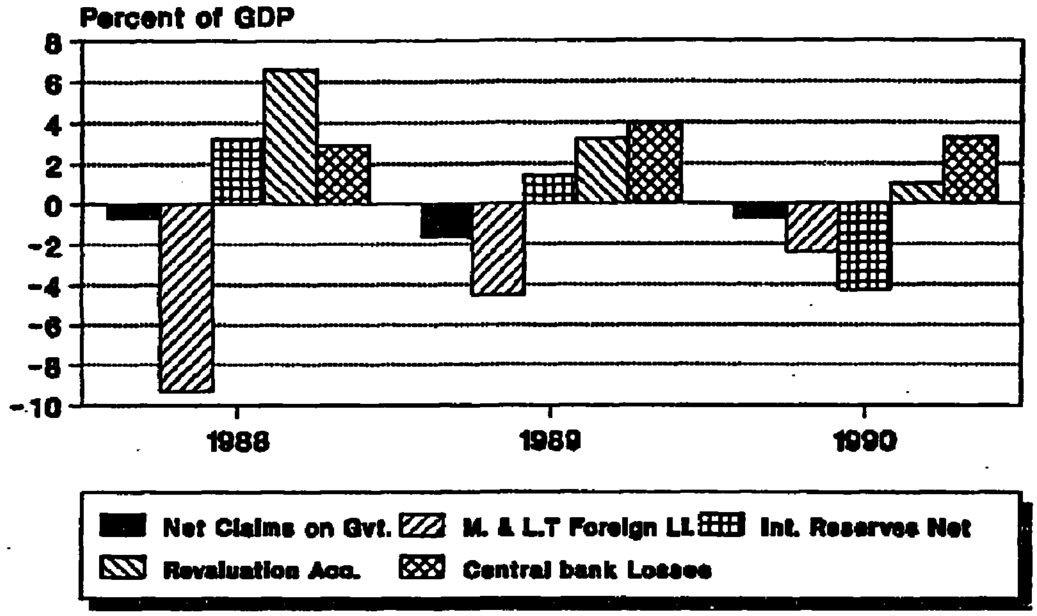
	1985	1986	1987	1988	1989	1990
Int. Reserves net.	-11.1	45.0	132.1	149.0	55.5	-176.5
Claims on Gvt. net	26.3	24.3	6.6	-25.2	-65.8	-19
Claims on Banks	-4.1	-4.6	5.2	5.2	1.3	115.7
Reevaluation account	19.4	185.5	653.1	227.6	126.8	76.6
Central Bank losses	50.0	55.0	105.0	100.0	160.0	49.0
Foreign liab. M. & L.T.	-75.2	-230.7	-818.5	-368.7	-179.1	-87
Other Items	-1.1	6.8	-44.3	-79.3	-9.0	9.6
Sub-Total	_13.1	81.3	39.2	8.6	89.7	-31.6
Monetary Base	-4.1	81.6	39.2	8.6	89.7	-31.6
(Errors and Omissions)	(0.6)	(0.3)	-	-	(0.1)	-

Note: The above table analyzes changes in the monetary base in terms of changes in the other items of the central bank balance sheet.

2.17 Expansionary and Contractionary Influences on Money Base: Three of these developments had an expansionary effect. The increase in the "revaluation account" had the strongest expansionary effect. It was followed by the gradually rising losses of the central bank and marginally by positive movements in net international reserves which, as mentioned above, can be considered as a residual. The main contractionary effects came from the expansion of medium and long term liabilities followed by the decline in net claims on the government. Expansionary and contractionary effects offset each other before leading, through monetary channel to an increase in demand for the monetary base that in turn led to an expansion in this money base every year from 1985 to 1989.

2.18 Key Features of Base Money Evolution: There are three notable features in the developments mentioned in the paragraph preceding and depicted in Figure 2.5. First, medium and long term liabilities increased faster than the reevaluation account. It appears that this disparity is mainly due to a significant discrepancy between the time value of payments in domestic currency made by the Treasury to the central bank to finance the servicing of the external debt and the time value of actual payments in foreign exchange made by the central bank to debt holders. This discrepancy arises by the two institutions using different debt servicing schedules related to the multiple rescheduling of the external debt (see para 2.1 below). In fact, the Government makes payments in domestic currency to BCRM based on the original external debt schedule while BCRM services external debt based on rescheduling agreements. A second feature of base money evolution is that total losses of the central bank over the 1985 to 1989 period are more than four times greater than the total money base creation during that period. Hence, considering central bank's losses as a policy variable, these losses can be viewed as accounting for more than total monetization. Third, net claims on government (i.e. BCRM lending less total government deposits) exerted a contractionary influence largely because of the accumulation of unspent counterpart funds (discussed in para 2.20 below) rather than because of a major fiscal effort.

Figure 2.5: Madagascar: Major Sources of Changes in Monetary Base



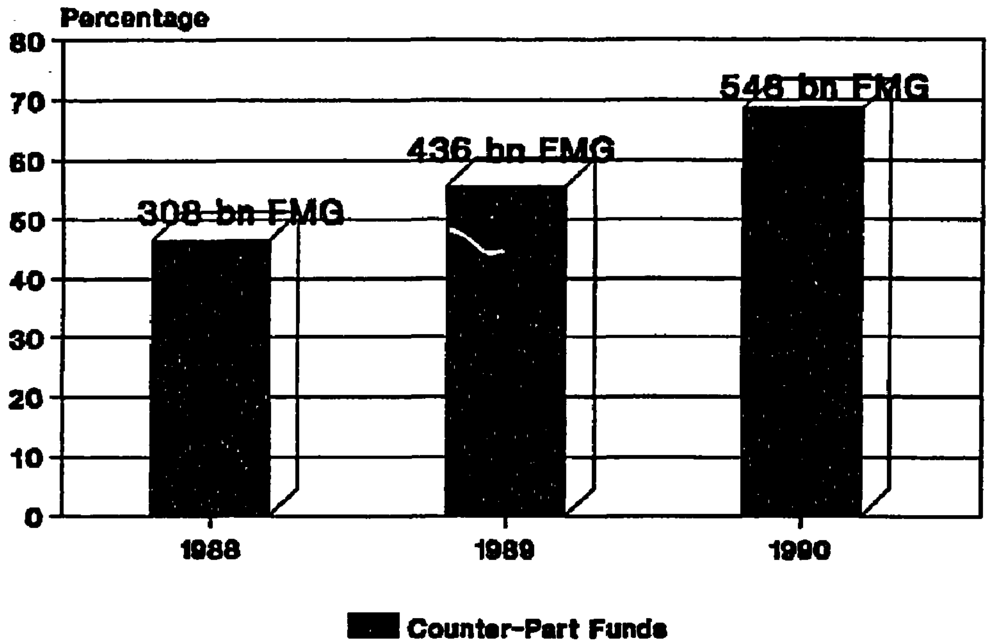
Note: The graph shows changes in the stocks of the above variables which are related to changes in the monetary base. Positive changes represent an expansionary influence on the monetary base while negative changes represent a contractionary influence. Total change in monetary base, as a percentage of GDP, is as follows: 1988:0.3% , 1989:2.3% and 1990: -0.7% .

2.19 Monetary role of the revaluation account: As noted previously, the revaluation account reports both accrued as well as cash operations. It therefore cannot be fully related to money base creation at a given point in time (paras. 2.10 and 2.11). However, accrued valuation changes in the stock of external liabilities become realized when payments are due and made. These cash operations then contribute to base money creation. The predominant contractionary influence, with regard to base money evolution have been the movements of medium and long term liabilities. The apparent time discrepancy between the recording and these movements on the liability side of the balance sheet and the posting of offsetting movements in the "revaluation account" on the assets side has generated on its own a contractionary influence on the demand for the monetary base. This would appear to result from inflows from the Treasury to BCRM corresponding to debt service payments as the original maturity schedule exceeding outflows from BCRM for debt service payments corresponding to rescheduling agreements. However, as discussed above (para. 2.11), valuation losses ultimately become realized and are reflected eventually in the mounting losses of the central bank. When there are time lags between receipts and payments or if different exchange rates are applied consecutively, then the net result of these cash operations can result in a contraction or expansion of base money, depending on there relative size. Until 1990, inflows from the Treasury exceeded outflows from BCRM; this situation is likely however to be reversed in the early 1990s, leading to potentially significant inflationary consequences or severe crowding out of the private sector. To effectively manage the monetary consequences of existing external debt servicing arrangements, the time profile of future inflows and outflows according to the original and rescheduled debt agreements should first be fully identified. Only then can future monetary impact of the revaluation account be systematically managed through adequate compensation of BCRM by the Treasury.

2.20 Monetary role of government deposits and counterpart funds: Although BCRM advances to the Treasury have not decreased in volume in recent years (see Figure 2.2), net claims on government have decreased on account of increasing volume of Government deposits with BCRM. The increase in government deposits in turn is due to a rising volume of counterpart funds. Counterpart funds are the proceeds in domestic currency of the sales of foreign currencies or goods originating from external loans or grants. Generally these funds are earmarked by related donors for specific projects. Most counterpart funds are deposited by the Treasury at the central bank and have accounted for an increasing percentage of total government deposits at BCRM (see Figure 2.6). They are now equivalent to well over FMG 500 billion or more than twice the amount of domestic debt repaid formally, hitherto, by the Treasury to the central bank and more than half of total government deposits in BCRM. These deposits do not bear interest. In the context of the ongoing macroeconomic stabilization efforts, the use of counterpart funds in Madagascar has in effect become an instrument of macro economic management. The accumulation, over the past six years, of unspent counterpart funds helped the Government to contain money supply. Had these funds been deposited in the commercial banking system instead of BCRM, they would have had an expansionary impact by allowing banks to fund further credit to the economy. From a monetary viewpoint, that is not considering the problems such accumulation may entail for the public investment program, the accumulation of counterpart funds allows additional quasi fiscal deficit financing and corresponding monetization to be delayed, to the extent that an offsetting fiscal effort is not taken.

2.21 On one hand, the accumulation of counterpart funds within BCRM may be seen as positive, given that it has helped contain inflation and helped increase the share of credit available to the private sector by allowing the Government to effect net repayments to BCRM. Yet the phenomenon of accumulated counterpart funds also underscores the problems created by a long fiscal austerity period unsupported by measures to structurally increase fiscal revenue and enhance the elasticity of fiscal revenue to economic activity. It is a reflection of the transfer of the fiscal pressure from the fiscal to the quasi fiscal area. The huge size of accumulated counterpart funds indicates that they are unlikely to be able to be released quickly for government expenditures. One possible way of reducing the potential volatility of counterpart funds on government deposits would be to use part of these funds for offsetting Government claims on the assets side of the central bank's balance sheet. Such an approach would however need to be done in the context of a comprehensive solution to the problems of BCRM relations with the Treasury and their impact of BCRM balance sheet and would necessitate the agreement of all donors and other parties involved.

Figure 2.6: Evolution of Government Counterpart Fund Deposits With The Central bank



Note: The above graph represents counterpart fund deposits as a percentage of total government deposits with the central bank.

Source: Government Data

2.22 <u>Magnitude of Quasi-Fiscal Deficit</u>: Table 2.3. shows the quasi-fiscal operations of the central bank that are close in magnitude to the conventionally defined fiscal deficit. These quasi-fiscal operations of the central bank in every year of the period 1985 to 1990, entailed some form of central bank financing as the losses of the central bank are greater than the Treasury net repayments. Had the Treasury been required to finance losses of the central bank, it would have had to find additional fiscal resources equivalent to about 3.0 percent of the GDP, on average, during the period 1985-1988 and to 4.0 percent and 1.1 percent in 1989 and 1990, respectively.

Table 2.3: <u>Quasi Fiscal Deficit and its Financing</u>
(in percent of the GDP)

	Conventional Fiscal Deficit of Treasury	Quasi-fiscal Deficit of BCRM 1\	Overall Fiscal Deficit	<u>Domestic</u>	<u>Foreign</u>
1984-88	3.6	2.9	6.5	3.4	3.1
1989	4.1	4	8.1	3.5	4.6
1990	.9	1.1	2.0	-.1	2.1

1/ Quasi-fiscal deficits represent the operating losses of BCRM and are fully financed domestically.

<u>Sources</u>: Government Data.

2.23 Impact of Quasi-Fiscal Activities on BCRM Income: In 1990, the revaluation account represented 40.2 percent of central bank's total assets. Accumulated losses represented 11.5 percent. This means that at least 51.7 percent of the central bank's assets in 1990 yielded no income, although they are or originate from claims on the government. The counterpart liabilities however generate expenses for BCRM which underlie the central bank's chronic operating losses. This has very serious implications for the independence and the financial situation of the central bank and therefore for its capacity of performing its key functions of monetary and liquidity management. In addition, for a given target of money growth, increased Central Bank operating losses in future imply increased financing needs of the public sector, which can reduce credit available to the private sector. In view of the importance of boosting private investment discussed in Chapter 1, the quasi-fiscal activities of BCRM must be halted and the corresponding financing needs be resolved in the context of overall public sector financing policies in a transparent manner.

2.24 Revenues from Seignorage and Inflation Tax: Owing to its unique role of "issuer of base money" the central bank in any country benefits from implicit revenue from this monetization. This revenue consists of seignorage and inflation tax. Seignorage is literally defined as government revenue from the manufacture of coins, calculated as the difference between the face value and the metal value of the coins. A broader and more contemporary definition is that of an increase or decrease in the real stock of base money related to movements in money supply. The net revenues from changes in the real base money are reduced by the cost of issuing money. In the case of base money, seignorage accrues to the central bank. Inflation operates like a tax on money and other financial assets. Money and asset holders pay the tax by losing purchasing power on their money holdings. Institutions that have issued money liabilities, usually central or commercial banks, collect the tax in the form of a reduction in the real value of their liabilities. To the extent, however, that interest is paid on these liabilities, some of the tax is returned to asset holders. Inflation tax is calculated as the product of the inflation rate and the real stock of money. In the case of base money, the inflation tax accrues to the central bank.

2.25 While incurring operating losses, BCRM has benefitted from significant but unstable revenue from seignorage and inflation tax. Estimates of these revenues are shown in terms of GDP in Table 2.4. The estimates include seignorage and inflation tax accruing from base money and government deposits (which are essentially unremunerated) with BCRM. Base money and these deposits generate the bulk of monetization revenue for BCRM. Revenue from the inflation tax has been inversely correlated with revenue from seignorage. When inflation increases, the real stock of base money decreases in general less than proportionally. This means that the tax base (the real stock of base money) declines as the tax rate (the inflation rate) goes up. Hence, the inflation tax revenues increase as inflation rises, but less than proportionally. Of the total revenue, 7.5 percent comes from banks reserves, excess and required, 17.5 percent from currency holders and 75.0 percent from the Government deposits.

Table 2.4: Seignorage and Inflation Tax
(in percent of GDP)

	Seignorage	Inflation Tax	Total Revenues
1981-83	-0.2	4.0	3.8
1984-88	1.5	1.7	3.2
1988	-0.2	3.1	2.9
1989	4.2	1.2	5.4
1990	-0.2	1.6	1.8

Note: Seignorage is defined as the increase in the stock of real base money.
Inflation tax is defined as the product of the inflation rate and the real stock of base money.

2.26 Inflation Tax, Seignorage and BCRM Financial Stability: The magnitude and pattern of central bank's revenues from seignorage and inflation tax has three implications. First, as macroeconomic stabilization leads to lower inflation, BCRM revenues from seignorage and the inflation tax will decrease. Second, as the Government reduces its net overdraft with the central bank ,the revenue from inflation tax will decrease for a given inflation rate. Third, if the central bank has to pay the Treasury a deposit rate of interest positive in real terms it will lose the revenue coming from the inflation tax. An increase in the overdraft rate would be necessary to ensure some positive income to the central bank. This however would worsen the conventional fiscal deficit. All three factors underscore the precarious nature of Central Bank financial stability and the necessity of finding offsetting sources of revenue; otherwise the losses of the central bank will continue to increase. The precarious financial stability of the Central Bank and the tradeoffs against fiscal stability necessary to offset this situation underscore the problems that arise when fiscal and monetary policies become inextricably interwoven. This situation can undermine effectiveness of both policies and quickly lead to a loss of control of the money supply. Unless this issue is addressed by separating fiscal and monetary management and restoring BCRM to a sound financial footing, the long-term benefits of Madagascar's adjustment process will be increasingly jeopardized and the resumption of self sustained growth delayed.

2.27 Relieving BCRM of debt service burdens: Restoring BCRM to a sound financial footing will require compensation for BCRM for all existing claims on Government and transfer of all debt servicing responsibilities on external liabilities to the Treasury. This would render the financing of a government operations, and specifically those presently related to the quasi-fiscal deficit, more transparent. This transfer of responsibilities from BCRM to the Treasury would however leave external debt servicing burdens for the country as a whole unchanged. The additional costs to the Treasury of this arrangement assuming no further debt relief or cancellation remains to be assessed and is likely to require some combination of adjustments in public expenditure, further tax mobilization and government financing through issuance of securities. The benefits of the new arrangement lie in the greater transparency of government financial operations and the ability of BCRM to conduct independent monetary policy. At the same time, this new arrangement obviates the potential of monetizing government financing needs.

2.28 Importance of eliminating BCRM losses: From a purely macroeconomic standpoint, the losses of BCRM are a problem only if they endanger attainment of monetary targets. This has not yet appeared to be the case till 1990. However, this situation is unlikely to endure especially once the outgoing external debt service payments by BCRM in accordance with rescheduling agreements begin to exceed the incoming payments to BCRM from the Treasury according to the original debt schedule. There are however also less tangible albeit significant consequences of BCRM losses. The perception that BCRM is financially unsound could undermine its stature within the financial system and its ability to use moral suasion as an instrument of monetary policy. Its independence in managing its internal affairs could be diluted by pressures to subject the administrative budget of BCRM to the Treasury to limit its losses. Except in such extreme cases, the implications of the erosion of the authority of the central bank are difficult to gauge. Yet, it is important for savers and investors alike to perceive that the central bank has the capacity to conduct credible monetary policy which assures price stability. The implications of these factors for the future of BCRM are discussed in the conclusion of this chapter following the review below of recent monetary policy.

Recent Trends in Monetary Management

2.29 Monetary policies in Madagascar are in a period of transition. Although direct instruments of monetary control are still in force, there is consciousness of the importance of shifting towards indirect instruments among policy makers (see Annex 3.1 for a discussion of these two approaches to monetary management). Current monetary policy instruments in Madagascar are a combination of direct controls and an emerging set of new instruments which, although still at a very embryonic stage of implementation, hold more promise for effective monetary management in an increasingly market-oriented economy. The various past and present monetary instruments in use are reviewed below.

2.30 Previous Monetary Policies: The monetary control system as it existed in Madagascar until 1990, resembled closely the system that existed in France at the time Madagascar became independent. It relied heavily on direct, administrative controls in the form of bank-specific credit ceilings ("l'encadrement du crédit"), and prior credit authorizations by BCRM ("autorisation préalable"). The direct controls were supported by reserve requirements on credits, the placement of interest-earning bank deposits with BCRM, and rediscount policies. The system was designed to facilitate selective credit policies. By applying different reserve requirement ratios to different types of credit, and by varying the conditions for rediscounting across types of credit, BCRM encouraged the banks to extend credit to priority sectors and activities at below-market interest rates. Characteristic of the old system were the detailed regulations and the many exceptions. For purposes of the reserve requirement and rediscount systems, credits had to be distinguished by maturity, type of guarantee, identity of recipient, economic sector, and nature of activity financed. Moreover, BCRM defined rediscount ceilings for each bank, derived from its target for banking system liquidity, and also for each major borrower, depending on their creditworthiness. The uncertainty this created, together with the prior authorization requirement, resulted in heavy involvement of BCRM in commercial bank credit decisions. This was accentuated further after the nationalization of the banking system in 1975.

2.31 Key Changes in Recent Monetary Policy: BCRM has now recognized that monetary management that is both more efficient and more conducive to financial sector development requires market-based instruments. In November 1990, it introduced a number of major innovations intended to prepare the ground for indirect monetary control relying primarily on BCRM's capacity to influence short-term interest rates. First, banks are now permitted to engage in interbank borrowing and lending on freely negotiated terms but with an obligation to inform BCRM. Second, BCRM replaced the old refinance system by a system that gives it more direct control over the supply of reserve money to the banking system. The new system is organized around regular auctions at which banks can either obtain BCRM refinancing ("Appel d'Offres Positive"-AOP) or place interest-earning deposits with BCRM ("Appel d'Offres Negative"-AON). The auctions are supplemented with interim BCRM interventions at less favorable interest rates, which may be at the request of the banks but always at the discretion of BCRM, and are always at less favorable interest rates ("Pensions" and "Pensions speciales"). Third, the reserve requirement system was replaced by a deposit-based one, designed to give BCRM more effective control over the demand for reserve money. Related measures included: the complete liberalization of interest rates (previously the six month term deposit rate remained fixed), coupled with the obligation on the part of the banks as of July 1991 to inform the public of their "base rate"; the announcement that BCRM's indicator rate ("taux directeur") would henceforth equal the maximum rate charged by BCRM for auctioned refinancing ("taux plancher"), and that the rediscount rate ("taux d'escompte") would also be equal to that rate.

2.32 Refinancing Auctions: While under the old refinancing system BCRM was in principle obliged to rediscount all eligible paper within its refinancing limits, under the new system BCRM decides on the amount of refinancing solely on the basis of its liquidity projections and monetary policy stance. The complete transition from the old to the new system took place on November 22, 1990: all outstanding refinancing plus bank deposits with BCRM, including accrued interest, were due on that day, and the first AOP took place on November 22 with value date November 22. When the new refinance system was introduced, the liquidity of the banking system required net injections of refinancing. BCRM initially organized refinance auctions (AOPs) every two weeks, but changed to monthly auctions when the banking system liquidity improved in January 1991. BCRM announces prior to each auction the minimum acceptable bid yield or minimum rate ("taux plancher"), and has decided for itself, but does not announce, the amount it wants to inject. After inspection of the bids, it decides on the maximum acceptable bid yield or maximum rate ("taux maximum"), and accepts all bids at or above that rate at that rate, uniformly prorating them if they exceed the amount it wants to inject. The rates for short-term BCRM interventions in-between auctions, either for 2 to 10 days ("taux des pensions"), or for shorter periods ("taux des pension spéciales"), are fixed at respectively 1.5 percent and 2 percent above the weighted-average yield resulting at the latest auction.

2.33 If BCRM perceives a need for absorbing liquidity from the banking system on a net basis, it would auction deposits (AONs), announcing a maximum rate and deciding on a minimum rate on the basis of the bids received. So far there has been no need for such auctions and the only absorption that takes place are in the form of interim interventions whereby BCRM accepts short-term deposits, currently at 9 percent. The purpose of setting minimum and maximum BCRM rates is to stabilize to some extent market interest rates, notably the interbank rate. On the other hand, the room for interest flexibility is limited by the spread between the two rates ("fourchette"). So far this room has been minimal: the minimum rate has been unchanged at 12 percent and the maximum rate unchanged at 13 percent. While it is understandable for BCRM to want to start off the new system with a relatively narrow spread, if continued for too long this threatens to undermine the auction process. Confident that their bids will be accepted at a maximum rate of 13 percent, banks currently do not care much about the yields they bid; and since their bids will most likely only be partially accepted, they bid for a multiple of what they really need. The weighted average yield of accepted bids is always 13 percent, and the interbank rate not surprisingly is very stable at about 14.25 percent.

2.34 A widening of the interest rate spread seems called for at this point in time. Interest rate flexibility is critical to the envisaged gradual shift from direct to indirect monetary control and the attendant reliance on interest rates to constrain credit growth. A wider spread will furthermore restore to the auctions their proper role of allocating refinancing, forcing banks to reveal their true liquidity needs, in terms of quantity and price. This presumes that bids will be accepted at the yields actually bid.

2.35 Interim Interventions: The auction refinancing is supplemented by a system of short-term BCRM interventions. In between auctions, banks may request BCRM for 2-to-10-day refinancing ("pensions") at the 1.5 percentage points above the latest weighted-average auction yield; in exceptional circumstances, banks may request loans for shorter periods ("pensions spéciales") at 2 percentage points above the maximum rate. Conversely, banks may approach BCRM to place short-term deposits which BCRM may accept for durations and at yields at its discretion (currently at 9 percent).The short-term facility is needed to correct errors made at the auctions in forecasting system-wide liquidity needs. BCRM can make errors in its forecast of the volume of refinancing or deposits to be auctioned. This is likely to be a problem, specially at the beginning (see para 2.32). In principle it is also possible for the banks collectively to underestimate their liquidity needs.

2.36 Shortcomings in Liquidity Management: Despite much improved liquidity forecasts, the possibility of unexpected developments always exists, both at the level of the banking system and of individual banks. Individual banks should compete for BCRM resources just as they do for other resources, access to which is never assured. There may be all sorts of technical reasons why an individual bank is unable to meet unexpected liquidity swings in the interbank market even though the liquidity is there. As noted, the short-term facility places a ceiling on market interest rates under such circumstances. To encourage banks to rely on the auctions more than on the short-term facility, the rates are less attractive than those obtainable at the auctions. In a well-functioning banking system. this should be sufficient to prevent undue reliance on the short-term facility. In addition, utilization is constrained by minimum and maximum maturities, by the availability of eligible collateral, and, finally, by the discretionary authority of BCRM. Nevertheless, uniformly defined utilization limits per banks might be considered. They offer BCRM better protection because they are more transparent and defensible than discretionary refusals. Such limits could be defined as a percentage of capital plus reserves, which would have the side benefit of stimulating banks to build a proper capital base.

2.37 Managing Chronically Illiquid Banks: If a bank is chronically illiquid due to problems of a structural nature, it is difficult for BCRM to satisfy its needs through the regular refinancing system. The bids at the auctions from this bank will inevitably drive up the general interest rate level, crowding out other bids. This rise in interest rates may not be warranted from a macroeconomic stand point. In addition, the higher interest rates may compound the problems afflicting the illiquid bank if it is tempted to engage in distress borrowing. The situation may also arise that except for the chronically illiquid bank, all banks are experiencing excess liquidity. BCRM would want to shift from injections of reserve money (AOPs) to absorptions (AONs), but is compelled to continue the AOPs to provide this one bank with the liquidity it needs. In the case of such a problem bank, BCRM should in the first instance move towards formulating a restructuring plan for the bank. In the context of such a restructuring program, the bank's access to the ordinary facilities should be terminated. Additional liquidity needs of the problem bank should be closely monitored by BCRM and financed, if necessary, through an extraordinary and limited line of credit. Therefore, chronic liquidity needs should be satisfied outside the auction process, through such a facility. By the time the restructuring is completed, all refinancing should be repaid, and any remainder written off as the case may be.

2.38 <u>Problems of Liquidity Forecasts</u>: The most challenging technical aspect of reserve money management is making accurate liquidity forecasts. As a basis for the volumes of refinancing or deposits to be auctioned, the central bank must forecast banking system liquidity during the period immediately ahead. The major "autonomous" sources, that is, those over which it has no influence, are the balance of payments and the government cash position. Once the liquidity created by those sources has been forecast, the central bank can choose settings for its monetary instruments so that the supply of banking system liquidity money is consistent with the demand. BCRM is finding liquidity forecasts very difficult, mainly as a result of the lack of accurate government cash flow forecasts. The Government has the possibility of obtaining advances from BCRM. BCRM has a statutory limit on total gross lending to Government, including advances, of 15 percent of ordinary revenues during the previous fiscal year. In practice this limit is completely ignored (see Fig. 2.2), and the Government's access to BCRM financing is limited only by the credit ceilings formulated in the context of the IMF adjustment programs. Thanks to this flexible access to BCRM financing, the Ministry of Finance has no urgent need for accurate cash flows. Hence, it is insufficiently motivated to overcome the technical and organizational obstacles to account consolidation, which are undoubtedly formidable given the state of communications and the 120 treasury agencies across the country. This suggests another reason for effective restrictions on government borrowing from BCRM, in addition to the monetary control reasons presented below.

2.39 <u>Collateral Requirements for Refinancing</u>: Under the old refinancing system, paper was rediscounted, that is, purchased by BCRM. For the most part these were promissory notes or bills drawn on enterprises which met the specified eligibility criteria. Presently, BCRM no longer rediscounts but extends refinancing credit against collateral. The eligibility criteria for collateral are essentially the same as before for rediscountable paper: a mixture of objective criteria, having to do with the nature of the activity financed, and subjective criteria, having to do with BCRM appraisal of the creditworthiness of the enterprise and the liquidity position of the bank. The proper application of these criteria is time consuming. Therefore, once they have extended a credit, banks will routinely submit the whole credit file to BCRM Credit Department, and ask it to determine in advance whether the paper in question is eligible collateral. BCRM will issue its agreement ("accord de mobilisation") which stipulates the portion of the face value of the credit it will accept as collateral ("mobilisable"). While BCRM rarely rejects paper outright, except for reasons like an incomplete file, the amount determined eligible is usually less than the face value. BCRM discretion in curtailing the eligible amounts adds yet another element of uncertainty to the regulatory environment in which banks must operate. Generally, a central bank should try to evaluate the soundness of a bank's loan portfolio in the context of its supervision function (see chapter 4) and not in connection with its refinance operations. If the central bank feels that a bank's loan portfolio is impaired to such an extent that it threatens its ability to repay its loans to BCRM, it should not refinance the bank's credit operations whatever the collateral supplied.

2.40 <u>Features of Existing Collateralization</u>: The credits submitted for an "accord" usually have a one year maturity; often, they are credit lines. The accord is granted for the lifetime of the credit with a maximum of one year. At the time a paper is submitted for an accord it must reflect the true credit to the customer, but subsequent repayments may lead to a lower actual credit; at the end of each month the credit must again be equivalent to the face value of the paper, or the paper withdrawn. For convenience, one credit may be divided into more papers. In addition to credits which are submitted with their files for an "accord de mobilisation", banks may every month submit lists of small credits, to professionals and to agriculture, for agreement ("billet global de mobilisations"). This list only contains names, credit amounts and the type of credit. After scrutiny BCRM may accept the credits as potential collateral, but only up to 80 percent of face value, as is usually the case. Every form of BCRM refinancing, obtained at the auctions or via "pensions" in between auctions, must be collateralized. Instead of depositing the collateral paper with BCRM, banks are allowed to draw up lists of collateral in their possession equal to the amount of refinancing sought, and submit those. At BCRM Credit Department the lists will be verified against the records. If a bank discovers at 4:30 p.m. that it needs a "pension" to balance its current account, as happens regularly, this process must still be completed that working day.

2.41 BCRM wants to expedite and simplify the current process of scrutinizing private sector paper to determine eligibility as collateral. For instance, much of the appraisal of enterprise balance sheets to determine their creditworthiness could be computerized ("centralization de bilans"). However, improving the current system would mean continuing the undesirable confusion of central banking and commercial banking tasks. Preferable would be the adoption of a collateral system that places the responsibility of appraising credit applicants squarely with the commercial banks as discussed below. BCRM should discontinue refinancing against private collateral. However, prime private paper might continue to be used for short-term interventions ("pensions") on the money market.

2.42 Alternative Collateral Mechanisms: BCRM could have at least two alternatives for collateral: government securities, or bankers' acceptances. In many countries the central bank insists on government securities, the idea being that these are essentially without risk and therefore most appropriate for a central bank. In Madagascar, the supply of government securities is insufficient at present, but with a more active government debt management policy (see para 2.56), an adequate volume and market for these instruments can emerge. Bankers' acceptances (BAs) can emerge as alternative collateral at a later stage. A BA is a draft or demand for payment drawn on a bank, asking the bank to pay a stated amount to a stated firm or its assignees at a definite date. When the draft is "accepted" by the bank on which it is drawn, it becomes a BA and is a payment obligation of the bank . Each of the accepting banks guarantees payment on the due date, for which service it will of course exact a price. Effectively guaranteed by a number of reputable banks, the creditworthiness of the underlying enterprise has become practically irrelevant. Central banks can evaluate BAs as collateral as a natural extension of their traditional task of prudential bank supervision. Once BAs have become popular because the central bank accepts them as collateral, an interbank market in them may develop. The development of markets for BAs and government securities are more fully discussed in Chapter 7.

2.43 Required Reserves: Required reserves are compulsory deposits made at the central bank by commercial banks. Reserve requirements help a central bank forecast reserve behavior, especially towards the end of the reserve maintenance period. Required reserves are usually used in conjunction with indirect monetary instruments to alter the financial structure of banks and other financial institutions. Required reserves should be used sparingly and should not be a day to day tool of liquidity management. Required reserves above same minimum that banks would usually hold anyway (usually 2-3 percent of deposits) should generally be remunerated. Excess reserves however should generally not be remunerated. An important condition for the efficient use of reserve requirements is that BCRM should have available instruments to mop up excess liquidity when this occurs in the banking system. Such instruments include securities issued by the Treasury or by BCRM itself.

2.44 In the case of Madagascar, the required reserve system introduced in December 1990 is a step forward in moving from direct to indirect monetary control. The new reserve requirements applies to a base consisting of sight and term deposits, and CDs ("bons de caisse"). The ratio was set uniformly at 6 percent. The base is measured as per the last working day of the month before the last. Half of the required reserves are to be maintained in a non-remunerated blocked deposit with BCRM, while the other half is to be met by the average balance over the maintenance month in the bank's current account with BCRM. The limited period averaging gives the banks considerable room for managing their liquidity. A pattern which has already started to develop is for banks to "save" by accumulating excess balances in their current accounts during the first half of the month, which they then run down during the second half. BCRM should begin to collect certain data from banks, such as the key elements of their balance sheets, on a bimonthly or weekly basis. This will set the stage for calculating, at a later phase, the required reserves on an averaging on a bimonthly or weekly end-of-period deposit base rather than end-of-period monthly data. However, as long as the delays in the payments system remain extended (see Chapter 3), banks will be forced to always keep large precautionary reserves.

2.45 Direct Monetary Controls: The direct controls of BCRM consist of global bank-specific credit ceilings plus sub-ceilings, and the prior authorization ("authorization préalable"). BCRM has decided to retain them for the time being, while it is gaining experience with its new indirect monetary instruments. A gradual shift from direct to indirect control is envisaged. Through greater reliance on indirect instruments, the credit ceilings will eventually become ineffective and will be dispensed with. As noted before, essential to this process will be greater interest rate flexibility.

2.46 Mechanics of Direct Controls: The global bank-specific credit ceilings are derived from the permissible credit expansion for the year decided in the context of the Fund adjustment program. The end-year ceiling is distributed over quarters, and then divided among the banks on the basis of deposit mobilization, except for the new bank which receives a more generous ceiling during its start-up period. While BCRM originally wanted to abandon the subceilings early on, it decided to retain them after the unexpected credit expansion during the second half of 1990 which was connected to the import surge. The subceilings apply to commercial rediscounting ("l'escompte commercial"), advances on merchandise ("avances sur marchandises"), and overdrafts ("découverts"), three types of credits which typically finance imports. The prior authorization requirement applies to all short-term credits to enterprises whose net borrowing from the banking system exceeds FMG 5 billion. This requirement will be abolished shortly. Bank-specific credit ceilings based on deposit mobilization during the previous period are preferable over ceilings based on outstanding credit. The latter technique tends to freeze market shares and discriminates against new and/or dynamic banks. However, the periods used for determining deposit mobilization should be relatively short (one quarter instead of one year) so that the link to credit ceiling allocation is an effective incentive to banks. It is important that the banks are well aware of the link to deposit mobilization, and BCRM might therefore consider issuing a circular to the banks describing the procedure for computing the ceilings.

2.47 Problems in Managing Direct Controls: The subceilings are bound to cause even more distortions than global credit ceilings. In the gradual shift towards reliance on indirect instruments, a high priority should therefore be accorded to abolishing these ceilings as soon as possible. The impression must further be avoided that it would not be in order for banks to seek out the most profitable lending opportunities, including import financing. The enforcement of credit ceilings depends on timely information and effective sanctions. In case of a first violation, the sanction is the obligation to place a non-interest earning deposit with BCRM equal to one half of the excess for the duration of one month. In case of any further violations, a deposit must be placed equal to the excess, on which, furthermore, interest is due equal to the "taux des pensions". Banks are required to send their monthly reports to BCRM by the 25th of the next month. However, in the case of one bank, accounting for some 40 percent of credit, a complete and reliable report takes much longer to reach BCRM. Enforcement of direct controls under such circumstances is difficult. It serves to underscore the need for more reliance on interest rates in constraining credit since their impact cannot be avoided and is felt rapidly. Furthermore, given that information on banking system credit and monetary aggregates is subject to such serious delays, BCRM should select an operating target from its own balance sheet, for instance, net domestic assets of the central bank or reserve money.

The Future Role of BCRM

2.48 Clarifying Responsibilities for Monetary Policy: BCRM's objectives (according to Article 30 of its statutes) are to "execute" the monetary, credit and exchange policies decided by the government. In this capacity, BCRM is to guard over the internal and external stability of the currency and to ensure the deployment of all productive resources of the country in the context of the development plan decided by the government. The objectives of BCRM should be more narrowly defined as ensuring price stability. This would be in line with recent trends in central bank legislation worldwide which tend to limit the central bank objectives to the maintenance of the domestic and external stability of the country's currency. This provision could be strengthened by assigning to BCRM not only responsibility for implementation but also for formulation of monetary policy. Consultation with the government could be prescribed, including appropriate conflict resolution procedures such as within the National Assembly where both the government and central bank could present their case, if there is a serious divergence between them which cannot be resolved by mutual discussion.

2.49 Independence of BCRM. The problems of BCRM arising from its quasi-fiscal operations are part of a larger issue of the independence of the central bank (see Annex 2.2 for a discussion of the growing attention worldwide to this question). The future role of BCRM must involve a greater degree of independence to effectively conduct monetary management. Of fundamental importance is a working relationship between the central bank and the government which gives the central bank a day-to-day operational role in macroeconomic management free of political interference. To ensure that BCRM can play an effective role in economic and liquidity management, a number of operating and legal changes must be envisaged in addition to a appropriate program of manpower development. A number of such changes are already being envisaged and discussed. These and other changes should ensure the legal, financial and operational independence of BCRM.

2.50 Central Bank Statutes: Central bank independence should have a strong legal basis. Since BCRM's statutes of 1973 (as amended in 1983) 3/ already contain many provisions intended to safeguard its independence, the first priority should be to implement those statutes. A solution must be found to end the flagrant violation of the limit on lending to Government. Also, in the interest of accountability, BCRM should resume publication of annual reports, including balance sheets and profit and loss accounts. While the major threat to BCRM's independence consists of the violation of existing provisions of its statutes, there are other provisions that could be strengthened. A commission has already been appointed to review BCRM statutes in light of the monetary policy reforms. This review could be broadened to try to strengthen BCRM's independence. Two areas in particular could benefit from improvements: the definition of BCRM's objectives, and the appointment and operation of BCRM senior management and executive board.

2.51 BCRM Management and Board Appointments: BCRM Governor and Board Members (according to Sections I, II, and III of BCRM statutes) are appointed for four years by the Cabinet. They can be dismissed at any time. BCRM's independence would benefit from a lengthening of the term, and inclusion in the statutes of specific grounds for dismissal. The Executive Board could further be strengthened by giving it the right to nominate new board members, who will be appointed by Government. Monthly instead of quarterly meetings would allow the Executive Board to play a larger role in policy formulation. Board members should only be eligible for dismissal by a majority of the National Assembly for reasons of moral turpitude and infirmity. Moreover, to avoid any conflict of interest, all BCRM Board members and staff should be strictly forbidden from any role in the board or management of any financial institution or enterprise. BCRM itself should not be a shareholder in any financial institution or enterprise.

2.52 BCRM Strategic Development Plan: To prepare itself for its rapidly evolving functions under a market-oriented economic system, BCRM should aim at establishing a strategic development plan. This plan should establish the main objectives of BCRM, its organizational plan and its manpower and logistics development strategy. The plan should be based on a comprehensive review of existing organizational structure, systems, methods and main operating problems and issues observed as well as a forecast of future development needs. It should include an audit of the educational profile and career potential of all BCRM personnel. Such a plan could be partly established and supported with external technical assistance.

2.53 Financial Independence of BCRM: Financial independence is one of the crucial dimensions of Central Bank independence, a general issue which is being widely debated in many countries. To fulfil its functions effectively, BCRM should have a sound revenue base and should not make chronic losses due to quasi-fiscal or other activities. Effective financial independence however can only emerge after a satisfactory resolution is obtained of BCRM losses, both in terms of their flows and accumulated stocks. At the same time, BCRM should be accountable for its actions and policies. As part of this accountability, it should resume publication of its annual balance sheet and income statement. Published accounts could be part of an annual report of BCRM which could also review economic developments as well as monetary policy over the previous year.

3/"Ordonnance No. 73-025 portant création de la Banque Centrale de la République Malgache," promulgated on June 12, 1973.

2.54 **General Approach to Resolving BCRM Losses**: A resolution of BCRM losses could proceed in steps. First, the flow of new losses should be stemmed by amending all BCRM operations, arrangements and accounting practices that can be identified as contributing to those losses. Specifically, it would mean that, henceforth, valuation losses on account of the foreign liabilities BCRM assumed from the Government are immediately covered by debiting the government's advance account. This advance account should be settled by the Treasury within a statutory time limit. Second, the flow of losses arising from the stock of past losses should be dealt with. This will require improving the return on BCRM assets. The decision to increase the interest charged on advances to Government to the money market level, and the payment of interest due on government deposits to the same rate minus one percentage point, was an important step in the right direction. Both decisions are to be applied retroactively to January 1, 1991. However, that still leaves 60 percent of BCRM assets earning no return at all (i.e., the valuation adjustment account plus accumulated operating losses).

2.55 **Remunerating Claims on Government**: To return BCRM to profitability, the government will have to pay an adequate interest on those claims. One way of achieving this is for the government to issue interest bearing bonds to BCRM to replace the revaluation account. The accumulated operating losses could be dealt with likewise. Alternatively, in the context of a comprehensive resolution of the loss problem, Madagascar's international donors could perhaps be persuaded to give up their lien on the sizeable counterpart funds and allow them to be used to write off the operating losses. It should however be stressed that irrespective of whether such exceptional resources are available, the Government should fully compensate BCRM for its accumulated losses. Once BCRM earns an adequate return on its claims on government and is profitable, the stock of those claims no longer poses a monetary problem. The stock can be reduced over time as BCRM profits are applied to redemption of the Government's debt. However, a legal problem remains in that the stock of claims, together with the advances to government, by far exceeds BCRM statutory limit on lending to government.

2.56 **Improved Government Debt Management**: With the interest on the advance account raised to the level of the money market rate in 1991, government borrowing should no longer contribute to BCRM's operating losses. However, the absence of an effective limit on the volume of borrowing still represents a weakness in monetary control. The BCRM statutes limit total gross lending to Government to 15 percent of ordinary revenues during the previous budget year, but this limit is being ignored. Both the overall volume and the variability of BCRM lending to Government present problems for monetary management. With effectively unlimited, and, until recently, very cheap, access to BCRM advances, the Ministry of Finance could afford to be careless about its cash-flow forecasts. As noted, the absence of such forecasts are a major problem for BCRM in conducting reserve money management. To protect BCRM's independence in matters of monetary policy, the Government must develop the means to cover its financing needs outside BCRM. Advances from BCRM should be used to finance cyclical cash flow fluctuations only, for which the statutory limit of 15 percent seems ample. The Ministry of Finance therefore urgently needs to rationalize and activate its government debt management. This requires enhanced coordination of monetary and government security issuance policies. This will also involve the creation of active primary and secondary markets in short-term government securities, which will produce valuable side benefits in promoting financial market development generally. This issue also is more fully discussed in Chapter 7 in connection with financial market development.

CHAPTER 3

REINFORCING THE INFRASTRUCTURE FOR FINANCIAL SYSTEM DEVELOPMENT

3.1 To enable the financial system to effectively play its two key functions of financial intermediation and provision of payments services, an adequate financial infrastructure is necessary. The key elements of financial infrastructure mainly consist of:

- the legal protection accorded to lenders and borrowers;
- the practices surrounding reporting of financial information; and
- the set of practices and logistic arrangements for discharging financial obligations incurred in economic transactions (payments system).

3.2 Financial infrastructure affects two ingredients for financial sector development. The first is the confidence of savers and financial intermediaries in the quality of financial assets they own. The quality of financial assets is reflected in the probability that their owners will get their money back according to terms of the financial contract. Without reliable information about banks and borrowers and adequate legal protection, financial transactions will tend to be limited to short maturities and to borrowers either personally known to the lender or those able to provide easily attachable collateral. The second ingredient is the speed and accuracy of the financial system to settle efficiently obligations that arise from economic transactions. Unless there exists an effective payments mechanism which inspires general confidence, economic agents will prefer to incur the high costs of conducting many transactions in cash and conveying and storing large volumes of currency in insecure conditions. At the same time, an effective external payments system for settling international transactions is necessary for expansion of exports and stimulating capital inflows, including capital repatriation from abroad. Together, these elements of financial infrastructure should help lower the costs and risks of transferring resources from savers to borrowers and of settling financial obligations among economic agents.

Legal Framework For Financial Transactions

3.3 Overall adequacy of legal framework: The emerging shift towards a market economy in Madagascar requires abrogation of previous legal provisions based on a state-controlled economy. Modernization of the legal framework pertaining to economic activities is an essential pre-condition for economic development. The modernizing process normally involves both updating of existing legislation and creation of new legal instruments as well as repealing inadequate or obsolete ones. In the case of Madagascar this process should also involve a review of the administration of justice itself. Of special relevance to financial sector development are procedures for recovery of claims, enforcement of contractual guarantees, legal procedure and the execution of legal judgments and other enforceable decisions. Specific related areas of law and legal procedure reviewed below are: company law and the law in respect of stocks and bonds; the law governing mortgages which should be applicable to all categories of real property and related rights; protection of consumers and savers; collective procedures to prevent bankruptcy with a view to protecting employment while facilitating the reorganization of enterprises; and procedures for enforcement of official or legal titles. In most areas, the relevant legislation in Madagascar is coherent and satisfactory. However, many of the laws inherited from the French system have become outdated and several recent reforms have introduced new provisions which are in many cases not sufficiently clear. At the same time, successive changes in policy have on occasion resulted in measures inconsistent with the traditional and constitutional hierarchy of the sources of law.

3.4 <u>General weaknesses in legal texts</u>: The legal system is perceived as archaic and the machinery of justice as slow, ineffective and unreliable. There is a striking lack of confidence in the administration of justice on the part of company officials.One example of outdated legislation which does not take into consideration present circumstances is the case of agro-industry which for certain purposes is still governed by the law regarding agricultural production because the law does not provide for industrial transformation of agricultural produce and still treats the company as "collecteur agricole" because it purchases its raw materials from farmers. Companies in Madagascar still operate under the 1867 company law. The Commercial Code dates from the colonial era. These laws were frozen at independence because the old colonial texts which used at times to keep pace with developments in the then "metropole" did not evolve after independence in line with new thinking within the legal system from which they were originally derived. Except for the 1987 Plan Comptable National, the basic legal framework for companies has remained unchanged, yet in recent years decrees have been adopted by the authorities introducing new instruments in the financial sector. These decrees based on modern practices and instruments available elsewhere are being grafted on a superstructure which is itself an antiquated one.

3.5 <u>General weaknesses in application of texts</u>: Lawyers point out that some decrees or circulares are not even published or are in contradiction with the enabling legislation. They also complain about the absence of law reports (no report seems to have been published since the mid 70's). Commercial, financial and economic law cannot develop without a proper reporting of case law. It is also observed that the common practice of subjecting ostensibly liberal pieces of legislation to administrative authorizations which by definition are discretionary and which also happen to rest on a very bureaucratic system render these legislations, in practice, anything but liberal. The exercise of the discretionary power of the bureaucracy with regard to treatment of visa applications for expatriate staff is quoted as an example of the discrepancy between new texts and actual practice.

3.6 <u>Legal issues in banking operations</u>: One of the most common complaints against banks is that securities required by banks before loans and other facilities are granted to enterprises are difficult to provide. Whereas mortgage ('hypotheque') is now little used in France for example, this is still the most common form of security required by banks in Madagascar. In addition to the consequent difficulties faced by enterprises because their property has already been mortgaged to a bank, providing the mortgage itself creates difficulties. This is because the titles to property are not always acceptable and the cost of complying with formalities required for mortgages is high. The available title may not be acceptable to banks which are not prepared to accept other forms of security. Banks complain of the difficulties in obtaining repayment even of secured loans because of the present system of administration of justice, the precarious nature of ownership deeds, the cost of recovery in remote areas, and the traditional and cultural factors which impede the execution of judgments.

3.7 <u>Legal changes for improving banking operations</u>: Banks should be encouraged to adopt the wide range of securities and financing schemes available elsewhere and in particular in countries whose legal systems are derived from French civil law. These include: (a) project financing (agreed proportion of income derived from the investment is contractually assigned to the lender);(b) a combination of "hypotheque" and "cautionnement" (instead of exclusive reliance on hypotheques); (c) "delegation" (to ensure that the number of creditors in relation to a particular project is as wide as possible); (d) greater use of shares and other title deeds as security (this would be facilitated by prior consolidation of the law relating to "valeurs mobilières"); (e) title reservation clauses in contracts of sale financed by loans; (f) insurance cover for loans (this would further develop the local insurance industry); and (g) securitization. Many of these products could probably be developed solely through agreement between the banks and their customer even before there is specific legislation covering them. Banks would thereby contribute to the establishment of a modern system of law. If the overall legal system and procedure for settlement of disputes and recovery of debts (including provisional measures to safeguard the interests of creditors) are improved, bank may be expected to adopt a more liberal approach to loans and securities. The solution therefore does not lie only in new credit arrangements and instruments. Banks in need of immediate liquidity or which face new attractive loan opportunities, but which are constrained by certain supervisory ratios, should be allowed to package and sell some of their loans to banks with excess liquidity. This will allow banks to both meet the legal requirements and reap the benefits associated with new loans. Such provisions will increase banks' leverage on loan creation and may reduce bank failures.

3.8 Recognition of Property Rights: A debtor's property constitutes a basic guarantee of financial obligations which lenders have to be able to rely on. Malagasy law recognizes various categories of property; however, only real property for which a registered title document has been issued can be formally mortgaged. Foreigners may only acquire real estate after obtaining prior authorization for the purpose. The right of foreigners owning properties of over 20 hectares to sell such property has been suspended since 1977. Foreigners may only be permitted to purchase property that has already been registered. These requirements should be amended to permit mortgaging of all real property and property rights whatever their situation or the category of title. Registration procedures are complex and very protracted. This is due to the large number of challenges and owners' failure to have the required entries made, and also to the lack of personnel and equipment to handle recording, demarcation and extension of the property records outside of the highlands. The same lack of means limits development of registration procedures, which are virtually restricted to urban areas. Strengthening of the means of the Registrar of Real Estate and of the property records service is a priority.

3.9 Problems of land law: Land law is of major significance to both real sector transactions and the functioning of the financial system. Land is also the most common form of security required by banks. A major problem faced by foreign investors in Madagascar is the unavailability of factory space. It would seem that at the moment companies controlled by foreigners and individuals residing in Madagascar but who do not have Malagasy citizenship are amongst those who are prepared to invest in industrial buildings but they are not in a position to do so because of present legal provisions (which are discussed below). The existing Land Law in Madagascar is also an inhibiting factor in economic development because the nature of the title to land ownership is often such that this cannot be given as security for loans. Indeed Madagascar still has the two regimes of "cadastre" and "immatriculation" for land. Those whose property are not yet subject to immatriculation (which is a costly and a lengthy procedure) find it difficult to have their ownership rights recognized by banks. As far as land ownership by non-Malagasy nationals is concerned, the law no 62.006 of 6 June 1962 provides that foreigners cannot acquire land without the prior authorization of the Minister of Interior. A circular adopted in 1968 provides for the criteria to be followed in deciding on applications by foreigners. However, an administrative note of 13 June 1978 provides that foreigners will henceforth be prohibited from buying land. This means that in spite of the law still in force which enables foreigners to buy land, subject to approval, there is a de facto prohibition since 1978. Non-citizens can however,still obtain leaseholds or devise other means of obtaining freeholds.

3.10 Improving land law: Authentication of titles to property issued by a properly organized Land Registry which can then be used as security for loans, will greatly facilitate the processing of loans. It is evident however that the costs of implementing measures needed to cover the entire country with appropriate land registries will be staggering. Therefore, for the medium term, the Government should given top priority to creating such registries in the major economic centers of the country. At the same time, the de facto prohibition on acquisition of property by foreigners should be reviewed and the June 1962 law should be adhered to. The Mauritian experience in this area is probably useful. Foreign investment in Mauritius does not seem to have been hampered by the Non-Citizens (Property Restriction) Act which provides that non-citizens must obtain the prior authorization of the Minister of Interior before purchasing, acquiring or holding property. It should also be noted that the Mauritius Citizenship Act provides for the possibility of a foreigner investing a prescribed amount in Mauritius being naturalized as a citizen. In Mauritius, the non-citizen seeking to acquire property applies to the Prime Minister's Office under the Non-Citizens (Property Restriction) Act for permission, giving the relevant details. The Prime Minister's Office will liaise with Exchange Control as to the financial transfers requirements and, once these matters are specified, approval is given for the acquisition proposed. The non-citizen who so acquires property is free to dispose of it as best he thinks fit, including the creation of a charge thereon.

3.11 Financial Contracts and Mortgages: Commercial law in Madagascar, having its main source in the legislation bequeathed by France, is based on the autonomy of the contracting parties' will and accordingly allows operators considerable freedom in agreeing on their reciprocal obligations. However, when a contract is concluded with a foreigner, Malagasy exchange regulations limit the freedom to transfer funds, purchase foreign securities and export goods. Real and personal guarantees governed by law are not always possible or effective. As noted above, mortgages can only be constituted on registered properties and that, if the creditor or borrower is a foreigner, the transaction is subject to discretionary authorization. Banks most often use the private mortgage method to avoid the cost of a notarized deed (about 2% of the amount of the mortgage) or else because there is no notary near enough to the bank office or agency concerned. Often, too, a mortgage is only registered for its date, but not entered in the formal records in order to avoid costs that could lead the borrower to reject the loan. This situations warrants a reform that would limit the cost of mortgage registration to a reasonable fixed fee, leaving application of a proportional fee to the time the mortgaged property is sold, with the latter fee being based on the selling price should that be less than the amount of the mortgage claim.

3.12 Alternatives to mortgages: There are various ways in which real property can be accepted as guarantee without a mortgage being taken out, such as promise or prohibition to mortgage or deposit of title with a bank. The "floating charge" used in English law makes it possible to guarantee a current account subject to appreciable variations against corporate capital, whereas a mortgage can only be taken out for a set amount. Pledging against equipment or merchandise is sometimes done by means of open warehousing, or by handing over the owner's key or through acceptance by a depositary. The establishment of general warehouses well run by a third party enjoying the confidence of all concerned would be the most appropriate means for using the warehouse warrant system. The various warehouses operated by the Chamber of Commerce in Madagascar do not offer appear sufficiently reliable for the warrant system. Crop pledges are used, as also assignment of livestock mortality insurance. However, in rural areas it is not guarantees that are the real problem but primarily the lack of funds for lending, which obliges farmers to turn to informal moneylenders who practice usury in a way that is socially and economically greatly to the disadvantage of borrowers.

3.13 Debt Recovery: Improvement of the means of debt recovery can help lower the costs of banking transactions in Madagascar. When a debtor fails to meet his obligations on time, or this failure to pay occurs in specific circumstances, the lending bank must consider instituting recovery measures. Debtors in good faith will have their payments rescheduled, or be granted additional credit, subject to appropriate guarantees, following examination of their cases. However, when bad faith or risk of nonpayment is evident, the bank will resort to enforcement of its claim. If it holds notarized evidence of debt, such as a mortgage or bond, it can institute proceedings for attachment of the goods or property mortgaged or given as security. If there is no executory deed or instrument, the bank must apply to the courts to have the debtor made to pay or to activate the guarantees or bonds given. Claims below FMG 125,000 and for acknowledged commercial claims, the bank can obtain an injunction or order to pay, which is simple, cheap and quick. However, if the debtor challenges the injunction, the case is transferred to the ordinary commercial court, presided over by a judge of the court of first instance and including two tradesmen appointed upon the proposal of the Chamber of Commerce.

3.14 <u>Court delays</u>: Local magistrates are most often artisans or small tradesmen with little knowledge of business or financial law. Consideration should be given to forming specialized courts, with judges elected by professional categories, so that the local magistrates could then assist the presiding judge in examining the documents and customs relating to each category. The commercial court functions in a fairly straightforward manner, setting short time limits for summoning the defendant, reaching settlement with the plaintiff and, if necessary, appealing. A decision should be reached within two to four months. In practice, cases can drag on for from one to three years, in first instance, and for as long on appeal, since appeals are often filed simply to spin the proceedings out. Moreover, adjournments are frequent because the assessors fail to show up. These unhelpful delays seem due in large measure to a shortage of judicial personnel and of office equipment, which holds up production of the relevant documents. They are also due to archaic methods and practices which slow the course of justice.

3.15 <u>Expediting court decisions</u>: To speed matters up and enhance the quality of the justice dispensed, the following measures could be considered:

- raising the limit from FMG 125,000 to FMG 1 million (without right to appeal) and setting the same limit for actions to obtain injunctions to pay.

- adjusting the legal rate for penalty interest against the debtor where no specific rate is set, if need be increased by a penalty clause. The present rate of 5% for civil cases and 6% for commercial, which is well below the rate for bank loans, goes back to the period of the French gold franc. Today it only serves to encourage debtors to defer payment. Taking the new French law as a model, for instance, the applicable rate could be stipulated to be the interbank market rate set by the Central Bank and published each month. At the same time, any rate exceeding by 25% or more the rates for each product as fixed by the schedule approved by the Central Bank and published at regular intervals, could be classified as usurious.

- improving of the courts' working methods by means of a system of permanent training as regards methodology and the technique and practice of business law. A part at least of this training could be done by the Department of Law and Business Technique of Antananarivo University, where various banking practitioners, magistrates and university people teach, who would be able to contribute toward better mutual understanding.

- providing the Inspectorate of Judicial Services with means and instructions to enable it to remedy or avert shortcomings or mistakes of the judicial apparatus more effectively.

- providing the courts with more office equipment, especially word processors and photocopiers.

3.16 Problems in enforcement of claims on property: Legal and official titles should, when duly enforced, produce prompt and specific results to the degree that the debtor's attachable property is sufficient to cover the principal, interest, penalties and costs involved. In practice, enforcement is often blocked by the following: (i) difficulty of finding the debtor in order to serve the orders to pay, either because he has gone into hiding or else because he has talked the server out of doing his job properly; (ii) third-party claims on the property attached, challenges to the claim when there is no registration deed, uncertainty regarding possession of cohabitant' movables, removal of objects pledged or of items given as security; (iii) traditional attitudes, which mean that rural dwellers never cooperate in any enforcement of claims against one of their number; (iv) practices that obstruct proceedings regarding exceptions that can be claimed, so that delays mount up due to the inefficient functioning of the judicial apparatus plus the debtor's use of all his connections.

3.17 Removing superfluous obstacles to claims enforcement: Attempts to improve enforcement of claims in Madagascar will necessarily have to be guided by two considerations. On one hand, anything deriving from traditions and attitudes vis-à-vis a foreign legal system and a different value system can only evolve by a combination of assimilating the values of that system and by a reshaping of attitudes which result from the contact of Malagasy economic operators with a more cosmopolitan business environment. On the other hand, many formalities and costs for which there is no functional need could be removed. Two examples of such changes are immediately evident. First, regarding attachment of nonregistered real property, is the requirement of an order authorizing attachment when the prosecuting party is acting based on an enforceable title. Second is the superfluous requirement of a creditor holding an enforceable title to submit a petition for authorization of attachment when the creditor's title is manifest (bill, check, statement of account) and when it would be sufficient to ensure for the debtor the right to challenge the attachment if he has a plea or other grounds for challenging the creditor.

3.18 Claims enforcement through property sales: Too often sales following attachment result in the property being knocked down to the prosecuting creditor because there are no other bidders. This raises a problem if the creditor is a foreigner since any change in ownership to the benefit of a foreigner is subject to authorization in the same way as sale of distrained goods. With participation by banks, a real state company could be formed that would purchase attached property for which there are no satisfactory bidders. This company could then develop holdings of rental properties which would serve a well-recognized social need in Madagascar.

3.19 Claims enforcement through assignment: A simplification of the guarantee procedures could prevent enforcement difficulties by ensuring the automatic collection of payments when they fall due. The procedures laid down by the October 9, 1961 Law regarding assignment of wages should be open to all tradespeople and not just to banks. The implementation of interim protective measures as soon as proceedings to enforce a claim are instituted would deter debtors from resorting to improper resistance. The judge should promptly grant orders for deposit, receivership or temporary inalienability of registered property, provided the petition is based on an obligation evidenced by regular titles and bank documents. Application of these measures and of conventional securities would limit the number of bankruptcy cases by allowing action to be taken before a debtor enterprise has collapsed.

3.20 Status of companies: There has been no modernizing of company law in Madagascar as was the case in Mauritius for example, in the context of the overall strategy to modernize the commercial and financial sectors. The only significant reform in recent years has been the adoption of the new accounting framework in 1987. Malagasy enterprises follow the classical French law divisions between partnerships (sociétes de personne) and companies (sociétes de capitaux). The vast majority of companies (approximately 90%) are set up as S.A.R.L which offer the following advantages over Sociétes Anonymes: (a) requirements and cost of formation are lower; (b) less stringent accounting requirements; and (c) statutory restrictions on transfer of shares. The S.A.R.L and the S.A are at present subject to different income tax rates which favor the S.A.R.L. Though there are no statutory restrictions on transfer of shares in S.A, the constitution of these companies often provide for a "clause d'autorisation", i.e that transfer is subject to prior approval. There is no obligation for an S.A.R.L to have its accounts audited and generally, audited accounts of companies are not easily accessible in any centralized place. The actual range of corporate statuses is more complex, because Malagasy law provides for commercial corporate bodies which are governed by public law. This discussion is limited to those enterprises which are governed by private law.

3.21 Problems of company law: Company officials express concern about the present law regarding dissolution which acts as a disincentive to new investment and expansion. The observations relate to: (a) the lengthy and complex procedure which is more bankruptcy-oriented and not geared towards provisional measures; and (b) the predominantly social approach to what is an economic situation, under existing laws regarding dismissal of employees before a company can be wound up. The delays in obtaining required authorizations to terminate employment means that employers incur heavy losses at a time when they are already facing financial difficulties. Though the "Code des investissements" now provides in its article 5 that dividends will be freely transferable as far as the "enterprises agrees" are concerned, transfer of dividends has been for many years one of the major concerns of companies. In one instance, between the time that an application was made and the time that the authorization was obtained the exchange rate for the Malagasy Franc had moved from 100 FMG to 1 FF to 300 FMG to 1 FF. Though the lack of recourse to debentures and other similar securities is understandable in the light of present economic circumstances, the legal framework conducive to the development of a "marche obligatoire" is lacking (see Chapter 7). It should also be noted that whereas corporate tax on profits is payable to the Tresor Public, income on securities is payable to the Direction Generale des Ressources Publiques. The lack of viable accounting records make it difficult for company taxation to be properly assessed and the situation is worse in so far as indirect taxation is concerned where companies only act as "collecteur". Not only does this impose a heavy burden on enterprises but the poorly kept accounts can affect national revenue.

3.22 Improving company law: The Government committee charged with revising the Commercial Code should provide for an entity to be set up to act as Registrar of Companies. This entity should register companies, keep records of financial and other returns and also monitor compliance with a revamped company law. A schedule to the new Companies Act should include model Articles (like table A in English Company Law which sets out the recommended provisions of the Articles of a company but leaves it to the company itself to decide whether it wishes to adopt these provisions or not) which seek to : (a) promote harmonization; and (b) induce companies to do away with practices and restrictive clauses which are now common in their "statutes" regarding, for instance, transfer of shares. The new companies legislation should provide proper framework for preference shares, debentures and convertibles. The new legislation should promote more transparency and accountability to encourage potential investors though provision should be made: (a) for exempt companies in accordance with criteria pertaining to turnover, number of employees, etc.; and (b) for gradual application of various requirements over a period of time or as the company grows. The mechanism for collection of taxes, charges sociales and dues on share transfers must be reviewed.

3.23 **Bankruptcy and liquidation**: The law in respect of collective procedures only admits bankruptcy and court-ordered liquidation in accordance with legislation inherited from the colonial period. The time limits set by this law for the stages of the procedure should not exceed three months from the adjudication of bankruptcy. However, it is not unusual for the proceedings to drag on for more than three or four years. This is partly due to the legal system's inability to give decisions and produce the required documents within the time set. The lack of qualifications on the part of managers and trustees is also regrettable; these individuals are not greatly motivated to try to put a troubled enterprise back on its feet nor do they display much efficiency in obtaining the best possible prices for its assets. A situation of this sort calls for modernization of the relevant legislation with institution of collective prevention procedures which can be initiated by representatives of the personnel, bankers and other creditors concerned, and subcontractors in particular. This prevention procedure would have the effect of suspending proceedings, starting with those initiated by the Treasury and the social security agencies, and of appointment of an adviser to the manager or a qualified temporary administrator to determine and implement restructurings and conversions required, with all available external assistance, to save the enterprise or retrain its work force. In the case of liquidation of assets, the debtor and a representative elected by the body of creditors should be able to supervise and facilitate the operations of the trustee to prevent any items from being sold off at bargain-basement prices. The law on winding up of companies must be reviewed so as to minimize the impact of social imperatives, reduce bureaucratic procedures and also promote reconstruction and administration. The appointment of professionals designated as insolvency practitioners by the relevant authorities by creditors or members themselves will give more confidence to investors and lenders alike.

3.24 **Prevention of Disputes and Reduction of Their Cost**: Improvements in the legal system should also aim at preventing disputes or reducing the costs of settlement. Choice of guarantees and special clauses should be made taking into account both the purpose of the contract and the customer's general attitude and reputation. In this way some traditional institutions can find modern applications, such as the "omby sisa mita" clause defining a joint liability, a "fehivava" contract that closely resembles sale with option to repurchase, and the "tsatoka" clause which is close to an arbitration clause. The current bank contract forms include election of domicile and assignment of competence to the court of the place of the contract. There is nothing to prevent the parties choosing instead an arbitration clause specifying an attempt at reconciliation followed, should that prove fruitless, by referral to one or more arbitrators, with or without authority to arrange amicable settlement. A single conciliation or arbitration procedure stipulated from the start seems preferable with regard to legal certainty than interminable legal actions ultimately ending in renunciations or a resignation transaction.

3.25 **Arbitration and conciliation**: Madagascar does not lack jurists and experts possessing the moral authority and intellectual capacities to work out conciliation and arbitration settlements or to act as mediators in jurisdictional conflicts. To further encourage low-cost means of settling disputes in financial and other transactions, magistrates should be empowered to act as arbitrators, on a personal basis and without encroaching on their regular duties. This would improve their status and enhance their social standing, giving them an opportunity to demonstrate their independence and wisdom. Until such time as the judicial system is strengthened, financial and economic operators should be encouraged to include arbitration clauses in their contracts and to favor recourse to arbitrators selected locally on the basis of their integrity and intellectual qualities. Establishment of an arbitration unit would help to relieve the Commercial Court and would facilitate the settlements frequently reached after protracted legal proceedings. Such settlements would then be more equitable, being the fruit of understanding rather than resignation.

3.26 Improving the settlement of disputes: A complete overhaul of the procedure for settlement of commercial disputes is required. This should entail: (a) a review of the composition of the Courts having jurisdiction in commercial matters; (b) better training and greater availability of basic documentation, law reports etc. The law should also encourage the parties (with the active participation in a conciliatory role of the judge himself, if necessary) to settle out of Court. Both procedural law and substantive provisions should promote this approach. A Small Claims Court should be set up to enable small enterprises settling their disputes in a more informal, flexible and cheaper manner. In addition, commercial arbitration should be developed preferably on a regional basis (as all the Indian Ocean Commission (IOC) countries have a more or less common civil law system) and a pool of arbitrators could be set up to service the business community in the region. Law reporting is a must and possibilities for assistance should be explored in updating law reports and ensuring continuing future compilation and publication. Confidence in the system will also be enhanced by better training of personnel. In this area, a regional approach may again be appropriate. The IOC could be asked to set up a Centre de Formation du Personnel Judiciaire for countries of the region. In addition to better training, measures to safeguard the integrity and independence of judicial personnel must also be taken since lack of confidence in the legal system on the part of the business community is largely attributable to the perceived lack of such conditions.

3.27 Sequencing of legal reforms: Reforms of the legal system to facilitate financial and other transactions will require time for preparation and implementation. Steps to sensitize and inform economic operators and legal professionals should be undertaken in order to motivate them to ensure sound implementation of the renewed law. Pending this general revision, some preliminary measures could be taken to ensure as of now better certainty as to the law and swifter resolving of disputes. Based on their urgency, costs and complexity, two phases of legal reforms could be envisaged which could be initiated at the same time although with different horizons for implementation. In the first phase, based on the recommendations made above, the following reforms could be envisaged in the near term: (i) new method for fixing the legal rate of penalty interest; (ii) increasing to FMG 1 million the competence level without appeal and the procedure for injunctions to pay; (iii) equipping of court offices with an initial batch of word processors and photocopiers; (iv) easing of procedures for enforcement and court seizure of goods in dispute; (v) setting up a center for permanent training and exchanges between bankers and the legal professions; and (vi) developing of arbitration and conciliation. In the medium term, and in the context of studies already undertaken by the Ministry of Justice, the following areas of legal reform could be studied: (i) modernization of collective procedures; (ii) development of legal supports for new financial products; (iii) modernization and revision of company law and the Financial Code to permit generalized use of mortgages; and (iv) preparation of laws and procedures to protect consumer and savers.

Accounting, Auditing And Financial Disclosure

3.28 Importance of sound financial information: The accounting, auditing and financial disclosure requirements and practices of a country are important for creditors, shareholders and potential investors. The main weaknesses in this area in Madagascar have historically been the obsolescence of the accounting framework set by law and the poor quality and availability of records and information in general on companies. The first weakness has now been remedied by the introduction of a Plan Comptable national which is largely based on international practices. However the framework must be coupled with the adoption of standards, general and sectoral, which will be based on international standards with appropriate adaptations. The need for improved and harmonized disclosure requirements and access to information must be given urgent consideration not only because this will give a better overall view of the performance of the economy but also to assist banks and other lending agencies and potential investors. Indeed, if Madagascar is to attract investment in both existing and new enterprises, the record and prospects of the existing enterprises must be made available in a recognized and approved form. This is also an essential pre-condition for the development of a securities market in Madagascar. Trading in securities whether on a listed or unlisted market, can take place only if there is proper disclosure of information.

3.29 Appropriate financial information for banking operations: An accounting report designed for taxation purposes does not necessarily suit the requirements of a lending banker. Moreover, certain features require emphasis for particular enterprises. Such features may be pointed out and worked out with the benefit of hind sight. Nevertheless, it is important to bear in mind that the lending banker, in so far as he does not rely solely on the securities pledged in respect of an advance, will alternatively base the financing of transactions on his perception of a firm's evolving balance sheet and amounts. For this reason, the accounts to be supplied in respect of borrowing will require more frequent reporting than an account which is otherwise filed as a legal requirement. Lending banks should be able to use the account supplied by borrower customers to assess the level of risk being taken by them with particular advances. The account reporting form should enable them to form a sufficiently clear option on the future prospects of the business they are financing. Pre-emptive action would thus be envisaged to avoid a port folio deterioration of this is seen to be the case. Objective conduct of banking business on the lines of a good account reporting system would also help to avert interference by outsiders favoring certain advances which are clearly worthless at the cost of others which may have been directly beneficial to economic development. Bankers employ a whole array of evaluation of balance sheets, ratio and cash flow analysis in order to determine the viability of projects and their sustainability. Businesses' inability to provide the requisite accounting data on a timely basis would tend to counteract a move towards sound banking practice based on objective criteria. Failure to meet a required account reporting level would be retrograde and not much progress may be expected in terms of achieving the general levels of sound financial management in the Malagasy economy. To prevent litigation and better assess the risk and opportunity in lending, bankers would like to have reliable and clear balance sheets and operating accounts from their customers.

3.30 Recent progress and outstanding accounting issues: A modern accountancy law adapted to Madagascar's needs was passed in 1987 (Plan Comptable). Madagascar now has a modern code of accounts developed through broad consensus and involvement of the accounting profession, teachers and business groups. A number of companies have submitted their accounts in accordance with the new code. Efforts to disseminate the new code have been undertaken by local accounting firms. Still to be enacted are related changes in the Commercial Law Code, the "cursus" leading to the qualification "expert comptable." The sectoral code of accounts for banks, insurance, public works, etc. have yet to be drawn up. No new law with respect to auditing has been passed. The following proposals should be considered: (i) accounting standards be prescribed by law for different sectors of the economy (as has been done in Mauritius) and departure from such standards must be disclosed and justified; (ii) the revised company legislation must spell out in detail the information that has to be provided by promoters, directors and auditors and those acts which are subject to publicity requirements; (iii) the need to provide for compulsory auditing of accounts by approved auditors; (iv) the regular submission of returns to a Registrar of Companies who should lead which should monitor compliance with company law requirements on publicity, accounting and disclosure.

The Registrar will ensure public access to records. The law should however provide for the gradual (application) introduction of new provisions by initially exempting certain types of companies from the scope of the new law in view of their low turnover for example. Mandatory auditing requirements could be initially limited to major enterprises including all those which receive funds (equity or debt) from the public or any forms of financial assistance from the Government or from financial institutions. Small enterprises which essentially rely on their own funds could be exempted. In the same spirit, exemption requirements could be tailored along the lines of the tax code where a "regime forfaitaire" is applied to small or artisanal businesses.

3.31 Special provisions for microenterprises and SMEs: Since 1989 all tradespeople have been required to use the General Chart of Accounts instituted by Decree 87332 of September 17, 1987. This system is clearly too complex for small traders and artisans who cannot afford to employ professional accountants. It would be desirable to consider adopting a simplified chart of accounts, as has already been done in France where three such systems are in effect: the general chart, the more complex version for big enterprises, and the simple form for small and medium enterprises (SMEs). Madagascar could also do as France has done and set up approved management centers, to facilitate bookkeeping for small and medium enterprises and training in accounting for their managers. To reduce the cost of disputes, the system of court fees collected by the clerk to the court or registration fees could be abolished to facilitate access by individuals and traders to justice and save the trouble and cost of keeping small but complex accounts.

3.32 Role of auditors: No system of account reporting is complete unless it is backed by auditors who are independent of the management of the borrowing unit. Auditors are required essentially for the reason that they should be able to form an opinion on the system of accounts being prepared. This opinion should be given free of any constraints and auditors should be satisfied that the accounts do give a true and fair view of the state of affairs of the party whose accounts have been drawn up. It is the job of the auditor to point out any material information pertaining to the accounts which, if not explicitly stated by them, could lead to misleading conclusions on the accounts being presented. Unless, the auditing practice is exceptionally strong, legal provisions may have to be inserted (e.g in the banking law) protecting auditors in the execution of their duties with impartiality and objectivity.

3.33 Auditing certification: In particular, auditors vouch that all material balances exist, are complete and fairly stated at the balance sheet date. They should ensure that all income and expenditure, gains and losses are properly accounted for. They should also state that all material liabilities, and commitments, contingent or otherwise, have been identified, provided for or adequately disclosed in the accounting statements. While an auditor's certificate would not be called for frequently in the case of accounts which are seen to be regular and unproblematic, that should be the case specially where banks are doubtful of recovery on certain debts. The auditing burden would thus increase directly in proportion to degree of insecurity and risk implied by accounts.

3.34 Increased harmonization with international practices: There is a worldwide movement toward standard auditing practices. The Malagasy system will sooner or later have to join the mainstream of this evolving situation which calls for a greater level of dialogue among accountants, management and auditors and for greater disclosure on the accounts of individual concerns. This worldwide trend is partly driven by the speed of evolution of the international payments system and the consequent needs for harmonized accounting systems. To the extent that Madagascar seek greater integration in world markets, it too has to move in the same direction towards greater harmonization of its accounting system with international standards and practices. This will be especially challenging given past weaknesses in the accounting system which to some extent underlay the accumulation of bad debts within the banking system in the mid-1980s. Given the existing gap between Malagasy and international accounting practices, the recent restructuring of the banking system should now be complemented by an accelerated drive to harmonize the Malagasy accounting system with international standards thereby lending transparency and clarity to presentation of accounts. If the new 1987 accounting plan is fully applied, such harmonization could be assured.

3.35 Strengthening the accountancy profession: No system of accounting and auditing requirements can work without qualified accountants. Madagascar does have a small number of qualified accounting firms and personnel. An accountancy training institution (INSCAE) produces graduates with a practically oriented training up to the master's level; in addition, several other accountants have been trained abroad. However, the Government has yet to issue the new text regulating entrance into the accountancy profession, which has been under discussion for five years. Without this text, existing firms are in an oligopolistic position and would themselves been unable to meet the demand for auditors which will follow full implementation of the Plan Comptable and related texts. It is essential for further financial sector development in Madagascar that this text be issued as soon as possible.

The Domestic Payments System

3.36 Role of the domestic payments system: In addition to financial intermediation, one of the essential services that the financial system usually provides to the economy of a country is the facilitation of payments and transfers among various economic agents. Figure 3.1 below depicts the flows of goods, services and money among economic agents as a result of various economic transactions. Households sell labor and capital services to businesses for money; people spend part of this money on goods produced by businesses; businesses get money for goods sold to the Government and also makes tax payments; and households also receive payments and transfers from the Government and also make tax payments. In a market economy it is important that these transactions are carried through as efficiently as possible for the economy and the country to develop. The most suited intermediaries to improve the efficiency of the payment systems are the banks and other financial institutions, by means of using instruments such as checks, money transfers and credit cards in addition to cash.

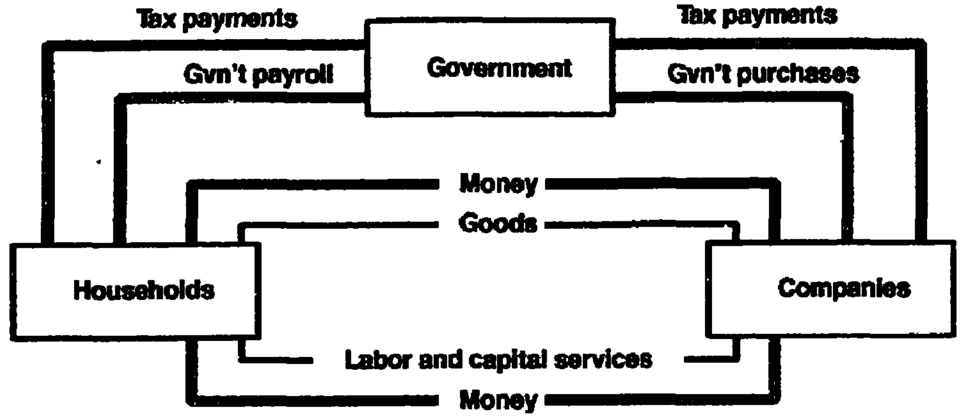
3.37 Structure of domestic payments system: There are three basic elements within the existing domestic payments and transfer system in Madagascar:

- a system of inter-bank payments among the four commercial banks and the postal checking and savings system operating through a clearinghouse in the capital and fifteen clearinghouses outside the capital;

- inter-branch payments within individual commercial banks and within the postal savings and checking system; and

- government payments and transfers to and from the Treasury. The operations of these elements of the system are described in detail in Annex 3.1.

Fig. 3.1 Flows of goods, services and money in the domestic payments system



▬▬ **Financial transactions (cash, checks, money orders, etc)**
—— **Real sector economic transactions**

3.38 **Evaluating the performance of the domestic payments system: The performance of the domestic payments system in Madagascar, as elsewhere, can be evaluated according to four criteria that are reviewed below:**

speed - the clearing should be done swiftly and not take more than three days, no matter if the checks/transfers are presented in a local clearinghouse area or in another area;

availability - the customer should be able to cash a check without circumstantial procedures in his local bank's branch, as well as when presenting the check in other banks' branches, and it should be possible to cash checks received as payments at the receiver's bank's branch without sending them for collection;

accuracy - possible errors should be reduced to a minimum and easy to detect (eg. bouncing checks, wrong accounts being debited, lost checks in transit); cashed checks should not be in transit for more than a few days before the account is actually debited, so as to receive updated balances;

acceptance - the checks should be generally accepted as a means of payments.

3.39 **Speed of domestic payments and transfers: One of the most obvious problems with the present domestic payment system is the long time for money to be transferred and before the payee is credited, particularly when cashing an inter-branch or out-of-town check. The main reason**

for this are communication problems among various parts of the vast territory that constitutes Madagascar. This is exemplified both by transportation problems, as during the rainy season large parts of the country can only be reached by airplane or by sea, and by telecommunication problems reflected in the poor quality of telex and telephone services. Poor communications makes it difficult to easily verify sufficient funds on the accounts and that the person signing the check is authorized to do so. The most viable sign of the inefficiency (slack) in the present clearing and transfer system is the exceedingly long time it takes for money to be transferred from one place to another. It can be measured in days, but, a more useful illustration to the inefficiency observed would be to quantify how much recipients of funds lose through these delays in monetary terms. An estimate based on empirical examination of the existing clearing and transfer system and a number of conservative assumptions indicates that through these delays recipients of funds collectively incur an opportunity cost equivalent to at least 1.2 per cent of GDP (see Annex 3.2 for detailed calculations and interpretation). Automatic transfers and automatic deductions from accounts are in use to help speed certain transactions. However, apparently there are no "guidelines" as to how many days in advance a payor has to make the money accessible to the bank, resulting in the bank not having any possibility to benefit from this cash-flow which could help defray the costs of this payments mechanism.

3.40 Role of postal checking: Although the postal checking system (which operates like the giro payments systems found in many countries) functions relatively well, it is still time consuming, cumbersome and can not be used as general payment mechanism for retailers. Only half of the approximately 45,000 accounts in the CCP at the end of 1990 were considered to be active. About 96% of the funds within the postal checking system are related to public sector transactions. The Government holds about 15% of its deposits in the CCP. Deposits from individuals were equivalent to less than 1.5% of personal checking deposits in the banking system. Individuals with CCP accounts are essentially civil servants who work in localities without any commercial bank branches or with an insufficient minimum deposit for a bank account. However, the individuals with CCP accounts represent less than 10% of all civil service and military personnel. Despite its relatively insignificant role in payments among individuals, the CCP has tremendous potential to operate as a major payments mechanism by acting as a "girobank" (see Annex 3.5).

3.41 Availability, accuracy and acceptance of the payments system: The present payments systems does not allow the check account holder to easily get his money, unless he goes into his local bank's branch where he has his account. Checks can only be cashed at drawee bank, otherwise they have to be sent for collection. The present clearing system, especially between different clearing house areas, and clearing between different branch offices of the same bank, result in checks being in transit for sometimes up to a month, thus not enabling either the bank or the customer to get an updated balance on his account. The long time-lags also make it more difficult to possibly detect any errors - for example, when documents in transit clearing disappear, it is difficult to find out what has disappeared and where. While checks are fairly widely used by the larger companies and the Treasury, and by individuals as payment of some bills, there is a lack of confidence for checks as a means of payment for cash payments among a majority of tradespeople and others. For them, checks are inconvenient in respect to long clearing, uncertainty of the identity of the customer and sufficient funds. Other reasons are probably a result of the banks not marketing their products properly and lack of financial knowledge amongst the people. Certain measures have already been taken to improve the acceptance for checks as a means of payments including the introduction by some banks of local currency travellers' checks. However, while such solutions mitigate the problem of providing alternatives to cash as a means of payment, they do not solve the problem of confidence in paper instruments since customers have to pay in advance for these type of travellers' checks.

3.42 <u>Improving the clearing and settlement system</u>: The present system of clearing payments in Madagascar is essentially a document clearing system which is dependent on physical transport of documents and therefore on existing mail and transport systems. Such systems are not likely to be substantially improved in the foreseeable future to an extent which would make it easily to clear documents within three days. An alternative clearing system would be one where the information of the document is exchanged, and not the physical document, and would be based on telecommunication. Although this alternative requires high-quality telecommunications to function efficiently, it is possible to begin to develop such a system even with the relatively lower quality of telecommunications currently available in Madagascar. A proposal for such an information clearing system is described in Annex 3.3 based on a decentralized regional clearing system. A clearing system should, in order to minimize errors, be integrated as well as automatically reconciled. Integration means capturing of data only once at the collecting/cashing branch to be used subsequently throughout the system. Any errors should be easily detected and corrected. Information clearing means that signature verification at drawee branch will not be possible and will, consequently, affect the design of the check system.

3.43 <u>Improving the design of the personal check system</u>: To help improve the clearing and settlement system as described above, the Malagasy payments system must move away from the present reliance on checks based on manual verification and restrictions. Private checks should be based on personalized check forms, designed and produced to make forgeries practically impossible. This entails a check guarantee card (standard ISO plastic card) of falsification-proof quality and signed by the account holder connected to the account, for identification of the account-holder and verification of signature. This system for protection of checks would make it possible for retailers to accept personal checks, and to make it safe for a branch to honor checks drawn on other branches and banks. Protection is carried out by calling drawee branch, where the request is notified. Too many requests for protection will cause inconvenience to the customer, and to the bank, by overloading system capacity. To avoid that happening, drawee bank should guarantee payment of smaller checks, up to a fixed amount, without protection. A check service segmented into one type of checks guaranteed by drawee bank and issued to reliable customers only, and another always demanding for protection of the check ought to be considered. (Details of specifications is described in Annex 3.4.) Other measures to improve check service for private customers are an automatic teller machine, "ATM", service at drawee branch using a check guarantee card and PIN code, and a new service for regular payments. Initially, the ATM service should only be used at drawee branch and not intrabranch or interbank withdrawals. The new service for regular payments could be accomplished through the customers writing a list with payment orders and handing that list and a check to the bank. This would shift some of the workload to the bank's back-office and unload the front-office, enabling them to deal with other matters.

3.44 <u>Improving corporate check design and verification</u>: Security of company checks should be the same as for private checks to make forgeries practically impossible. All checks should be crossed (barré) and no signature control would be necessary. The crossed checks ought not really be of any inconvenience to the payees, since they are likely to be other corporate suppliers. The payor bank could for instance send transaction lists to the respective companies every day, for the clients to control all cashed checks being correct and no false ones being in circulation. To restore checks to their normal place, a computerized system should be set up capable of posting the relevant data and numbers of lost or stolen checks within one hour of their loss or theft being reported. The same system should also post, within one day, the account numbers and other data concerning persons or organizations that write checks without funds to cover them. Tradespeople accepting checks should be able to consult this computerized record system, after paying the fee for its services, to verify that the person writing the check has not been prohibited from using checks or caught writing bad checks, without waiting for them to be formally convicted should they be taken into court.

3.45 Need for an improved payments and transfer system: A more efficient payment system would facilitate and promote trade between different areas in the country, and also to a certain extent within local areas. Improvements in the domestic payments system would help integrate the fragmented structure of domestic markets in Madagascar and exploit the significant inter-sectoral multiplier effects within the economy notably through stronger linkages between urban and rural economic agents. In the longer run, such improvements are also likely to favor external trade by reducing domestic obstacles to settling payments obligations and by increasing liquidity. To proceed with improvements in a systematic way with close collaboration between Government and financial institutions, a three-prong process is outlined below which would enhance the security and use of checks as payments instruments, increase the efficiency of the present clearinghouse system and develop a girobank-based payments system as a complement to the existing check-based payments system.

3.46 Enhancing check security and use: A new and revamped professional bankers' association (see Chapter 4 for suggestions in this area) should take the lead in designing new standards for checks, including minimum requirements for its security printing layout as for identification of account holders when checks are cashed. This should possibly include the issue of a check guarantee card by banks to its trusted account holders. Once the standard is agreed upon and in place, the banks should be prepared to sign an agreement of limited indemnification whereby checks (up to a certain amount) as payments instruments would be accepted as "good cash" when presented in any bank and provided that the standard procedures are followed by the casing bank. This procedure could with preference be extended to other financial actors than banks such as stores, supplier and others as long as there is a standardized practice to be followed. With these changes, checks as payment instruments would over time be widely accepted and thereby facilitate easy and safe transactions in trade-related matters. It would transfer responsibility of customer behavior to the bank handling the account instead of the financial agent accepting the check as payment. This will in turn make banks more judicious in issuing checking accounts in the short run but would in the long run also have a disciplining effect on general customer behavior. The phenomenon of bounced checks would then be reduced to a relatively insignificant amount.

3.47 Increasing the efficiency of clearinghouse operations: Once the new standards and practices for check use have been implemented, it would be appropriate to consider an information-based clearing system to avoid the physical transportation of documents (see Annex 3.3). This telecommunications-based system could be implemented gradually and initially in areas where telecommunications is of acceptable standard. Since such areas are likely to be where most transactions are conducted, the new clearing system could have a major impact in terms of volume of transactions covered right from the beginning.

3.48 Developing a girobank-based payments system: Alongside the improvements in the check system, studies should commence for a girobank-based payments system (see Annex 3.5 for details). This would be an alternative or complement to the existing check-based payments system which in Madagascar as in other countries has handling costs that tend to rise beyond certain relatively low volumes. Developing such a system in Madagascar should be considered in the context of revamping the existing postal checking system which already acts like a giro system and restructuring of the postal savings system (see Chapter 6).

3.49 Creating a payments information center: When the new check standards are in place and communication systems implemented for a new clearinghouse system, a payments information center could be set up through the active involvement of all banks. The government could have a catalytic role as well as be a minority partner in such a center which would gather and maintain information about individuals and companies who are not able to manage check accounts or otherwise fulfill financial obligation undertaken.When banks consider opening new accounts, verification should be made from this preferably computerized register to prevent misuse of banking facilities and trust by unscrupulous individuals or institutions. As the banking system grows in Madagascar and as more accounts are opened, such a facility will become increasingly important.

3.50 Role of government in payments system: The role of the Government in improving the payments system as described above severalfold. First, Government should, at least initially, play the major catalytic or leadership role in ensuring that the various necessary studies are undertaken to implement the above proposals. Second, as a result of these studies, the Government should initiate any legal changes required governing the payments system and payments instruments. Third, BCRM should make the necessary changes in the practices of the clearinghouse system to facilitate local clearing and introduction of an information-based clearing system. This would also require the cooperation of other Government departments notably the telecommunications authority. Finally, BCRM should ensure that any payments information center that is established follows certain rules regarding its ethics, secrecy and integrity and that it is not abused. All three elements of the payments system development strategy proposed above would also entail programs to increase financial knowledge amongst the population to make them aware of the benefits of banking and check accounts such as safety, convenience and access to financial services. This could be done through savings campaigns jointly promoted by financial institutions and the Government.

The External Payments System

3.51 Role of external payments and transfer system: Just as for the domestic payments and transfer system, an external payment system is important to facilitate imports and exports as well as investment flows and transfers from abroad. The salient feature of the present Malagasy external payments system is the restrictions on any institution other than the Central Bank to deal in foreign currencies. As Madagascar seeks to expand its trade and investment flows in the coming years, there will be occasion to progressively decentralize this present system of external payments and foreign exchange management (see Chapter 7). The detailed workings of the present system of payments and transfers to and from abroad are described in Annex 3.6. The payment system should be characterized by speed, availability, accuracy and acceptance which are evaluated below.

3.52 Evaluation of the external payments system: The general opinion among the banks, appears to be that payments are for the most part handled rather efficiently. This observation is made apart from the facts that the BCRM has to be involved in that only once a week purchase orders for import transactions can be sent to the BCRM. Furthermore, given that the FMG is not convertible, the present system is time consuming. There are sometimes unnecessary delays in transactions where money is arriving from abroad to one bank to a payee who is client in another bank. In such a transaction, the transfer is not forwarded immediately but is handled slightly different between the banks without any agreement between them on how to deal with such transactions. There is also a need to upgrade the telecommunications infrastructure in order to improve the trade finance possibilities for importers and exporters in Madagascar. It is important that the banks have sufficient resources to meet the credit requirements of importers and exporters adequately, on terms which will enable them to compete in world markets.The presence of Free Trade Enterprises is one way to stimulate capital flows from abroad and to facilitate trade. Presently, there is no possibility for companies or banks to hedge or secure its foreign exchange need, since the companies always receive the exchange rate as of the notification day in an export transaction or application day in an import transaction. Thus, the importer and exporter stands the currency risk through the whole transaction. Delays in external payment system does not only seem to depend on whether the transaction is forwarded by mail or telex, but also to a certain extent which other country is involved and how well established the contact is between the corresponding bank and the domestic one. It appears that most transactions with France and the banks' correspondents there are handled more efficiently than transactions with other countries, such as in North America. However, there is scope for improvement when the SWIFT system is implemented.

3.53 The need and scope for decentralized foreign exchange management: In order to make the external payment system more convenient and reliable, it is necessary to decentralize the management of foreign currency transactions to the banks, and not have all the transactions centralized to the BCRM. However, it is important that any decentralization and deregulation should be done with the utmost care, and slowly step by step. When implementing decentralization and deregulation, it is important that a monitoring system be installed in the BCRM. Most Malagasy banks appear to be well prepared for some degree of deregulation of the currency restrictions and decentralization of the foreign exchange trade. Before the commercial banks were nationalized in 1975, they were allowed to have foreign exchange accounts. There therefore is likely to still be some knowledge with the banking system concerning management of foreign currency. Furthermore, since the first quarter of 1991, there are three banks with foreign shareholdings, which implies that even if the banks themselves do not have the required expertise to deal with foreign exchange, such skills are easily accessible.

3.54 Options for progressive decentralization and deregulation: One step towards a deregulated currency market could be to give banks possibility to only buy or sell the net amount needed in foreign currency, instead of having to buy and sell foreign currencies to and from the BCRM on a gross transactions basis. In this way, instead of import applications taking two days, when sent to the BCRM once a week, and export transactions taking three days, all transactions could be dealt with in two days. Another step could be to license the banks to become "currency banks," i.e., authorize them to deal in foreign currencies. This should be linked to certain conditions, such as, the banks having to prove they have the capacity and knowledge deal in foreign currencies. Furthermore, allowing the banks to hold (limited) accounts in foreign currencies requires an improved reporting system to the BCRM and is thus tied to overall improvement in prudential supervision and regulation. In addition to allowing the banks to deal in foreign currencies on the spot market, they could be allowed to operate in the forward exchange market in order to hedge against currency risks. The dealing in currencies should be focused on customer service, and it is important to point out, the banks should not initially be allowed to use more sophisticated hedging instruments such as currency-swaps and options which also places additional strain on the limited supervision capacity on the BCRM. An authorization for the banks should enable the companies to receive documentary credits. Not only the bank's head office should be allowed to give those documentary credits but also the regional offices (but not all the local offices). These regional offices would then report their transactions to the central foreign exchange department with the bank, which would report to the BCRM. Another way to improve external payments could be to authorize the banks to issue checks in major foreign currencies. In a deregulated and decentralized market, it is important for the banks to open up corresponding accounts with banks connected to the SWIFT system and thus eliminate unnecessary delays. It is also important for banks to agree on how different transactions should be dealt with, such as when money is arriving from abroad to a client of another bank, in order to avoid delays.

CHAPTER 4

PROMOTING THE EFFICIENCY OF BANKING INSTITUTIONS

4.1 Commercial banks are likely to continue to represent the preponderant segment of the financial system in Madagascar throughout the 1990s in terms of their share of funds mobilized and resources allocated by the financial system. This chapter analyzes the recent evolution of the banking system in Madagascar, with an emphasis on the efforts undertaken by the Government during the past few years and challenges which remain to promote the sector's efficiency. The chapter first reviews key banking developments since 1975, focussing on changes in ownership structure, and quality of loan portfolios and on the current distribution among banks of branches, staff, assets, deposits and capital. Subsequently, the chapter analyzes the main operational features of the banking system since 1987 and in particular the evolution and funding of bank assets, the sectoral distribution of credit and bank liquidity. Third, the chapter assesses the overall performance of the banking system since the advent of private banking in 1989 and examines bank interest margins, profitability and costs of intermediation. Fourth, the chapter looks at challenges that lie ahead to further develop efficient banking in Madagascar. Finally, the chapter examines needs for regulation and supervision in a market-oriented economy.

Banking Developments Since 1975

4.2 Nationalization and Mergers. Banking in Madagascar dates back to 1886 when the Comptoir National d'Escompte de Paris opened an office in Antananarivo. Madagascar's modern banking history however can be dated from the June 1975 nationalization of the banking system, which then consisted of a central bank, four private commercial banks (with significant foreign participation) and one development bank. By January 1977, the five banks were restructured into three commercial banks with the intention of specializing each in a major sector of the economy: agriculture, industry and commerce. In December 1976, the National Bank for Industry (BNI) was created, by merging the industrial component of the Banque Nationale Malgache pour le Developpement (BNM) with the Banque pour le Commerce et l'Industrie de Madagascar (BCIM). A few days later, the agricultural component of BNM was merged with the Banque Malgache d'Escompte et de Credit (BAMES) to form the National Bank for Rural Development (BTM). Finally, by mid-January 1977, the two remaining commercial banks, Banque Commerciale de Madagascar (BCM) and Banque Financiere et Commerciale Malgache (BFCM), were merged to form the Bank of Commerce (BFV). All three banks were 100 percent state-owned, either directly by the Government alone (BFV), or through the participation of other government institutions.[1]

4.3 Growth of Bank Credit. The ten years following the nationalization of banks were characterized by a rapid increase in the economy's domestic credit. During the first half of this period (end 1975-end 1980) domestic credit quadrupled, with 64 percent of the credit expansion accounted by the increase in the Central Bank's net lending to the central Government. This was largely due to the Government's "all-out" public investment program, which resulted in growing budget deficits. The second half of the period (end 1980-end 1985) witnessed a significant slowing down in the rate of average annual expansion of domestic credit from 32 to 19 percent, and a decrease in the central Government's share in the credit expansion from 64 to 51 percent. These

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1/ The state acquired 90 percent of the share capital of BTM (with the remaining 10 percent held by the Central Bank), and 56.77 percent of BNI. The other shareholders in BNI were the Central Bank (6.67 percent) the Social Security Fund (19.90 percent) and two state-owned insurance companies (8.33 percent each).

developments were the result of the measures aimed at financial stabilization through demand management that were initiated by the Government in mid-1980 and reinforced after 1982.

4.4 Deteriorating Loan Portfolios. The Treasury did not involve the state-owned commercial banks in the financing of its 1978-1980 investment program. However, the commercial banks quickly became heavily engaged in extending short-term credit to the nationalized and newly-created public enterprises. By the end of 1985, about 48 percent of outstanding gross loans of commercial banks were to public enterprises. Since many public enterprises were financially not viable, they had limited ability to repay their commercial banks loans. Their problems were compounded from 1983 onwards, by the Treasury's inability to maintain subsidies and grants to them, in the context of its financial stabilization programs. The outcome was a significant increase in the arrears of the public enterprises, and a serious deterioration in the quality of the banks' loan portfolios.

4.5 Risk Classification and Loan Provisioning. It was not until 1985 that the Central Bank set up criteria for classifying bank borrowers according to their degree of risk,[2] although it did not define clear-cut rules on such matters as the treatment of consortium credits, accrual of interest on doubtful loans and write-offs. Available information indicated that the quality of the banks' loan portfolios deteriorated significantly after 1984, with doubtful loans (that is loans included in categories C and D) accounting for 40 percent of the gross loans at the end of 1985, as compared to less than 27 percent a year earlier. While the banks substantially increased their loan loss provisions in 1985, total provisions were still equivalent to less than 20 percent of gross loans and 49 percent of doubtful loans at year-end (see Table 4.1).

2/ Banks were asked to classify their loans into the following four categories (after taking into account the collateral offered by the borrowers): category A comprises the least risky loans ("minimum risk") because they are functioning normally with no arrears; category B comprises loans "to be watched" because they are encountering some liquidity or profitability problems and hence are sometimes behind in their loan repayments; category C comprises loans with "probable risk", because they are encountering serious operational difficulties and, at the same time, do not provide adequate collateral; and category D comprises loans with "definite risk" that will entail partial or total loan losses.

Table 4.1
Deterioration in the Quality of Commercial Banks' Loan Portfolios
(in billions of FMG)

	End 1984	End 1985	End 1986
Gross Loans Outstanding	316.0	386.8	438.7
Doubtful Loans	85.1	154.9	173.9
Provisions for doubtful loans	46.4	75.3	89.9
Net Loans Outstanding	269.6	311.5	348.8
Ratios (%)			
Doubtful Loans/Gross Loans	26.9	40.1	39.6
Provisions/Gross Loans	14.7	19.5	20.5
Provisions/Doubtful Loans	54.6	48.6	51.7

Source: C.I.F.P.B., Etude du Secteur Financier de Madagascar: Rapport de Synthese, 1988.

4.6 **Revaluation of Fixed Assets**. By the end of 1986, the non-performing loan portfolios of the banks were established at FMG 174 billion, while their loan loss provisions totalled FMG 90 billion. Although provisions had increased as a percentage of gross loans between 1984 and 1986, they were clearly inadequate to meet eventual loan losses. Given that the combined capital plus reserves of the three banks was only FMG 29 billion at the end of 1986, it became evident that if the banks were required to take additional loan loss provisions equivalent to 7 percent of their gross loans outstanding, they would become technically insolvent. Consequently, the Central Bank instructed the banks early in 1988 to revalue their fixed assets and incorporate the revaluation reserves in their 1987 accounts.3/ As shown in Table 4.2, the combined net fixed assets of the banks stood at less than FMG 8.7 billion at the end of 1986, while the increase in valuations of 1987 totalled FMG 41.6 billion, thereby substantially increasing the banks' non-callable reserves.

Table 4.2: Revaluations of Fixed Assets of Commercial Banks (in millions of FMG)

	Fixed Assets (net) End 1986	Land (1987)	Buildings and other Fixed Assets (1987)	Total Fixed Assets (1987)
BTM	3,509	997	19,204	20,201
BNI	3,3376	1,239	9,883	11,122
BFV	1,783	612	9,674	10,286
Total	8,668	2,848	38,761	41,609

Source: Annual Reports of individual banks.

3/ Banks were instructed not to consider the revaluations as profits, but to record them as non-callable reserves.

4.7 Cleaning-Up of Loan Portfolios. Following the instructions received from the Central Bank in March 1988, the banks proceeded to clean up their loan portfolios. The 1989 certified accounts of the three banks showed cumulative write-offs of FMG 112 billion in loans and off-balance sheet commitments. The banks relied primarily on their internal resources in financing the cleaning-up operations. As shown in Table 4.3, the amounts written-off were financed by the drawing on the provisions for bad loans (65 percent) and the revaluation reserves (16 percent), with the remaining 19 percent covered by interest free loans from the Treasury.[4/]

Table 4.3

Cleaning-Up of the Commercial Banks' Loan Portfolios
(in millions of FMG)

Bank	Loans Taken Out* of Portfolios	Loan Loss Provisions	Interest Free Loans (Treasury/CCCE)	Revaluation Reserves
BFV	44,403	37,824**	6,579	-
BNI	37,394	30,994	6,400***	-
BTM	30,020	4,452	7,755	17,813
Total	111,817	73,270	20,734	17,813

* Including small amounts of off-balance sheet commitments.
** Including provisions for accrued interest reported separately.
*** It is not clear whether this amount is to be repaid, or considered as a grant.

Source: Information obtained from individual banks.

4.8 Improvement in Loan Portfolios. As a result of this cleaning-up process, the quality of the banks' loan portfolios improved significantly. At the end of 1989, less than 15 percent of the banks' loan portfolios was considered doubtful (as compared to 40 percent at the end of 1986) and loan loss provisions were equivalent to 84 percent of the doubtful loans, as compared to less than 52 percent three years earlier (see Table 4.4).

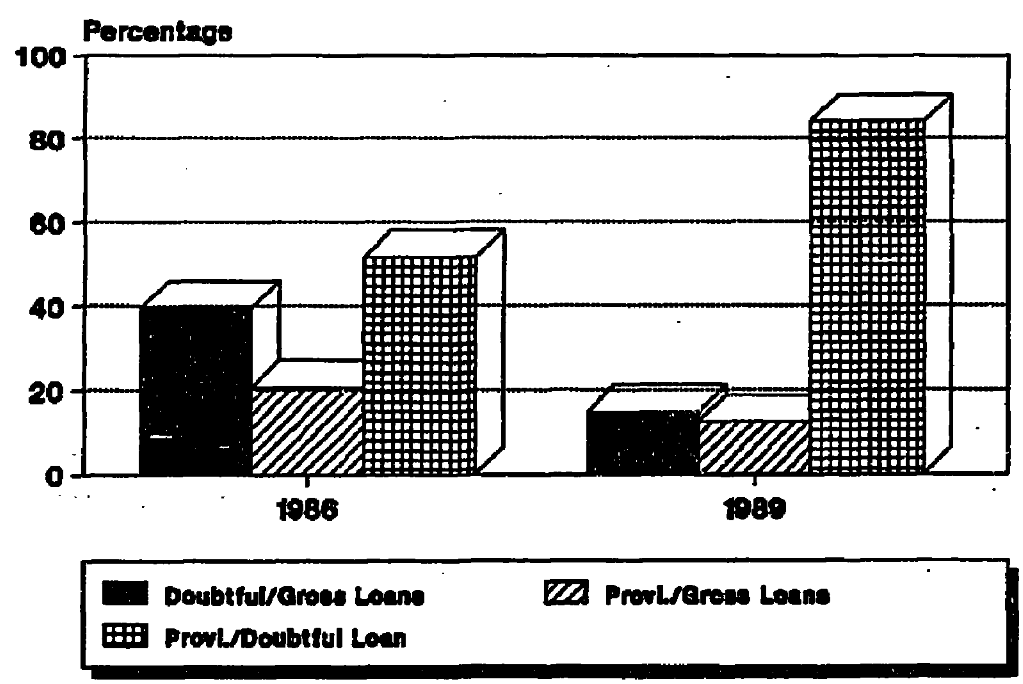
4/ The Treasury used the French CCCE-PCAS counterpart funds to cover the interest-free loans extended to BTM and BFV which are to be repaid out of the recoveries from the delinquent borrowers. By the end of 1990, BTM's repayments to the Treasury totalled FMG 2,337 million, while those of BFV totalled MGF 2,130 million.

Table 4.4
Effects of the Cleaning-Up of the Loan Portfolios
(in billions of FMG)

	End 1986	End 1989
Gross Loans Outstanding	438.7	627.3
Doubtful Loans	173.9	91.9
Provisions for Doubtful Loans	89.9	77.3
Net Loans Outstanding	348.8	550.0
Ratios(%)		
Doubtful Loans/Gross Loans	39.6	14.7
Provisions/Gross Loans	20.5	12.3
Provisions/Doubtful Loans	51.7	84.1

Source: Information obtained from the individual banks.

Figure 4.1: Effects of Portfolio CleanUp



Source: Information obtained from banks

4.9 **Introduction of Private Banking.** The enactment of a new Banking Law in May 1988 paved the way for the privatization of the banking sector, by allowing the private sector (both local and foreign) to establish new banking institutions or participate in the capital of existing ones. Subsequently, in October 1988, the Banque Nationale de Paris Intercontinentale (BNPI) reached an agreement with the Malagasy Government to establish a commercial bank, which was named Banque

Malgache de l'Ocean Indien (BMOI). The new bank, which is managed by BNPI and controlled by two foreign banking institutions,[5] started operations in August 1989. In addition, 1991 saw the establishment of representative offices in Madagascar of two foreign banks - the Mauritius Commercial Bank and Banque Francaise du Commerce Extérieur.

4.10 Divestiture of Government Shareholdings. The first quarter of 1991 witnessed a substantial reduction in the Malagasy Government's ownership in the banking sector. On February 20, 1991, a leading French bank, the Credit Lyonnais (CL) acquired from the Malagasy state 51 percent of the shares of BNI, and assumed the management of the institution. On March 1, 1991, the French subsidiary of a leading Italian bank, l'Instituto Bancario San Paolo di Torino (IBSF), acquired a minority participation in BFV, buying 22 percent of the share capital which was increased from FMG 3 to 6 billion. While these developments still leave significant state ownership in the banking system, only one of the four existing banks - BTM -remains under the full ownership and control of the Malagasy state.

4.11 Current Structure and Market Shares. At the end of 1990, the present banking system comprising four banks, together operated 83 branches and 35 offices, employed a staff of 4,300 and had assets approaching FMG 1,200 billion. The level of total assets per employee, equivalent to FMG 279 million (or roughly US$169 thousand) in 1990, is very low by international standards, and is even below the prevailing average for African countries which amounted to US$224 thousand in 1989. As shown in Table A.1, Madagascar ranked 27th out of 35 sub-Saharan African countries with respect to the level of commercial bank assets per employee. This suggests the scope for the banking system as a whole to improve its employee productivity. The share of each of the four banks in total assets, gross loans, outstanding custom deposits and shareholders' funds as of end October 1990 is shown in Table 4.5.

Table 4.5
Branch Network, Staff and Market Shares of Malagasy Banks in 1990

	BNI	BTM	BFV	BMOI	83Total
Number of branches	16	48	17	2	35
Number of offices	6	19	10	-	4,300
Number of staff	1,130	1,680	1,350	140	
Market Shares*					
Assets	36.0	36.1	21.3	6.6	100.0
Gross Loans	34.8	35.7	21.0	8.5	100.0
Customer Deposits	29.8	35.4	24.5	10.3	100.0
Shareholders' Funds	38.4	35.0	23.2	3.4	100.0

* As of end October 1990.

Source: Information obtained from the individual banks.

5/ Each one of the two foreign banking institutions, BNPI and SFOM (Societé Financiere d'Outre-Mer) holds 37.5 percent of the share capital, while the remaining shares are held by around 300 private Malagasy investors.

Main Operating Features of the Banking System Since 1987

4.12 The aggregation of the assets and liabilities of the commercial banks is undertaken by the Central Bank for the purposes of the monetary survey. As such, the balance sheets presented in Table A.2 are designed to highlight such variables as liquid assets in local currency, net external assets, net claims on government, gross credits to the economy, customer deposits and other domestic liabilities. A review of the aggregate balance sheets for the period 1987-1990 brings out a number of salient features, developments and trends reviewed below.

4.13 Growth of banking assets: Reflecting the recent growth of the economy,[6] aggregate commercial bank assets increased from FMG 742 billion at the end of 1987 to FMG 1,064 billion by the end of 1989, an increase of 43.4 percent (see Table A.2). Average total assets of commercial banks during 1989 were equivalent to 23.5 percent of GDP at market prices (as compared to 22.6 percent during 1988), reflecting a slight deepening of the banking system. However, there was a slowing down in the rate of growth of bank assets in 1990. During the first ten months of the year, total bank assets increased at an annualized rate of 10.6 percent, barely exceeding the estimated rate of inflation (10 percent).

4.14 Government's Net Creditor Position. Unlike public enterprises, the Government has traditionally been a net creditor to the banking system with its deposits accounting for 9-12 percent of total commercial bank deposits. Bank financing to the Treasury has essentially been limited to holdings of a small volume of government securities. At the end of 1988, the Government's net creditor position amounted to FMG 47 billion. However, as a result of the banks' subscription to FMG 62 billion in Treasury bills during 1989, the Government's net creditor position dwindled to FMG 10 billion by the end of 1989. Following a 19 percent increase in its deposits with banks during 1990, the government creditor position improved to FMG 30 billion by the end of October 1990 (see Table 4.6).

Table 4.6
Government's Net Creditor Position with Banks
(in millions of FMG)

End	Claims on Government	Due to Government	Government's Net Creditor Position
1987	10,654	61,656	51,002
1988	15,042	62,246	47,384
1989	78,645	89,057	10,412
1990 (October)	30,399	110,420	30,021

Source: Central Bank of Madagascar.

4.15 Increased Lending to Private Sector. As shown in Table 4.9, there has not been much variation in recent years in the shares of the various sectors in total credits. The industrial sector is

6/ Between 1987 and 1989, GDP increased by 47.0 percent in money terms and by 8.9 percent in real terms (at constant 1984 prices).

the recipient of more than one-half of the credits extended by the banks, with the agricultural sector accounting for roughly one-sixth and the services sector (mainly commerce) accounting for less than one-fourth. The last three years have, however, witnessed a significant shift in lending from the public to the private sectors. With the banks' tightening of credit to loss-making public enterprises, more resources became available for lending to the private sector. Consequently, the share of the private sector in total credits extended by the banks rose steadily from 52 percent at the end of 1987 to about 74 percent by end October 1990 (see below).

4.16 High Loans to Deposits Ratio. At least since their nationalization, Malagasy banks have operated with a high ratio of loans to deposits. At the end of 1987, gross loans exceeded total deposits by 22.3 percent. With deposits increasing at a faster rate than loans between 1987 and 1989, the ratio of loans to deposits fell to 90.4 percent. However, with the slowing down in the rate of increase in deposits during 1990, the trend was reversed: by the end of October 1990 the ratio had risen to 98.6 percent (see below). These high ratios are explained by at least three factors. First, banks have relied on external sources -- mainly foreign donors -- to fund part of their term loans. Second, banks had until recently practically no investment opportunities to channel their surplus funds, aside from the segment of the money market that is managed by the Central Bank.7/ Third, until recently, banks needed to increase earnings from new loans given the high ratio of non-performing loans in their portfolios.

Table 4.7

Ratio of Loans to Deposits

END	Gross Loans* (billions of FMG)	Deposits** (billions of FMG)	Loans to Deposits Ratio (%)
1987	488	399	122.3
1988	513	469	109.3
1989	572	633	90.4
1990 (October)	670	679	98.6

* Excluding credits to government.
** Including government deposits.

Source: Central Bank of Madagascar.

4.17 Increased Domestic Funding of Term Credit. In the past, Malagasy banks extended term loans only when these loans were predominantly externally funded. More recently, the banks started relying more heavily on domestic sources of funding. As reflected by the data below, the share of medium and long-term loans in total lending rose from 17.0 percent at the end of 1987 to

7/ The interbank market started functioning only as of March 1987, and banks were allowed to subscribe to Treasury bills only as of September 1988.

20.4 percent by the end of October 1990. During the same interval, the ratio of time deposits (including certificates of deposit) to total deposits (including government deposits) also rose from 37.4 percent to 41.4 percent. As a result, the ratio of term loans outstanding to time deposits actually fell from 55.7 percent at the end of 1987 to 48.7 percent by the end of October 1990.

Table 4.8

Relative Increase in Term Loans and Time Deposits
(in billions of FMG)

	Gross Loans		Deposits	
End	Short-term	Medium and Long-term	Sight	Time
1987	405	83	250	149
1988	414	99	300	169
1989	455	117	400	233
1990 (October)	533	137	398	281

* Including certificates of deposit.

Table 4.9

Sectoral Breakdown of Gross Loans
(Percent of total*)

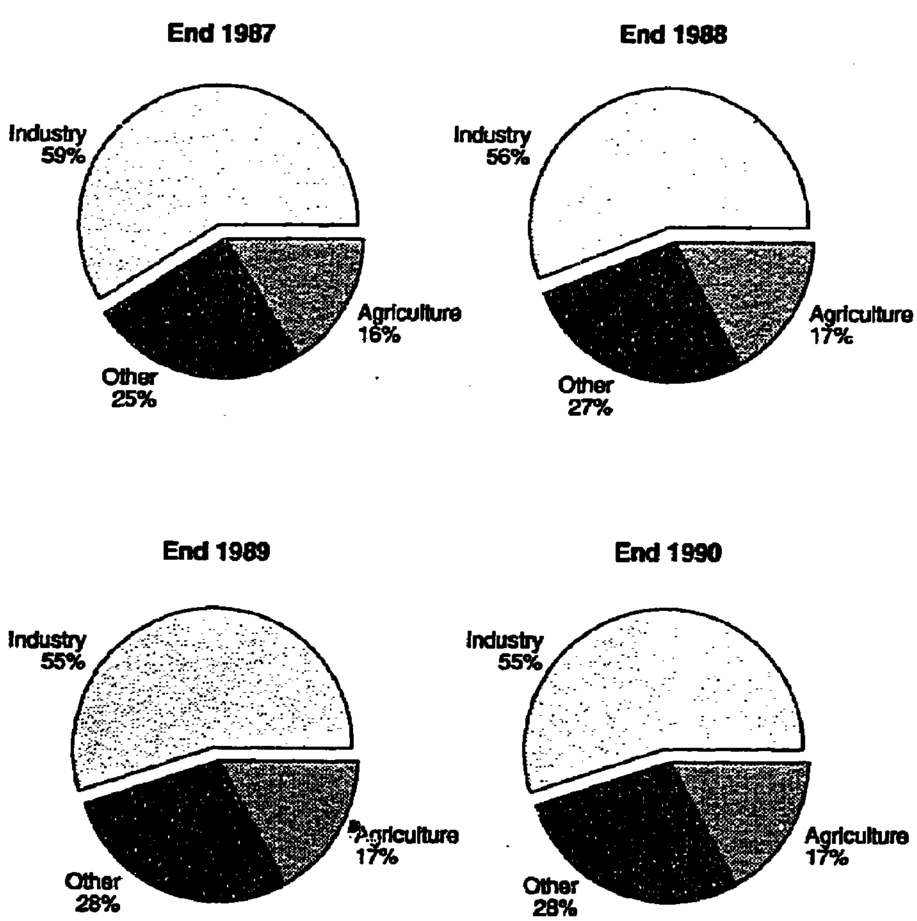
Sector	End 1987	End 1988	End 1989	End October 1990
Agriculture	15.4	16.5	16.6	16.9
Industry	58.8	56.2	55.8	54.8
Services	20.5	21.8	23.6	22.8
Not Classified	5.3	5.5	4.0	5.5
Private	52.4	63.3	66.2	73.6
Public	47.6	36.7	33.8	26.4

* Includes only borrowers whose indebtedness exceeds FMG 10 million.

4.18 Reduced Liquidity. The liquidity position of Malagasy banks fluctuated widely during 1988-1990. Excluding the statutory reserves with the Central Bank, the banks' liquid assets in local currency totalled FMG 49 billion at the end of 1987, while their net external assets stood at FMG 46 billion. During 1988, the banks reduced their excess reserves, with liquid assets in local currency dwindling to a low level of just over FMG 8 billion at the end of October. Despite a recovery during the last two months of 1988, liquid assets in local currency remained at year-end FMG 16 billion below the level of a year earlier. By contrast, the banks' net external assets increased by FMG 13 billion during 1988. In the wake of the significant increase in deposits during 1989, the banks' liquid assets in local currency (excluding statutory reserves) increased substantially reaching a record level of FMG 75 billion at the end of December. Net external assets also peaked at year-end, totalling FMG 90 billion.

4.19 The situation was again reversed in 1990, which was marked by an acute liquidity crisis experienced by one of the banks, and an over-all reduction in the liquidity position of the banks. The latter appeared to largely result from a surge in credit-financed imports triggered by the liberalization of the trade regime. During the first ten months of 1990, the banks' liquid assets in local currency decreased by FMG 65 billion, while their net external assets decreased by more than FMG 23 billion. In addition, the banks' indebtedness to the Central Bank increased dramatically during the interval from FMG 12 to FMG 97 billion (see Table A.2).

Figure 4.2: Sectoral Breakdown of Gross Loans



Overall Banking Performance Since 1989

4.20 Data Constraints. The Central Bank requires the banks to submit to it monthly data on the evolution of their assets and liabilities, but does not require them to make regular submissions on their profit and loss accounts. Therefore, the banks' published annual reports are the only source of information on the performance of the banking system. Since BMOI (which started operations in August 1989) is yet to make public its first annual report, and the results for 1990 are not yet available for any of the banks, the analysis of the recent performance of the Malagasy banks is restricted to three banks and covers the two-year period 1988-1989.

4.21 The aggregate balance sheets of the three banks, presented in Table 4.3, differ slightly from those published by the Central Bank, even for 1988, although they cover the same institutions and are derived from the same certified accounts. The differences between the two sources naturally become larger from 1989 onwards because Central Bank data include BMOI as well.

4.22 Evolution of Assets and Liabilities. Data in Table A.4 indicate that the combined assets of BNI, BTM and BFV increased by 16.5 percent in 1989 and a further 6.5 percent during the first ten months of 1990 to stand at FMG 1,021 billion by end October. A 33 percent increase in total deposits (including the government) during 1989, enabled the banks to enlarge their loan portfolios (by 12.8 percent in gross terms and 10.4 percent in net terms), subscribe to Treasury bills to the tune of FMG 62 billion, and increase their balances at the Central Bank by about FMG 37 billion. By contrast, a 1.2 percent decrease in total deposits during the first ten months of 1990,[9] coupled with an expansion of the loan portfolios (by 5.1 percent in gross terms and 7.9 percent in net terms) forced the banks to resort to substantial borrowing from the Central Bank.[10]

4.23 Importance of Interest Margin. Banks in Madagascar enjoy a significant adequate interest spread (difference between the average lending rate and the average cost of deposits), which averaged 6.7 percent in 1989.[11] The interest margin or the net interest income (i.e. interest income less interest cost) accounts for the bulk of the gross earnings margin or gross operating income of Malagasy banks. Owing to a 20.9 percent increase in the interest margin in 1989, the contribution of the interest margin to the operating income rose from 65 to 71 percent, and resulted in 10.7 percent increase in the gross earnings margin (see Table 4.10). Given the limited range of fee-generating banking activities and current prohibition on foreign exchange transactions the interest margin remains more important as a share of gross earnings margin for banks in Madagascar than most Sub-Saharan African countries.

9/ The decrease was a direct result of the entry of the fourth bank (BMOI), that managed in just fourteen months of operations to capture 10.3 percent of the system's deposits.

10/ It should be noted, however, that about 91 percent of the increase in the banks' indebtedness to the Central Bank during 1990 was accounted for by one bank, that experienced serious liquidity problems, the magnitude of which is still unknown.

11/ The average lending rate was 12.8 percent, while the average cost of deposits was 6.1 percent.

4.24 Increased Profitability in 1989. Although the increase in operating costs – 11.9 percent in 1989 – outstripped that of the gross earnings margin, the net earnings margin increased from FMG 31.3 billion in 1988 to FMG 34.4 billion in 1989. However, it is the sharp decline in other net costs (owing predominantly to a decrease in net provisions for bad debts from FMG 26.5 billion in 1988 to FMG 20.8 billion in 1989) that explains the jump in operating profits from FMG 1.3 billion in 1988 to FMG 11.6 billion in 1989. Furthermore, owing to the significant increase in the banks' net exceptional income (which is largely due to the recoveries from the old loans that had been taken out of the portfolios), profits before tax increased from FMG 3.6 billion in 1988 to FMG 20.4 billion in 1989, while profits after tax increased from FMG 1.9 billion in 1988 to FMG 15.4 billion in 1989. Net profits in 1989 represented a return on average shareholders' funds of 22.2 percent, as compared to less than 3 percent in 1988.[12] This increased profitability enabled the banks to distribute substantial dividends in 1990, equivalent to 62.4 percent of their 1989 net profits.

Table 4.10
Aggregate Profit and Loss Accounts, 1988-1989
(in millions of FMG)

	1988	1989
Interest Income	72,966	84,272
Interest Cost	36,647	40,379
Interest Margin	36,319	43,893
Other Operating Income	19,393	17,798
Gross Earnings Margin	55,712	61,691
Operating Costs	24,432	27,334
Net Earnings Margin	31,280	34,357
Other Net Costs	30,004	22,772
of which: Net Provision for Bad Debts	(26,455)	(20,835)
Operating Profits	1,276	11,585
Net Exceptional Income	2,326	8,819
Profit before Tax	3,602	20,404
Taxes	1,681	4,958
Profit after tax	1,921	15,446

Source: Annual Reports of individual banks.

4.25 Costs of Intermediation. Improvements in bank performance in 1989 is reflected not only by the increase in the return on average total assets and average shareholders' funds, but also by the decrease in the costs of intermediation, which are equal to the gross earnings margin divided

12/ Computed after deducting dividends and payments to Board members.

by average total assets.[13] As shown in Table 4.11, the costs of intermediation decreased from 7.37 percent in 1988 to 6.93 percent in 1989. Especially in view of low labor costs, operating costs, which were relatively low by developing country standards, decreased further to 3.07 percent in 1989, thereby making banks in Madagascar even more competitive in this respect than some industrial countries such as Italy and the United Kingdom (see Table A.7). Other costs, net of non-operating and exceptional income decreased substantially during the interval from 3.66 percent to 1.57 percent, partly due to the decrease in net provisions for bad debts. Consequently, net profits as a percentage of average total assets increased from 0.26 percent in 1988 to 1.73 percent in 1989.

Table 4.11

Elements of the Costs of Intermediation
(Percent of average total assets)

	1988	1989
Operating Costs	3.23	3.07
Other Net Costs*	3.66	1.57
Net Provisions for Bad Debts	(3.50)	(2.34)
Other Items	(0.16)	(-0.77)
Taxes	0.22	0.56
Net Profits	0.26	1.73
Costs of Intermediation	7.37	6.93

* Including net exceptional income.

Source: Derived from Tables A.4 and A.5.

4.26 Reduced Profitability in 1990. Although the results of the banks for 1990 have not yet been made public, indicators are that for the banking system as a whole the returns on assets and shareholders' funds were lower in 1990 than in 1989. The entry of BMOI into the scene, which has introduced a welcome element of competition into the system (through price competition and the introduction of new products relating to savings and credit) probably resulted in a reduction in interest margins, and consequently, a further reduction in the gross earnings margin which is relatively high not only by international standards, but even by African standards.[14] Since it is unlikely that the reduction in the gross earnings margin was offset by a corresponding reduction in operating costs and other net costs it follows that 1990 was less profitable than 1989. Another important reason for the system's reduced profitability in 1990 stems from BTM's liquidity crisis. Indeed, 1990 was an extremely difficult year for BTM. The institution suffered from an extended employee strike during

13/ The costs of intermediation are generally divided into four elements: operating costs, other net costs (which usually consist mainly of net loan loss provisions and depreciation costs, but in the case of Madagascar also include net income items resulting from the cleaning up of the banks' loan portfolios), taxes on gross profits, and net profits.

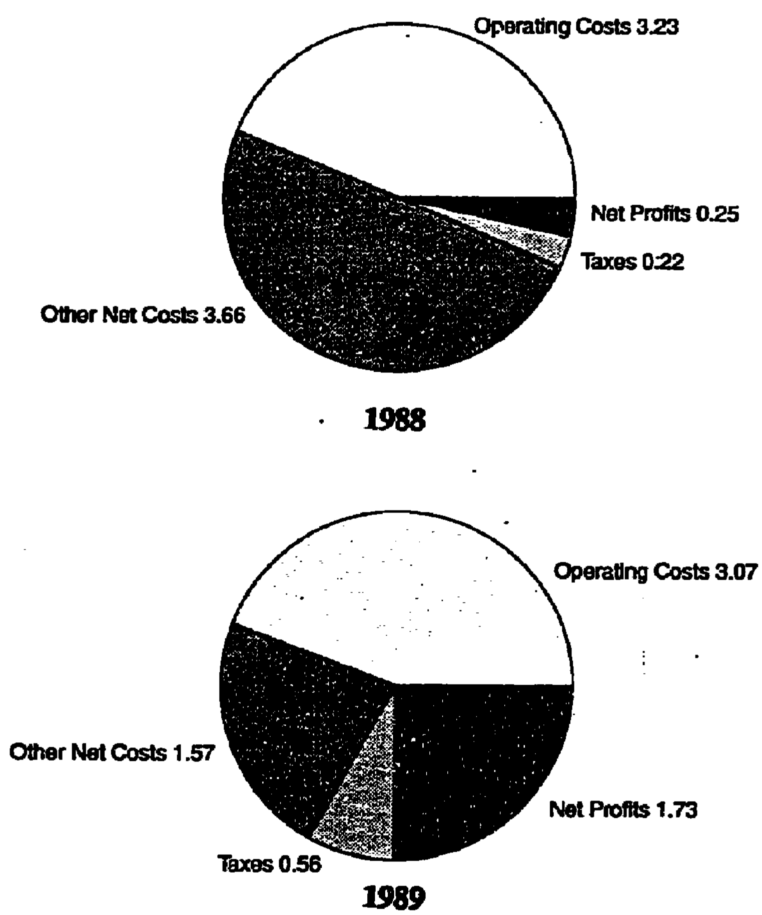
14/ As shown in Table A.7, the interest margin is higher in Madagascar (4.93 percent in 1989) than in countries such as Ghana (2.99 percent), Rwanda (3.72 percent) and Malawi (4.50 percent).

the second quarter, as well as serious weaknesses in the management of its operations including its loan portfolio, that undoubtedly resulted in substantial losses.

Future Challenges of the Banking System

4.27 Since the series of nationalizations in the mid 1970s, the Malagasy banking system has undergone a major transformation. As the economy moves in the 1990s towards greater emphasis on private sector investment and production, the banking system will face new challenges in adequately providing efficient banking services which minimize risks and costs to depositors and investors and helps them maximize returns on investment. Given continued strengthening of the structure and management of individual banks and their regulatory framework as well as the development of an independent banking profession, there is much promise for the emergence of a dynamic and competitive banking system in Madagascar within the 1990s.

Figure 4.3: Elements of the Cost of Intermediation (percent of average total assets)



4.28 Redressing Systemic Strains from BTM: The immediate challenge facing the Malagasy banking system is the containment of BTM's liquidity crisis. Since BTM accounts for 36% of assets, 35% of deposits, 57% of branches and 39% of the employees of the banking system, internal liquidity and other problems of such a major bank can potentially jeopardize the liquidity and depositor confidence in the banking system as a whole. There is an urgent need to clearly assess the problems of BTM in its accounting, liquidity and portfolio management, and operation of its large branch network. This evaluation is likely to confirm the need for a significant restructuring of this bank. This prospect has led the government to envisage opening up the capital of this institution, a goal which should be pursued once a restructuring plan for BTM is identified.

4.29 Enhancing Bank Competition: A key challenge for the 1990s remains making the banking sector more competitive. Lack of competition has resulted in relatively high interest margins that penalize to some extent both depositors and borrowers. This in turn limits the scope of the banking system to increase its deposit mobilization and to reduce the costs of real sector economic activities. The present size of the banking sector coupled with prospects for future economic growth indicates scope for addition of a fifth commercial bank to the financial system in the near term. Such a development should lead to a decrease in the interest margin, without unduly affecting the existing banks' profitability. In addition, the recent move by the BCRM to require all commercial banks to post their base lending rate and terms of their banking operations should favor further competition by enabling clients to more easily choose among banks for their needs for various financial services. This should help mitigate a major problem among users of banks services who are presently facing great uncertainty in the pricing of both their deposits and borrowing as well as other services from banks (see Annex 1.1). This move should be accompanied by a strengthened framework for prudential regulation and supervision which would require mandatory disclosure of certain basic financial information by banks enabling their clients to better assess the management strengths and soundness of individual banks.

4.30 Pursuing privatization of the banking sector: Government ownership in the banking sector has generally not been conducive to financial sector development as experience in Madagascar as well as elsewhere has shown. Madagascar's move towards an increasingly market-oriented economy would be firmly buttressed by a fully private commercial banking system. The Government should therefore pursue the process of privatization of the banking system which began in the latter part of the 1980s. Competition would also be favored by further divestiture of government shareholdings in banking, notably in BFV and BNI in addition to BTM as discussed previously. Since demand among the general public for share ownership in the banking sector appears to be high, the Government could use the occasion of the divestiture of such holdings to further broaden and deepen the shareholding habits of the population. If undertaken through public offerings organized under a simple embryonic framework for capital markets, this further privatization of the banking system could also be used by the Government as a vehicle for catalyzing the emergence of full-fledged capital markets (see Chapter 7).

4.31 Strengthening the banking profession: There is a need to establish a new and independent professional banking association in Madagascar. The existing Association Profesionelle Bancaire (APB) that was created in 1985 supposedly represents the interests of the banking industry. However, it does not appear to fulfill the needs of commercial banks and does not seem to work to the full potential of such an institution, partly because it is managed and reports to the Government. The Government should therefore take the initiative to dissolve the existing APB and encourage commercial banks to independently create such a new institution which would not have any Government participation. The new banking association should be free to set its own rules and should work in areas of common interest to all banks. Among such common issues are banking ethics, education and training issues including the organization of various professional bankers' examinations, promotion of standardization of checks (further discussed in Chapter 3 and Annex 3.3) and education campaigns to encourage better financial and savings habits among the general public. This new association should be the primarily channel through which the Government should address banks on general banking matters on which mutual consultation and collaboration are useful.

Regulation And Prudential Supervision In the New Economic Environment

4.32 Regulatory imperatives in banking transactions: Even as their economies are liberalized and perhaps especially when they are, governments retain a special role in regulation and supervision of banks. In contrast to most transactions in product markets which are carried out on a spot basis, the operations of banks involve the exchange of intertemporal claims (short-term deposits are used to fund long-term loans). Although bankers tend to maintain a reserve of cash on hand to cover net withdrawals that can occur on any given day, they may be wrong in their judgments and may be too optimistic with respect to the success of projects or customers. Consequently, in addition to liquidity management policies of the Central Bank (see Chapter 2), prudential regulation and supervision are of paramount importance in order to avoid the ensuing problems associated with insufficient liquidity and insolvency. The soundness and solvency of a bank's loan portfolio do not always insulate it from liquidity difficulties. Mismatches in the maturity structure of assets and liabilities could lead to serious liquidity problems if, for example, the duration of assets largely exceeds the duration of liabilities. Safeguards in the form of supervisory ratios which attempt to match the duration of assets and liabilities are important prerequisites of a safe financial system. Banks are also particularly vulnerable to possible opportunistic behavior on the part of managers and employees. Managers and employees of all types of enterprises may occasionally be tempted to take unfair advantage of their positions. Given the relative ease with which money can be misappropriated, compared to the real assets of nonfinancial enterprises, the scope for such behavior in banks and other financial institutions is substantial. Experience shows that bank failures often results not from incompetent management, but from fraud. Consequently, appropriate supervisory measures should be established to protect saver's money from serving the immediate interest of managers or of loan officers.

4.33 Importance of prudential regulation and supervision: The confidence of economic agents in the soundness of the financial system depends fundamentally on the existence of an effective regulatory and supervisory framework. Within the financial system, banks in particular hold a special position in most economies as creators of money, principal depositaries of financial savings, the principal allocators of credit and managers of the country's payments system. For this reason, governments establish public policy for banks in the public interest. Central banks play an important role in ensuring effective regulation and supervision of the financial system, particularly banking institutions. In liberalizing economies such as Madagascar's, prudential regulation requires central bank supervisors to move beyond a focus on compliance with monetary policy regulations, foreign exchange controls and credit allocation regulations to reviewing the overall quality of bank assets, accounting procedures and management controls. In order for BCRM to effectively and credibly play its role as an independent monetary institution, it must give top priority to developing an effective regulatory and supervisory capacity over financial institutions. This function will assume greater importance and complexity as the financial system evolves in Madagascar in coming years.

4.34 Recent progress and outstanding issues: The 1988 Banking Act defines supervisory functions for BCRM. This was the legal basis for the establishment of the Commission de Controle des Banques et Etablissements Financiers (CCBEF) in April 1990. The legal basis of the CCBEF also foresees its supervisory role for non-bank financial institutions. Regular off-site monitoring is now taking place on the basis of monthly statements of the banks as well as their audit reports. At least one on-site inspection has taken place under guidance of an experienced foreign bank supervisor. Work on the new accounting plan for banks has been in progress since 1987 since the country's new accounting plan (Plan Comptable) was adopted. Notwithstanding this progress, there remains many outstanding issues in bank regulation and supervision. The adaptation of the general accounting plan for the purposes of prudential analysis of all banks should be completed as soon as possible to enable several outdated texts to be replaced (eg. December 1973 text on liquidity ratios). BCRM should also make the strengthening of its prudential regulatory and supervisory capacities one of its key priorities in the next three to five years. It should aim at improving off-site inspection and at eventually being able to undertake at least one regular on-site inspection of each commercial bank once a year. In strengthening its capabilities in all these areas, BCRM should consider some of the key issues reviewed below.

4.35 Key areas of regulation: Among the main measures aimed at controlling the risks incurred by banks are regulations of market entry, capital adequacy and portfolio diversification. In most countries, regulations begin at the market entry stage. Before they are authorized to operate, banks must satisfy a number of requirements, and sometimes a minimum range of services to be offered to customers. Also in most countries, banks are required to maintain a sufficient level of net worth to protect the solvency of the banks against some minimum level of losses from nonperforming assets. Typically, a bank's total lending is constrained by a maximum "gearing" ratio between its capital and its total assets (loans, etc.). Closely related to capital adequacy ratios are rules of portfolio diversification and risk limitation. Most countries seek to limit risk concentrations by imposing formal or informal limits are stated as a percentage of the bank's capital and vary from country to country. The 1988 Banking Act covers many of these areas of bank regulation adequately. However, there are specific aspects of bank supervision which could be strengthened as discussed below. It should be noted that the supervisory functions of BCRM can be expected to grow especially if small-scale depository and credit institutions emerge to cater for needs for small-scale entrepreneurs and rural areas (see Chapter 6), and new instruments such as banker acceptances and negotiable certificates of deposits (See Chapter 7) are developed in the medium term.

4.36 Existing capital adequacy guidelines: Minimum capital adequacy guidelines of some kind for banks exists in nearly all countries in order to provide the banking system with a cushion against unusual losses. These guidelines are usually based on either deposits or in some countries, on the risk structure of assets and off balance sheet activities. In Madagascar, the solvency of a bank is seen as its ability to absorb unusual losses based on its ratio of equity capital to liabilities. Under the 1988 Banking Act, banks are required to observe a solvency ratio of at least 8 per cent. Table 3.1 shows that the commercial banking system in Madagascar has historically been able to comply with this requirement without any difficulty. However, these capital adequacy guidelines are geared more towards matching the equity level with the level of deposits than towards offering depositors real protection against massive defaults. High rates defaults can occur and can indeed lead to bank failures and bank panics even if such a deposit-based solvency ratio for the overall banking system is high. BCRM should therefore begin considering moving towards a system of capital adequacy guidelines based on the risk structure of assets as described below.

Table 4.12
Solvency Ratio Of The Malagasy Banking System

Year	Solvency Ratio (%)
1981	11.8
1982	12.6
1983	11.9
1984	14.9
1985	17.9
1986	17.4
1987	16.6
1988	21.3
1989	18.7

Note: The solvency ratio is defined as the ratio of equity capital to liabilities.

Source: BCRM Data

4.37 Risk-weighted capital adequacy guidelines: The risk-based capital standards defined by the Bank for International Settlements and to be widely adopted by industrial countries by the end of 1992 should provide the Malagasy authorities some guidance on how to reform the existing solvency ratio prescribed for banks. These risk-based capital standards distinguish between five different categories of assets with different risk weightings. These range from zero weightings for short-term central bank and government securities to one hundred per cent weightings for commercial loans exceeding one year. The capital guidelines also distinguish between two types of capital ("core" and "supplementary"). Adapting such guidelines to the Malagasy commercial banking system will be important for a number of reasons. First, depositors need real protection based on the actual risks that banks incur through their asset portfolios. Furthermore, as the economy develops and diversifies, commercial banks can be expected to expand their off-balance sheet commitments including loan guarantees, irrevocable credit instruments and eventually interest rate and currency swaps. Existing capital guidelines in Madagascar do not capture the different degrees of risks associated with the range of commercial bank activities that exist and that can be expected to broaden in future.

4.38 Liquidity guidelines: Banks are generally required throughout the world to maintain a minimum level of liquid assets in order to meet depositors' demand for immediate liquidity. In Madagascar, under a decree which dates back to December 20, 1973, banks are required to comply with a coefficient of liquidity which aims at maintaining a minimum ratio between liquid assets and short-term liabilities. The following items are included among liquid assets: cash, current accounts at the central bank, short-term claims on domestic depository institutions (less than six months) and other highly liquid short-term claims. The liquidity ratio in Madagascar has been fixed at 70%. At the end of 1989, all commercial banks were well in excess of this liquidity ratio. The 1973 decree should be reviewed in the context of the new chart of accounts to make the coefficient more representative of the liquidity situation of commercial banks. In particular, BCRM should give more weight in its liquidity guidelines to short-term liquid assets of one month maturity, rather than those of six months maturity, in order that banks compute their liquidity coefficient accordingly. The 1973 text therefore needs to be reviewed with attention to the definition of highly liquid claims and short-term liquid assets.

4.39 Minimum prudential reporting and disclosure: Confidence in the monetary system is maintained, inter alia, by guaranteeing the solvency, liquidity and profitability of the banking system. The banking system would be in a position to achieve these desirable outcomes provided it operates in an accounting framework which does not obscure from view matter which should be clearly seen into by the banks and other financial institutions as lending agencies.For a desired degree of transparency to prevail, the BCRM should have the legal power to call from the banks all such information which it needs in order to fulfill its Central Banking functions. The 1988 Banking Act empowers BCRM adequately in this respect. However, the appropriate supervisory capacity within BCRM commensurate with these powers has not yet been developed.

4.40 At the same time, the public at large should also be able to judge the performance and strengths of individual commercial banks, notably by way of their publication of their annual accounts. In many developing countries, including neighboring Mauritius, this disclosure requirement is mandatory. Mandatory publication of annual accounts is also provided for in the 1988 Banking Act in Madagascar but there are no guidelines yet on which specific items of information should be published. Certain income and expenditure items need to be disclosed specifically in this context: interest and similar income; interest experience and similar charges; dividend income; fee income; commissions received; gains and losses from foreign exchange transactions; gains and losses from dealing in stocks, shares, securities (if applicable); gains and losses from investments in securities; other operating incomes' losses on loans and advances; general administrative expenses; specific operating expenses; and other operating expenses. These items should not be reported on a net basis as important information is thereby lost.

4.41 Similarly, balance sheet items of banks should be listed out, preferably in an order which reflects the liquidity of individual items. No offsetting should be done since this leads to loss of information. In particular, the following specific items require separate reporting: cash and balances with the BCRM; Treasury bills and other commercial bills eligible for rediscounting at the BCRM; bills not eligible for rediscounting; Government and other securities held for dealing purposes; investments in Government and other securities; placements with and loans and advances to other banks; other money market placements; loans and advances to customers by type; other assets (external claims, domestic claims); deposit from other banks; other money market deposits; amounts owed to other depositors; certificates of deposits issued; promissory notes and other liabilities evidenced by paper; other borrowed funds. Contingencies and the amount of unsecured advances should be separately also disclosed.

4.42 Ensuring sound banking portfolios: To avoid a bunching up of bad and doubtful debts, bankers should be urged by the BCRM to adopt continuous provisioning for bad and doubtful debts. Indeed, the BCRM should see to it that excessive unrealized profits are not being declared by banks because of lack of or under-provisioning for bad and doubtful debts. This would help ensure that banks would not be put under financial pressure when such debts have to be provided for or written off and that banks will not carry a weak loan portfolio as if it were completely sound. Indeed, if the quality of a bank's loan is allowed to deteriorate, the more it will get reflected in a higher average interest rate charge to borrowers, irrespective of the rate of interest paid by the banking system to depositors.

CHAPTER 5

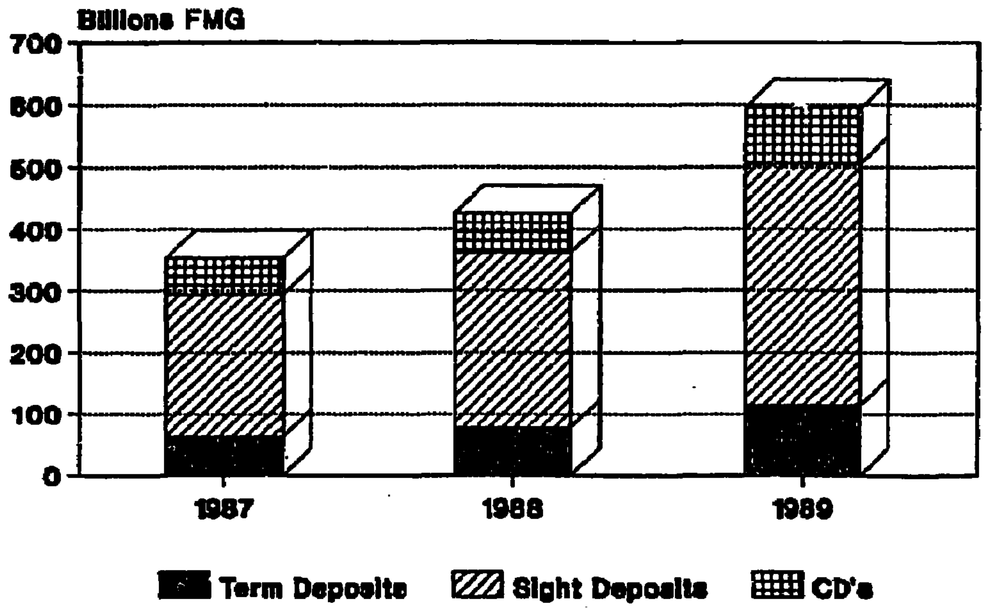
ISSUES IN TERM FINANCE: CONTRACTUAL SAVINGS AND HOUSING FINANCE

5.1 Term finance (ie. mobilization of resources and development of financial assets for the medium and long-term) is needed in all countries to ensure that the full productive potential of the economy is realized. In an economy such as Madagascar's which is rapidly restructuring, term finance is becoming increasingly essential to business, household and private sectors. It is needed for expanding the capital stock of the enterprise sector as new machinery replaces old, production and distribution facilities are upgraded and new plants are built; for providing for the development of physical infrastructure such as commercial buildings, schools, and roads; and for creating residential housing which is the major long-term asset of households. To address these needs, the financial system has to meet one of its basic challenges which is to mobilize resources to be transformed into medium and long-term financial assets with adequate attention to risk, return and liquidity. This chapter looks at ways of mobilizing savings through long-term financial contracts to provide long-term debt finance to enterprises and individuals. A few issues of equity finance, which is another form of term finance, are examined in Chapter 6 (role of venture capital companies) and Chapter 7 (development of capital markets).

5.2 Term finance directly and indirectly involves the entire range of financial institutions, instruments and markets within the financial system. Commercial banks have a major role to play in this respect both in resource mobilization and in term credit. Their roles are briefly discussed below. However, their activities must usually be reinforced by other institutions which have an even more specific and direct role in term finance. Perhaps the most important of these are contractual savings institutions (life insurance companies, occupational pensions schemes, national provident funds and funded social security schemes) which are directly involved in mobilizing savings through long-term financial contracts. Contractual savings institutions in Madagascar are the major focus of this discussion. At the same time, housing finance is one of the most important areas in term finance in any country. The specific problems in this area from the standpoint of the financial system in Madagascar are also briefly reviewed in this chapter. Finally, for term finance to operate effectively in any country, there must exist well functioning financial markets which facilitate the pricing and transfer of financial resources among individual and institutional investors and borrowers. The issues of financial market development are more extensively discussed in Chapter 7.

5.3 In the near term in Madagascar, banks will continue to play the major role in term finance within the overall financial system. In comparison to many developing countries including low-income countries in Sub-Saharan Africa, the Malagasy banking system remains relatively biased towards the short-term in its mobilization and allocation of resources. For example, Figure 5.1 shows that term deposits in the commercial banking in Madagascar have tended in recent years to account for only about one-fifth or less of total bank deposits. Although this proportion has been growing in recent years, it is still considerably lower than many other countries, for example those in the Western African Monetary Union (UMOA) (see Figure 5.2) as well as elsewhere (see Table 5. 1). The prevalence of double-digit inflation in Madagascar during most of the 1980s is one of the underlying reasons for this phenomenon. This underscores the importance of a stable macroeconomic outlook to encourage savings through long-term financial contracts.

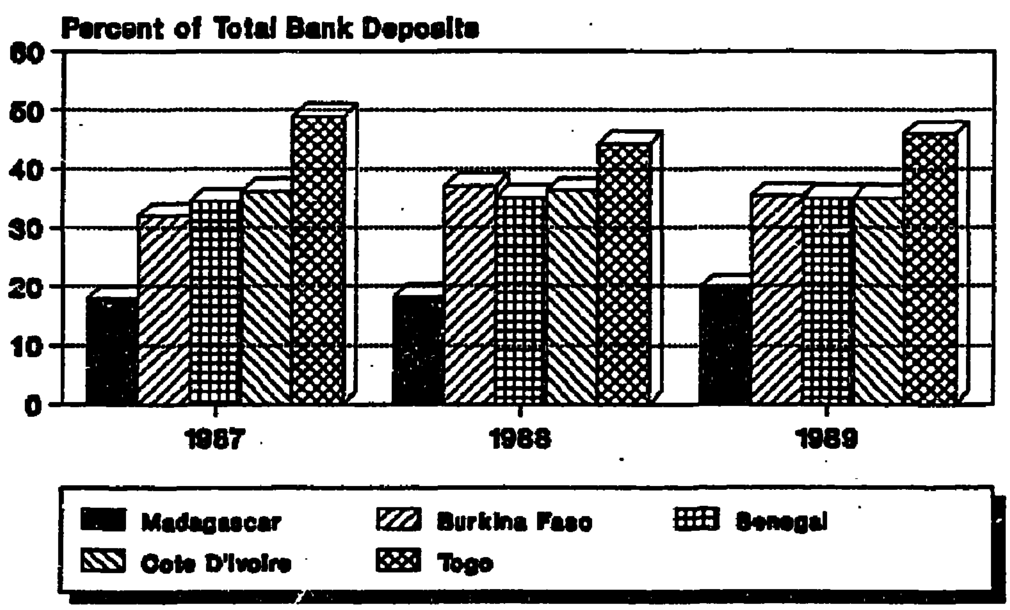
Figure 5.1: Share of Term Deposits in Total Bank deposits



Note: Term Deposits as a percentage of total deposits: 1987-17.9% 1988-18.3%
1989-19.8%

Source: BCRM Data

Figure 5.2: Comparative Share of Term Deposits in Total Bank Deposits



Source: BCRM & BCEAO

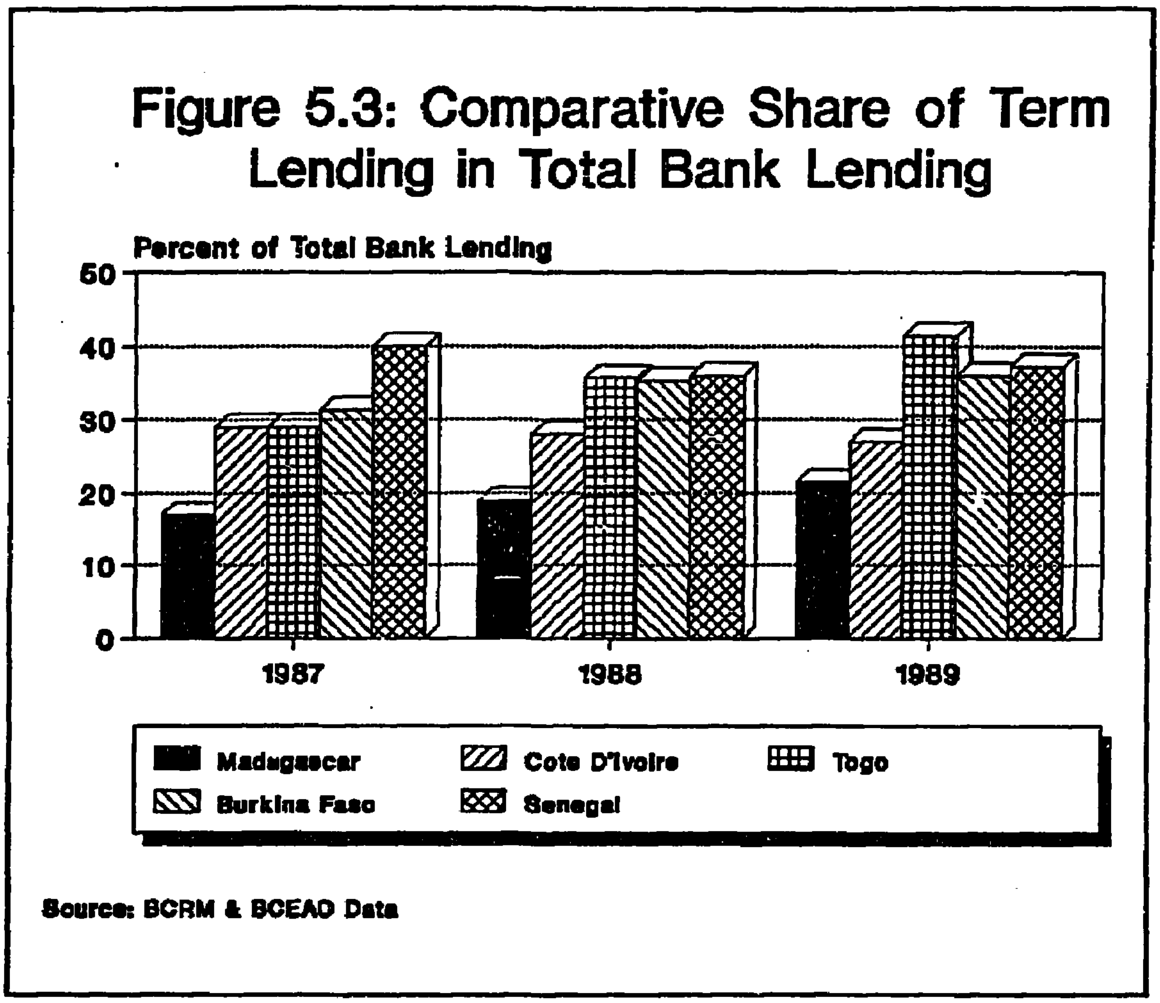
5.4 Increased mobilization of term resources within the banking system will also depend on how successfully banks develop products and savings schemes that are attractive to depositors. A number of such products have already emerged in Madagascar which, for example, encourage savings for housing finance. In Mauritius, there has been great success with remunerated savings accounts where deposits are available at all times but remuneration is applied to the minimum balance for a specific period (generally one month). These and other schemes could have much potential in Madagascar for shifting deposits towards term funds. This is especially since demand or short-term deposits are generally unremunerated or have a rate of return below inflation. Banks will therefore incur higher costs to attract longer deposits which they must compensate with more profitable lending activities including term lending.

Table 5.1: Comparative Share of Term Deposits in Total Bank Deposits
(in percentage of total bank deposits)

	1987	1988	1989
Sub-Saharan Africa:			
Burkina Faso	32	37	35.4
Senegal	34.4	35	35
Cote D'Ivoire	36.1	36.2	35
Togo	49	44.3	46
Low Income Countries:			
India	81.6	81.4	81.6
Nepal	81.7	84.1	83.5
Haiti	64.7	63.2	66
Indonesia	69.6	72.4	70.8
Madagascar	17.9	18.3	19.8

Source: BCRM, BCEAO and IFS data.

5.5 Just as with resource mobilization, term lending by banks in Madagascar remains below that of many other countries. Once again, the comparison with countries of the Western African Monetary Union is illustrative (see Figure 5.3). Enhanced term lending by banks in Madagascar requires a combination of factors including the availability of viable projects to finance, the development of appropriate means of securing bank lending and monitoring projects, and the acquisition of appropriate term lending skills within banks. Public policies are also important in strengthening of the legal, accounting and payments infrastructure discussed in Chapter 3 which should facilitate further commercial bank activities in term lending. Commercial banks have already recently begun to build on previously acquired skills in term lending in the changing economic environment but would benefit from continued upgrading of professional skills in this area.

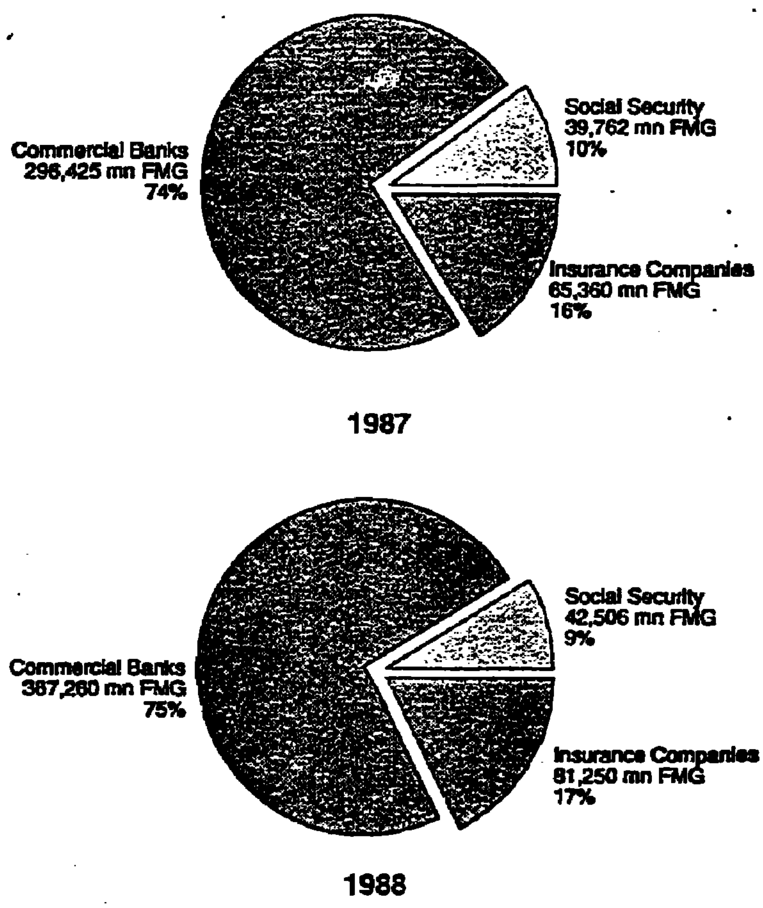


Source: BCRM & BCEAO Data

5.6 In addition to commercial banks, other financial institutions have an important role to play in term finance. Although Madagascar lacks a development finance institution found in many other countries, it is highly questionable whether such an institution should be seen as a priority for financial sector development in the near term. Most such institutions in developing countries have been public or quasi-public institutions that derive much of their funding from the government or foreign assistance. Given the poor record of such institutions in other countries generally and the still nascent state of financial markets in Madagascar suggest that it is unlikely that a development finance institution could be created which could expect to be self sustaining in the near term. Confidence of both savers and investors first needs to be more clearly restored through macroeconomic stability and the completion of reforms to improve the incentive structure for private investment. In addition, the legal and institutional basis for a sustainable long-term finance institution would first need to be firmly established. It would therefore appear to be more appropriate to envisage a substantially or possibly even wholly private development finance situation only once financial markets in Madagascar have begun to develop and the banking system begins experiencing more demand for long term finance for investment than it is willing or able to accommodate.

5.7 At the same time, most financial systems feature an insurance industry and social security system which together constitute the contractual savings subsector of the financial system. This sub-sector can play a critical role in Madagascar both in the mobilization of term resources and in the development of financial markets. Madagascar has, like the greater majority of developing countries and more specifically Sub-Saharan Africa, a relatively small contractual savings subsector compared to major component of its financial which are its banking institutions. Figure 5.4, for example, shows that insurance companies and the social security institution in Madagascar together accounted for about one-quarter of resources of the financial system in Madagascar with banks providing the rest. Notwithstanding the small size of this sector, contractual savings institutions in Madagascar have a great potential to develop the financial system, given their generally stable cash flows and predictable long-term liabilities. A number of other developing countries in Asia, Africa and Latin America and the Caribbean have already made great progress in developing their contractual savings subsector which in many cases provide term funds not only to Government but also to the industrial sector and housing sector. These countries include Barbados, Chile, India, Malaysia, Trinidad and Zimbabwe.

Figure 5.4: Relative shares of Commercial Banks and Contractual Savings Institutions in Total Financial Resources

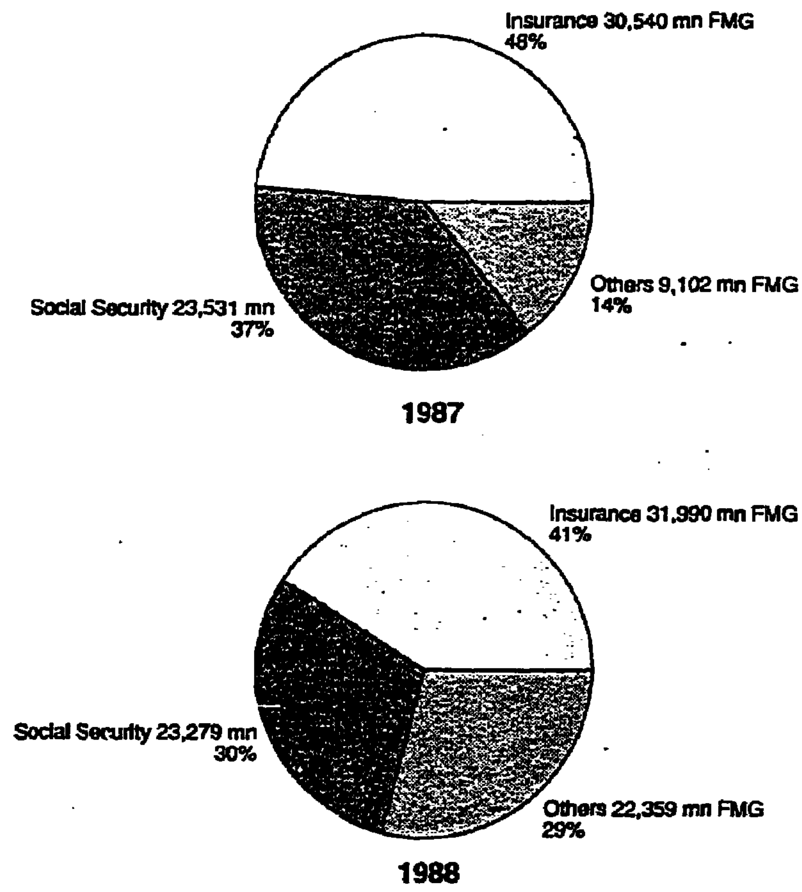


Source: BCRM and Financial Data from Insurance Companies & CNAPS.

Note: Total financial resources are the sum of commercial bank deposits, insurance and social security investment portfolios. Insurance and social security deposits with commercial banks are subtracted from bank deposits to avoid double counting.

5.8 Figure 5.5 shows that contractual savings institutions in Madagascar already contribute almost three-quarters of term deposits of commercial bank in Madagascar. To discuss contractual savings institutions in Madagascar within an appropriate perspective, an overview of the types of institutions and issues involved in contractual savings, focussing on their operating characteristics and their economic effects, and their implications for policy makers in Madagascar who might consider alternative strategies for developing contractual savings, is provided in Annex 5. 1. The discussion below successively looks at the insurance industry and social security system in Madagascar mainly from standpoint of their mobilization and placement of financial resources as well as their potential for developing financial markets. For convenience, this discussion also covers non-life or general insurance in Madagascar which is conventionally not defined as a contractual savings activity. Following this discussion, the special problems of housing finance are reviewed.

Figure 5.5: Contractual Savings Contribution to Commercial Bank Term Deposits



Source: BCRM and Financial Data from Insurance Companies & CNAPS.

The Malagasy Insurance Market

5.9 Relative size of the Malagasy insurance industry: In the developing countries of Sub Saharan Africa, Madagascar being no exception, the insurance industry is very much in an early stage of development. The ratio of gross insurance premiums to GDP in developed countries averages 4.5 percent while developing countries attain less than 2 percent. Table 5.2 below gives comparative data for Africa and other selected countries, while Table 5.3 illustrates life insurance funds as a percentage of GDP in developed countries. In developing countries the "supply leading approach" is often apparent when governments establish and control the institutions to try to force financial development. Insurance industry development depends on many factors such as the level and distribution of income and wealth of a country. Social and cultural structures also play a major role since, as the case is in many African countries, rural communities have a lesser need to cover risks as the extended family steps in and covers the shortfalls. The efficiency, solvency and public image of the insurance industry as well as the tax treatment of insurance premiums and benefits and the regulatory framework are important considerations in its development.

Table 5.2
LIFE INSURANCE PREMIUMS IN DEVELOPING COUNTRIES, 1983

	Premiums/ GDP Percentage	Premiums Per Capita US$
Africa		
Botswana	0.26	2.56
Burkina Faso	0.04	0.53
Cameroon	0.08	0.57
Congo	0.01	0.13
Ethiopia	0.04	0.06
Gabon (1984)	0.04	1.20
Gambia	0.03	0.13
Ghana (1984)	0.01	0.08
Lesotho (1985)	0.01	0.02
Madagascar (1987)	0.05	0.11
Malawi	0.6	1.22
Mozambique	0.03	0.13
Nigeria (1984)	0.25	1.75
Rwanda	0.01	0.88
Senegal	0.26	1.83
Seychelles	0.04	0.08
Sudan(1984)	0.01	0.04
Zambia (1984)	0.90	3.70
Zimbabwe	3.11	23.79
Others		
Chile	0.92	15.53
Guyana	3.01	15.90
Jamaica	2.59	44.39
Korea (1984)	4.59	93.07
Malaysia	0.99	21.35
Mexico	0.21	4.04
Singapore	0.86	61.85
Venezuela	0.67	19.60

Source: UNCTAD Secretariat (1987) and World Bank Data

Table 5.3

LIFE INSURANCE FUNDS IN INDUSTRIAL COUNTRIES

	1986	1987 % GDP	1988
Switzerland	28.0	29.8	31.6
United Kingdom	30.8	30.9	31.1
Japan	22.4	25.7	29.0
Germany	18.9	19.6	20.3
Netherlands	17.2	18.3	20.2
United States	17.3	18.4	19.2

Includes insured pension and burial funds

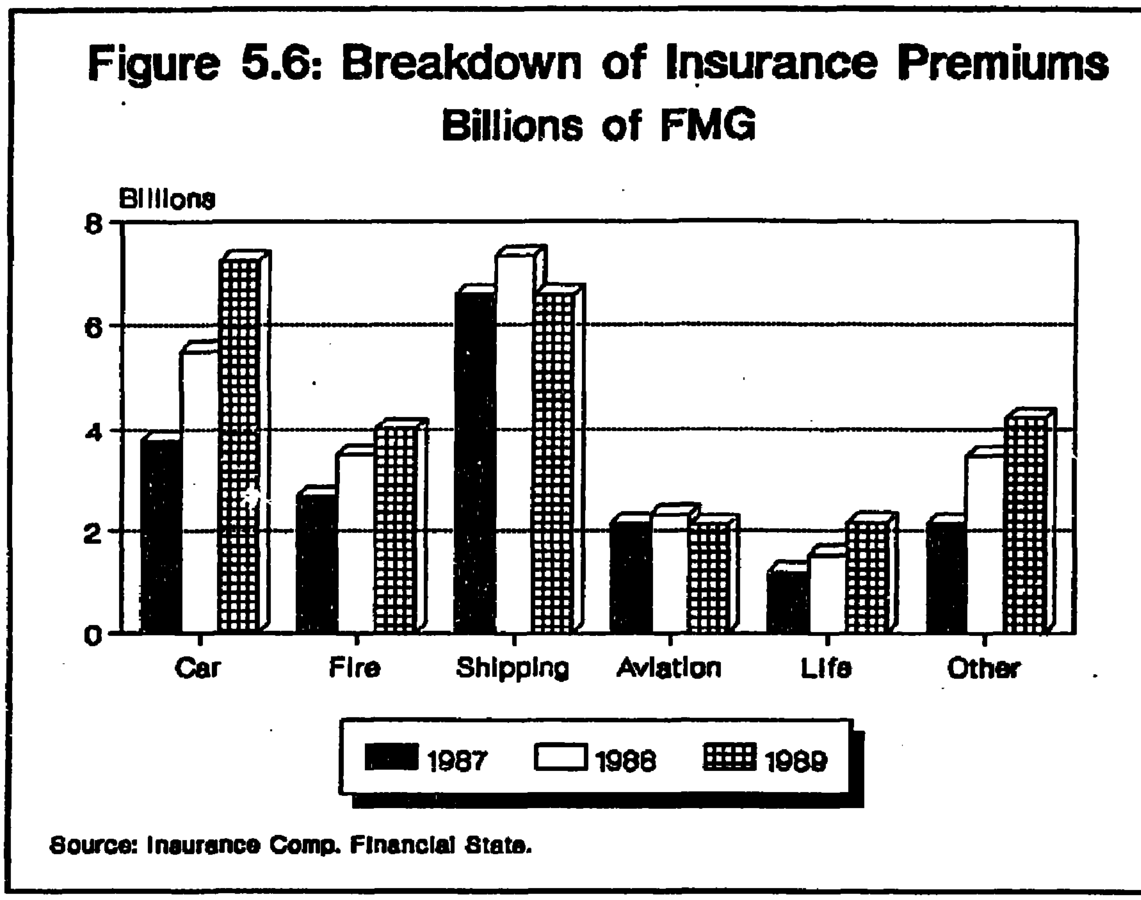
Source: National Central Banks

5.10 Role and structure of the industry: The primary function of insurance is to provide protection against financial loss from uncertain but predictable events. Since insurance companies accumulate substantial reserves which are intended to meet future claims and obligations, they also play an important role as financial intermediaries in the mobilization and allocation of the financial resources they have on hand. There are two major branches of the Malagasy insurance business general casualty or non-life insurance and life insurance. Four companies are presently engaged in the insurance business in Madagascar: ARO, NY HAVANA, MAMA and AVOTRA. The first two, being the major players in the market, are stock companies with majority interests held by the Government while the other two are mutual companies, in quasi-liquidation, dedicated to general casualty business having a limited impact on the total market. The organization of the present day insurance sector can be traced back to the period when foreign companies were nationalized, without affecting local Malagasy shareholdings. Marketing and distribution methods have not changed since the times when the agencies were dealing purely with maritime risks. There are regional bureaux as well as independent commission agents which do not have specific geographical territorial limitations.

5.11 Role of state ownership and control: The monopolistic quality of the insurance sector has effectively limited participation to two companies of virtually equal size, ARO and NY HAVANA who share more than just government shareholder majority participation. ARO and NY HAVANA also have boards of directors with nearly identical participants, there is also a non-competitive agreement where one company will not take a client that the other company has rejected (as they use the same sources of information to evaluate clients), they also give a right of first refusal for business they cannot take because of risk limitation, and they also share rate strategy and information. These elements have lowered the operational costs of each of the two companies and have limited the competition in rates allowing the two companies to survive the recent periods of economic decline. Given the limited total market of casualty business of 26 billion FMG and of the life insurance subsector which added 1.7 billion FMG in premiums in 1989 (about USD 17 million in total premiums, both casualty and life), it has been argued that it is beneficial for the financial health of both companies that additional companies have not chosen to compete. However, in an expanding, diversifying and more market-oriented economy, this oligopolistic industry structure is not likely to provide the dynamism necessary to fully exploit the potential of the insurance industry in Madagascar. As a first step to promoting more dynamic management, the Government has recently begun a process to augment the autonomy of these companies by electing separate and different board of directors for each company.

5.12 Relative size of general and life insurance: Figure 5.6 shows the breakdown of insurance premiums in Madagascar by major branches of activity. General insurance, which accounts for approximately 94 percent of the insurance written in Madagascar, provides coverage that is limited to short time frames, normally less than a year. The short term nature of general casualty policies is dictated by the difficulty in assessing loss probabilities in periods extending over a year. Among the determining factors that relate to the short time frame are cyclical nature of losses as well as the impact of inflation on the value of the perceived losses. As a result of the short term-nature of their policies, technical reserves of casualty companies are only a small fraction of the annual premiums and make little direct contribution to the generation of long-term financial savings. Life insurance coverage, which is poorly developed in Madagascar accounting for only 6 percent of total policies written, covers two types of personal risks: the risk of premature death and the risk of excessive longevity. The former is covered by various life policies such as whole life and term policies while the latter is covered by various forms of annuity contracts. Life insurance policies also provide an efficient means for contractual savings. This includes endowment policies, which can be a fixed nominal value, or indexed policies (which are more suited to developing markets where inflation and devaluation of the currency are of prime concern to the insured party). Yet, it also appears that life insurance is the fastest growing segment of the insurance market and has much potential to develop as the economy expands. Life insurance premium grew on average by 25 percent annually during 1987-1989 which is about 6 percent annually in red terms.

5.13 Reinsurance: Certain 'large' risks, as in maritime and aviation policies, have traditionally been passed on to foreign reinsurers. Each company has a different set of reinsurers and they play an integral part in setting the premiums for these policies. This aspect of the insurance business is not under Government control but rather by mutual accords where the insurer receives a percentage of the premium while taking a share of the risk. Another form of reinsurance is the policy which covers the risks over a certain deductible amount. The reinsurer only comes into play over the stated amount giving more responsibility to the local insurer. These policies serve the needs of the local market while at the same time limiting the total exposure of the local insurer. The key issue in the reinsurance market is how to transfer the risks of domestic activities to foreign insurers. It should be pointed out that by engaging in reinsurance in FMG, Malagasy companies might be incurring a higher costs than if at least part of the reinsurance could be undertaken in a less exotic currency by a foreign insurer. Given the relatively large volume of reinsurance in Madagascar undertaken by foreign insurance companies (between 30 to 40 per cent of total premiums), this suggests that the Government should review the insurance industry regulation to consider whether and see how existing foreign exchange controls specifically in relation to insurance should be made more flexible.



5.14 **Earnings performance and investment policies**: Given the limitations of the market coupled with the massive financial adjustment program that has been taking place in Madagascar during the past few years, Table 5.4 shows for fiscal years 1987 - 1989 an earnings performance by the Malagasy insurance sector which is promising for future development.

Table 5.4
Malagasy Insurance Sector: Financial Results
(Billion FMG)

	1987	1988	1989
Premiums Reserves	19.7	24.0	25.3
Financial Yield	6.7	8.8	11.9
Charge Offs	(25.2)	(16.9)	(22.4)
Dev. & Management Charges	(5.7)	(7.6)	(8.5)
Gross Balance	(4.7)	8.4	6.3
Balance of Assignments	6.3	5.9	4.1
Net Bal. of Operation	0.6	2.5	2.2
Bal. of Estate Operation	0.0	0.2	0.2
Net Earnings	1.7	2.3	2.0
Net Earnings as a percentage of Premiums Recovery	9.%	10.%	8.%

5.15 The present insurance industry regulation requires reserves of non-life companies must be kept liquid. Figure 5.7 shows the preponderance of liquid assets in the investment portfolio of insurance companies. Investments are traditionally made in treasury bills, commercial paper (demand deposits in Madagascar), and short-term marketable securities. As can be seen in the table below, assets are almost equally invested in Government Treasury Notes and commercial bank deposits with the combined total, in percentages, for the three year span hovering around 87 percent.

5.16 Fiscal stimuli for developing insurance: A strategy for future development of the insurance industry hinges upon three assumptions that are normally observed for developing countries like Madagascar. First, insurance demand is an increasing function of income; second, the real quality of insurance demand is a decreasing function of its real price; and, third, there exists a positive relationship between overall financial development of a country and the individual's ability and/or willingness to buy insurance. Any positive step toward lowering taxes on life insurance premiums (where these funds are held with the fiduciary agent for a given period of time or until the policyholder reaches retirement age, failing which a penalty could be assessed) could stimulate contractual savings, especially for salaried individuals. Presently there exits a heavy tax burden on life annuities; less than three year deferred - 20.1 percent total taxation, and more than three year deferred - 18.5 percent total taxation. Life insurance policy premium taxation is the lowest at 3 percent. Experience in other developing countries shows that the lost or deferred tax income, resulting from a reduced tax burden tends to be outweighed by the benefit of mobilizing further financial savings through long-term financial contracts and therefore the increased availability of investment funds. The Government might consider further study on the issue to rationalize insurance taxation in order to stimulate greater financial savings.

5.17 Improving investment policies: To help promote overall financial savings through insurance policies, a means of indexation of financial instruments, linked to the inflation rate and the currency rate, could be considered. This is, however, a market innovation which requires careful preparation. It is clear that, until restrictions on investment in foreign currency assets are reduced and arrangements for forward cover against exchange risk are developed, the ability for insurance companies to protect policyholders from this risk will be limited. As part of its review of the insurance industry, the Government should therefore also consider how foreign exchange controls might be adapted to enable insurance companies greater flexibility in undertaking both foreign currency investments and insurance contracts. The amount and variety of "acceptable' investment instruments available to insurance companies should be increased with greater care taken by the Government not to use these vehicles as a means to finance deficits or to keep Government enterprises afloat.

The Malagasy Social Security System

5.18 Structure of social security: In Madagascar, wage earners are covered by two systems of social security - a small government scheme for public sector employees by way of the Ministry of Finance and the Caisse Nationale de Prevoyance Sociale (CNAPS). For those individuals who are not wage earners, there is no organized social protection. A small number of independent entrepreneurs and farmers are covered by insurance policies issued by the insurance companies. The discussion below focusses on CNAPS which is the main element of the organized social security system. The oversight function of CNAPS is jointly undertaken by the Ministry of Public Works and the Ministry of Finance. The main office is located in Antananarivo and regional representation is carried out through fourteen regional offices. In 1989 the staff of CNAPS totaled approximately 600

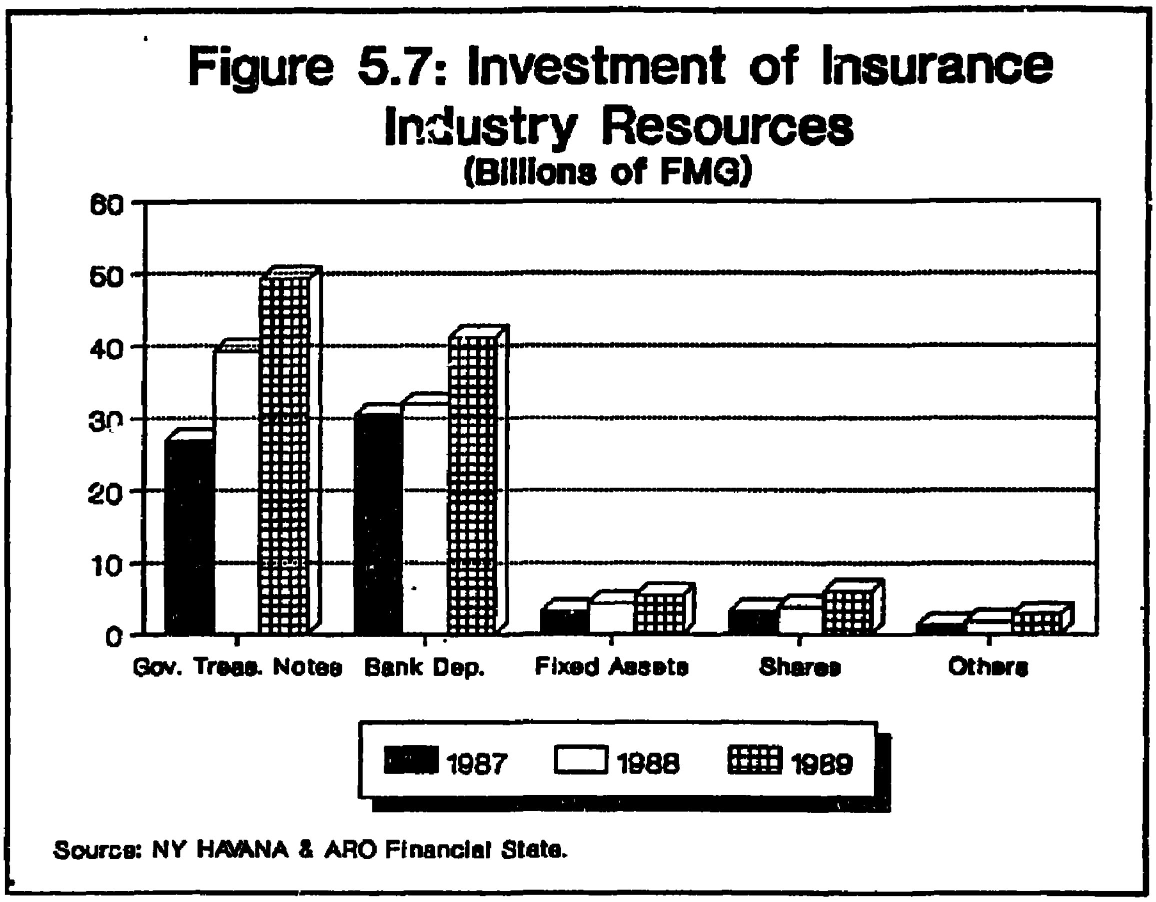


Table 5.5
Malagasy Insurance Company Investments
(1987-1989) (Billions FMG)
NY HAVANAN & ARO

	1987	%	1988	%	1989	%
Government Treasury Notes	26,980	41	39,330	48	49,280	47
Commercial Bank Deposits	30,540	47	31,990	39	41,090	39
Fixed Assets	3,306	05	4,366	06	5,936	06
Shares (Investments)	3,264	05	3,814	05	5,464	05
Others	1,270	02	1,750	02	2,800	03
TOTAL	65,360	100	81,250	100	104,570	100

Source: Financial Statements & other sources of NY HAVANA & ARO and managed the three social security functions: family benefits, workers compensation and retirement benefits.

5.19 Coverage of CNAPS: In 1989 the workforce (able workers) of Madagascar was estimated at 5,642,000 individuals, with 4,500,000 in the active workforce and 1, 100,000 seeking employment. Salaried employees, affiliated to CNAPS during the time frame since inception in 1969 to 1989, amount to approximately 810,000 individuals. Active employees, affiliated to CNAPS in 1989, amounted to approximately 261,000 individuals equivalent to a coverage of 5 percent of the active workforce. Only 8 percent of the participants in CNAPS have less than one year of affiliation while 44 percent have less than seven years of affiliation and the remaining 48 percent have over seven years with the program. Approximately two to four percent of agricultural workers, which make up the bulk of the Malagasy workforce, have sought social security protection. Only eight percent of local entrepreneurs have sought some sort of social security protection while a total of only five percent of non-salaried workers sought protection through the purchase of insurance policies from the two major carriers in Madagascar.

5.20 Social pension systems, being national or at the most regional institutions, have centralized management, although their operations are often decentralized. Their operating costs may be lower than under private and, therefore, completely decentralized systems. By their nature, social pension insurance systems are susceptible to political influence, both with regard to the payment of benefits and with regard to the investment of their reserves. In many countries, such as in Madagascar, social pension insurance institutions lack autonomy from central government and they also suffer from administrative weaknesses that affect their ability to keep records and to enforce compliance with the rules of the schemes, especially the prompt payment of the contributions. The challenge for the government and its social partners is to identify specific actions that will meet the legitimate needs of the government, as final guarantor, and of employers and workers who have contributed to this scheme, that will simultaneously increase the financial and managerial autonomy of CNAPS and assure the required external monitoring of decisions and the long-term financial soundness of the institution. Such actions should take into account the recent evolution of Malagasy economic policies, and foresee management of the CNAPS as much as possible along the lines of a private enterprise. As was recommended by a recent study[1], the institution of a dialogue among all parties concerned would help to move in this direction.

5.21 Contribution structure: Financial resources of CNAPS depend largely on the collection of the quotas payable by affiliated members. Fourteen percent of the worker's salary is payable to CNAPS on a quarterly basis. A yearly ceiling of FMG 1,200,000 was established in 1969, and has not been changed since then. One logical way to increase contractual savings in Madagascar would be to make a one-time adjustment in the ceiling, to compensate for inflation since 1969, and then to make regular changes thereafter. The fourteen percent is comprised of the worker's participation of 1 percent of salary and the employer's participation of 13 percent. These amounts are deducted from the salary by the employer and therefore the employee is deemed to have paid his share whether or not his employer makes regular payments to the Government. As seen in tables 1 and 2 below, Madagascar ranks high among African countries in terms of its pension contribution rate as a whole, but the employee share is disproportionate to the employer contribution.. An

[1] International Labor Office, Madagascar: Rapport au Gouvernement sur la Situation actuelle et les Perspectives d'Evolution de la Protection Sociale, Report MAG/82/005, 1992

additional financial resource is the levy of penalties on employers who delay more than one month past the quarter in which the deposit is to be made. This penalty is only charged at the time which the late deposit is made, thereby producing an incentive for employers to delay payments at long as possible. This creates an accounting problem that translates into a financial deficiency or discrepancy between book balances and actual financial balances.

Table 5.6

Social Pension Insurance Systems
Contribution Rates
(Percent of Salary Contribution)

	Employee	Employer	Total
Africa			
Seychelles	5.0	10.0	15.0
Sudan	5.0	9.0	14.0
Madagascar	1.0	13.0	14.0
Benin	3.6	5.4	9.0
Burkina Faso	4.5	4.5	9.0
Cameroon	2.8	4.2	7.0
Gabon	3.0	3.5	6.5
Zaire	3.0	3.5	6.5
Rwanda	3.0	3.0	6.0
Togo	2.4	3.6	6.0
Cote D'Ivoire	1.2	1.8	3.0
Niger	1.6	2.4	4.0

Source: Social Security Administration (1986)

5.22 Compliance and collection: Collection problems are severe with CNAPS, since the declaration of payments by employees must include the corresponding bank checks to be accepted by the regional offices. This creates an internal problem with the contributing members when they are confronted with financial difficulties. Late declarations continue to pile up when difficulties arise with the employers and they no longer consider their obligations to be a priority. Collection is very weak when legal action is undertaken by CNAPS. A major difference between insurance companies and CNAPS is that in the case of insurance companies a requirement of payment of premiums is necessary to activate the issuance of the policy protection. CNAPS on the other hand is required to provide benefits to the individual employee and his family if a claim is made since it is assumed that the payment is deducted by the employer at the source. The fault in the existing system of collection lies with the "ex-post' determination of amounts due and not an 'ex-ante' verification of what should be paid. Therefore there is no effective control of collection or recovery of this social debt. It should be stated that CNAPS functions through the good-will of the employers that participate in the system and not through an effective checks and balances of their social and legal responsibility. The lack of careful control is apparent when, in 1987, more than 8,500 technical default of payments occurred out of a total of 15,000 employers, without any significant verification of these accounts and the subsequent write-off of a significant portion of these obligations. There is a significant lack of perseverance in the collection patten established of the CNAPS accounts. In all fairness to the organization, there appears to be a legal void, with regard to the collection process, which has created and still fosters a general indifference among employers in the legal payment of the social obligations they undertake as an economic unit of Madagascar. Resolution of these legal ambiguities and the undertaking of an actuarial evaluation of CNAPS are recommended.

5.23 Government responsibility: The final responsibility of fulfilling the social contract in Madagascar lies with the Government. Any shortfalls between the amounts received by CNAPS and the amounts paid out to recipients, must be covered by the Government Treasury. Due to the uncertain nature of the benefits to be disbursed annually, a reserve fund was established on April 26, 1969 under Article 127, Decree 69-145, and is strictly required to equal one sixth of the amount spent or disbursed during the year. This is therefore established on the basis of the previous fiscal year.

Table 5.7
CNAPS
Evolution of Reserves
(in millions FMG)

	1985	1986	1987	1988
Technical Reserve	5,376	5,888	6,771	7,321
Ordinary Reserve	11,604	13,095	13,920	19,037
TOTAL	16,980	18,093	20,691	26,358

5.24 As can be noted in Table 5.7, two types of reserves were created. This is the result of the vague nature of the legal code, with regard to the constitution and maintenance of statutory reserves. The technical reserve is established under the strict guideline of the law and the surplus is added to the ordinary reserves which has grown to over FMG 19 billion in 1988.

5.25 Investment policies: CNAPS has a statutory obligation to deposit its excess liquidity with the Treasury. CNAPS does not derive any financial benefit from these funds. The investment policy of CNAPS is extremely limited. CNAPS holds investments in both local and foreign corporations. The foreign component dates back to the period prior to 1972. The domestic corporate investments have been undertaken in start-up ventures of government controlled companies. The other holdings result from participation in restructured companies that had unsettled accounts with CNAPS. The majority of the equity portfolio lies with domestic companies. According to the ILO study cited previously, 23 per cent of the receivables amounting to FMG 38 million are doubtful assets of CNAPS in state companies. Similarly, around FMG 220 million in the accounts of CNAPS represent losses from participation in liquidated state enterprises. Current accounts are held with local banks as are long term deposits. Long term deposits are placed with commercial banks at a set interest rate which is not indexed and therefore carries the inherent risk of inflation and currency devaluation, both of which have been significant since 1986. In real terms the equity of CNAPS has been eroding at a very dangerous level which could result in the Government having to cover shortfalls at a later date as more employees retire. As noted in paragraph 5.12, the growth rate of 8 percent of new members in CNAPS is hardly enough to cover the perceived demands on the system when the older affiliates retire. There is an urgent need to ensure a positive rate of return on investments that would at least cover the rate of equity erosion.

Future of Contractual Savings in Madagascar

5.26 The relative place of Malagasy contractual savings: Table 5.8 ranks Madagascar with respect to a group of industrial and middle and high-income developing countries in terms of their assets of life insurance companies and pension funds as a percentage of GDP. While the overall propensity to save in Madagascar is extremely low, closer examination of contractual savings as discussed above reveals that there are many disincentives to contractual savings under present conditions. The first among these is lack of an appropriate taxation system. Another recurring problem to be faced is the nagging inflation and the repeated need by the government to devalue the currency to maintain effective international competitiveness. These elements, along with a lack of domestic financial instruments and the lack of necessary capital market institutions has stifled the growth of contractual savings in Madagascar. This in turn has led to a slowing down of economic activities. All indications suggest that, under the proper conditions, greater financial savings and the economic activity generated through effective contractual savings mechanisms are possible with appropriate incentives.

5.27 To identify appropriate incentives, the Government must engage in a thorough review of both segments of the contractual savings subsector in Madagascar. First, a comprehensive review of the regulatory framework of the insurance industry that is already planned by the Government should be pursued which would include, among others, a review of the appropriate framework for taxation and exchange controls in the insurance industry. Second, the Government should engage a comprehensive external financial and organizational audit of CNAPS with the view to identifying how to make this institution an autonomous and accountable entity that could eventually play a major role as an institutional investor. The external audit of CNAPS should include an actuarial evaluation and a revaluation of the assets of CNAPS. The review of taxation and exchange controls for the insurance industry should be done in conjunction with a similar review for CNAPS as the financial products involved both for mobilization and allocation of resources are very much the same in both cases. In the course of this review of contractual savings, there is a need to ensure coordination of private and social security insurance to ensure that the strengths of both are used to the maximum.

5.28 At the same time, the financial system as a whole in Madagascar must become more creative in its ability to offer investment instruments to both individual and institutional investors. The creation of well functioning financial markets in Madagascar will depend greatly on the promotion of a favorable investment climate which has for so many years been neglected through previously inward looking policies. A specific effort must be made to develop financial markets which eventually lead to full-fledged capital markets in Madagascar. The scope and possible initial approach for doing this is more fully discussed in Chapter 7.

Table 5.8

ASSETS OF LIFE INSURANCE COMPANIES AND PENSION FUNDS, 1987

	% GDP
Switzerland	133
Netherlands	117
United Kingdom	105
Singapore	78
United States	72
Sweden	63
Malaysia	48
Denmark	47
Canada	43
Japan	32
Germany	29
Chile (1988)	22
France	19
Korea	18
Madagascar	4

Source: Financial Times, 12 July 1990 and National Central Banks

Problems of Housing Finance

5.29 Perhaps the most immediate major challenge to term finance in Madagascar is in providing finance for housing which has become more pressing in Madagascar with the marked deterioration in urban housing conditions. In most economies, the stock of housing forms a major share - usually in excess of 20 per cent - of national wealth and is especially closely tied to the internal efficiency and productivity of towns and cities. Despite its importance, housing finance in Madagascar, as in many low-income countries, remains fragmentary. A number of studies have already been completed which underscore the complexity and diversity of problems in housing finance in Madagascar. Several general conclusions can be derived from these studies that are of direct relevance to the financial system in the near and medium term.

5.30 The rental market provides a means whereby the majority of urban households can improve their housing. Rentals account for 50 to 60 per cent of the urban housing market in Madagascar and up to 80 per cent among the lowest income groups. Financial institutions should be able to attract deposits from small-scale property owners and from real estate developers who can provide adequate guarantees. The key role for public policy here is to allow rental charged to follow the market and possibly of granting tax exemptions for new rentals. Given the substantial demand for rental properties, these policies would ensure that bank loans for these activities are viable.

5.31 While the inherent commercial risk in housing finance can in principle be relatively small, these risks are multiplied when titles are insecure or when claims cannot be adequately enforced. The recommendations in Chapter 3 concerning improvements in land law and titling should also facilitate a greater role by financial institutions in housing finance. Given the inherent term transformation risk to which banks are currently averse, improvements in the legal framework could also help banks to package creatively or even securitize housing loans, thereby given them an additional margin of liquidity when needed. In addition, if other financial instruments such as mortgage insurance, mutual guarantees and other guarantees are introduced, there could be ample security for banks to more aggressively provide finance for housing.

5.32 At the same time, the demand for housing finance should provide opportunities for the banking system to increase financial savings. Some banks have already begun mobilizing funds through savings for housing schemes among the middle and upper-income urban households. There however remains a real need to develop intermediaries in urban areas for intermediaries which could channel savings to banks, especially but not exclusively from the lower-income segments of the population. Mutual savings associations could be established at the level of a firm or government department, professional association or community to facilitate this process. An ideal candidate for interfacing with these associations is the postal savings system which already has as a client every fourth inhabitant in Antananarivo. Over the medium term, such mutual savings associations could develop housing schemes in conjunction with a revamped postal savings institutions as well as banks. These possibilities are more generally discussed in Chapter 6.

5.33 Growth in housing finance might also be envisaged through contractual savings institutions. A more detailed study would however be required to determine how insurance companies and CNAPS could both mobilize and allocate resources for finance without subjecting their investment portfolios to undue risk. It is premature at this stage to envisage, for example, the development of mortgage-backed securities as a vehicle for housing finance in Madagascar. Nonetheless, several schemes have been developed in other countries which could be studied for possible adaptation to Madagascar, where provident funds, for example, allow for individuals to withdraw funds to be used for financing home ownership.

CHAPTER 6

PROVIDING FINANCIAL SERVICES FOR SMALL-SCALE ECONOMIC AGENTS

6.1 A majority of economic agents in Madagascar are "small-scale" both in terms of the volume of their savings and their finance needs. These small-scale economic agents comprise smallhold farmers, owners of microenterprises or small and medium-scale enterprises (SMEs), artisans, small traders, landless laborers and migrant workers. Of the 30,845 registered and active firms in 1987, only 6% employed more than 10 persons. Over 65% of these firms are in the commercial sector which represents less than one-tenth of employment in the country. Some 1.5 million of the 1.6 million rural families in Madagascar work small, mainly subsistence farms of about one hectare or less and account for 85% of the total population in Madagascar. It is also estimated that there are well over 30,000 microenterprises which are widespread throughout the country including a variety of artisanal and informal sector activities and in addition to some 300 SMEs in the formal sector. Together, these small-scale economic agents represent the largest number of actual and potential users of financial services in Madagascar as well as a potentially significant source of financial savings.

6.2 Sustainable and equitable long-term growth in Madagascar cannot be envisaged without the active participation of this overwhelming majority. Yet, many of them have little or no access to the existing financial system and are therefore unable to effectively contribute to resource mobilization nor to fully avail themselves of payment services, working capital, term loans or equity finance from existing financial institutions. One of the biggest challenges for the future will be to improve financial services to this category of the population and better integrate them within the overall financial system.

Nature of Small-Scale Finance

6.3 Socio-economic characteristics of small-scale operators: Despite their considerable diversity, small-scale economic agents as a group have certain preponderant socio-economic characteristics. Most small-scale economic agents are noncorporate: small farmers, producers, tradespeople, and independent traders. One common characteristic is that the cash balances (and potential deposits) and average finance requirements (whether debt or equity) of this group tends to be considerably smaller than average resources and needs of customers of existing established financial institutions. Another prominent characteristic is that they tend to represent family-based or individually-owned businesses (in contrast to salaried employee or wage earners in the public or formal private sector). These small-scale activities collectively account for significant shares of output and employment in their respective spheres of production.

6.4 A majority of small-scale farmers are subsistence farmers who produce virtually no marketable surplus but account for nearly two-thirds of all farms. Smallholders as a whole (including those producing cash crops) account for about 42 per cent of output in the economy. About two-thirds of SMEs (which collectively account for an estimated one-fifth of industrial production and employment in Madagascar) are managed by their owners, also reflecting the strong family nature of such businesses. Microenterprises are largely individually-owned businesses that nonetheless are thought to account for up to half of employment in urban areas. In both rural and urban areas, the activities of such microenterprises (and some SMEs) include pottery, iron-working, charcoaling, silk weaving and small-scale processing activities such as rice hulling and groundnut oil extraction. Landless laborers and migrant workers who are not business owners in any sense make up the remainder of small-scale economic agents. The majority of small-scale economic producers and enterprises are not registered with any government office, do not maintain accounts, and are often not licensed as businesses. A final important characteristic is that many small-scale economic agents are already or have the potential for being associated into groups, based on communal and other interests, to strengthen their access to financial and other services.

6.5 Demand and supply of financial services: Small-scale economic agents vary in their needs for financial services. In the normal banking context, their needs tend not to be distinguished by geographical segmentation (rural versus urban) but by end-use of finance broadly grouped into corporate and private needs. Street vendors need short-term finance to buy stock and a depository for temporary surpluses. Small-scale producers (mainly SMEs) need somewhat larger and longer-term loans to buy equipment and labor; although their businesses tend to be closely held, they also have a need for equity finance to strengthen their financial base. Among small-scale farmers (whose major input is hired labor), there is an overwhelming need for credit for land preparation and planting, and to a lesser extent for seeds and fertilizer as well as agricultural equipment. Many landless laborers and migrant workers seek but have no access to capital; a number of them would thereby be able own and operate their own services (examples include push cart operators and producers of artisanal wares). Payment services using financial instruments are a basic need for all these economic agents although it varies by degree of marketability and monetization of their output. There appears to be potential demand for non-banking financial services such as insurance (life and non-life) and leasing, although appropriate financial products in these and other areas have not yet been developed. Personal financing needs for this group such as for marriages, funerals, and family tombs, are normally met through contributions from family members, relatives, and friends. Against this variety of needs, the actual supply of financial services to small-scale operators from both formal and informal institutions, as discussed below, appears at best below potential and is, at worst, completely absent.

6.6 Relationship to formal finance: There are a number of general features which tend to characterize the relationship of most of these small-scale economic agents to formal financial markets, institutions and instruments, although these features may vary in degree according to the type of activity or location of a particular household or enterprise. A large portion of the production undertaken by this population is believed to be unmonetized, particularly among subsistence farmers. In addition, many of these farmers as well as salaried herdsmen in the highlands tend to invest their savings in unmonetized forms such as land and cattle. A major unfulfilled financial need for most small-scale economic agents is the opportunity to save in financial assets as a means of helping smooth seasonal variations in income and providing a hedge against risk. At the same time, there are also many small-scale economic agents who maintain cash balances mainly for economic transactions. However, for a number of reasons, they tend not to place funds within the formal financial system and mainly because (i) they do not qualify for the minimum deposit necessary for a checking account in a commercial bank; (ii) their access to a formal depository institution is poor; (iii) even if they manage to maintain deposits within a formal institution, they have difficulty obtaining credit, thereby discouraging relationships with formal institutions; or (iv) they lack knowledge and experience with formal financial institutions. Many of these economic agents, including those located in urban areas, are not actively sought as clients (both as depositors and borrowers) by formal financial institutions because of perceived high transactions costs, risks, and low profitability of these activities.

6.7 Informal finance: Small-scale economic agents often turn to informal finance as an alternative to established financial institutions. While knowledge on informal finance in Madagascar as a whole is limited, a number of basic patterns seem evident. Although Madagascar resembles many Sub-Saharan African countries in the preponderance of small-scale economic agents in its population, it does not seem to have the various kinds of organized and widespread systems of informal finance found elsewhere (eg. "tontines" and "isusu" in Western Africa). Informal finance appears to largely take a highly localized form of mutual help between family or friends or, in some areas, of usury practiced by traders or landed proprietors. It is reported that, given the difficulties of obtaining finance from formal institutions, such usury is seen as essential, being the only source of finance for many small-scale farmers and economic operators. In some specific areas of production and marketing such as the cattle business, informal finance has taken the form of certain profit-sharing and prefinancing schemes, where one party lends out a herd for fattening by another party or where herds are pooled for sale. However, attempts to "formalize" such schemes by integrating them to formal financial system have failed. Small traders are believed to some extent to fill the gap between large-scale and retail and between informal and formal financial service providers and users. However, while informal finance in Madagascar appears to provide valuable financial services through its flexibility and availability, it appears on the whole, that its fragmentary and unorganized nature makes it an inadequate alternative to formal finance.

6.8 Overall impact of small-scale finance: There is much evidence to suggest that substantial savings exists in Madagascar among small-scale economic agents, particularly in rural areas (where much traded output is produced in contrast to the substantial non-traded character of urban production) which tend to generate net surplus resources. However, for various reasons, the financial system in Madagascar has not captured the bulk of savings among small-scale economic agents who tend to prefer real assets to financial assets. At the same time, their demand for financial services (both debt and equity finance as well as depositary and payment services) is high but is known to be largely unmet by formal financial institutions and believed to be inadequately provided by informal institutions. The fundamental problem remains one of access of small-scale economic agents both to financial services and information. In addition, improvements in infrastructure as well as in regulatory policies and in the legal framework, which would be conducive to improving the profitability of small-scale economic activities, would in turn improve their access to finance. Much therefore remains to be done to realize the considerable productive potential of this preponderant segment of the population. A coherent approach by the government is therefore needed to ensure that public policies support rather than impede the activities of this important segment of the economy and population.

6.9 Policies toward small-scale finance: Government policies toward small-scale finance have not shown a distinct pattern. In the past, such policies have varied from neglect to outright interventionism but more recently there has been renewed consciousness of the importance of such policies but with an approach which is still not yet fully defined. Government policies have been compounded by a multiplicity of initiatives from donor agencies and from non-governmental organizations (NGOs) which have not been fully coordinated. A variety of support programs have been tried which have not either individually nor collectively attained national coverage of small-scale economic agents. Notwithstanding these results, Madagascar has a history of relatively active cooperatives and groups which indicates significant potential for developing alternative professionally or community-based grassroots institutions for helping improve access to financial services. At the same time, existing financial institutions can either be revitalized or stimulated to improve their provision of services to this important segment of the market for financial services. Together with the economic reforms initiated during the 1980s, this background augurs well for the development of a set of viable, responsive, and sustainable institutions, instruments and markets for servicing the financial needs of small-scale economic agents during the 1990s.

Key Areas of Government Policy

6.10 Although a top-down or "blueprint" government approach to small-scale finance has not succeeded in any country, there remains considerable scope for supportive public policies which rely primarily on market forces to direct financial services towards small-scale agents and to mobilize resources from them. Future policies toward small-scale finance should aim at appropriate actions in four areas: (i) efficiency and competition among banking institutions; (ii) sustainable and demand-driven small-scale finance policies encouraging both savings and credit; (iii) linkages and integration of small-scale finance within the overall financial system; and (iv) improvements in the regulatory framework and in financial infrastructure which would lower transactions costs and risks. Such policies should be guided by past experience which provide many lessons on which approaches or initiatives might be replicated and which should be abandoned.

6.11 Efficiency and competition among banks: Efforts to create specialized banking institutions solely catering to the needs of small-scale finance (notably for either SMEs or rural credit) have not generally been successful in any developing country. In Madagascar, the post-nationalization restructuring of the banking system led to the creation of a new bank (BTM) which was intended to have primarily an agricultural vocation. In fact however, such specialization did not occur largely because agricultural activities, especially on a small-scale, were not an attractive source of business for banks who continue to prefer to finance large-scale manufacturing or trade activities. There is therefore, first of all, a need to make such small-scale activities profitable enough to attract bank financing for which banks tend to face significantly higher transactions costs than lending to large enterprises, for example. At the same time, there should be sufficient competition within the banking sector to ensure that banks have an incentive to look beyond their traditional sources of business. Although banks in Madagascar appear to face somewhat increased competition since the introduction of private banking in Madagascar in the late 1980s, they still enjoy a significant interest margin and exhibit relatively high costs of intermediation (see Chapter 4). The measures recommended in Chapter 4 for pursuing greater competition within the banking sector should therefore be adopted for improving the overall financial system. This would also favor the development of small-scale finance. Increasing such competition among banks is not likely in the short term to generate a significant increase in their activities towards small-scale economic activities. However, such competition is essential for sustaining small-scale finance activities over the medium term and ensuring that they become increasingly integrated within the overall financial system.

6.12 Sustainable and demand-driven small-scale finance: Policies towards small-scale finance have traditionally been dominated by agriculture-related programs. These programs have a long history in Madagascar which predate its independence in 1960. The salient features and results emerging from the main programs, which have been undertaken by the government, BTM, and NGOs, are summarized below. Several of the lessons from these and other programs are also confirmed by experience elsewhere. First, the operational costs of many of these programs can be high and often require continuous injection of donor funds or government subsidies. Such programs are not conducive to sustainable small-scale finance and in fact may retard efforts to develop financial institutions and instruments which can be sustained and expanded independently of external subsidies. Among programs which have worked are those that substantially rely on self-disciplining incentives of group-based lending which themselves depend substantially on the resources of group members. A second and related lesson is that "rural credit"" alone is not likely to result in a sustainable program - both resource mobilization and allocation should form an integrated small-scale finance program.

6.13 A third lesson is that, linkages with formal financial institutions should be allowed to develop freely. Full integration within the overall financial system tends to develop only over time and cannot be forced from above. However, a "bottom-up" approach which stimulates institutions in specific geographic areas or within specific types of activities, for example, should be guided by considerations of how these institutions could eventually form links with the broader financial system. Small-scale finance policies should not, for example, aim at encouraging a distinct "rural finance system" which implies geographic segmentation of financial markets and dissociation from the "urban" financial system. Rather, it would be more beneficial to envisage small-scale finance programs which as a whole eventually stimulate alternative finance institutions for the full range of small and medium-scale economic activities found in all geographic areas. The clear implication of this geographically unsegmented approach to small-scale finance is that farmers groups, cooperatives and producers associations should develop linkages among themselves as well as become integrated within the broader financial system. It is possible that a variety of such institutions in both rural and urban areas could benefit from economies of scale in terms of external assistance and might eventually become more closely associated through a higher-level apex institution (as has been, for example, the case of cooperatives operating in both rural and urban areas in several countries). At the same time, such integration reduces the risk of small-scale finance because the risks of rural activities alone are highly covariant.

6.14 Coverage of small-scale finance programs: Almost all small-scale finance programs targeted at rural areas in Madagascar, whether undertaken by the Government, BTM, NGOs or other donors, have to date individually reached less than one percent of rural households. The collective impact of these programs in terms of number of households or enterprises served is also extremely small. This results from a number of factors which suggests important lessons. Given the sheer size and variety of the country, it is not only unfeasible but also undesirable to attempt to create a centralized national-level small-scale finance program. No single approach of program is likely to be suited to all the different agro-climatic regions in Madagascar nor to the heterogeneous activities found among small-scale economic agents. In order to succeed, any new program should be established in areas where economic activity is already profitable; in other areas, additional inputs such as infrastructure and other services are likely to be necessary before small-scale finance programs can succeed on their own. At the same time, as further discussed below, appropriate legal and regulatory mechanisms need to be put in place (and certain other regulatory restrictions removed) to catalyze small-scale finance activities.

Improved coordination among the various sources of outside support (Government, donors, NGOs) is essential to enable suitable programs to be replicated and to avoid conflicting uses of resources.

6.15 Recovery rates in small-scale finance programs: Recovery rates in various small-scale finance programs have varied tremendously - ranging from extremely poor to almost 100 per cent. A number of factors account for the differences. In general, the best recovery rates are observed in programs where some form of group-based lending takes place drawing on the tradition of communal cooperation found in certain areas. Recently developed programs by BTM based on this approach have shown distinctly greater success than its small-scale credit to individuals. However, the ability to establish a legal basis for the association also appears to be important as is the avoidance of the risk of politicization within a group and control by a handful of individuals (smaller groups therefore tend to work better). A second determinant of recovery rates is the inherent risk associated with certain programs. Vagaries of weather and high transactions costs can easily undermine a program. In contrast, the cereal banks program in the Antsirabe area allowing associations to obtain off-season credit by pledging rice as security in a locked store illustrates a low-risk program with a high recovery rate. Third, experience of BTM and some NGOs in high recovery rate programs indicate that associating credit with savings appear to create stronger incentives for more disciplined use of resources. An association or group can use the savings so generated for communal projects. Finally, programs with high recovery rates tend to have the following key characteristics: (i) trust between providers and users, and among users within a group or association; (ii) easy access to services, implying a minimum of formality as well as simple and easily understood procedures; (iii) as few conditions attached as possible on the end-use of finance provided, enabling users to freely choose as needed; and (iv) timeliness in the provision of required financial services.

6.16 Subsidies and transactions costs: Small-scale finance tends to be associated with high transactions costs, although this can also vary considerably by type of region and activity. Many of the small-scale finance programs in Madagascar contain both disguised and explicit elements of subsidy. Considerable debate and controversy has therefore arisen over the justification for subsidized finance in such programs. A number of basic principles should be observed to ensure that such programs can be sustained over the long-term and enable small-scale economic activities to grow independently of external support. Subsidies to the end-user can rarely, if ever, be justified, whether this is represented by lowered interest rates, subsidized equipment or any other form. Such subsidies are distortionary and impede resources from being allocated to their most efficient use. In contrast, subsidizing the delivery mechanism for finance because of high transactions costs could possibly be justified. However, even in these cases, the reasons underlying the high transactions costs must be first examined fully. Where inadequate infrastructure (roads, power, water supply) is the reason, it is better to tackle these factors first rather than use subsidized finance because they can undermine the profitability of the underlying activity. Where high risk of crop failures through bad weather is a factor, the scope for organizing an insurance program aggregating a large number of risks should also be considered unless these risks are highly covariant. Where transactions costs and risks result from legal or regulatory factors or absence of adequate accounts, these factors should be tackled in the first instance rather than applying a subsidy. In all cases, there should be a clear program for phasing out any explicit or implicit subsidy. All costs and subsidies of small-scale finance programs should be made as transparent as possible to enable scarce resources to be most effectively deployed. This approach towards subsidies - essential for the long-term success of small-scale finance policies - calls for careful analysis, discipline and coordination among the government, donors, NGOs and other actors concerned.

6.17 Legal and regulatory issues: In every country, a host of legal and regulatory issues emerge in the course of building an effective approach to small-scale finance, Madagascar being no exception. On one hand, specific legal and regulatory mechanisms are needed to improve the access of small-scale economic agents to financial services, to facilitate the entry of certain providers of service such as NGOs, and to provide adequate security to both providers and users of financial services. At the same, certain legal impediments or formal or informal regulations may have to be revised or eliminated (see Chapter 3). The legal character of mutual savings groups and associations should be clearly established and universally understood and recognized. Access to certain financial services such as leasing would also require groups and associations to develop a recognized legal character (see Chapter 7). Simplified accounting rules need to be devised to enable small-scale economic agents to produce accounts where these are necessary for establishing and operating an enterprise and providing necessary information to a lender (see Chapter 3). The present open policy towards the activities of NGOs in small-scale finance should become established government policy while at the same time the prudential practices of such activities be clearly defined from the outset. Without adequate prudential safeguards, savers' money will not be adequately protected and experiences with losses at a later stage could severely undermine a small-scale finance program by damaging confidence in new institutions.

6.18 Linkages with the overall financial system: One tendency to be resisted in small-scale finance policies is the formulation of strategies and support of institutions in dissociation from the operational and regulatory framework of the rest of the financial system. For efficient allocation of resources, appropriate prudential supervision and regulation, and effective conduct of monetary policy, it is important to ensure that small-scale finance programs become integrated within the broader financial system. An integrated financial market ensures that funds can flow freely across sectors and regions and be priced according to criteria of risk, liquidity, and maturity. The persistence of the particularly difficult present state of communications and the fragmentary nature of real sector markets in Madagascar will continue to render integration of financial markets imperfect in many respects. However, under appropriate policy conditions, greater integration between small-scale financial institutions and the rest of the financial system can and should progressively evolve on several levels and should broaden and deepen over time. Two aspects of such linkages are discussed below which are especially important: operational relations with established financial institutions and conformity with the overall prudential regulatory and supervisory framework.

6.19 Operational relations with financial institutions: Small-scale finance institutions naturally become associated with established financial institutions through their need for payment and depository services. This reflects a widely observed phenomenon in small-scale finance which is that small-scale economic agents first and foremost need appropriate financial savings facilities. Agriculture, in particular, tends to generate surplus resources which can be transformed into financial savings for use in other generally faster growing sectors. Experience in other countries, for example Cameroon and Rwanda, indicate that grassroot-level finance institutions tend to mobilize deposits much faster than they are able to allocate credit. They therefore tend to have much lower loan-to-deposit ratios in their early years than established banking institutions. Consequently, they need to place their excess liquidity within the broader financial system either through financial instruments such as Treasury bills or term deposits with banks. It is important to ensure that emerging group-based or other mutual savings and loans associations can freely choose whichever existing financial intermediary best serves their needs at any given time. Although some institutions (eg. BTM, the postal savings and checking system) are especially well-positioned by virtue of their past experience and existing customer relations to serve new small-scale finance institutions, there is no need to mandate a privileged role for any individual institutions in these areas. In order to encourage new savings groups and associations to develop relations with established financial institutions, it is important to dispel the natural suspicion that many small-scale economic agents might harbor towards established financial institutions, especially if these institutions are perceived to have historically pursued "top-down" approaches to credit allocation or to be subject to various forms of government interference. Both the banking industry and Government could jointly conduct campaigns to improve knowledge of various banking products and legal protections among the members of grassroot-level or group-based savings associations.

6.20 Prudential regulatory and supervisory standards: It is important that government policy not interfere with a multifaceted approach to building small-scale finance institutions which would enable a multitude of mainly group-based savings and credit activities to emerge throughout Madagascar. However, all existing and new grassroot-level savings associations should in principle be subject to the same prudential regulatory and supervisory criteria as other deposit-taking and lending institutions in the country. At the same time, in their initial stages and especially while their operations are solely limited to their members, these institutions could at least partially, if not wholly be exempt, by decree from the monetary authorities, from the full reporting and disclosure requirements of established institutions until they develop their capacity for producing regular and complete accounts. However, once these institutions mature to the point of becoming full-fledged deposit-taking and credit institutions, and especially when these operations are opened to outside the membership of the group, these institutions should be subject to similar regulatory and prudential supervision standards applied to other financial institutions.

6.21 It is therefore crucial that monetary authorities be closely consulted at an early stage in the formulation of small-scale finance policies. Otherwise, such programs tend to come almost exclusively under the purview of sectoral ministries such as the Ministry of Agriculture which primarily focus on practical aspects limited to their area of sectoral responsibility. This can lead to neglect of issues of monetary policy and prudential supervision whose importance becomes especially evident in later stages of development. At the same time, it is crucial for the BCRM to begin preparing itself for these new functions by strengthening its supervisory capabilities. Otherwise,it would be not realistic to expect the BCRM to extend its limited human and other resources to the potentially costly and difficult task of supervising a large number of far-flung depository institutions. This should form part on an overall program of development of the supervisory capacity of the BCRM (see Chapter 4).

6.22 For practical reasons, it would not be possible for BCRM to undertake on-site inspections for all small-scale depository institutions. However, financial returns (in as simplified form as appropriate) that are mandatorily submitted with a prescribed frequency (at least once a year and possibly more for larger institutions) should enable BCRM to detect any problems that warrant on-site inspections. BCRM could also examine the possibility of delegating at least part of this function to a "financial extension services" bureau that could be part of a technical assistance program to small-scale institutions. Inspection of small-scale institutions could be a "training ground" for junior supervisory personnel of BCRM. At some point in future when an APEX institution is formed out of a group of smaller institutions, the APEX institution could become the primary focus on supervision efforts which in turn would facilitate supervision of its members.

Revitalizing the Postal Savings System

6.23 Potential of the postal savings system: The Malagasy postal savings institution (Caisse d'Epargne de Madagascar or CEM) continues to operate as a traditional postal savings institution although it was legally transformed into a savings bank in 1985. CEM already attracts the business of every fourth inhabitant in Antananarivo and hence, has a good foundation from which to grow further. Apart from its one outlet in the capital, CEM operates 220 windows in post offices in 208 towns throughout Madagascar, giving it the widest financial network in the country. The vast majority of its accounts are held by individuals; the rest are held by a handful of enterprises, local governments, educational institutions, and religious as well as other associations. Individual accounts however average only about 40,000 FMG (much lower than the minimum deposit required by commercial banks for a checking account) while enterprise accounts are on average fifteen times higher. Thanks to its widespread network, the CEM could form an excellent base for establishing the necessary link between informal and formal financial activities. With an access rate to the market of one account for every four person in Tana it makes it a formidable platform to be the link to the formal banking system. At the same time, a large portion of the small-scale finance initiatives could be both initiated and operated through the CEM. Notwithstanding this potential however, the CEM remains fraught with organizational and other problems.

6.24 Key problems of the CEM: The present CEM is weak in key management areas and provides only very limited service to its customers. Its financial management is hampered by its dependence on the Treasury with which it is required to place all its funds and which pays a below market interest rate on its accounts. Delays in making funds available to customers reduce the attractiveness of the CEM as a major agent for mobilization of resources. There is no clear-cut marketing strategy through which the CEM could better adapt and design financial products so as to broaden its clientele and enlarge its deposit base. The revenue generating capability of the CEM is constrained in its present form, making it difficult to make the necessary investments for CEM to play a more active role as a financial institution.

6.25 Market position of CEM: Unlike CCP, the postal checking institution (see Chapter 3), CEM has a clientele among which customers other than civil servants are an important group. Individual depositors who number about one quarter of a million are drawn from artisans, traders and farmers, mainly in urban areas. By offering an interest rate on its passbook savings which is about 2 percentage points below the comparable rates offered by commercial bank on term deposits, CEM is handicapped in its marketing policy. Despite this handicap and a relatively passive promotion effort, CEM manages to open 1500 new accounts on average every month. At the end of 1990, CEM deposits were equivalent to 35% of all term deposits held at commercial banks by individuals. This underscores the substantial scope for developing CEM as a savings bank. However, its attractiveness to depositors will remain limited by relatively cumbersome service, among other factors. For example, interest on passbook savings must be updated at the CEM center in Antananarivo and be personally certified by a public accounting agent ("agent comptable publique"), creating delays for customers.

6.26 Revitalizing the CEM: The CEM is the most promising candidate in the near-term for a formal financial institution which could provide linkages between small-scale, informal and formal segments of the financial system. To enable the CEM to play such a role, a broad revitalization program for CEM could be envisaged entailing a strengthening of its organization and management, marketing, financial and personnel policies. An essential step would be for the Government to envisage, plan and institute such organizational changes as necessary for the CEM to gain operational independence. As part of this exercise, a new corporate strategy should be drafted which should aim at making CEM a fully fledged banking institution over the medium term. This should occur in the context of a broader transformation of the postal and telecommunications services (PTT) in the country which is being envisaged by the Government. A similar process has already occurred in many other developing countries in Africa and elsewhere which could provide some lessons for Madagascar (see Annex 6.1). The other elements of the revitalization are reviewed below. Such a program would clearly extend over a number of years. Implementation of the initial steps however could be envisaged in the near term once the basic strategic studies have been completed.

6.27 Transforming the CEM: The new corporate charter for CEM need not entail immediate change to its present legal study as a public enterprise ("EPIC" or public enterprise of an industrial and commercial character). By initially preserving its current legal status, CEM could maintain its implicit government guarantee which would be necessary during a transition period before it becomes a full-fledged banking institution. The new corporate charter should not include the provision of article 22 of the March 6 1985 decree allowing 50% of CEM funds to be used for loans. As discussed below, the role of CEM as a credit institution should be deferred until it has fully established itself as a solid savings institution. In addition to representatives from its oversight ministry, the Board of CEM should include representatives from its staff and clientele, the latter including local chambers of commerce or other socio-professional organizations whose members are substantially represented in its clientele. CEM should be required to produce annual audited accounts. The CEM Board should meet at least twice a year to approve its budget and accounts. If the corporate charter enables CEM to borrow funds, the Board should approve any such loans negotiated by the general manager.

6.28 Relations with the Post Office: The cooperation arrangements with the Post Office should be reviewed and an adequate agreement signed between the parties stipulating charges, fees and other services to be performed by the Post Office as an agency of CEM. In this respect, the close relation with the Post Office should be re-examined with a view of developing new and more efficient routines for handling of CEM transactions by the post offices. Furthermore, the possibility of CEM operating its own offices in areas where business volumes could warrant the costs should not be ruled out. The aim should be however for CEM transactions to be transacted in any post office throughout the country. Where feasible, CEM could construct offices of its own; alternatively, some existing or new post offices could be designed in such a way as to allow the two distinct operations to work in the building. Arrangements such as separate entrances which have been undertaken, for example, by the Postal Savings Bank of Zimbabwe, could also be considered. The Post Office could be reimbursed through a fee system, thereby giving it one source of income.

6.29 Marketing policy: Marketing policy would be crucial component of a revitalization program for CEM. As a savings bank, it should aim at improving the savings facilities in the country by way of product development with an emphasis on the larger segments of the market, including households and SMEs. It is important that the marketing policy is geared towards volume products which have a chance of a wide acceptance, thereby making it possible to take advantage of economies of scale in the operations. It is clear that the revitalized CEM should be given autonomy in its deposit pricing policies although posting of its remuneration of various products as well as competition with other institutions, where possible, should prevail. A number of marketing programs could be undertaken taking into account the particular socio-economic characteristics of various regions of Madagascar. Account features such as deposit size, remuneration and lead time necessary to make funds available could be tailored to suit the particular needs and demands of various segments of the CEM clientele. At this juncture, without the benefit of any marketing surveys, it would be premature to speculate on what specific products could be marketed by CEM in future. However, among some basic ideas which might be tailored to some customers is to qualify them for loans after a pre-established period of time during which they would have accumulated deposit balances equal to the loan amount they seek and repayable over the same period of time. Another possibility would be to introduce a "lottery account" remunerated at a lower than usual interest rate which could qualify for a prize awarded at regular intervals when drawings are made from a number of such accounts.

6.30 Financial autonomy: It is crucial that CEM have the ability to become a financially viable institution free of dependence of subsidies. Its financial operations should also be transparent. To achieve this, CEM requires to be financially autonomous of the Treasury and free of cross-subsidies within the PTT. Financial autonomy for the CEM would entail a review of its pricing policy for its various products and services. Estimates of operating revenues and costs based on the existing assets of CEM and its current operating costs show that financial autonomy could lead to financial viability. For example, had CEM received a market interest rate of 12% or more on its funds in 1990, instead of the below-market interest paid by Treasury, it would have been able to cover its operating costs and generate a profit. The ability of CEM to freely place funds in the money market (including subscription of Treasury bills which currently pay an attractive interest rate) or bank deposits is therefore crucial to its financial viability. In the near term, it is likely that CEM will control costs by keeping interest rates on its deposits below those of banks. Since its clientele is likely to remain substantially different from those of commercial banks for sometime, such a policy may be both feasible and necessary. However, CEM should also eventually prepare to adapt its strategy to be able to fully compete with banks, especially once it begins to earn income from lending rather than just placing funds in the money market or banking system.

6.31 Among the most promising avenues of further financial viability lies in considering revitalization of the CEM alongside a proposal for the CEM to operate the existing postal checking system (Compte des Cheques Postaux or CCP) as a girobank (see Annex 3.5). The latter could also help improve the payments and transfer system in Madagascar (see Chapter 3). The CCP already operates as a rudimentary payments and transfer system in Madagascar. There appears to be considerable scope for enhancing its role into a true girobank along the lines of similar institutions developed elsewhere in the developing and industrial world which handle regular transactions such as salary, utility, rental, tax and other payments in addition to transfers. Experience worldwide has shown such institutions can be very profitable once they are able to manage the substantial float that is available from the lags between payments received and payments made. Part of this float could constitute a permanent source of funds as the flow of funds is continually renewed by regular payments into the girobank. This would afford the scope for the CEM to become to a become a viable financial institution, capable of self-financing a substantial portion of its investments in domestic currency. CEM could either own the girobank wholly or possibly together with equity participation from commercial banks who would also have an interest in an institution which could improve the domestic payments and transfer system. It is important, however, that alongside the transformation of CEM into a more aggressive and proper banking institution, the Government make such provisions necessary for a money market to develop, notably in the area of negotiable Treasury bills as well as introduction of other instruments which could be traded (see Chapter 7). There must exist ample opportunities for the CEM to invest its resources for long and short term, at least until such a time the CEM can start to operate lending operations on its own.

6.32 Manpower development policy: The prospects for a greater role of the CEM hinge fundamentally on the possibilities of developing adequate and properly trained staff. Following a step by step approach, a first phase of the manpower development plan could cover basic management-level skills, accounting and finance, and operating procedures for staff in which tellers and other categories of staff should be the primary audience. Marketing skills should also be developed particularly aimed at promoting the CEM among clients who may not be of prime interest to commercial banks such as artisans, traders, farmers, and low-income urban wage earners, either individually or through appropriate communal or socio-professional groups. At a later stage, if and when the CEM actually engages in credit operations, traditional banking-type skills adapted to its specific functions could be developed. The entire process should be assisted by a technical assistance program which should first entail drafting and approval of a new charter for the CEM. This program could also cover training needs for the girobank which the CEM could operate as a separate entity. Staff of the post office also assigned to handled CEM transactions should be given training by CEM itself with the CEM jointly selecting such personnel together with the Post Office.

6.33 Initial relations with small-scale savings groups: The revitalized CEM should have such a policy and such products from the beginning that it would become natural and attractive to use this institution as the primary financial institution for group-based savings associations. Using its widespread network of offices, it would be possible to service groups in more or less every part of the country The role of CEM should mainly be that of the account holder of group while allowing for more than one group could use the same CE office. The individual accounts should be administered by the group itself and it should be possible for the group to operate more than one account for various purposes. One example could be one account for long term savings and another of more short term character, from which withdrawals could be effected in accordance with terms and rules set out by the group itself. Economic activities of the group and income from this activity could be channelled directly to the group through the CEM and distribution done by the group itself. Marketing of milk, for example, and proceeds being paid at certain intervals from the dairy company elsewhere could easily be transferred through the CEM direct to the group's account. Of course, other income of the group could be channelled otherwise and directly to the group, but it is important to have other formal channels open. It is clear, as previously stated, that there should be no compulsion to use the CEM over any other financial intermediary, although it is likely that a revitalized CEM would be able to capture much of the business of far-flung savings groups through its wide network.

6.34 Broadening and extension of CEM services: Through its own technical assistance program, it is possible that the CEM could render some assistance to emerging savings groups. This could notably entail training in financial matters which could benefit both customer and CEM equally. Such assistance administered through the CEM could also be associated with the beginning of loan activities from the CEM to the group, if warranted by its activities and past performance (a prequalification step for credit activities). The beginnings of CEM activities in lending however should also be conditioned on adequate improvements in the legal and accounting within the country. This is especially given that the credit risks among the CEM clientele might be higher than those in the commercial banking sector, particularly for lending to individuals. To manage such risks, lending by CEM should primarily be seen as a complement to the lending likely to take place within the group as part of their own activities. Such lending could, however, be beneficial if the business volumes could be boosted in this manner, for particular projects of interest to the group or association concerned. Groups and associations should also be encouraged to cooperate cross regions and financial flows resulting from such cooperation could then easily be handled through the network of CEM. A similar role could be played by the revitalized CE with regard to cooperatives. It would not seem feasible at this stage, to envisage any cooperative banking institution in Madagascar and it would be preferable for cooperatives to use existing institutions to meet their needs for financial services.

The Role of Venture Capital

6.35 Importance Of Venture Capital: One of the major problems faced by small-scale economic agents (particularly SMEs which need capital equipment) is a lack of equity financing. One potential vehicle for such financing which is yet to fully develop in Madagascar is venture capital. Venture capital is equity financing based on the principle that a partnership can be forged between the entrepreneur and the investors. This is still a relatively new financial instrument in both industrial and developing countries. It is significantly different from bank financing and financing by passive "portfolio investors" in that venture capitalists generally add value to their investments through the provision of management assistance. Venture capital companies can make a significant contribution to the development of the real sector, especially through promotion of SMEs, by: (i) providing capital to small business with substantial growth prospects but inadequate security to tap bank loans; (ii) supporting new ventures in the form of "seed capital"; (iii) increasing the capital base of SMEs to enhance their potential to mobilize resources from existing financial institutions;(iv) being an active partner in the business (as opposed to the "sleeping partner" status of many other shareholders), thereby allowing the SME to benefit from the experience of the VC company in management and marketing and its access to global information network. More generally the contribution of venture capital companies to the growth of enterprises can be more meaningful than banks and other lending institutions because: (i) by providing capital or loans which are convertible into equity after some time, they do not impose on new or restructuring business the burden of high debt servicing which are unbearable in the initial years; and (ii) the remuneration of the venture capital company being through a combination of dividends and capital appreciation, it has an incentive to make every effort to ensure the success of the enterprise.

6.36 Venture capital companies in Madagascar: The first venture capital company in Madagascar, the "Financiere ARO" (FIARO) was established in 1988. Initially a subsidiary of the ARO insurance company, its capital was subsequently opened to private companies (25 %), individuals (5 %) and international financial institutions (21 %) and reached 4 billion FMG in 1990. Up to December 1989, it had taken equity in 11 companies to the tune of 1,230 MFMG (about USD 850,000). For its first 18 months of operation it had made an operating loss of 83 MFMG. It is planning to invest between 700 and 1000 MFMG (USD 500,000 to USD 700,000) annually which could generate 10,000 to 15,000 MFMG of new investment in the industrial and commercial sector. Of this amount between 150 and 300 MFMG will be used to finance SMEs. The only other venture capital company is the "Societe d'Investissement pour la Promotion des Entreprises a Madagascar" (SIPEM) which was launched in 1990. Initially a scheme for helping the creation of new enterprises, under the name "Association pour la Promotion de l'Entreprise

Malgache" (APEM), with the participation of local industrialists, banks and foreign donors, it became a VC Company with shareholding from local private organizations (52 %) and international financial institutions (48 %). It has just started its activities and it is planning to make available some 160 MFMG (half as equity and half as loans) to 16 SMEs on an annual basis. It would benefit from some grants from international agencies (ILO, UNDP) initial years.

6.37 Impact of venture capital companies: The impact of venture capital companies in Madagascar on the growth of private enterprise has been so far very limited, both generally and particularly for SMEs, for several reasons. First, the volume of finance made available (less than USD 1 million) is insignificant with regard to the enormous investment needs (both debt and equity finance) of enterprises generally and SMEs in particular. Second, the bulk of the resources (83%) have gone to large established companies (SMPL, KOBAMA, NY HAVANA, etc) or to now highly credit-worthy ventures (BMOI) which could probably have mobilized resources from other sources. Third, resources allocated to SMEs which could provide maximum benefits in term of value added and employment have been marginal. Fourth, only part of the activities of existing companies are devoted to purely venture capital activities - FIARO, for example, is being involved in other investment activities (purchase of immovable property and building of an industrial zone). The prospects for a more significant contribution from the two existing venture capital companies in future are remote as they have themselves fixed their combined annual equity participation to about 1000 million FMG. Under their most optimistic scenario, only some 25 - 30 SMEs would obtain an average of 15 - 20 MFMG (about USD 1,000) annually. More such companies should therefore be encouraged if venture capital is to claim a significant role in equity financing in Madagascar.

6.38 Incentives for venture capital companies: The development of venture capital faces a double handicap in a developing country like Madagascar: (i) limited real investment opportunities (few businesses offer a minimum security and entrepreneurship that would attract venture capital); and (ii) absence of a readily available market to realize the capital appreciation of their investment. Venture capital companies can only grow at the pace at which private enterprise thrives and matures, and a capital market develops. If venture capital companies are artificially promoted, the result will be (i) companies investing in "blue chips" rather than high risk/high return ventures with limited developmental impact (to some extent, this is already being done by the existing companies); and (ii) loss making companies which invest in development oriented but very risky business (SMEs) and have to be supported by public grants; and (iii) companies which only nominally engage in venture capital in order to benefit from any special incentives. The main incentives for venture capital companies will come from policies that improve the profitability of real sector activities and which facilitate entry of SMEs into new spheres of activity. At the same time, the government could also undertake specific measures to begin establishing a basis for a future capitals market (see Chapter 7). In addition, with longer term perspective in view, it is appropriate to grant some incentives to companies given the nature of the business and the positive role they can play in the financial sector. Tax breaks to venture capital companies irrespective of their actual activities tend to favor abuse and create a distorted incentive system. Instead of generalized tax breaks, it would be more proper to give allowances on returns on specific investments (eg. new enterprises, extension and rehabilitation, SMEs) which need to be promoted and for which no immediate income can be envisaged.

CHAPTER 7

FINANCIAL INNOVATION FOR TRADE EXPANSION, INVESTMENT PROMOTION AND FINANCIAL MARKET DEVELOPMENT

7.1 To ensure that Madagascar's economy becomes increasingly diversified and export-oriented, the financial system will need to be better placed to facilitate the expansion of domestic and foreign trade and both domestic and foreign investment. While it is unrealistic to expect Madagascar to develop within the 1990s the sophisticated trade finance systems which exist in industrial countries, Madagascar can follow the example of a number of developing countries which have succeeded in developing a strong export base in recent years, notably those in East Asia and neighboring Mauritius. This chapter considers in particular what financial policies the experience of these developing countries might suggest to Malagasy policy makers for development of a more diversified economy with a strong export base. In addition, the development of financial instruments and institutions to increase efficient trade and investment flows is generally one of the key ingredients for developing full-fledged financial markets - the other major topic of this chapter.

7.2 Both the medium and long term horizons - which could extend beyond the 1990s -are considered in this chapter in examining which financial instruments, markets and institutions could be developed to expand trade and investment and stimulate trading of financial assets. It should therefore be stressed that several of the financial innovations discussed here involve instruments, markets and institutions which cannot be realistically expected to emerge in the near term. They especially include relatively sophisticated trade finance instruments such as bankers' acceptances or capital market securities and institutions such as an export credit guarantee scheme or an offshore banking center. These and other relatively sophisticated innovations will notably require: (i) prior improvements in the financial infrastructure, many of which are discussed in Chapter 3; (ii) greater diversification of real sector activities and especially exports; and (iii) effective operation of more basic instruments and markets including a secondary market in trade and Treasury bills and an active inter-bank market (see also Chapter 2). Since it is not unrealistic to expect these basic prerequisites to be in place within the medium term given appropriate policies, the more sophisticated innovations could also be envisaged in the longer term once the Malagasy economy begins to realize its substantial scope for broad diversification and export orientation. As discussed below, public policy will have an important role in the 1990s for helping lay the ground for a number of financial innovations in Madagascar.

Developing International And Domestic Trade Finance

7.3 A strategy of sustainable growth in Madagascar based on expanding and broadening the export base requires effective international trade finance. Without this, Malagasy exporters cannot respond effectively to foreign demand. They will have to continue to substantially rely on self-financing which severely constrains the scope for expanding trade and particularly exports. The survey of Malagasy enterprises conducted for this Report showed that much remains to be done to improve international trade finance in Madagascar. For most Malagasy enterprises, payment of imports is made generally at sight while a good proportion of exports is settled after shipment or delivery (normally 60 days). The need to finance international trade from domestic sources could be reduced if the payments terms could be altered in favor of Madagascar. A combination of increased supplier credit, foreign bank trade finance and preshipment finance will be required as discussed below.

7.4 The discussion below points to at least three policy areas which are crucial to improving financial system for trade expansion and investment. First, it is crucial that the Government rapidly exploit the full potential of the business investment and free trade zone policies it has already adopted. While the basic free zone legislation already exists and appears adequate, many outstanding problems remain in the application of this legislation which is unnecessarily cumbersome. The proposed one-stop window ("guichet unique") to facilitate new enterprises should also be implemented as soon as possible. Second, improvements in the legal and accounting framework, broadly discussed in Chapter 3, are needed to encourage the development of a bills market in Madagascar. A third area of attention are foreign exchange controls which could be made more flexible to adapt to the needs of exporters and importers.

7.5 Supplier credit: Supplier credit is generally one of the most important sources of credit for importers. Foreign suppliers' credit depends on suppliers' assessment of the credit worthiness of the Malagasy importers and their general confidence in the Malagasy economy. The severe external payments situation which the country had experienced during most of the 1980s led to an erosion of confidence among foreign suppliers. With the emerging liberalization of the economy and the improvement in the financial situation in the country, Madagascar should normally be eligible for more suppliers' credit. The business community and the government have a joint responsibility to promote the credit worthiness of the country. Yet, confidence building is likely to be a gradual process.

7.6 To accelerate the availability of trade finance, joint ventures with foreign firms can open the way for suppliers' credit on favorable terms. Almost all respondents to the enterprise survey in Annex 1.1 who indicated they had access to suppliers' credit were either partly or wholly foreign-owned. One such company had 180 days credit from its partner. Many newly industrializing developing countries including Malaysia, Mexico and Singapore have been able to dramatically expand exports and employments by developing trade finance through affiliations with foreign or multinational companies. Madagascar should therefore continue to favor joint ventures to enhance the catalytic role that well-established foreign companies can play in fostering stronger trade links: strategic alliances between Malagasy firms and multinational firms could also be pursued to facilitate Madagascar's access to foreign export markets. Strategic alliance, more specifically, refers to the association between two or more companies at a particular stage of the production/distribution process which, in general, results in synergistic benefits for all the parties involved. For instance, a Malagasy firm with a highly marketable product, but without any prior experience in foreign markets, could associate itself with a reputable foreign firm which would be primarily involved in the marketing of the product abroad, in return for a share in profits. In this particular case, an association with a firm of established reputation will tell the market that the Malagasy firm's product is of good quality and is a winner. Strategic alliances can also be considered at other stages of the production/distribution process such as manufacturing, financing, and research and development.

7.7 Foreign bank trade finance: Foreign banks, including offshore banks, can provide trade finance both on imports and exports. On the export side, an offshore entity can discount export documents and provide the exporter with the expected foreign earnings which would be settled on payment of the foreign exchange by the foreign importer. This would be a self-liquidating operation in foreign currency which accelerates the receipt of foreign exchange and it would, therefore, be in line with the Central Bank's policy of early transfer of exchange earnings. The recourse to offshore banks might be less appropriate (because of global foreign exchange limitation) and more risky (the importer has to bear the exchange risk) for imports. However, it could be very helpful for export enterprises operating under the free zone regime envisaged in Madagascar. The example of Mauritius is instructive where offshore banks are already financing the imports of the Mauritius EPZ companies. There is also the possibility for offshore banks to discount the documents of a foreign exporter enhancing thereby his capacity to grant suppliers' credit to his Malagasy importers. Offshore banks can also finance international trade through factoring.

7.8 Problems of preshipment finance: Bank finance is more readily available for finished products which are marketable than for products in earlier stages of production. In Madagascar, as elsewhere, producers who are at the initial stage of the production cycle are often be denied financing simply because the product has not yet reached a marketable stage. Yet it is essential that producers at this level are duly supported by means of adequate financing. Producers of intermediate inputs are often forced to rely on their own equity or working capital which constrains their production considerably - in Madagascar, this problem particularly affects small and medium-scale enterprises whose access to equity and working capital finance is already limited (see Chapter 6). In some cases, the absence of such financing may act as a severe constraint on the volume of final products which emerges from real sector activity among "indirect exporters." The reluctance of financial institutions in their intervention at this "preshipment" stage of production is mainly due to the fact that there is a significant element of risk that final production, and hence payment, may not materialize specially where there is a long time lag between the "preshipment" stage of production and the final product. Banks are worried that their funds may become tied up for too long and without much guarantee of repayment as in the case of marketed finished products. There is therefore a distinct preference for financing the finished product due to the self-liquidating character of such financing.

7.9 Enlarging preshipment finance: Preshipment finance, especially for indirect exporters, will become important as Madagascar seeks to increase its exports. Enlarging preshipment finance will require increased synergy between direct and indirect exporters and small and large manufacturers and adequate backward linkages between exporting enterprises operating under the free zone regime and the rest of the economy. The free movement of bills of exchange should assist in overcoming this financial constraint (see para 7.7). The need for specifically supporting producers at the "preshipment" level was identified in the early stages of industrialization in Mauritius. The fear was that many potential exports would not eventually materialize due to lack of adequate financing in the raw material transformation stages. Banks in Mauritius were and still are unwilling to take the associated risks in this part of the market. Over time, the speed and turnover of real sector activity provided a solution to this problem in so far as the exporting sector in Mauritius progressed at unexpectedly high growth rates. Banks became willing in these circumstances to enlarge the overdraft limits of thriving businesses in the fast growing phase of the exporting sector. Consequently, both the pre- and post- shipment financing requirements of producers were fulfilled by the larger access to overdrafts. However, the smaller units which supplied "pre-shipment" requirements of larger enterprises were the first casualties of this evolving situation as the larger production units became more closely integrated vertically and started themselves attending to both their pre- and post- shipment material requirements with the benefit of the greater access to funds.

7.10 Developing a bills market: In addition to the above mentioned means of facilitating international trade, notably for exports, Madagascar should also strive to develop a system of trade financing using bills of exchange which could be discounted. The survey of Malagasy enterprises described in Annex 1.1 reveals the acute lack of a real bill market in Madagascar. This is generally attributable to the lack of credit worthiness of the issuers of the bills which may fail to be honored on due date. In a financial market where tight credit limits are applied and where smaller enterprises in particular had problems in obtaining bank credit, it is quite likely that individual issuers of bills may fail to honor their obligations on due date. Better access to credit by the smaller enterprises would be part of the solution to this problem. As transportation and other problems hindering domestic trade in goods and services are gradually overcome, Malagasy enterprises should be encouraged to adopt bill financing as a convenient mode of extending credit to each other which would also ease pressure on domestic commercial banks to provide trade finance. Careful attention should be paid, therefore, to the development of a sound and dependable bill market. Wider circulation of internal bills would depend on the time taken to introduce the necessary safeguards regarding the determination of liabilities on bills in the context of an overall improvement of legal provisions relating to bills. Bills should be a legal obligation to pay debt that is binding on the acceptor, the drawee, and the endorser. An inadequate legal framework or some instances of defaults on bills should not prevent these credit instruments from gaining general acceptability as quickly as possible in order that the present dependence on cash for trade transactions is minimized.

7.11 Once bills become a common financing instrument, other financial products may be introduced. For example, the same bills may be accepted by banks so as to enable a holder to obtain funds prior to the maturity of the bill. While it may not be appropriate for the Central Bank to go directly to the market in the first instance to support such a facility, one or several discount houses specialized in the key sectors may be established with the appropriate legal backup to facilitate direct recourse against drawers of bills who default on their obligations. The discount houses may be refinanced in turn by the Central Bank in accordance with the stance of monetary policy. Similarly, the barter trade which now characterizes part of agricultural trade within Madagascar may come to be financed by means of these instruments which would become negotiable and, hence, put the farmers and peasants in funds according to their needs. At a more advanced stage of development of trade finance in Madagascar, bills can be accepted by banks which are then traded as bankers' acceptances (BAs) as further discussed below (para 7.34).

7.12 Exchange Risk Cover: To encourage Malagasy exporters to expand foreign trade, they should be given wider options for taking and managing exchange rate risks associated with import and export transactions. This has been the case in Mauritius where foreign exchange receipts continue to be closely managed by the Central Bank, as in Madagascar, but with greater flexibility. Mauritius offers yet another advantage to the export sector which, unlike exporters based in Madagascar, import most of their raw materials or semi-finished inputs. The typical Mauritian exporter generates a demand for foreign exchange in the first phase of its production cycle due to these imports which is followed by the generation of foreign exchange when export receipts are realized. Normally, an enterprise buys the foreign currency for its imports by utilizing the local currency and then selling the foreign exchange earned subsequently to the banks in exchange for local currency. A special proviso in Mauritian Exchange Control regulations permits exporting enterprises, however, to retain export earnings in the foreign currencies if the latter have to be utilized towards payment of anticipated imports (see Annex 7.1). It is only the net residual export earnings which are eventually repatriated into local currency. Exporting enterprises are thus covered against exchange rate fluctuations and do not always feel the need to obtain exchange risk cover against short or long term positions held in particular currencies.

7.13 Madagascar might be able to adopt a similar scheme for retention of foreign exchange earnings and its management by Malagasy banks which should help to develop expertise among banks in foreign currency management. As more business is generated by the exporters retaining foreign exchange, banks will accordingly come to hold large foreign exchange balances in conformity with the scale and growth of business in the exporting sector. In addition, Mauritian exporters have been for some time also permitted to avail themselves of short-term credits in foreign currency from offshore banks. Such credit is normally provided as a substitute for short-term import financing and the main advantages to the borrower are an enlargement of access to bank credit outside of credit ceilings as well as a relatively lower rate of interest on the debt than if the borrowing was undertaken on the domestic market. There is an increasing use by Mauritian exporters of this financing mechanism in spite of the implied exchange rate risk borne by the borrowing enterprises.

7.14 Near term scope for export credit guarantee scheme: Both industrial and industrializing countries have had recourse to export credit insurance or export credit guarantee schemes (ECGS) to promote their exports.The need for an ECGS arises when exporters and those who provide export finance (banks, trading houses) have imperfect information on overseas buyers. An ECGS can open new markets to exporters and enable the financing of exports to these markets by otherwise unwilling financial institutions. This is done through access to information on overseas markets (the economies of scale in information - gathering are such that it cannot be due effectively on the level of an enterprise or a bank) and through pooling and reduction of risk. There does not seem to be an immediate need for an ECGS in Madagascar for a number of reasons. The bulk of Malagasy exports are directed towards industrial countries where political risks, including debt rescheduling, are minimal. Madagascar can expand its exports to prime markets like the EC (through the Lomé Convention) or the United States (where it is still well below its quota); it is therefore, not compelled to look for riskier markets at this time in order to expand exports. Experience shows that an ECGS becomes viable when exports, especially non-traditional items (which are generally not exported to traditional markets), reach a minimum level; this is not yet the case in Madagascar. The premature establishment of an ECGS in Madagascar would result in a heavy loss-making institution (the small amount of premiums would not match the fixed cost) without any significant effect on the promotion of exports.

7.15 Long-term scope for an ECGS: If Madagascar succeeds in developing a diversified (manufacturing) export sector where products would have to be sold on more diversified and riskier markets, then an ECGS might play an important role in export development. While this is clearly a long-term prospect, there might be some lessons that Madagascar could derive from other countries in considering the establishment of an ECGS at some future date. First, there should be an appropriate partnership between private sector and government in instituting such a scheme. While purely private schemes might result in too conservative underwriting in some respects, purely public schemes can unnecessarily relegate commercial risk to the government and create a moral hazard problem. Government is generally the logical provider for covering political risk but partnerships with the private sector where the latter assumes at least part of the commercial risks would be a better formula (as has been the case in Mexico and South Africa). An ECGS cannot be in deficit in the long-term because it would violate GATT rules which equate it to an export subsidy. ECG institutions should therefore be properly capitalized and started so as to provide a good service (that is why they should not be prematurely set up).

Enhancing Regional Trade And Cross-Border Trade In Financial Services

7.16 Madagascar is uniquely situated in close proximity to the highest income countries in the Africa and Indian Ocean region (with the exception of oil producing countries), notably Mauritius, Seychelles, and South Africa. In addition, neighboring Reunion, a department of France, affords a potential gateway to the European market. There is particular scope to further develop Madagascar's commercial and financial relations with these neighboring countries in the region to expand trade and investment flows including trade in financial services. Madagascar's rich physical and human resource base is a special attraction with its labor costs being one-fourth or less of those from these neighboring countries. In addition, international companies (notably from Hong Kong and Taiwan) operating in Mauritius are very keen to extend or transfer part of their labor-intensive activities to Madagascar. Further development of regional commercial and financial relations could help the existing financial system and the productive sectors of the economy in several ways: (i) through encouraging private direct foreign investment which can help meet the capital needs of local entrepreneurs; (ii) through provision of offshore financial services which could improve trade finance; and (iii) through further provision of onshore financial services by foreign financial institutions through partial or complete ownership of a financial institution domiciled in Madagascar which could help improve financial skills and develop international banking relationships. The scope and constraints of further trade between Madagascar and individual countries which are two of the key neighbors in the region - Mauritius, and South Africa- including prospects for trade in financial services, are discussed below. This discussion illustrates demonstrates how, during the 1990s, Malagasy policy makers will increasingly face choices on whether and how to exploit the considerable potential for increasing trade and investment flows from these countries. Also discussed below is the related issue of the scope and prospects for establishing offshore banking within Madagascar.

7.17 Mauritius: In the near-term, the greatest potential for Madagascar to enhance trade and investment flows within the region appears to lie with Mauritius. The low cost and relative abundance of qualified labor as well as the abundance of land are major attractions to Mauritian investors. The government of Mauritius has waived the 15 % tax on transfer of capital for approved investment projects in Madagascar within its strategy to encourage labor intensive industries faced with severe labor shortages to transfer part of their business there. Already, some half a dozen Mauritian companies have already invested in Madagascar or are in their pre-operational phases. Continued investment from Mauritian and Mauritius-based companies in Madagascar will create a need for more regional financial services. One leading Mauritian bank already maintains a representative office in Madagascar. The National Mutual Fund, a Mauritian unit trust very similar to the French SICAV, has been authorized to invest 40 % of its resources in foreign assets and could be prepared to consider investing some of its funds in Madagascar. Although Mauritian offshore banking is still in its infancy, at least one offshore bank in Mauritius has intervened both in favor of a Malagasy financial institution by providing a foreign loan and Malagasy enterprises by financing their imports and exports.

7.18 South Africa: Since relations improved between the two countries, there have been several major trade missions to Madagascar. Most traders and financial institutions saw the availability of export credit insurance facilities as vital to the development of trade and investment with Madagascar. In South Africa such facilities are offered by the Credit Guarantee Insurance Corporation (CGIC) which underwrites export credit risks in co-operation with the South African Government. According to the Export Credit Re-insurance Act of 1957, the Government underwrites the political risks component while the CGIC assumes the other risks. The CGIC offers two major types of cover: short term (up to 180 days) and medium to long terms (180 days to 10 years). Given the lack of reliable information on the trading community in Madagascar, the CGIC is proceeding cautiously. It has in principle accepted to provide both commercial and political risk cover for short term credit and it has actually underwritten some transactions. However, it has not yet provided any cover for medium to long term risk as it feels that guarantees on payments conditions are inadequate.

7.19 South African interest in direct investment in Madagascar is still at an exploratory level. The most promising sector to South African investors seems to be the mining industry which has a big potential and in which South Africa has considerable experience; tourism, construction and agro-industry could be of interest to various large groups. However, to be able to proceed further, potential investors need to be assured of the legal status and security of their investments and ability to obtain necessary work permits and remit profits. Also, they need to be convinced on the real advantages of investing in Madagascar as they are now having a wider choice of investment opportunities as almost every country in sub-saharan Africa is opening its frontiers to the South African business community. As they tend to be risk-averse, they will prefer countries which already have a high international rating as an investment center. South Africa also has the most developed financial system of the region with a broad range of services offered by commercial banks , merchant banks, discount houses, factors, confirming houses, a stock exchange (the largest in sub-Saharan Africa), insurance companies and the Credit Guarantee Insurance Corporation. There could be considerable scope for further regional trade in financial services including technical assistance to Malagasy financial institutions.

7.20 Improving regional payments: Madagascar's trade in the Indian Ocean was traditionally limited because of historical trade links with other regions, similarities with the export product mix of neighboring countries and political differences. The inward-looking development strategy of the late 1970s and early 1980s hindered further the development of regional trade and related financial services. However, the recent significant liberalization of trade and the opening up of the financial sector to foreign participants have generated new interest and initiatives in several countries. In addition , Madagascar is a member of the Indian Ocean Commission which is still in the process of consolidation. To the extent increased trade and investment flows results in a shift in direction of trade in Madagascar more towards the countries in the region, there might be benefit to Madagascar for expanding its participation in regional trading arrangements. Madagascar however is still only an observer, not a member, of the eighteen-nation Preferential Trading Arrangement (PTA) which operates a clearing house arrangement which enables the amount of hard currency supporting regional trade transactions to be minimized. Exporters in a PTA member country received payments from a client in another country in the exporter's local currency. This transaction gives rise to a claim and a liability denominated in a regional unit of account which is recorded in the PTA clearinghouse in the accounts of the two central banks concerned in a given transaction between two member countries. By settling receipts and payments on a net basis, this system reduces the amount of foreign exchange needed to support trade transactions than it would be if all transactions were settled on a gross basis. This system is due to become a full-fledged autonomous clearing house for all intra-PTA trade transactions as from 1992. This is expected to be a nucleus of a proposed plan for monetary and financial harmonization among PTA members countries. At the moment, a similar bilateral arrangement exists between the central banks of Madagascar and Mauritius outside the framework of the PTA.

7.21 Near and medium term scope for offshore banking: Several developing countries have set up an offshore financial sector. Some have derived substantial benefits from its operations although the contribution to the long term economic growth of individual countries have been uneven, depending on the diversity and depth of their offshore center. To establish an offshore financial center, any country such as Madagascar should offer at minimum a number of basic conditions to offshore financial institutions. These include: political stability with a government committed to free enterprise and an outward looking development strategy; advanced and efficient telecommunications facilities; good supply of skilled labor (banking, legal, accounting, information technology) preferably multi-lingual or bilingual (with a knowledge of English); availability of office premises and housing facilities at reasonable cost; convenient international transport facilities; healthy economic conditions; complete freedom from exchange control; minimum prudential and other regulatory requirements; ability to repatriate profits freely; generous tax incentives (on profits, income of expatriates, interest); and liberal entry of expatriate staff.

7.22 Over and above the basic conditions mentioned above for the setting up of an offshore center, Madagascar would also have to offer some special benefits which would attract business from elsewhere. The classic advantages over other countries include: time zone advantage which would provide a strategic link between existing major financial centers (like Singapore and, to a lesser extent Bahrain); geographical advantage in the case of the proximity of potential resources availabilities (Bahrain) or investment areas (Philippines, Hong Kong) or both (Singapore); significant lower costs of operation (local staff, rent, licenses, other services; and better tax incentives. It is clear that Madagascar does not fulfill many of the basic conditions required to qualify as an offshore center and it is improbable that all these conditions would materialize in the medium term. Furthermore, the special advantages which Madagascar could offer with respect to other offshore centers are very limited. Madagascar is only three hours ahead of G.M.T. and is in the same time zone as Bahrain and only an hour behind Mauritius. The possible potential for an active center in the Southern Africa/Indian Ocean region is already being exploited by Mauritius and it cannot be excluded that other well-suited countries in the region (especially South Africa) would follow the Mauritian example. Madagascar can hardly improve on the already attractive tax incentives in existing centers which its competitors could easily adjust (as, for example, Singapore did to counter Hong Kong).

7.23 <u>Long-term scope for offshore banking</u>: On the assumption that over the next decade Madagascar would be able to diversify its economy and embark on the path of sustained growth, the demand for international financial services would grow tremendously (given the significant potential of the Malagasy economy). The volume of financial transactions might then attain the critical mass which would make viable an offshore center in Madagascar geared mainly towards satisfying the needs of the Malagasy economy (on lines of the offshore center in Manila, Philippines). Such a center would have greater chances of success and of withstanding the competition from other centers as its driving force would be the Malagasy economy itself. The strategy should, therefore, be to avoid the "brassplate" or purely offshore centers (which are solely internationally oriented) in which Madagascar has clearly no advantage in the region or compared to other offshore centers. In order to favor the development of a future offshore center which could service the Malagasy economy, short and medium financial policies should be so devised to: (i) promote transactions between domestic banks and offshore financial institutions within the global framework of a gradual liberalization of exchange and credit controls; (ii) provide incentives/safeguards to other financial institutions (notably insurance companies, venture capital firms) to go on international financial markets; (iii) allow export enterprises, especially those operating under the Free Zone Act, to raise finance (both trade finance and loans) from offshore units; and (iv) develop an appropriate legislative, prudential and regulatory framework in line with the growing relations between the offshore and domestic financial system.

<u>Accelerating Domestic Investment Through Leasing</u>

7.24 <u>Concept and advantages of leasing</u>: One of the most attractive financial vehicles for encouraging domestic investment is leasing. Leasing is based on the concept that assets in the form of plant and equipment generate profits through use rather through the mere fact of ownership. It can generally be defined simply as a commercial agreement whereby an equipment owner (the lessor) conveys to the equipment user (the lessee) the right to use the equipment in return for the payment of specified rentals over an agreed period of time. The legal owner of the assets can therefore be different from the user, who can be seen as holding the economic ownership of the leased assets, which includes the right to use them beneficially as well as the risks related to the loss and obsolescence of the equipment. In developing countries such as Madagascar with underdeveloped capital markets, leasing may be the only form of medium- to long-term finance available for capital equipment on suitable terms. Leasing is being increasingly used in developing countries as a method of financing equipment.

7.25 <u>Policy framework for developing leasing</u>: The development of leasing normally raises a number of legal, accounting and fiscal questions which have to be considered in the context of the framework and standards already existing in a given country. The legal questions include protection of title in the leased assets, responsibility for maintenance, indemnity in favor of owner, restrictions on use of the asset, creation of liens or other charges, insurance, rentals and default in payments, and right to repossession. Questions are also raised as to accounting principles applicable to leased assets and their depreciation. Fiscal questions notably include the capital allowance entitlement for firms with leased assets. The fiscal implications for the parties may also vary from country to country.These questions will have to be answered in the first place in the light of existing Malagasy law of contract and property.

7.26 In Mauritius, no amendments were made to the law when leasing was introduced in the country. Existing provisions of the Civil Code were considered sufficient to enable leasing transactions to start. No law relating to leasing of equipment was passed when this concept was introduced. Questions were asked about whether companies would be entitled to capital allowance under income tax regulation, since they do not own the leased equipment. Without any amendment being made to the law, the Commissioner of Income Tax agreed that no objection will be made to capital allowance being claimed for leased equipment. If such an administrative measure is not possible elsewhere, then statutory provision should be made to enable capital allowance for leased equipment so as to promote leasing. Malagasy law would also seem to be adequate for initial leasing transactions. Experience will indicate the direction in which the law needs to be amended to accommodate the actual development of leasing.

7.27 <u>Features of leasing transactions</u>: Lease equipment may be provided to both self-employed entrepreneurs or to firms. The lease contract may typically range from three to seven years depending on the type of equipment involved. However, the minimum value of equipment eligible for leasing should be specified. It would be the responsibility of the client to maintain and service the leased equipment. The client would also have the responsibility of insuring the equipment and assigning the insurance policy to the leasing company. This factor implies the development in parallel of the insurance sector. Lease payments could be arranged on a monthly basis. In certain case, these payments may be effected on a quarterly basis; each instalment would involve a composite servicing of both the interest and principal elements. The concept of leasing would carry more weight as a financing mechanism for overcoming other financial constraints provided it is properly monitored. Even if the institution of leasing is set up, it would need general acceptance and the proper environment for its feasibility. As stated earlier, a leased equipment would be valid if its usefulness has been demonstrated. Even so, the debt servicing aspect will be directly linked to the marketability of output, seasonality of production and the prevalence of facilities such as "faisance valoir" or advances to farmers against standing crops. Without these, the timely payment of regular installments would be avoided and that, it turn, may start affecting the general scope for providing lease finance.

7.28 Leasing among small enterprises and farmers: Although leasing of equipment exists for quite some time in Mauritius now, it has not been very popular with small enterprises nor with individual farmers. The difficulty comes from the side of the lessor of equipment in that although it is insured, as required, the lessor is unwilling to simply take the leased equipment as security for his stake in it. It is also likely that in Madagascar that a grouping of lessees would become useful as a means of promoting this notion. The group would need to be attuned to the concept of joint liability on the equipment and should explicitly endorse this concept before embarking on the venture. Technical operators of the equipment rather than individual farmers tend to use leased equipment. They provide the service of land improvement by use of the mechanical device leased from the leasing company. Some element of grouping of farmers is a pre-requisite in popularizing the demand for this type of financial facility among farmers in Madagascar. The group should have a legal character for it to operate the leased equipment on non-personal preference basis. The extent of work to be done by the leased equipment, its turnover, the ready availability of expensive spare parts equally on lease should all be considered before engaging in a lease.

Promoting Financial Market Development

7.29 Role and place of financial markets: Increasing trade and investment flows both facilitate and are favored by the development of financial markets which allow for various debt and equity instruments to be issued and traded. Traditionally, there are two segments of financial markets which can be distinguished: money markets where debt instruments of up to one year in maturity are issued and traded, and capital markets, which cover longer-term debt and equity instruments.In the immediate term, financial market development in Madagascar should focus on the shorter segments of the market. The key element to this is the development of a well-functioning Treasury bill market, an issue that also relates to government debt management and to monetary policy (see Chapter 2). Further developments to the market can occur through other instruments used in the inter-bank market and the discounting for instruments related to self-liquidating transactions (as discussed in the section of domestic trade finance).

7.30 Currently, banks in Madagascar tend to rely excessively on the liquidity window provided by the Central Bank which in principle should be a last resort. In a well functioning financial system, commercial banks should first adjust their overall position by recourse to the interbank market. It is only when banks' portfolio needs are insufficiently funded by their own overall resources that recourse may be had to the central bank as a lender of last resort. This not only imposes discipline on commercial banks in their treasury management but also avoids developing an inflationary tendency that can result from extensive indirect Central Bank financing of the private sector. Reviewed below are some of the key money market instruments that could develop over time in Madagascar given the appropriate incentive and supervisory framework. Also outlined below is a basic strategy for developing capital markets wherein debt instruments of longer maturity than one year as well as equity could be issued and traded.

7.31 The present government securities market: Presently, the government issues two types of debt instruments. The first - "Bons de Trésor Classique" (BTC) - is sold with a coupon at face value with denominations of FMG 1,000. It exists in two forms. Category A BTCs basically represents a state lottery and is usually sold in scrip form ("deliverance de titre"), with a maturity of one year. Every six months, 20 BTCs in this category are awarded a prize of FMG 10,000. Category B BTCs have maturities of up to five years on which coupon rates have been unchanged since 1987. The funds raised by these BTCs are negligible. The other type of government debt instrument - "Bon de Tresor par Adjudication" (BTA) - is also sold with a coupon but at a discount. BTAs are available only in book-entry form ("compte courant") and in minimum denominations of FMG 500,000. They are issued at the beginning of each month in maturities of six and twelve months. Subscriptions can be entered with the commercial banks which act as agents and are centralized by the Central Bank which consults the Ministry of Finance on the maximum discount acceptable. With coupons of 15 and 15.5 percent respectively for six and twelve month BTAs, the effective yield is around 20.5 per cent for 6 months and 18.5 per cent for 12 months BTA (February 1991). In practice, the outstanding volume of BTAs has been constant for a long time with FMG 1 billion in 6 month BTA and FMG 0.5 billion in 12 month BTAs being rolled over every month. Thus, government securities are presently a very marginal means of financing the government deficit compared to Central Bank financing, amounting to less than one percent of the latter (see Chapter 2).

7.32 Revamping the Treasury bill market: Since the Treasury bill market can be a conducive element in promoting financial market development, it is important for the Government to carefully review how it could revamp this market. Despite their lucrative return, investor interest in Treasury bills has remained minimal. The Ministry of Finance should consult with financial institutions to investigate why there is such a poor response among investors. The Government could also begin undertaking various measures which could help increase confidence and interest in Treasury bills among investors. First of all, all references to obligations to invest in Treasury bills should be removed from existing legislation. To save on administrative costs and for transparency, these bills should be sold at a straight discount with no coupon. A single but important step would be to ensure that the results of Treasury bill auctions are announced and published immediately after each auction. It is crucial that these bills become freely negotiable. Increased liquidity of Treasury bills would also allow BCRM in due time to conduct open market operations using these instruments. Future Treasury bill issuance should be carried out in the context of transforming part of the existing domestic debt of the Government and of reducing the dependence of the Treasury on advances from the BCRM (see Chapter 2). The Treasury should attempt to sell large volumes of bills in maturities which suit investors liquidity preferences. The objective should be to deepen the short-term segment of the government securities market. The agency arrangement of the Treasury with commercial banks should be reviewed to ensure that they contain adequate incentives.

7.33 The organization of issuance policy for Treasury bills should be strengthened. As in other countries, BCRM manages Treasury bill issues. Consequently, it should establish and maintain an information system on the domestic public debt. This system should include statistical data on total outstanding notes by holder and the maturity profile for Treasury bills. Such a system would help the BCRM to predict the net flows of reserve money injected into the banking system due to government operations (see Chapter2). Centralization and computerization of the present manual book-entry system should also be considered.

7.34 Bankers' acceptances: Banker's acceptances (BAs) are an extension of domestic trade finance that facilitates self-liquidating transactions. They could be introduced once Madagascar has an adequately functioning market for trade bills. BAs are also the cornerstone of modern trade finance. They represent a security backing commercial indebtedness of a borrower whose bank accepts a bill of exchange, issued as a result of a trade transaction. In countries where these instruments are actively used, they are traded in the marketplace at a margin (basis points) over the most liquid and highest grade instruments available in the local market (treasury bills). While these instruments have the full credit worthiness of the bank accepting the bill of exchange, as well as the underlying trade transaction which renders the transaction self-liquidating, supervisory authorities should be careful to understand the nature of the contingent liabilities which banker's acceptances represent and should make sure that the balance sheet of the bank reflects these contingent liabilities and the bank's total exposure in the marketplace.

7.35 Certificates of deposit (CDs): Often used to generate general purpose short and medium term funding for commercial banks, these instruments can also be traded in the money markets if they are classified as negotiable. Non-negotiable CDs ("bons de caisse") are already in use by banks in Madagascar. Negotiable instruments could be used especially once an active Treasury bill market is developed. Negotiable instruments normally trade a few basis points below non-negotiable certificates of deposit for the simple reason that they can be transferred as many times as necessary during the life of the document. Rates will vary among banks as perceived risks are evaluated by the investors. In general, the extension of CD issuing power to non-bank financial institutions, when such instruments are often designated Certificates of Investment if these institutions are prohibited from taking deposits, should be closely supervised by the monetary authority which normally supervises financial institutions. Depending upon the skill and powers of the monetary authority, a gap may exist between the public perception of the degree of oversight exercised by such authorities, and the reality, which may lead to over-borrowing and eventual default by non-bank financial institutions which would eventually erode the public's confidence in the financial market in general. Adequate supervision is therefore essential in this and other aspects of financial markets.

7.36 Commercial paper: In a number of countries with emerging securities markets, investor and corporate preferences have combined to allow the issuance and secondary market trading of short-term corporate debt, otherwise known as commercial paper. Commercial paper involves the securitization of debt which would, in other circumstances, be proffered to such issuers by commercial banks. One frequently observed feature of developing countries where commercial paper flourishes is a shortage of suitable bank credit. However, this is a money market instrument that generally does not appear at an early stage in the development of finance as is presently the case in Madagascar. Nonetheless, over the medium and long term and with an appropriate supervisory framework and other financial infrastructure, commercial paper could be issued by major enterprises in Madagascar, particularly those that are also likely to become issuers in an eventual bond market, such as public utilities (power and telecommunication). It is essential that, where a public market is established where commercial paper may be issued and traded, that (in addition to normal supervisory control of all financial instruments by an independent supervisory commission) an independent rating agency be established to establish credit worthiness of the issuers. This would provide investors with criteria for the rate structure to be applied to various financial instruments in relation to each other.

This in turn requires that Madagascar begins to further strengthen the existing framework for accounting, audit and financial disclosure discussed earlier (see Chapter 3).

7.37 Capital markets development: A well-functioning capital market is one of the pillars of a developed market-oriented economy. The size of an economy, its savings rate, business environment and structure of ownership are important determinants of how feasible it is to develop a market for debt securities and equities. With an economy which will remain primarily agricultural in the near future, many economic transactions which are not monetized, domestic savings rate below 10 per cent of GDP, a per capita income only over $200, and more than three-quarters of household consumption spent on basic necessities (food, housing, clothing, fuel), there is no immediate prospect of establishing a full-fledged capital market in Madagascar. In comparison, other developing island economies which have developed fledgling stock markets such as Jamaica and Mauritius are economies where only about 60 and 40 per cent respectively of household income is devoted to basic consumption. At the same time, Madagascar enjoys the advantage of being able to carefully prepare development of capital markets and thereby avoid the pitfalls that have been experienced elsewhere. Such a planned approach to capital markets development can help avoid some of the difficulties faced by newly emerging stock markets in some developing countries. The experience of Mauritius where a Chamber of Brokers has existed for almost a century, provides some lessons for Madagascar (see Annex 7.2). By taking a long-term view of financial development in Madagascar, one could envisage a rudimentary stock exchange in the medium term for which preparatory measures could begin soon. It should be stressed that confidence in the economy and in the framework for securities transactions is essential for a viable securities market to emerge. The fiscal and legal framework can be made to evolve in a way to promote the emergence of a capital market which generates confidence.

7.38 Objectives of capital market development: Before embarking on a program to prepare the development of capital markets, the government should be clear on the objectives for capital markets development. These can generally be stated as the following: to increase domestic savings; to improve the efficiency of the allocation of savings to investment in the public and private sectors; to broaden the base of ownership of real and financial assets and thus to indirectly improve the distribution of income; to make investment capital available to a broader range of the population; to ensure the availability of long-term financial resources, while minimizing the risk of financial instability, by lengthening the term of financial assets acceptable to savers and establishing a proper framework for term transformation by financial institutions; and to widen the range of financial services available through financial institutions and to improve their operational effectiveness. A preliminary feasibility study should also be undertaken to more definitively establish the potential and nature of an embryonic capital market in Madagascar. The study should assess, among other things, the potential breadth and depth of investor interest in securities and the relative importance of various motivations for holding shares (e.g. control of an enterprise, dividends, capital gains). The study should examine the potential demand for securities among both individual and institutional investors, the latter including banks, insurance and social security plans and potential unit trusts or mutual funds which might be established. On the demand side, potential issuers of securities should be identified among venture capital firms, enterprises and utility companies (JIRAMA and PTT) who might issue equities and bonds.

7.39 Preparatory measures for capital market development: Once the feasibility of a rudimentary capital market is clearly established, a number of preparatory steps can take place. As a first step, a committee (an embryonic COBOTA- Commission Boursiere de Antananarivo) should be set up with the following main terms of reference: (i) to recommend measures to be taken to establish a mechanism for the purchase and sale of securities; (ii) to promote the concept of securities trading among savers and investors (in Madagascar); (iii) to be responsible for the development of the legal, regulatory and supervisory framework and (iv) to oversee the development of a stock exchange over time. The main players in the capital market should be involved in the process from the beginning: (i) the Ministry of Finance; (ii) the Central Bank; (iii) the commercial banks; (iv) the insurance companies; (v) venture capital firms; and (vi) various employers', business and professional associations. External technical assistance should be sought at an early stage to help guide the committee in its technical work. The committee would be responsible for elaborating the rules and regulations under which trading will take place. It would also have to ensure that enough Malagasy are trained abroad in both the institutional aspects of a stock exchange and in stockbroking activities so that by the time a stock exchange is officially launched there will be adequate trained personnel. This has been a major pitfall of the Mauritian experience where scant attention was given to the training of stockbrokers who, were thus in the initial months, unwilling to play an active role in promoting the stock exchange which was in fact their institution.

7.40 Supervision of securities markets: Supervision of trading in the securities markets is essential if shares and bonds are to become attractive assets in Madagascar. Otherwise, the public may justifiably feel too exposed to the risk of market manipulation and other abuses and may decline to invest. The objectives of regulation and supervision should be: to provide for full disclosure and wide dissemination of accurate information about the companies whose stocks and bonds are traded; to prevent various forms of market rigging; to protect the interests of minority shareholders; and to encourage the development of specialized financial services and techniques. It is clear that the improvements in the legal system and the framework for accounting, auditing and financial disclosure discussed in Chapter 3 are absolutely crucial prerequisites for proper development of capital markets in Madagascar. For the purposes of adequate legislation for disclosure and shareholder protection, some sort of supervisory body is necessary, For Madagascar, such a body should initially be relatively simple and inexpensive, given the embryonic nature of the market that is expected initially.

7.41 Costs of capital markets development: While the costs of supervision in a capital market are normally borne by the government, the operating costs of the market should be borne by the private enterprises who are involved. These costs need not be high, given the relatively simple market one could expect in Madagascar. For example, features of sophisticated and well-established stock exchanges such as an expensive building on a separate location, electronic price boards and automatic clearing and settlement systems would not be necessary until perhaps a much later stage of maturation of capital markets in Madagascar. An embryonic securities market would require only a few key elements such as a periodic meeting place, accurate recording of transactions, and basic communications links among brokers and investors. The preliminary feasibility study mentioned above should establish that private enterprises with an interest in capital markets development are willing to incur such basic costs of operating a rudimentary securities market.

7.42 Initial operating procedures: Initially, the banks and financial institutions could act as dealers in securities. Enterprises wishing to obtain long term finance should be encouraged to seek equity finance. Bank activities in the capital markets should, however, be insulated from normal credit and lending activities in order to minimize possible conflicts of interest. The BCRM should carefully monitor commercial banks' involvement in the securities market and appropriate supervisory ratios should be established to ensure that banks are not overtly exposing depositors' money to speculative practices. The responsibility of dealers can be ensured if they are made to underwrite first issues. Trading could initially take place once a month until activity picks up, using the "casier" system used in Mauritius, described below. As the market grows, its institutional features could be progressively developed to handle a larger volume, broader range and greater frequency of transactions. The possibility of forming a twinning arrangement with a more established stock exchange could also be considered to improve knowledge and practices of market participants.

7.43 Demand and supply-related incentives: The government should help ensure that there is adequate supply and demand for securities to encourage development of an active capital market. On the demand side, the following incentives could be given, so that securities are traded through the authorized dealers:(i) tax exemption on dividends earned for the first three years; (ii) exemption of stamp duty; (iii) exemption of registration duties on transfer of shares; (iv) tax exemption on profits earned from the sale of securities by individuals (a ceiling will have to be determined). However, such incentives should only be considered once there is a thorough assessment of the taxation of all financial instruments. A fundamental principle is that all financial instruments should be effectively taxed evenly to begin with. Only once this is the case can temporary tax incentives be considered.

7.44 On the supply side, the government should give serious consideration to the prospects of using public offering of viable state enterprises as a means of accelerating capital markets development. This was successfully used in Britain and France in the late 1970s and early 1980s to popularize shareholding among the general public and has also been adopted in a number of developing countries such as Chile and Jamaica. The privatization program in Nigeria has created over a half a million shareholders who have interest in over twenty privatized enterprises. The program generated a side benefit in enhancing the professional expertise of legal, accounting and financial firms in the country. Similarly, a handful of viable public shareholdings in banking, insurance, utilities, industry, and commerce could be identified immediately and prepared for an eventual public offering to the Malagasy general public. These public offerings should be preceded by a well-planned media campaign explaining the nature and benefits of shareholdings and should seek to ensure as broad participation in the stock market as possible.

7.45 Initial trading system: Under the " casier" system, stocks are classified in price-related groups and prices are not allowed to vary beyond a certain margin(about 4%) between two trading sessions. This system serves a two-fold purpose : (i) gradually developing a stock market culture in the country until a full-fledged stock market is established; and (ii) preventing the market from succumbing to too much initial speculation. As the volume increases substantially, more meetings could be held until a full-fledged stock market finally emerges. The merits of this approach are: (i) it allows proper planning and sequencing; (ii) a "securities trading culture" is gradually developed; (iii) it is a flexible approach which moves in step with the general economic development; and (iv) it is easy to implement. Commercial banks could play several roles in the securities market as (i) brokers, through the setting- up of separate subsidiary companies, separately capitalized; (ii) underwriters; (iii) issuing houses; (iv) holders of securities; and (v) fund management.

7.46 Issuance of corporate bonds: Bonds could also at a later stage be transacted along the same lines as indicated for equities especially once there is a relatively active money market in which short-term instruments are traded as described above. The best prospects for issuers of such bonds would appear to lie among utilities (power and telecommunications companies). Recent experience in the telecommunications sector demonstrates the significant willingness within the private sector to participate in the financing of badly-needed infrastructure. Experience in other developing countries suggest that there is therefore scope for the utilities to develop appropriate medium-term financing instruments which could be sold to the same individuals or enterprises who subscribe to utility services. The Government should particularly consider the introduction of such new instruments in the context of restructuring the PTT wherein it should seek new finance and investment strategies for future development of the telecommunications network.

CHAPTER 8

TOWARDS A FINANCIAL SECTOR STRATEGY

8.1 The preceding chapters of this report have reviewed the main features of the existing financial system in Madagascar and analyzed the key aspects of future financial sector development: policies, infrastructure, institutions, instruments, and markets. In order for the government to arrive at an appropriate and coherent strategy for financial sector development for the rest of the decade, an overall agenda of key issues and related government policies must be established, followed by a definition of priorities, and identification of an appropriate sequencing of policy actions. At the same time, financial sector development in Madagascar cannot be expected to follow a "blueprint" established by the government. The speed with which new instruments, institutions and markets emerge will depend crucially on other macroeconomic and sectoral policies which directly affect the real economy and the response of the private sector to the incentive structure which is created. The pace of any financial sector development strategy should therefore be continually reviewed in the light of these developments. Reviewed below are the main directions for an initial financial sector strategy for the rest of the 1990s which are suggested by the analysis of the preceding chapters in this Report.

Strengths and Weaknesses of the Malagasy Financial Sector

8.2 Measures of Financial Liberalization: After almost a decade and a half of socialist economic policies characterized by heavy state intervention in both the financial and real sectors, Madagascar began showing the beginning of significant financial liberalization in the latter part of the 1980s. Among the key aspects of this liberalization was the opening of the banking sector to private capital in 1988, resulting in the entry of a new private bank and subsequent partial privatization of two of three government-owned banks. There has also been progressive liberalization of interest rates which, since November 1990, have been fully freed. Selective credit policies have also been progressively dismantled. At the same time, substantial restructuring and clean-up of loan portfolios has moved the banking system from its state of quasi-insolvency in 1986 to one of overall soundness and profitability. Madagascar also been one of the pioneering countries in the Africa and Indian Ocean region to began moving away from direct to indirect instruments of monetary control. In addition, it does not show any unduly discriminatory taxation of the financial sector found in some other countries where high unremunerated reserve requirements are coupled with explicit forms of taxation.

8.3 Overall Weaknesses in the Financial Sector: Madagascar's financial system operates in an economy which has one of the lowest savings rates among developing countries and whose financial depth is among the most shallow. Part of this is simply due to the fact that Madagascar remains among the fifteen poorest countries in the world. However, a number of other countries of similar income levels in Africa and especially in Asia, exhibit markedly higher levels of aggregate and financial savings. While nominal interest rates on both deposits and lending are now freely set by commercial banks, real interest rates for most demand and short-term deposits (including CDs) are still negative, reflecting an inflation rate which has hovered slightly above 10 per cent in recent years and nominal deposit rates averaging 9 per cent. The majority of the population still suffers from very limited or no access to financial services. Notwithstanding the clearly visible reforms of recent years, there persists a problem of confidence in existing financial institutions and instruments, partly reflecting continued suspicions and fears of the financial system engendered by past policies.

8.4 <u>Inadequacies in Policies and Infrastructure</u>: Monetary, regulatory and supervisory policies remain inadequate for the market-oriented vocation that the Government has now chosen for the economy. The Central Bank's move toward indirect instruments of monetary control remains hampered by its continued involvement in financing activities that should normally be borne by the Government budget. An adequate supervisory and regulatory framework for the financial system has not yet been developed, reflecting the long-standing past neglect of this key policy area. At the same time, the basic infrastructure for financial transactions, notably the texts and practices of relevant laws, accounting, audit and financial disclosure, requires substantial improvements before new financial institutions and instruments could be expected to operate effectively.

8.5 <u>Structural Imbalances in Financial Sector Flows</u>: Significant imbalances persist between the demand and supply of financial resources. These imbalances are compounded by strong biases in the sectoral allocation and term structure of lending. Between 1987 and 1990, the consolidated balance sheets of banks showed high credit-deposit ratios, generally in excess of 90 per cent. Such high ratios have been symptomatic of high rates of non-performing portfolios in the past and continued over-stretching of bank resources. To a significant extent, this situation reflects the inability of banks to place their resources in alternatives other than customer loans because of poorly developed financial markets. As the economy is further liberalized and increased growth stimulates demand for financial resources, this imbalance will grow unless the financial system improves deposit mobilization and the financial system is widened and deepened. At the same time, the maturity structure of both bank deposits and lending remains significantly biased towards the short-term, making term finance less developed in Madagascar than many other Sub-Saharan or low-income countries. Partly as a result, bank lending favors commercial and trading activities much more than activities in primary and industrial sectors which require longer-term funds. To some extent, a previous bias towards allocation of financial resources to the public sector has been mitigated in the latter half of the 1980s. However, continued improvement in public expenditure management and resource mobilization should improve the scope for releasing more financial resources for the private sector. Credit is a key constraint for a majority of firms in the country- none but the larger firms have access to formal credit sources.

8.6 <u>Inadequacies in the Financial System</u>: The existing financial system in Madagascar is heavily dominated by banking institutions which by themselves cannot be expected to satisfy the full range of needs of an expanding and diversifying economy. In addition to banks, there is usually a need for an intermediate layer of financial institutions and instruments which can also eventually act as a bridge between the short-term money market and the longer-term capital markets. Without this continuous array of financial institutions and instruments acting for the diverse maturities of funds on the financial markets, the free market determination of equilibrium interest rates and auctioning of Treasury bills, for example, cannot be completely effective. At the same time, the survey of user of financial needs conducted for this Report (Annex 1.1) and the examination of the financial system confirms that several special financing needs are not being adequately met. These needs mainly pertain to individual sectors (agriculture and housing), term finance (medium and long-term finance), and certain other types of finance (trade finance, leasing and equity financing). In all these and other areas, adequate financial services to small-scale economic agents are especially lacking.

<u>The Agenda for Financial Sector Development</u>

8.7 <u>Changing the Thrust of Public Policies in Finance</u>: Given the present thrust on market orientation, financial sector development in Madagascar should proceed largely through the initiative of the private sector. As is now becoming the case, the previous emphasis on state ownership of financial institutions, selective credit policies, interest rate and other controls, and privileged access of public institutions to financial resources should now give way to a new strategy for financial sector development. An important new role exists for the Government in terms of providing the necessary supporting policies and infrastructure to ensure that the supply of financial services is commensurate with demand, that the financial system effectively mobilizes resources and allocates them efficiently by pooling and pricing of risk in accordance with returns and liquidity. This implies a fundamentally different set of policies toward the financial sector than pursued previously, just as is the case for real sector activities.

8.8 <u>Priority Issues for Policy Actions</u>: Given the ongoing transition from an essentially socialist to a market-based economy, the agenda for the new approach to financial sector development is wide-ranging. Based on the analysis of preceding chapters of this Report, five broad policy issues can be identified which should be given priority consideration in formulating a financial sector strategy. First, the resources of the financial system as a whole should not be subordinated to the needs of public finance through captive financing from the Central Bank, postal savings and contractual savings institutions. At the same time, as a major user of financial services, the Government should reorient its depository, borrowing, lending, investment and payment operations so that these favor rather than impede the development of financial institutions, instruments and markets which can more effectively service the needs of the real economy. Second, key aspects of macroeconomic management essential to financial sector development should be reviewed and strengthened. In particular, independence and strengthening of the BCRM should be pursued to ensure that the central bank is capable of formulating and executing a credible role in monetary management. At the same time, exchange controls and tax policies need to be carefully reviewed continually to ensure adequate incentives for developing, among other things, dynamic contractual savings institutions. Third, adequate safeguards in the regulatory framework and other aspects of financial infrastructure need to be rapidly developed to protect savers and lenders alike and to ensure that the financial system can be deepened and diversified. Fourth, the government should maximize effective use of privatization and free zone development as two potential vehicles for accelerating financial sector development which simultaneously enhance private sector roles in the economy. Fifth, long-term training for relevant public agencies and the private sector as well as sensitization of the general public to financial issues must be given prominence in a financial sector strategy. Each of these policy issues is reviewed in greater depth below.

8.9 <u>Public Finance and Government Financial Operations</u>: Presently, public finance in Madagascar relies significantly on several sources of captive finance with the financial system. These include the Central Bank (through its advances and quasi-fiscal operations), the postal savings and checking system, and contractual savings institutions (insurance and social security). To ensure monetary stability and avoid pre-emption of resources from the private sector, the Government should aim to free these institutions from either formal or implicit obligations to finance the public sector. It should instead improve its own domestic resource mobilization through taxation policies and user charges. This coupled with greater budgetary discipline and efficiency in public expenditures should help control inflation, making financial assets more attractive. Domestic public borrowing should be increasingly done through the issue of government securities. The latter would be a linchpin for developing financial markets in Madagascar which normally use government securities as a benchmark for pricing other debt instruments. Although this reduced dependence of the public sector is crucial, it is clear that it is among several actions that can only be fully realized over the medium term once alternative financing mechanisms are tapped. At the same time, government expenditures and investment financed through these alternatives should complement private investment which would be increasingly financed by the financial system. Furthermore, rather than engage in equity participation in enterprises, the Government should increase the potential supply of equities through continued divestiture of state shareholdings. Payments to and from the Government could also be channeled through a more effective and largely private-operated payments system which could include a girobank.

8.10 <u>Strengthening macroeconomic management</u>: A first priority for strengthening macroeconomic management for financial sector development is to ensure that BCRM develops the capacity for effective and credible monetary management. This implies an independent role for BCRM formulation and execution of monetary policy which requires re-establishing its finances on a sound footing and modifying its statutes accordingly. At the same time, BCRM must establish a strategic plan to acquire the technical wherewithal to play a credible leadership role in financial sector development. Other aspects of macroeconomic policies which should be reviewed include exchange controls and taxation policies which might be effectively used to deepen the financial sector and improve the efficiency of financial system operations. Present exchange controls should be reviewed see how payments services for exporters and importers can be improved (see Chapters 3 and 7 for examples) and how contractual savings institutions can further develop their products and increase their investment returns so that long-term savings are stimulated (see Chapter 5). It is evident that such changes need to be undertaken cautiously and that supervisory capacity of relevant government agencies like the Central Bank need to be strengthened accordingly to minimize undue risks.

8.11 <u>Financial Infrastructure</u>: A precondition for further development of the financial system is the strengthening of a variety of safeguards for depositors and lenders alike. A key element is prudential supervision, especially by the Central Bank, which needs to be substantially reinforced and should form part of an overall program of strengthening the Central Bank to enable it to play a more important role in macroeconomic, and especially monetary, policy. Although there is no need for an overhaul of the legal and accounting framework in Madagascar, as is the case of many countries with a strong socialist heritage, it is imperative that legal texts and procedures as well as accounting rules, auditing practices and standards of financial disclosure become modernized in order for the financial system to deepen and diversify. All these efforts involve both measures that could be immediately implemented as well as a process of changes over the medium term. The Government should also jointly undertake with financial institutions a review of the existing payments and transfer system and development of a program to upgrade these key services to the economy performed by the financial system.

8.12 <u>Privatization and Free Zone Development</u>: Given its considerable economic potential evidenced by its human and natural resources, Madagascar has great opportunity to benefit from appropriately designed policies towards privatization and free zone development. A significant number of developing and industrial countries have actively pursued privatization and free zone development, thereby benefitting from substantial gains to both the financial system and real sector. Although much of Madagascar's ongoing program of privatization of viable state enterprises is likely to be undertaken through private offerings, a number of selected enterprises can feature in a carefully developed program of public offerings which could substantially catalyze capital market development in the medium term (see Chapter 7). Private demand for existing government shareholdings in banking, insurance, utilities, and possibly other areas, is likely to be high, as evidenced by substantial oversubscription observed in the handful of share issues in Madagascar in the recent two years. If viewed as a broad-based program for popularizing shareholdings, this would also help modernize financial habits among Malagasy savers and investors (successful initiatives in these areas have occurred in Chile, Jamaica, Malaysia). At the same time, Madagascar is well positioned to follow the Mauritian example of export development through expansion of its free zone enterprise sector. This policy has a natural consequence of rapidly increasing access of Malagasy enterprises to external sources of trade finance and improving the ability of the private sector to assume and manage foreign exchange risk.

8.13 Training and Public Information: The essence of financial system development involves the building of institutions and associated human resources, the inculcation of appropriate financial habits, and familiarity with and access to financial information. Training and information is a multifaceted process that is crucial to successful financial sector development in country like Madagascar where substantial scarcity of skills and information coexist with a considerable economic potential. Under a market-oriented economy, private financial institutions should be given an incentive to lead training and public information programs in partnership with the government where this is helpful. A first step would be to create a banking association independent of Government (presently not the case) which could, among other things, develop a program for professional training of bankers at all levels. Revitalizing the postal savings system to play a more dynamic role in small-scales savings should also entail a major training program aimed both at the new institution and its potential clientele which constitutes the majority of the country. The improvement of the payments system through introduction of an improved checking system should also be part of a public savings campaign undertaken jointly by the Government and financial institutions. The future development of a capital markets should be facilitated by an early program for training of stockbrokers and security analysts. This should be accompanied by a public campaign associated with the privatization program to explain the nature and benefits of ownership and dealing in securities. Training needs for government agencies are also important, particularly in the areas of supervision for key institutions such as the Central Bank, and public debt management. Finally, the Government should ensure that information which should be in the public domain is readily available such as the results of all existing and future Government securities auctions and capital market offerings, base lending and deposit rates of banks and BCRM refinancing auction rates.

8.14 Translating Policy Issues into Policy Actions: Meeting effectively the challenge of this substantial and broad agenda should lead to improvements in the existing financial environment as well as development of new institutions, instruments and markets. Each of these policy issues in this agenda in turn entail specific actions to be undertaken by the Government and partly in collaboration with the private sector. It is clear that public policy actions would be simultaneously required on several fronts. Attention therefore needs to be paid to the coordination and sequencing of these actions as the time span for their design, implementation and maturation are different, ranging from the short term (within two to three years), medium term (three to five years), and beyond to the long term. There is also close interdependence among these various facets of financial sector development with broader macroeconomic and sectoral policies, with certain measures being prerequisites for others. The sequencing plan proposed below is an indicative attempt to begin developing a framework for ordering financial policies which would be mutually reinforcing over time.

Sequencing Policies for Financial Sector Development

8.15 Appropriate sequencing of a financial sector development program entails managing and coordination of a series of policy reforms, diagnostic and feasibility studies, and institution building measures over a period of many years. To ensure the success of such a program and its coordination with other economic policies, it should be overseen by a committee at the highest level of the executive arm of Government. In addition to steadfast Government commitment and close collaboration with the private sector, a combination of material and technical assistance would be essential to realize this program. Owing to its multifaceted character, this program would involve a range of policy measures to be realized in a series of overlapping phases. The timing and phasing of such a program proposed below is indicative since the actual time horizon for each phase would vary depending on the individual time frames of the specific actions or policies in each phase.

8.16 Near-term measures: Table 8.1 schematically outlines a series of measures in the policy areas which have been extensively analyzed and discussed in the previous chapters of this Report. Most of these measures could be initiated if not completed within six to twelve months given three necessary elements. First is adequate discussion and understanding of the various parts of the program within and between various Government agencies (notably, the Treasury, BCRM, telecommunications authority, existing entity in the Prime Minister's Office in charge of privatization, among others). Second is a necessary level of dialogue between Government and the private and financial sector (notably, commercial banks but also all contractual savings institutions and a number of professional associations). Third is a minimum amount of external support, particularly technical assistance in a number of specialized areas which require further diagnostic or feasibility studies. Each of these elements is discussed below.

8.17 Within the Government, there should first and foremost be thorough discussion and understanding of this program among key decision-makers and staff of the BCRM and Treasury which should be integrated into a number of ongoing initiatives. Within the BCRM, the committee reviewing the central bank statutes should complete its work taking into consideration the proposed modifications to strengthen the legal, operational and financial independence of BCRM. At the same time, the senior management of BCRM should engage in a comprehensive review of the existing and future objectives of the central bank in the context of the formulation of the proposed strategic plan for BCRM. At the same time, the Treasury should actively review government debt management policies and investigate the existing weaknesses in the issuance and marketing of Government securities. Institution building needs and measures should be identified within the Treasury to prepare for a more active government debt management policy principally relying on sale of Government securities to finance Treasury needs. A program for improving Treasury cash flow forecasts should also be identified. Within the Government's privatization program, the responsible entity within the Prime Minister's office ("structure unique") should be charged with identifying an appropriate program of capital market offerings. The telecommunications authority should also be consulted to help coordinate and help facilitate development plans for the national payments system.

8.18 The first step in soliciting collaboration with the private and financial sector should be the creation of a new professional banking association. This should then become the principal interlocutor with the BCRM for the formulation of a plan to improve the national payments system. The new association should take the lead in engaging in a new system of check design and verification with BCRM providing necessary support in terms of changes in the legal framework for payments instruments and in the operating framework of clearinghouse operations. BCRM and the banks should then jointly proceed towards formulating a plan for an information-based clearing and settlement system. This new system would involve a pilot testing stage limited to the capital as well as one or two other key provincial clearinghouses (eg. Tamatave, Mahjunga) where telecommunications links can be expected to improved shortly or where alternative modes

Table 8.1: Near-term financial policy measures

POLICY AREAS	KEY ACTIONS	PREREQUISITE OR PARALLEL ACTIONS
1. Regulation & supervision	Adaptation of PC 1987 to banking sector Development of risk-based capital adequacy ratios Update of prudential liquidity guidelines	Identification of manpower and logistics plan to strengthen bank supervision as part of BCRM strategic development plan Finalization of entrance requirements to accountancy profession
2. Central Bank statutes	Development of new BCRM statutes including lengthened tenure for Board members and BCRM mandate in formulation as well as execution of monetary policy.	Coordination with development of BCRM strategic plan
3. Central Bank-Treasury financial relations	Identification of steps for complete removal of BCRM claims on Treasury on revaluation and accumulated losses accounts	Implementation of new market rates for BCRM lending to and deposits from Treasury; coordination with review of government securities market
4. Central Bank Strategic Development Plan	Comprehensive review of BCRM organizational structure, systems, methods, manpower and logistics	Coordination with review of BCRM statutes and articulation of existing and future goals of BCRM
5. Monetary Policy	Collection of key commercial bank data on a bimonthly or weekly basis Elimination of all prior authorization for bank credits Discontinue use of private collateral in refinance operations	Strengthened information systems for monitoring banks and managing public debts Flexibility in interest rate spread ("fourchette") in money market auctions
6. Government securities	Market survey for government securities; review of agency arrangements of Treasury with banks; negotiability of Treasury securities	Formulation of plan for institutional strengthening of debt management capacity of Treasury and coordination with BCRM

Table 8.1 (continued)
Near-term policy measures

POLICY AREAS	KEY ACTIONS	PREREQUISITE OR PARALLEL ACTIONS
7. Banking system	Encourage banks to establish new and independent professional banking association Complete a restructuring plan for BTM with a view to privatization	Dissolve existing Association Profesionelle des Banques (APB) Examine feasibility of including remaining Government shareholdings in banks in future program of capital market public offerings
8. Payments system	Develop new system of check design and verification; begin identification of new clearinghouse operation system; begin feasibility study for a giro-based payments system	Establishment of new professional banking association; coordination with national telecommunications development plan
9. Postal savings	Begin study of new corporate charter and plan for autonomous postal savings institution	Promotion of small-scale savings groups and associations
10. Capital markets development	Establish joint commission to study capital markets development including all key financial and professional institutions Preliminary study to assess nature and scope of investor demand for securities	Engagement of appropriate technical assistance to assist commission in identification of regulatory and operating framework and training programs for capital market development
11. Privatization of public enterprises	Identification of a selected number of public enterprises as candidates for future public offerings to catalyze capital market development	Formation of capital markets development commission

of data transmission (eg. courier system, satellite communications) could also be developed in the near term. Consultation with the national telecommunications development plan would be essential. Both BCRM and the banks should also be involved in a separate feasibility study for the development of a giro-based system to complement the existing payments system based on checks. Primarily responsibility for this study would appear to most logically lie with the existing postal checking system (CCP) which already operates like an embryonic girobank. Finally, a broad range of representation within the Government, financial and private sectors should be sought in the committee which would be set up to discuss and plan the groundwork for an embryonic capital market.

8.19 A range of external support would be needed to help ensure success of this program and should be sought by the Government at an early stage. Once it has identified an appropriate framework of near and medium term development objectives, BCRM should engage external assistance to perform a comprehensive review of its existing organizational structure, systems, methods and accounting with a view to formulating a strategic development plan. If needed, assistance should also be sought to complete the adaptation of the 1987 accounting plan to banks for purposes of prudential supervision and for development of a system of risk-based capital adequacy ratios and new liquidity guidelines. The Treasury should seek expert help to assist it in a survey of the government securities market and identification of an institutional strengthening plan for improved government debt management. Payments specialists should be consulted to help identify and develop the new system of checks, the improved clearinghouse operations system and the proposed girobank. Specialists should also be sought to help the postal savings institution develop a new corporate charter and organization plan to plan for its eventual autonomy from the Treasury and its operation as a full-fledged banking institution, beginning with its role as a depository especially for small-scale economic agents. External expertise should also be used to complete the financial and organizational audit of CNAPS and to assist in the review of the regulatory framework and taxation and exchange control regimes pertaining to contractual savings institutions. Experts in capital markets regulation and development should also be made available to the capital markets commission once it is established with clear terms of reference.

8.20 Completion of some if not all of the above near-term measures would lead to a second and third phase of the financial development program which could respectively extend for up to thirty six months (medium term) or beyond to five years or longer. The major developments in the financial sector during the second and third phases are schematically shown in Table 8.2. Many of these developments are of the nature of institutional development which is necessarily a gradual process.

8.21 A major policy objective of the Government during these two phases is to provide the basis for effective and relatively independent monetary and fiscal policies. This objective would be achieved on one hand by providing the BCRM with a sound financial footing, a strong basis for legal independence, and the acquisition of the necessary expertise in liquidity management, economic forecasting, bank regulation, and other areas of monetary management and financial policy. At the same time, the Treasury should have acquired the necessary expertise to conduct regular issues of government securities tailored to the needs of various institutional and individual investors and managed by a professional team in conjunction with appropriate agency arrangements with banks and other financial agents. Both existing and future investors should be considered (including the proposed girobank which could potentially become an important subscriber of government securities) in developing more active issuance of government securities. Close collaboration between BCRM and Treasury would then be a basic feature of macroeconomic management to ensure an adequate quality of liquidity and macroeconomic forecasts as well as coherent macroeconomic statistics including those pertaining to both domestic and external debt.

8.22 At the same time, a medium term goal for BCRM is to operate an indirect system of monetary management. The necessary training of BCRM staff and the cooperation between BCRM and the Treasury are contingent on a fundamental commitment by the Government to maintain fiscal

Table 8.2 Medium- and long-term financial policy measures

POLICY AREAS	KEY ACTIONS	PREREQUISITE OR PARALLEL ACTIONS
1.Establishment of independent and accountable monetary authority	Adoption of new charter for BCRM Settlement of all previous BCRM claims on Government on revaluation and accumulated losses accounts	Enforcement of statutory limits on Treasury borrowing from BCRM Adequate functioning of government securities market including secondary market trading Regular publication of BCRM annual report including annual accounts
2. Institutional strengthening of BCRM	To include strengthened or new research, supervision and international operations units or departments within BCRM	Completion of diagnosis and implementation of new systems and methods for accounting, forecasting, and statistical reporting within BCRM Ongoing technical assistance for manpower development in all key areas of monetary management
3. Monetary Policy	Beginnings of open market operations Required reserves on a weekly or bimonthly end-of-period base	Creation of active primary and secondary government debt market Improvement in domestic payments system
4. Government debt management	Regular issues of negotiable Treasury securities for private and institutional subscription Improved coordination of government cash flow forecasts with liquidity management of BCRM Maintenance of computerized government debt records and publication of all necessary market information on Treasury issues	Reinforcement of agency arrangements with all government security agents Active ongoing assessment of investment portfolio needs of major institutional investors (contractual savings, postal savings, girobank, commercial banks) Creation of a professional government debt management team in Treasury

Table 8.2 (continued)
Medium- and long-term financial policies

POLICY AREAS	KEY ACTIONS	PREREQUISITE OR PARALLEL ACTIONS
5. Revitalized postal savings and checking system	Operation of postal savings as an independent and possibly credit entity Financial extension services to small scale and mutualist savings groups Parallel operation of postal checking as a girobank to complement system of payments through bank checks and clearinghouse operations	Autonomy of both existing CEM and CCP from Treasury; revision of statutes and transformation of both entities into autonomous bodies Coordination with overall restructuring of PTT Conclusion of new agency and cooperation agreements with Post Office Operation of an appropriate technical assistance program for postal savings training, marketing and financial extension services For girobank, existence of an adequately liquid government security market for placement of funds
6. Social Security Fund	Operation of an autonomous and accountable Social Security entity	Completion of financial and organizational audit of CNAPS. Completion of review of all regulatory statutes of contractual savings institutions and appropriate changes as necessary Review of taxation and exchange control regimes affecting contractual savings institutions

Table 8.2 (continued)

Medium- and long-term financial policies

POLICY AREAS	KEY ACTIONS	PREREQUISITE OR PARALLEL ACTIONS
7. Payments system	Movement towards an information-based clearing and settlement system to replace document-based system	Operation of new check system with enhanced design and safety features Pilot testing of a decentralized regional clearing system Coordination of information-based clearing with development of telecommunications network and alternative modes of data transmission
8. Capital markets development	Public offerings of selected public enterprises Functioning of embryonic capital markets (less than daily trading)	Preparation and implementation of regulatory framework for securities transactions Completion of evaluation and prospectuses of public enterprises for sale to public Media campaign to explain and promote capital market offerings Completion of initial training program for securities professionals

responsibility and disciplined control of money and credit while fostering a market-oriented financial system. Given this commitment, the issues of staff training and technical coordination can be tackled through adequate institution building measures.

8.23 Among the other major goals for institutional innovation during these stages is the operation of an autonomous postal savings institution possibly in conjunction with a revamped postal checking institution as a girobank. This objective should be closely coordinated with the overall restructuring of the posts and telecommunications sector in Madagascar for which the Government is also envisaging an autonomous operating entity for telecommunications. A new set of cooperation and agency agreements between the Post Office and the new postal savings and checking institution should also be in place.

8.24 Another institutional innovation would be the emergence of an autonomous Social Security Fund which should play a major role as a dynamic element of contractual savings and as an institutional investor in Madagascar. At the same time, the insurance industry could be expected to feature greater private capital and dynamism with active marketing policies to tap the potential for life and other insurance products. As a prerequisite, the Government should put in place a revamped regulatory framework for these institutions with adequate taxation incentives and greater flexibility in foreign exchange controls, if appropriate.

8.25 Progress in the area of capital markets development could also be expected to lead to an embryonic stock exchange. With the appropriate regulatory framework and incentive structure in place and an adequate level of familiarity and expertise developed among professionals, securities trading could be expected, initially on a monthly or even weekly basis. Among the traded securities would be those of the selected public enterprises which would have been targeted earlier and prepared for public offerings through appropriate valuation exercises and a well-developed media campaign aimed at the creation of as broadly based a class of shareholders as possible on the lines of successful experiences in countries such as Chile, Jamaica and Malaysia.

8.26 Implementation of the above mentioned program of financial policies and institution-building measures will help provide the necessary boost to aggregate investment and savings. As discussed in Chapter 1, this will be necessary to ensure long-term sustainable growth in Madagascar. Discussed below are the three major ways in which the financial sector development strategy proposed above can help boost aggregate savings and investment in Madagascar during the 1990s. These are: (i) increased financial savings; (ii) improved financial intermediation and payments services; and (iii) increased efficiency of investment.

8.27 Financial saving can be expected to increase as a result of these policies. With strengthened Central Bank management of monetary policy, greater price stability will be facilitated. Together with the recent freeing of all interest rates and with further increases in nominal interest rates as necessary, this should lead to increases in the real return on financial assets and fully recoup the losses in financial deepening which occurred during the first half of the 1980s. Increased private participation in the banking system and entry of one or more new commercial banks would increase competition in the system and help induce savers to shift wealth holdings to monetized savings. Financial deepening would be further enhanced as the postal savings and checking system is revamped and new small-scale savings associations are developed. Further development of contractual savings institutions -presently the major source of term deposits in Madagascar- would result in a boost in financial savings as insurance companies and the social security system become more dynamic mobilizers of funds and institutional investors.

8.28 The recommendations above would also help improve financial intermediation and payment services. The purpose of this is to minimize the costs and risks of transferring financial resources from savers to borrowers and from payers of financial obligations to recipients of funds. The recommendations in this report to improve the legal framework are therefore important as these will help ensure that financial contracts are adequately protected. Similarly, the improvements recommended in the framework for accounting, auditing and financial disclosure will lower the costs and risks of financial intermediation. Finally, increased speed, accuracy and acceptance of the domestic and external payments system will encourage further use of the financial system to settle economic obligations and to transfer resources.

8.29 With improved financial intermediation, the increases in financial savings should be matched by improvements in aggregate investment. The main strategy for increasing the efficiency of overall investment is to ensure that the private sector can assume an increasing share of domestic investment within a well functioning financial system. Reduction and elimination of Central Bank losses related to the quasi-fiscal deficit as recommended in this report would eliminate a potential source of crowding out of private investment during the 1990s. Unless compensated by offsetting payments to the Central bank from elsewhere within the public sector, bank losses in Madagascar to date reflect financing needs of the public sector which should normally be made transparent in the government budget. For a given growth of money, increases in central bank losses can be inflationary or otherwise can reduce the availability of credit to the private sector if the Central Bank is to maintain a given monetary growth target. Greater independence of the Central Bank and credibility of its monetary management policies would be enabled by eliminating their operating losses and should increase investor confidence in the economy. Further privatization of the financial system would help increase competition. Increased efficiency of the financial system would thereby result in resources being channelled to high-return investments. At the same time, the emergence of many markets and, eventually, capital markets, will help price and distribute the risk of new investments. In turn, the increases in the level of financial savings and efficiency of investment should help increase incomes, thereby increasing aggregate savings and investment.

Complementary Policies for Financial Sector Development

8.30 A number of other policies should complement the financial sector development program schematically outlined in Tables 8.1 and 8.2 and discussed above. Of paramount importance are legal safeguards for the full range of financial transactions. Reforms of the legal framework and the judiciary go beyond the scope of just development of the financial sector. At the same time, these reforms are essential to the successful emergence of new financial institutions, instruments and markets. The Government should therefore ensure that its ongoing initiatives in reforms of the legal framework and strengthening of the judiciary include the necessary provisions to enable financial transactions to be conducted in a framework of accepted, well understood and well enforced contractual obligations. Among the several measures that have been discussed in this Report in this regard is the beginnings of a modern land registry in the key economic centers of the country, an endeavor that might also be supported by external assistance if necessary.

8.31 The fiscal implications of the proposed financial sector development program needs to be carefully managed. Since the banking system has now been rehabilitated, there will be no need for government expenditure in this area as was the case in the 1980s. However, full compensation of the BCRM for its past losses and complete assumption by the government of all external debt obligations could create a significant burden for the Treasury, depending on the availability of external resources. Assuming some form of exceptional financing could be found to compensate BCRM for its past losses- including use of part of the counterpart fund deposits of the Treasury- then the additional financial burden to the Government will only be the full remaining value of future external debt obligations. The magnitude of this financial burden remains to be determined. It will depend on the availability of further debt cancellation and relief. It is certain that some degree of enhanced tax mobilization will be necessary, especially given its relatively low level in Madagascar compared to other countries. It is important that a carefully designed taxation system which does not upset incentives for private savings, investment and production be implemented over the coming years in tandem with the proposed program of financial sector development.

8.32 At the same time, the Government can provide a catalyst for investment activities of the private sector by active pursuit of policies it has already adopted to favor free zone enterprise creation. The success of neighboring Mauritius in developing its trade finance system owes much to its free zone policies and it is similarly likely that Madagascar would need to rely on active development of supplier credit and foreign trade finance before the financial system can begin featuring more sophisticated instruments for domestic and foreign trade.

8.33 Finally, the Government's pursuit of policies to improve its own revenue mobilization and expenditure management should ensure that public savings and investment become complimentary to those promoted within the private sector through the financial system. An efficient and dynamic financial system would also give the Government a wider range of tools to improve its own resource mobilization and investment efforts. Given such complementarity and mutual reinforcement between public and private and financial and real sectors, the 1990s can become the decade where Madagascar's considerable physical and human resources can begin to be fully harnessed for growth to substantially and widely benefit all segments of the population.

ANNEX 1.1

SURVEY OF FINANCIAL NEEDS OF MALAGASY ENTERPRISES

This survey was conducted for the Report to assess the perceptions of Malagasy enterprises regarding the importance of finance to their business activities and the adequacy of the existing financial system in Madagascar. The survey consisted of (i) individual in-depth interviews with 24 businesses and (ii) responses from 54 out of 104 enterprises to whom the questionaire had been mailed.

Interview findings

Interview sample and context: The interviews were conducted in March 1991 in a financial environment characterized by a sharp contraction in new bank credit. As was expected, all enterprises appeared concerned mainly with the immediate problem of credit, although the magnitude of their concerns varied according to their size and sector of activity. The persons interviewed represented various sectors ranging from agriculture to precision machining, import and export to soap and chocolate manufacturing, construction to service sectors. The size also ranged from small (less than 25 employees) to large (more than 100 employees). The respondents were asked not to focus on the credit problems they were immediately facing but on the general experience with credit in recent times. Most big firms, especially trading ones, did not appear to have any problems to obtain loans from banks. The SMES appear to be particularly affected by the banking rules and practices. Notwithstanding these difference between SMEs and large enterprises, there was a consensus on the need to lower interest rates which were repeatedly described as "usury rates". The interviews with enterprises were supplemented by meetings with the commercial banks, one of the two insurance companies, two consultancy firms, and other professionals who are knowledgable in financial issues in Madagascar.

TABLE A.1 NUMBER OF FIRMS INTERVIEWED BY SIZE AND SECTOR

	SMALL	MEDIUM	LARGE	TOTAL
Agriculture	0	2	0	2
Agro-industry	0	0	5	5
Industry	1	2	4	7
Trade	3	2	2	7
Mining	0	1	1	2
Construction	1	0	0	1
TOTAL	5	7	12	24

<u>Main problems cited</u>: Broadly, the main constraints mentioned during the interviews were:

- high rates of interest
- banks refuse as security the asset for which loan has been taken
- too long delays in processing loan applications
- the banking system is inefficient as only 40% of the system meets the needs of economic agents
- banking practices are too conservative and banks do not take industrial risks but prefer commercial risks.
- communications gap between banks and operators
- checks of clients often bounce
- no long term credit available, especially for the construction industry
- transport problems(freight)
- agricultural producer never receives any loans; barter is prevalent and the profit motive is often an alien concept to producers
- credit is not monitored by the banks: Loans taken for one purpose may be used for another
- the banks have too many functions. Since banks themselves invest, they often are biased in channelling credit
- devaluation has increased the number of enterprises on the verge of bankruptcy
- absence of coordination between aid donors
- no collaboration between public and private sector
- 30% equity required by banks too high
- low purchasing power
- exchange rate control (repatriation of funds 90 days after settlement)

<u>What entrepreneurs would like to see</u>: During the interviews, the following were suggested as financial innovations in Madagascar which would help the productive sector:

- a development bank (three of the interviewees even mentioned the DBM, Development Bank of Mauritius)
- exchange risk cover
- export credit guarantee scheme
- the banks' spread on line of credits from international institutions should be reduced
- new investors should know exactly the ratio of debt to equity acceptable to banks
- a leasing institution
- more competition in the banking sector
- a joint economic committee , that is a forum where the different economic partners (government, employers, and workers) meet to discuss issues pertaining to the economic development of the country. Such a committee exists in Mauritius.
- mutual funds

<u>Finance problems outside the capital area</u>: The interviews also included company officials in the provincial capital of Majunga to determine whether enterprises based outside the capital and its surrounding areas face specific difficulties of their own. The main problem faced

by enterprises in Majunga seems to be that of poor or inexistent communications. The only links with the capital are by road. After a bridge was damaged in a recent cyclone, air transport is at the moment the only link with the capital. Telephone, telex and fax facilities are scarce and inefficient. Industries face frequent interruption in production because of power cuts. According to the company officials interviewed, these factors have led to a virtual absence of banking and insurance facilities. Every transaction is made via Antananarivo. In addition, because of the communication difficulties the usual bureaucratic delays in Madagascar are even longer for companies in Majunga. The lack of confidence in the legal system and the administration of justice which were noted in the interviews in Antananarivo seem more pronounced in Majunga because of what is perceived as part of a broader problem of institutional decay.

Questionnaire findings

Design and response rate of questionnaire: In addition to the individual enterprise interviews, a questionnaire was mailed to 104 enterprises. The questionnaire consisted of six sections (see attachment): (i) sectoral profile and production characteristics of the enterprise; (ii) method of payment used for purchases and sales; (iii) sources of domestic debt and equity finance; (iv) sources of external debt and equity finance; (v) constraints to enterprise growth; and (vi) means of improving financial services. The response rate to this questionnaire as at end of March was 52 per cent which is highly satisfactory when considering the relatively short time given and little experience of most firms with such surveys. The sample was drawn from "Guide des Affaires" (a census of firms produced by a local accounting firm) according to the relative weight of each sector and sub-sector in the Malagasy economy . Enterprises were then grouped for analytical purposes into 5 categories as indicated in the questionnaire. The distribution of enterprises by sector and the response rate is given in Table A.2 .

Size And Sectoral Characteristics Of Respondents: Other characteristics of the respondents were as follows:

- 53 per cent were SMEs
- 58 per cent were totally local-owned and 13 per cent wholly foreign-owned
- 50 percent imported more than half of their inputs/products
- only 24 % exported their products

It must be pointed out that the enterprises were classified according to their main activity. However, individual interviews with 24 enterprises showed that most of them to be highly diversified.

Payments For Local Purchases and Sales: Local purchases are mostly paid on delivery for 39 percent of enterprises and after delivery for another 37 percent. Only 2 respondents said they settled the bulk of their accounts on order. But the pattern of payment varies from sector to sector:

-Agriculture: Payment is made at delivery for more than 60 percent of enterprises purchases. But most sales are paid after delivery.

-Agro-industries: Large businesses settled their accounts mostly after delivery while the medium-sized firms usually pay on delivery. Sales payments are made after delivery.

-Industry: Large businesses pay more than 60 percent of their purchases after delivery. In fact, out of the 14 enterprises which mentioned they settle their accounts 15 - 60 days after delivery 9 belong to the industrial sector. And of these, 6 are large, 2 medium and 1 small-sized firms. Sales payments follow the same pattern as for purchases.

-Trade: As would be expected, the majority of traders pay on delivery. Sales also are paid on delivery. But small traders in the majority accept payments after delivery.

External payments: External payments made and received differed with respect to imports and exports:

-Imports: Almost 95 percent of enterprises pay their imports on receipts of documents. The next method of payment most used is after shipment. Very few (only 3 firms) pay after delivery.

-Exports: No clear pattern emerged with respect to payment received for exports. About thirty percent mentioned after shipment and another thirty percent after delivery.

Source of Domestic Funds: The overwhelming conclusion of the questionnaire results is that the banking system is the main, if not the only, source of funds for Malagsy enterprises. Shareholders' funds are indeed mentioned frequently; these funds however are exhaustible and increased with more difficulty than debt finance. In effect, banks enjoy a quasi-monopolistic situation in financing Malagasy enterprises for all maturities:

-Long-term finance: Long-term credit is a major problem for all enterprises. Most of them provide for their long-term financial requirements from their own funds. In fact, three mechanisms were mentioned in the following order: (i) shareholders' funds; (ii) bank loans; and (iii) non-bank loans. Within the questionnaire sample, no enterprise in the agricultural sector had received bank loans. Similarly, firms in the construction industry reported hardly obtaining long-term bank finance. The sector which seemed to have relatively easier access to long-term bank loans is industry. Nonetheless, the majority of industrial enterprises mentioned the main source of long-term finance to be shareholders' funds.

-Medium-term finance: Bank credit ranked first among the instruments available. It was mentioned by more than 60 percent of the sample and all the sectors used it as their main source of medium term finance. A further 24 percent mentioned shareholders' funds while 16 percent indicated suppliers' credit. Therefore, irrespective of size and sector, it can be safely concluded that bank credit is the single most important source of medium term finance.

Table A.2: Sample Distribution & Response by Sector

	Sample		Response		
	No.	Total	Small ENTERPRISES	Medium	Large
1. Agriculture Fisheries & Mining	19	7	1	2	4
o/w Agriculture	11				
Fisheries	3	0			
Mining	5	4			
2. Agro-industry	26	9	0	2	7
3. Industry	41	21	5	4	12
o/w					
wood & paper products	11	6			
Rubber & Plastic	7	4			
Chemical	10	4			
Textile	5	2			
Machinery	6	3			
Printing	2	2			
4. Trade & Services	15	14	6	3	5
5. Other (Construction)	3	3	1	1	1
Total	104	54	13	12	29

-Short-term finance: Bank credit is equally the single most important source of short term finance, It was mentioned as the first source of finance 20 out of 30 times. The next important source is suppliers' credit. However, the commercial sector obtains its short-term finance from shareholders' funds(specially for large establishments) and bank credit. Bank and suppliers' credit are very important for small trading companies. Agro-industry relies foremost on suppliers' credit whereas the industrial sector uses bank credit. As would be expected, the construction sector obtains its financing from customers' advances.

External sources of finance: Thirty-two percent of respondents enjoy suppliers' credit. Foreign shareholding contributes as a source of funds to about 18 percent of enterprises while another 18 percent obtain funds from international funding agencies.

<u>Constraints to growth</u>: Two types of constraints were specified in the questionnaire: (i) general constraints; and (ii) specific financial constraints. Enterprises were asked to rank the constraints - eight choices were given. If the answers are treated as an aggregate, i.e the number of times a problem is mentioned, then the following appeared to be the major constraints impeding the sample of Malagasy enterprises surveyed: (i) lack of finance (mentioned 39 times); (ii) tax structure (mentioned 36 times); (iii) narrow market (mentioned 35 times); (iv) freight costs (mentioned 28 times); and (v) access to raw materials (mentioned 21 times). When the responses are considered in terms of the ranking they were given by individual enterprises, then the order of importance changes slightly in some cases depending on sector and size. The majority (44 percent) still views lack of finance as the first constraint. Growth is restricted in 31 percent of cases by the limited size of the market. The tax burden prevents 13 percent from expanding whereas 9 percent find difficulties to grow because of scarcity of raw materials. With further disaggregation, it appeared that the main constraint varies from sector to sector as follows:

SECTOR	MAIN CONSTRAINT
Agriculture	Narrow market (42%)/Insufficient finance (29%)/ Scarcity of raw materials (29%)
Agro-industry	Insufficient finance (56%)/Tax burden (22%)/Scarcity of raw materials (22%)
Industry	Narrow market (48%)/Insufficient finance (38%)
Trade	Insufficient finance (43%)/Tax burden (29%)/Narrow market (21%)
Other (construction)	Insufficient finance (100%)

When constraints are related to size, the following picture emerges:

-<u>Small enterprises</u>: Thirty eight percent consider the size of the market to be the limiting factor while 31 percent suffer from insufficient finance.

-<u>Medium enterprises</u>: Forty two percent altogether mention both insufficient finance and limited market size and 33 percent insufficient finance.

-<u>Large enterprises</u>: Fifty five percent are restricted by insufficient finance; 31 percent by size of market, and 17 percent by the heavy tax burden.

Other constraints mentioned were: (i) labour law; (ii) packaging costs; (iii) customs duties too high; (iv) uncertainty about the market regulations within the country.

<u>Potential financial constraints</u>: Among the potential financial constraints faced by the sample enterprises, the ranking is as follows: (i) high interest rates; (ii) inadequate working capital; (iii) insufficient capital; and (iv) foreign exchange scarcity. A sectorwise analysis reveals that both high interest rates and inadequate working capital are most often mentioned but the ranking differs from one sector to another:

-<u>Agriculture</u>:	(a) working capital (57 %) (b) interest rates (29 %)
-<u>Agro-industry</u>:	(a) high interest rates (56 %) (b) working capital (33 %)
-<u>Industry</u>:	(a) high interest rates (57 %) (b) working capital (52 %)
-<u>Trade</u>:	(a) working capital (36 %) (b) high interest rates (21 %) (c) insufficient capital (21 %)
-<u>Other</u>: (Construction)	(a) insufficient capital (60 %) (b) working capital (60 %)

Sizewise, the ranking of the financial constraints is the same except that 12 out of 25 SMES find the high interest rates as their principal financial constraint, while only 38 percent of large establishments consider this a major nuisance and 52 percent of the large enterprises have problems of working capital.Other potential financial constraints mentioned are:

-long-term credit is almost inexistent; this affects the construction sector in particular; and
-in the agro-industry sector, security for loans is considered an important problem.

<u>Perceived inadequacies of the financial system</u>: After the respondents had enumerated the constraints they faced for growth, a question was introduced (Q 19) to find out what causes they perceived to be at the root of the inability of the financial system to meet their needs. The choices given were: (i) banks' refusal because of scarcity of loanable funds; (ii) credit ceilings; (iii) inadequate security; and (iv) any other reason. More than half the enterpr'ses saw credit ceiling as the main factor while about 15 % thought it was due to scarcity of funds. SMES are evenly divided between pereceving insufficient guarantee and refusal of banks (30 percent). Sectorwise analysis shows that 80 percent of enterprises in agriculture attribute to the credit ceiling the cause of their financial problems. This percentage goes down to fifty percent for agro-industries, fifty-three per cent industry and thirty for trade. This tends to substantiate the prevalent opinion that too much of the loanable funds have gone to trade. Other reasons given were:

- in agro-industry, no credit available for harvesting;
- inadequate working capital;
- inefficient banking system; and
- loans are given not on transparent criteria but on strength of relationship with bankers.

Means of improving financial services: This section of the questionnaire sought to obtain the entrepreneur's view on actions to be taken to improve the financial system to allow his enterprise to function more efficiently. The answers were also expected to give an insight into the depth of knowledge of the financial system on the part of the economic agents in Madagascar. The results were, as expected to some extent, the following:

- 82 percent wish for a reduction in interest rates;
- 68 percent want better access to bank credit;
- 42 percent desire more competition between banks;
- 24 percent would like to see new instruments; and
- 18 percent want new institutions.

What is somewhat surprising is the ranking. Given the conjunctural problem of credit, one would have expected access to credit to be mentioned more often. It is not the major improvement sought. although it ranks first for 29 percent of firms andis 8 points ahead of interest rates. More SMES (about 40 percent of them) find it difficult to have access to credit whereas the main problem for large firms is interest rate level. This finding strengthens the view of a banking system completely biased towards large firms.

New institutions: New institutions rank as the first improvement sought for about 10 percent of the sample. The fact that only 18 percent of respondents propose the setting up of new financial institutions reveals that many entrepreneurs in Madagascar do not have a clear idea of what type of institutions exist. However, they are aware that they need an institution for long-term financing. Some call it an investment bank, other a credit bank, others still a development bank. The construction sector would wish to see the setting up of an institution like a building society which would finance long-term loans (15 - 20 years) or a mortgage bank.

New instruments: The predominant concern among the enterprises surveyed is to cater for long-term finance. Leasing was frequently mentioned as well as factoring, cheque clearances, preshipment finance, exchange risk cover, and technical assistance. Among existing regulations which some would like modified are: credit ceilings; rescheduling of short-term loans to medium term; and the classification of enterprises. Some enterprises asked for a grace period for long-term loans. Preshipment financed would help 38 percent of the respondents to increase their exports.

ANNEX 2.1

DIRECT VERSUS INDIRECT MONETARY CONTROLS

In pursuing its monetary and credit objectives, a central bank has, broadly speaking, a choice between direct and indirect instruments. Direct instruments are characteristically administrative controls imposed on the banks that operate "directly" on the target variables. They include interest rate controls and portfolio restrictions, both of which can occur in a variety of forms. A typical form of portfolio restriction are bank-specific ceilings on credit expansion. In contrast, indirect instruments rely on market forces to achieve their objective. By regulating the liquidity of the banking system, they affect short-term and eventually long-term interest rates, and thereby indirectly the monetary and credit aggregates that serve as target variables.

While direct instruments appear to have the advantage of simplicity and precision, in practice they are seriously flawed. Since they interfere with the commercially motivated decisions of banks and their customers, they distort the allocation of financial resources. In particular, bank-specific credit ceilings inhibit interbank competition, freeze market shares, and encourage banks to ration credit in a way that discriminates against new borrowers. In combination with a loose monetary policy, credit ceilings cause excess liquidity in the banking system and discourage banks from mobilizing deposits.

Direct instruments are also popular for pursuing selective credit policies that channel commercial bank credits to economic sectors and priority activities. These credits, which usually bear below-market interest rates, are often not commercially sound and eventually saddle banks with losses. Moreover, money being extremely fungible, these credits and their implicit subsidies in many instances do not reach the activity they are intended for.

More generally, direct controls undermine the desirable division of labor between commercial banks and the central bank. Motivated by a desire to attain maximum profits, banks should develop a close familiarity with the business of their customers and specialize in appraising commercial credit risks; the central bank, in line with its responsibility for a sound financial system, should specialize in supervising banks on the basis of prudential regulations it has issued. By involving itself ex-ante in commercial credit decisions, the central bank inevitably reduces the onus on the banks to properly appraise and follow credits.

Reserve money management

Indirect monetary controls often operate on the liquidity of the banking system through reserve money management. Reserve money encompasses the immediately liquid liabilities of the central bank, i.e., currency in circulation and bankers' deposits (see table below). Deposits other than those from banks are netted out on the asset side and not considered part of reserve money because they are usually governed by institutional or legal and not monetary considerations. Moreover, such deposits do not create lending capacity that can fuel the money multiplier process.

Central Bank Balance Sheet

ASSETS	LIABILITIES
Net Foreign Assets	Reserve Money
	Currency
Net Domestic Assets	Bank Deposits
Net Credit to Government	
Claims on Banks	
	Capital and Reserves
Other Items (net)	

The sources of reserve money are to be found on the asset side of the central bank's balance sheet. They are the net changes in its foreign and domestic assets, the latter one consisting of net credit to Government and claims on banks (assuming the absence of central bank lending to non-banks). These changes can be positive or negative, implying respectively the creation and absorption of reserve money.

In other words, reserve money creation is a function of the balance of payments outcome, the balance in the Government's account with the central bank, and the central bank's policy regarding lending to banks. Since a central bank would normally have a target for foreign assets, attention focuses naturally on net domestic assets as the source of reserve money creation to be managed.

The uses of reserve money appear on the liability side. To avoid the risk of hindering the payment process, the demand for currency for circulation (notes and coins) must always be met. That leaves only bankers' deposits or bank liquidity to be influenced by the central bank. Hence, this is the aggregate that guides the central bank in its day-to-day operations in the context of reserve money management.

Banks hold deposits with the central bank for two basic reasons: because they are obliged to by reserve requirements and to have sufficient "precautionary reserves" to settle any net claims that may be presented against them in the course of their normal business. Any reserves beyond these two components could fund a credit expansion which may or may not be desirable under the circumstances.

By managing the sources of reserve money over which it has influence, the central bank tries to steer bank liquidity in a direction consistent with its monetary policy stance. Sometimes the distinction is made between "defensive" and "dynamic" central bank operations. The former are used to compensate for uncontrolled factors affecting the supply of and demand for bank deposits in the short run, and the latter to keep money and credit in line with the growth potential of the economy.

Use of Open-Market Operations

In general, the shift toward indirect monetary controls has generally entailed a greater reliance on open market operations. This has been, for example, the case of nearly all Asian countries during the 1980s which moved towards use of market-based instruments instead of direct controls. However, open market operations in their countries have, at least initially, been limited by the absence of government debt instruments and the thinness of private money markets.

Thus, the shift towards open market operations has been accompanied by the issuance of central banks' own debt instruments, the use of private money market securities for open market operations, and measures to encourage the development of interbank markets and private secondary markets in government securities. These developments have often necessitated bringing the yields on government securities in line with market levels and/or discontinuing the practice of forcing the Central Bank or commercial banks to absorb government securities. Also, more restrictive access to discount facilities and increases in discount rates were implemented to preclude financial institutions from circumventing the effects of open market operations through the discount window. In some countries (Indonesia, Korea and the Philippines) the use of central bank discount facilities was reduced or phased out during the 1980s.

Lessons from other developing countries

The decision of Malagasy policy-makers to gradually shift to indirect instruments of monetary control is consistent with the increasing market orientation of the economy. The experience of several Asian countries in this area - Indonesia, Malaysia, Sri Lanka, the Philippines, Thailand, Nepal, and Korea - during the 1980s can provide useful lessons for Madagascar. Generally speaking, the shift towards market-based monetary instruments and away from direct controls on interest rates and credit during the 1980s, allowed these Asian countries to deregulate their financial systems and develop financial markets and institutions in a liberalized environment. The experience with the implementation of monetary policy and financial reforms varied widely among these countries. However, the adoption of market-based monetary controls was on the whole a positive factor which helped them achieve greater monetary depth and greater flexibility of interest rates to serve allocative roles.

At the same time, the experience of these countries shows that inadequate development of financial markets and instruments for open market operations coupled with large domestic financing needs of the government can lead to open market operations which are inadequate to stabilize monetary growth during periods of particularly severe disturbances. All countries to various degrees faced the challenges of conducting monetary policy with open market and other instruments while confronting monetary disturbances from factors such as widening fiscal deficits, financial crises or large inflows of funds from abroad. In Malaysia and Korea, the central bank was able to use indirect policy instruments to effectively manage the growth of reserve money in the face of significant changes in reserve money. In Indonesia, the continued active use of open market operations during 1988-89 helped contain monetary growth despite a sharp expansion of liquidity in the economy.

The shift to indirect monetary control in these countries was associated with broad financial liberalization, that is, reduced government intervention in setting interest rates and allocating credit. When contrasted with the experience of several Latin American countries - Chile, Uruguay and Argentina - the Asian experience of financial liberalization provides important lessons. First, price stability and, more broadly, macroeconomic stability is the key to successful liberalization. Second, raising interest rates has inherent limitations since they cannot be increased unduly without creating adverse selection or moral hazard problems among borrowers within the banking system. At the same time, excessively high positive real interest rates in imperfect and oligopolistic money and credit markets characteristic of developing economies including Madagascar, can lead to arrears within the banking system. Third, in financial systems such as in Madagascar where there has been a long history of interest rate and credit controls, the participants in a financial system - whether bank managers, borrowers, lenders or civil servants - are not accustomed to new ways o dealing with a liberal and competitive system. Closely related to this observation is the fundamental importance of well-planned financial infrastructure with adequate information flaws, legal and accounting framework and appropriate regulation and monitoring of the financial system. As a result, Malagasy policy makers, while pursuing the recently-initiated shift to indirect monetary control, should be careful not to neglect the crucial importance of improvements in financial infrastructure proposed in Chapter 3 of this report.

ANNEX 2.2

ASPECTS OF CENTRAL BANK INDEPENDENCE

There is a great deal of interest these days in the notion of central bank independence. In Europe, it plays an important role in the discussions surrounding the creation of a European Monetary Union, and also in the former plan economies where proper central banks are being established. Chile and New Zealand recently enacted new laws to strengthen the independence of their central banks in the hope of improving these institutions' records in fighting inflation. The belief that independent central banks are more effective in achieving price stability has spurred calls for changes in central bank statutes and central bank relations with Government in many countries. Below is a brief discussion of the rationale for and dimensions of central bank independence.

Rationale for central bank independence

The theoretical rationale for central bank independence derives from the proposition that the expectations of the public are critical to the effectiveness and efficiency of monetary policy, and that in turn policy credibility is critical in shaping expectations. The contention is that the real costs of a deflationary policy are higher if the public is not convinced of the sincerity and long-term commitment of the central bank. This line of thought spawned a large literature on the advantages of "rules versus discretion" in monetary policy.

Inspired by this theoretical debate, many central banks experimented in the recent past with pre-announced monetary targets. Due to large, sudden shifts in the demand for various monetary aggregates, those targets have for the most part been abandoned by now. What remained, however, was an awareness of the importance of convincing the public of the central bank's motivation and ability to pursue anti-inflationary policies. This has led to a study of the institutional arrangements most conducive to central bank credibility.

The conclusion appears to be that a central bank with a narrowly defined mandate to pursue
rice stability and the ability to implement monetary policy without political interference will more likely be credible. Adequate monetary policy instruments, public accountability and high quality policies help build credibility. The more pronounced these attributes are, the more the central bank is considered "independent."

A survey of the degree of independence enjoyed by central banks around the world suggests that it may be useful to think of three types: in addition to central banks with minimal,[1] or very substantial independence,[2] there is the third type where the Government can in principle

1/France and the United Kingdom.

2/Germany, the United States, and Switzerland.

overrule the central bank but only according to a particular conflict resolution procedure, usually involving public debate.[3] It should be noted that in the context of recent debate in Europe, the French or British model with limited central bank independence has tended to be less persuasive than the German model of substantial central bank independence.

It should, nonetheless, be pointed out that central bank independence in monetary policy can never be absolute. The political authority will always reside with the government, as evidenced by its ability to change the central bank's law.[4] Furthermore, governments retain control over
fiscal and, usually, exchange rate policies, both of which are closely linked with monetary policy.

Dimensions of central bank independence

A central bank's responsibility for monetary policy formulation and implementation can range from complete formal responsibility for both (e.g., in Germany and Switzerland) to formal responsibility as agent for the Ministry of Finance for implementation only (e.g., in France and the UK). In between these extremes are central banks with a formal responsibility for policy formulation and implementation that are obliged to consult with the government (e.g., in the U.S.); or which are subject to government directives (e.g., in Japan), possibly with resort to prescribed procedures for conflict resolution (e.g., in the Netherlands and New Zealand). A critical component of the conflict resolution procedures in the Netherlands and New Zealand is an open, political debate in which the central bank can present its case, and the government is held accountable to the electorate.

In general, central banks with less formal policy responsibility tend to have more broadly defined statutory objectives, covering a range of macroeconomic goals besides price stability, referring to the need to promote the country's welfare, or speaking of means rather than ends (such as "regulating money and credit" for the Bank of France). The statutes of central banks with more formal independence tend to emphasize stability of the value of the currency. Narrowly defined objectives contribute to transparency and accountability, and thereby enhance credibility.

To be accountable, central banks must provide information on their operations. At a minimum this consists of regular balance sheets. In most countries central banks further publish annual reports including profit and loss statements. A central bank may further announce monetary or inflation targets against which it can be held accountable. In general, it is found that sustained respect for central bank independence is conditional on transparency and accountability.

The board structure of central banks can consist of several tiers: two tiers are common, for instance, an executive and supervisory board, and three tiers also occur. Sharing executive

3/The Netherlands, New Zealand, and Chile.

4/A government may even decide to liquidate the central bank, for instance, upon entering into a monetary union.

and supervisory powers between board members chosen for their technical competence bolsters the central bank's independence and enhances the respectability of its decisions.

In recognition of their ultimate responsibility for monetary policy, governments have the primary role in the appointment of their central bank's directors and senior management. Nevertheless, the more independent the central banks are, the more the appointment and dismissal powers are circumscribed. For instance, at least some of the nominations have to come from outside the government (often the existing boards play a role in the nominating procedure); the terms of office are long relative to the electoral cycle, and staggered, to prevent a government from dominating the central bank with its appointees; and directors and managers can only be dismissed for technical causes, not because of policy disagreements. For the least independent central banks the heads of state make all appointments, on the recommendation of or in consultation with the minister or the cabinet (e.g., in the UK and France).

An important safeguard for central bank independence is commonly considered to be a statutory limit on lending to government. In the strictest of cases this limit is zero and covers all forms of lending to government, including the purchase of government paper (e.g., in Chile). More often, the limit is not zero, and applies to direct central bank credit, permitting the purchase of government paper in the secondary market for monetary policy purposes. Such limits are usually defined as a percentage of government revenues.

Central banks tend to have substantial financial independence from their governments. Under normal circumstances they should always be profitable thanks to their seigniorage income, from which they can then finance the expenditures which they freely determine. Central bank statutes usually prescribe arrangements for distribution of profits and the constitution of reserves. Typically central bank statutes are less explicit in their treatment of losses than of profits. Nonetheless, a government responsibility for losses, such as might arise from quasi-fiscal functions, is usually implicitly assumed. On a microeconomic level, the significance of financial independence is, among other things, that central banks can offer their staff incentives and facilities which are competitive with the private banking sector. On a macroeconomic level, its major significance is that it enables central banks to avoid losses which could undermine its monetary policy independence.

Finally, central bank independence may be impaired by constraints on the use of monetary instruments. For instance, variations of reserve requirements are often subject to government approval (e.g., in Japan and France) or to consultation with the banks (e.g., in the Netherlands and the UK), plus may be subject to statutory limits.

Note: A more extensive discussion of the issue of central bank independence can be found in "Central Bank Independence" (by Mark Swinburne and Marta Castello-Branco; International Monetary Fund; June, 1991; IMF Working Paper #91-58). This annex draws substantially from the IMF paper.

ANNEX 3.1

OVERVIEW OF THE DOMESTIC PAYMENTS SYSTEM IN MADAGASCAR

There are four key elements of the domestic payments system in Madagascar:

– payments between banks (interbank payments);

– payments between branches of the same bank (inter-branch payments); and

– payments through the postal checking system; and

– payments to and from the government.

A related issue is the use of automatic transfers.

INTERBANK PAYMENTS

Payments with checks and transfers between different banks have to go through the clearinghouse ("chambre de compensation") which is governed by an agreement between the participating banks. Apart from the clearinghouse in Antananarivo there are 15[5] local clearinghouses in Madagascar. In 1990, clearing outside Antananarivo accounted for 36 per cent of total clearings, which compares to 38 per cent the previous year, measured in monetary terms. This minor decline was mainly due to transactions in Antananarivo increasing by 40 per cent, whilst the increase in other areas was only 29 per cent. The most notable increase outside Antananarivo was seen in Tamatave, where the activity was up by over 60 per cent in 1990. One of the reasons for this is likely to be Banque Malgache de l'Océan Indien, "BMOI", establishing a branch there.

In Antananarivo, BCRM, organizes and chairs the clearing sessions, as is the case in BCRM's branch in Tamatave. Whilst elsewhere the BCRM appoints one of the commercial banks to act as its agent. The appointments are based on the banks' relative size in the local area.

Clearing procedures at the clearinghouse

To be allowed to participate in the clearing, a bank must sign the "Reglement de la chambre de compensation", which thereby becomes a binding convention for the bank in question.

5/ In total, the BCRM is represented in 21 towns, out of these there are five towns with only one bank.

The clearings take place on a daily basis. In Antananarivo the participants are the four commercial banks (BFV, BNI, BTM, and BMOI), the Centre Cheques Postaux, (CCP), and the BCRM, both as a central bank and as agent for the Treasury.

Consolidation of the non Antananarivo activity

The clearing sessions outside Antananarivo are organized in the same manner as in Antananarivo, except that as earlier mentioned, the agent bank acts as organizer in the place of the BCRM. As agent, the organizing banks keeps temporary accounts ("comptes de passage") for all banks, including the BCRM as agent for the Treasury. At the end of the clearing, the amounts due to and from the participants are recorded in these accounts. At the end of the working day, these accounts are consolidated with the banks' principal account at the BCRM head office, i.e., the negative or positive balances are passed on, to be subtracted from or added to the balances in the principal accounts.

None of the BCRM agents has any telex on its own premises. However, some have access to a telex at the local post-office. Due to bad connections telexes can be delayed for days, this results in delays of up to 10 days for consolidation of the comptes de passage and in local transactions always being carried out for the original value date. If a bank, after consolidation, is in deficit, it is automatically granted with a "credit revolving". For this the bank is charged with an annual interest rate of 13 per cent on the transactions the specific day. The interest is calculated and charged at the end of every three months.

Insufficient funds on check accounts

Even though the convention of chambre de compensation states that checks have to be rejected before the end the following day's clearing, it appears that in Antananarivo the banks have up till 48 hours to reject a check. Issuers of bounced checks are placed on a "black list" which is sent to the Procureur General for legal action, which in severe cases can mean imprisonment for two years. Furthermore, the banks usually withdraw the customers checks, not necessarily closing the accounts.

According to the banks some 3-5 per cent of the total number of checks passing the clearinghouses are rejected, which is not an alarming rate. However, banks and businessmen look upon bouncing checks as a big problem, even though this is not evident in available statistics from the BCRM, showing rejected checks accounting for less than 1 per cent.

Clearing procedures regarding checks between different banks in different clearinghouse areas

When a customer in one town has received a check from somebody who has an account in a different bank in a town outside the local clearing area, the procedures, before the customer is actually credited, take much longer time. This is mainly due to communication problems between different areas in the country.

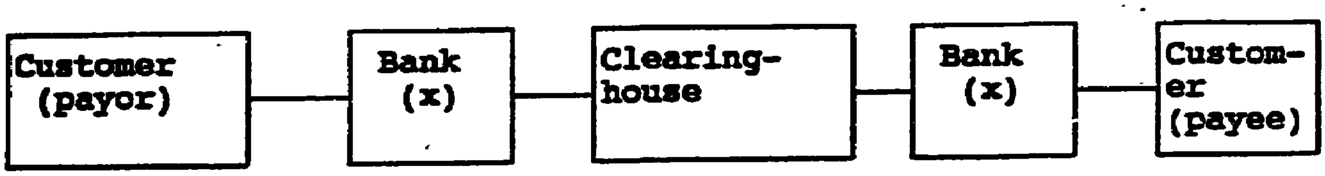
For a check presented in a bank in a town were the issuing bank is not represented, check displaced, the period for rejecting a check is extended to 20 days compared to the 48 hours within the same clearinghouse area. This is due to difficulties in communication and transportation from sometimes very remote areas. The rejection period of 20 days evidently applies to any check presented outside the payer's clearinghouse area.

According to the BCRM, checks originating from another town should pass through the clearinghouse in the payer's town. Thus, the payee bank sends the check to its branch office in the other town, which then presents it to the chambre de compensation. However, the banks have an internal agreement stating that checks can also be presented in the chambre de compensation in the payee's town.

In addition to the 15 clearinghouses of BCRM, there are a number of "clearing zones". This initiative was taken by the banks within the Association Professionelle des Banques, APB, to speed up clearance of out of town checks. Within these geographic zones, banks have committed themselves (in a form of signed convention) to give credit for out of town checks within 20 days. The first such zone was created around Antananarivo, and a few more have since been established, but the total number of zones is less than the number of clearinghouses.

<u>Transfers from one bank to another</u>

Transfers from one person to another are followed out in the same manner as for checks, and usually are as time consuming.



A customer asks his bank to transfer a certain amount to somebody else's account. The bank presents the transfer at the clearinghouse, the receiving bank gets the transfer and the customer(the payee) gets his money. In these transactions the payer is debited the amount the day he gives the order and the payee is credited the amount the day he receives the money on his account. In transfers between different clearinghouses the payers' bank ask the local BCRM's agent to transfer money to the other BCRM's agent to execute the transfer to the payee bank.

INTERBRANCH PAYMENTS

Transfers and payments with checks within the same bank can also sometimes be very time consuming, despite the fact that the clearing does not have to go through the clearinghouse.

Delays mainly refers to transactions between different towns, and internal clearing of checks and transfers within the same bank can take a month.

The bank which has the largest coverage of Madagascar is the most exposed to delays. About half of its 70 offices are said to have access to telephone only. Even though telex and telegram facilities are accessible the communication lines are that bad that it sometimes take three to four days for messages to get through, which in certain cases can be longer than for letters.

To improve its internal communication BTM five years ago embarked on a decentralization and automation programme of its accounting. The idea is to equip a limited number of branches with personal computers and appropriate accounting software. The branches selected all have their airline connections, although, sometimes with only one flight per week. The other branches will deliver their documents to the nearest automated branch for processing, unless connections to Antananarivo are faster, as it is in some cases.

Presently, BMOI has only two branch-offices outside Antananarivo, which is an advantage when handling its intrabranch communication. The Diego Suarez office transmits its transactions by satellite over night to Antananarivo and the Tamatave office sends its transactions on a diskette by airplane. The system enables a transfer from an account in Antananarivo to be executed, and thus, credited a BMOI account in Tamatave the same day. The reverse situation still is not possible.

To handle its intrabranch communication BNI has its own courier system which covers all but one or two of its 22 branch-offices.

Postal checking system

Postal services in Madagascar handle about 3,500 transfers ("mandats postaux") daily. These comprise both domestic postal orders as well as inward and outward international transfers ("mandat internationaux payés" and "mandats internationaux emis"). The number of domestic transfers has fallen from almost one million in 1985 to about three-quarters of a million in 1989, indicating a decreased importance of the postal system in this area. Outward international transfers have also fallen sharply during this period, reflecting foreign exchange security and currency devaluations. However, inward transfers from abroad have tripled, making the postal system a net generator of foreign exchange resources for the country, of about 3.3 billion FMG (USD 2 million approximately). This is a complement to the external payments system operated by banks (see Annex 3.6).

Apart from the banks' transfers and checks and postal transfers, there is another form of settling domestic payments. This system is the Centre Cheques Postaux, CCP, the postal checking system, which is represented in 209 post-offices all over the country. Presently, the CCP has some 45,000 accounts of which some 80 are held by banks, which use the system for its payments. The Government also operates the largest volume of accounts. The CCP has essentially functioned as a mechanism for the Treasury for paying salaries of about 10% of all civil service and military personnel and for paying various providers of services to the public sector. Most PTT personnel are paid through the CCP. On average, payments with cheques postaux take some 7-10 days.

Anyone can open a CCP account and there is no minimum amount to be deposited. When opening an account, the customer receives a check-book. He can then write a check on any amount, provided he has sufficient funds. The annual fee for the account is FMG 1,200 and FMG 1,500 for every check-book the customer gets. The customers do not get any interest on their balances on the accounts. When transferring money from one CCP account to another no fees are charged. However, if checks are written on amounts less then FMG 50,000, a FMG 75 fee is charged.

GOVERNMENT PAYMENTS

The Treasury handles the payments to and disbursements from the Government, eg collects the income tax, duty on goods, pays the Government payrolls. As such an intermediary, it is a large participant in the domestic payment system in the economy.

The Government receives 80 per cent of its payments in forms of checks and transfers, 13 per cent in cash payments and the check postaux account for 7 per cent. The most common forms of disbursements are also the checks and transfers, which in 1990 accounted for 79 per cent of total disbursements. However, there still appears to be a reluctance to use checks, especially outside Antananarivo. This results in the money orders, "bons de caisse", accounting for 14 per cent. The money orders need a "visa" to be valid. They are non transferable and can only be cashed in one of the Treasury's 120 offices. In addition to these forms of disbursements cheques postaux account for the remaining 7 per cent.

The Treasury executes the transfers, sends the orders to the BCRM, i.e., a check and lists to the banks containing whom to be credited and by how much. The BCRM forwards the lists to the commercial bank's head offices, which then is to credit the customers check accounts. These transactions do not pass the clearinghouse.

The Government's and enterprise's employees receive their wage net of tax. The enterprises then make tax payments to the Government in the middle of the following month.

The salary system requires the Government, as well as other employers, to submit payroll lists in advance. Banks do not appear to have a common policy; it was said that BNI receives the lists some 7-10 days in advance, whilst BTM only one day in advance.

AUTOMATIC TRANSFERS

Most of the larger enterprises' salaried employees receive their salaries on check accounts, but most blue collar workers receive their wages in cash. The enterprises give lists to the banks, containing information regarding from which account the money should be drawn as well as receiving accounts and amounts. All these transactions are then carried out by hand.

The most common way to pay for telecom, utilities and rent is to, in a bank, pay the bills cash or by check. To pay for electricity there is also a possibility to settle the bills directly at Jirama's, the electricity company's, offices. Check account holders have yet another option; to make an agreement with the bank regarding monthly deductions from the accounts to pay for telecom, utilities and rent. Another possibility for the customers is to have their electricity and telephone bills settled "automatically" by the banks. In such case for instance Jirama sends lists to the banks with customers name, account number and amount to be paid. These list are sent to the banks some 15 days before the money is due for payment. It is then up to the bank when to withdraw the money from the customers' accounts. All these transactions are presently carried out by hand.

ANNEX 3.2

COSTS OF EXISTING DELAYS IN PAYMENTS AND TRANSFER SYSTEM

As in any country, the delays encountered in the system for clearing and transferring payments between economic agents result in costs that are essentially borne by the recipients of funds. In order to estimate the magnitude of such costs in Madagascar, a calculation is made of how much recipients of funds lose through delays when payments and transfers are made through the system of clearinghouses in Madagascar.

Calculations

Based on data provided by BCRM, the average monthly volumes of total checks and transfers presented for clearing in the clearinghouse system in Madagascar are shown below (millions FMG).

	1988	1989	1990
Antananarivo	19,239	23,684	35,254
Outside Antananarivo	21,172	26,273	33,127
Total/month	40,411	49,957	68,381
Total/day	2,021	2,498	3.419

Four assumptions are made based on empirical observation:

1. 10% of total amount is assumed to be subject for delay. This is a conservative assumption since this is below the percentage of transactions between different clearinghouses (eg. between Antananarivo and major cities such as Antsiranana or Mahjunga) which in particular can be subject to substantial delay.

2. An internal discount rate of 13% as an indicator of cost; this is one percentage point above the existing reference money market rate used by BCRM.

3. 5 days on average has been assumed to be the delay and is probably a fairly conservative assumption based on the discussions with the banks in Madagascar.

4. 240 days has been used as the number of banking days over the calendar year.

Using the above assumptions, one can estimate the costs for one year with a delay of 10% of the transactions for day 1, for 5 days; on day 2, a delay of 5 days for 10% of transactions; and so on for 240 days, all at an internal discount rate of 13%. Thus, taking the average daily clearing volume of 3,419 FMG in 1990, the potential cost to recipient of funds is estimated at FMG 53,336 million (= 3,419 x 0.10 x 0.13 x 5 x 240 MFMG). This is equivalent to about 1.2% of GDP in 1990.

Interpretation

The delays in the clearing and transfer system represents a redistribution of income from payees to payors within the economy who use the financial system to settle economic obligations. The above calculation estimates how much these delays costs in the aggregate in terms of economic opportunity cost. In reality, any given economic agent is both receiving and making payments, and it is from the net receipt of funds that the true cost could be calculated for an individual financial actor. If a given economic agent receives on net substantially more payments than payments made through the financial clearing and transfer system, this agent is bearing some of the costs of delays of the system. This cost is akin to a tax on economic agents who decide to use the financial system to settle obligations. As with any tax, therefore, this dampens the demand for use of this financial service.

ANNEX 3.3

A DECENTRALIZED REGIONAL CLEARING SYSTEM

Below is a proposal for a new payment system based on telecommunication in place of mail service, meaning exchange of transaction data instead of documents. Received documents are retained and filed at receiving branch. Checking of signature at the branch keeping the account will consequently not be possible. Traditional signature checking has to be replaced by, for example, a cheque guarantee card for personal cheques and a confirmation procedure for corporate cheques. For transactions not being confirmed corresponding documents or copies are requested from the filing branch.

Exchange of data takes place on two levels, one on a regional level (intraregional clearing) for exchange of data between branches of a bank within a region and between different banks, and one interregional clearing for exchange of data between the regions of a bank. A clearing center conducted by the Central Bank (BCRM) is organized in each regional center city. At places where the BCRM has no branch one of the participating banks acts as agent of the BCRM. If a bank does not have a branch in a regional city the bank is represented in the clearing by another bank. Interbank clearing implies a set of technical standards to be agreed upon and an agreement between participating parties regulating liability and compensation. Below is an outline of successive steps and their timing.

Transaction day:

1. After banking hours the branch sends outgoing clearing transactions to the regional center office.

Transaction day plus 1:

2. In the morning at the regional center, received clearing transactions are sorted into:

   - transactions to branches in the region - intraregional transactions (regional intrabranch transactions);
   - transactions to other regions of the bank - interregional transactions (intrabranch transactions between different regions); and
   - other banks transactions by participating bank - interbank transactions

3. Interbank transactions are exchanged at the clearing center once a day at a fixed point of time, eg at noon.

4. Transactions received in the clearing are sorted into intraregional and interregional ones and merged with corresponding transactions coming from the bank's own branches in the region (Step 2 above).

5. Interregional transactions are sent to the head office to be merged with transactions from other regions.

Transaction day plus 2:

6. In the morning transactions (Step 5 above) are sorted by region and routed back to regional centers.

7. After the interbank clearing procedure at the regional center transactions from the central office and interregional transactions (Step 4 above) are merged to become incoming clearing to the branches in the region. Incoming clearing then consists of transactions from the region made yesterday and transactions from other regions made the day before yesterday.

Lists of transactions could be made up manually and transmitted by means of telefax or telex between the branches and the regional center, and the regional center and the head office. To minimize errors and maintain an acceptable security in the system, a rather high integration and automation of the process is needed. The system could be based on PC technology and regional centers and the head office should be computerized at least. Interbank clearing is performed by changing diskettes and transactions are transmitted computer to computer. If transmission computer to computer should not be possible, depending on insufficient quality of the telecommunication system, transaction lists produced in the system have to be transmitted by means of telefax or telex if PCs are equipped with a telex interface.

Accounting and reconciliation

For accounting and reconciliation purposes each bank participating in the clearing has accounts with the BCRM, one central account and one at each regional center.

Each branch has an account with its regional office and the regional office keeps an account for each of its branches. An analogous set of accounts is set up between the regional offices and the head office. (A loro-nostro accounting set up.) An accounting and reconciliation technique divided up according to levels creates a necessary condition for a controllable and safe clearing process.

1. Outgoing clearing transactions of the day are to the debit of the account of the branch with the regional office. Transactions received at the regional office are to the credit of the account with the branch concerned.

2. Outgoing transactions to the other banks are to the debit of the regional account with the BCRM.

3. Incoming clearing from other banks are to the credit of the same account.

4. Intraregional transactions coming from other banks and from branches in the region are merged and sorted as per branch. Transactions are to the debit of the accounts with the branches concerned.

5. Interregional transactions from other banks merged with corresponding transactions from the region are to the debit of the account with the head office and to the credit of head office account with the region.

6. Incoming clearing from the head office to the regional office to be forwarded to the branches is booked in an analogous way.

7. The balances of the regional account with the BCRM is transferred daily to corresponding central account.

Each batch of transactions either on computer diskette or on paper contains, besides the clearing transactions and the sum of them, the balance of the sender's account as well. The receiver then can check, with correction for remittances in transit, that the corresponding accounts agree, either automatically in the PC system or manually. By giving batches sequence numbers, reasons for possible differences are easily detected.

The three-level accounting and reconciliation technique constitutes a base for control and safety in the clearing process. Before implementing the system as a large scale operation it is, however, important to test the system on a small scale basis to make sure the quality of the telefax being sufficient.

ANNEX 3.4

TOWARDS AN IMPROVED SYSTEM OF CHECKS IN MADAGASCAR

Present situation

Checks are presently available to account holders of the four commercial banks in Madagascar. Out of these four commercial banks, there is only one bank which has a considerably higher minimum deposit than the others, when opening an account. One of the reasons for this is the perceived need to improve the confidence for checks. BMOI requires FMG 1,000,000, whilst the other banks' minimum deposits vary between FMG 50,000 and 150,000.

An already existing system, to make checks more accepted as means of payments is to have it endorsed ("visé") by the bank before the client signs the check. The bank writes the amount on the check and also signs it. The check is then "guaranteed" by the bank that sufficient funds are available.

"Cheques bleus" and Traveller Checks in FMG

In order to improve the confidence in and acceptance of checks, there are two banks which in 1989 and 1990, respectively, introduced two new similar checksystems. BTM issued Traveller Checks and BNI "Checque bleu", both nominated in FMG.

The Traveller Checks have a fixed value, whilst the Checque bleu can have either a fixed value or a specific amount corresponding to the customers' request. The customers pay "up front" for the checks, which are not linked to any account, but purely used as a means of payment. Thus, it should be regarded as a supplement to already existing check accounts, and not as a replacement.

The banks have made agreements with several enterprises, hotels, restaurants, and other businesses, where the checks can be used as means of payment. Of course, the checks can also be presented directly in other banks and then forwarded to the clearinghouse as ordinary checks. Both BTM and BNI consider their checks to have been well received by the market, both by users and by hotels and other businesses, since the checks are safer than cash and, in case of loss, are reimbursed.

Notwithstanding the usefulness of these new checking instruments, which increase the confidence in the use of checks, these forms of checks should only be regarded as a temporary solution to the problem of confidence in checks as payment instruments. The checks cure the symptoms of the problems, but they do not solve them, since the customers have to pay in advance for the checks.

Enhancing the safety and use of checks

Security measures, forming part of current check system, consist of manual checks and restrictions in the use of the system, leading to inconvenience to the customer and consequently to a low use of checks. A check system meeting the objectives of an improved payments system (including improved clearing operations described in Annex 3.3), cannot rely on manual checks of the present type.

A new check system must allow for a mode of use according to the need of the customer. The limited use of checks for payment is mainly caused by insufficient security in the system itself. Manual checks are generally time consuming and inconvenient. A check system for private customers ought to be designed differently from a system for corporate customers, as use and need of service differ.

<u>Private checks</u>

The check system recommended here is based on personlized check forms, designed and produced to make forgeries practically impossible. A check guarantee card (standard ISO plastic card) of fake-proof quality and signed by the account holder is connected to the account, for identification of the account-holder and verification of signature.

A system for protection of checks is required to make it possible for retailers to accept personal checks, and to make it safe for a branch to honour checks drawn on other branches and banks. Protection is carried out by calling drawee branch, where the request is notified. Too many requests for protection will cause inconvenience to the customer, and to the bank, by overloading system capacity. To avoid that happening, drawee bank should guarantee payment of smaller checks, up to a fixed amount, without protection.

A check service segmented into one type of checks guaranteed by drawee bank and issued to reliable customers only, and another always demanding for protection of the check ought to be considered.

Based on the above considerations, a new system of personal checks could be devised which would conform to the following procedures:

1. The check form has to be regarded as a value document, be printed on security paper, and be designed in order to hamper forgery.

2. The check form is personalized by imprinting name of the account-holder.

3. Imprinting of account number, check number and name takes place in security controlled printing shops.

4. The account-holder is furnished with an identification card - a check guarantee card. The card is a standard ISO card with built-in security in order to hamper forgery. The card is personalized with name, account number and card number (customer number). The card has a limited validity marked on the card.

5. The account-holder writes the signature on the card at the space stated. Checking related to encasement of checks or accepting a check as payment, is in the main carried out by comparing name and signature on card and check. The authenticity of the check and card can be taken for granted and additional checking is limited to balance.

At present, withdrawal of cash withdrawal is in most cases allowed at drawee branch. This restriction hampers the use of checks. It is important to develop a system allowing any branch to honor checks. It is furthermore necessary to create a system which could guarantee a retailer payment for an accepted check. In the check system proposed here, checking of balance is the only thing which necessarily has to be performed by drawee branch. The following system of protecting checks would allow all branches to honor checks and retailers to accept checks as payment, while keeping the control of the account at the drawee branch:

1. Honoring branch calls drawee branch and asks for balance check.

2. If sufficient balance is available the check is protected. Drawee branch gives honoring branch a key number to be noted on the check. The key number forms part of following clearing transaction.

3. At drawee branch, the transaction to protect the check is entered into the branch accounting system. The transaction is made up of account number, check number, amount, honoring branch, key number and date for clearing.

4. Protected amount is taken into account what concerns available balance up to noted clearing date.

5. Transactions are shown on the accumulated transaction list.

6. Protected checks arriving in clearing can be verified by comparing with the transaction list.

The success of extending the use of checks depends to a large extent on the possibility to protect checks, but may be hampered by bad telephone systems and administrative difficulties at the branch. For this reason it is advisable to create a system which under controlled risk of the drawee bank allows honoring checks up to a certain amount without being protected. The amount should be sufficiently large to cover 90 per cent of payments expected to be made by checks.

Unacceptable losses for the banks are conditional on following system of rules and procedures.

1. Obvious misuse of checks is made criminal offence (which is already the case).

2. The bank has the right to demand security for a check account, eg a minimum balance on the check account.

3. Check accounts with features described are opened only for customer being unequivocally identified.

4. A central file of customers having misused checks is set up. Banks are obliged to report any misuse to the file. Banks consult that file before opening a check account.

5. A central file of blocked accounts is set up. An accumulated list of the blocked accounts is delivered to branch-offices and retailers accepting checks once a month.

6. Accepted and honored checks drawn on blocked accounts to be found in the list are returned and are not the responsibility of the drawee bank.

Other measures to improve check service for private customers are:

– an automatic teller machine, "ATM", service at drawee branch using a check garantee card and PIN code. Initially, the ATM service should only be used at drawee branch and not intrabranch or interbank withdrawals.

– a new service for regular payments which could be accomplished through the customers writing a list with payment orders and hand that list and a check to the bank. This would shift some of the workload to the bank's back-office and unload the front-office, enabling them to deal with other matters. (An extended service for regular payments is described, in form of a girosystem, in Annex 3.5.)

Corporate checks

The demand for security of company checks should be the same as for private checks and should make forgeries practically impossible. All checks should be crossed (barré) and no signature control would be necessary. (The crossed checks ought not really be of any inconvienence to the payees, since they are likely to be suppliers, ie other companies.) The payor bank could for instance send transaction lists to the payee companies every day in order for the clients to verify that all cashed checks are correct and no false ones are in circulation.

Education and centralized information

There is also a need in Madagscar to increase financial knowledge amongst the population. To make them aware of the benfits (safety, etc) with banks and check accounts. This could be done through savings campaigns, etc, from not only the banks, but probably also from the Government. Another method to enhance the acceptance of checks, and thereby also the banks' reputation, could be to introduce an "institution" were the banks can get information on a check account applicant's solvency, etc.

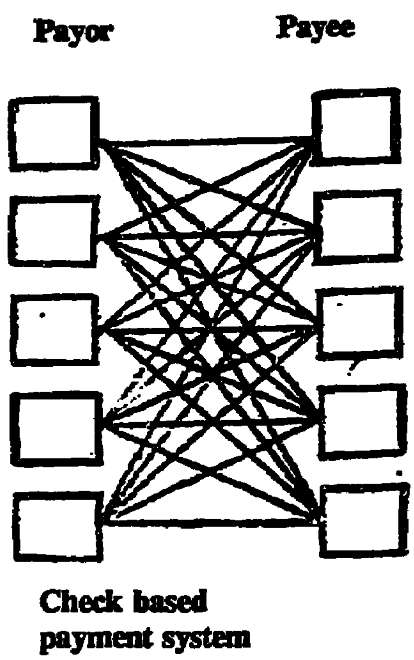
ANNEX 3.5

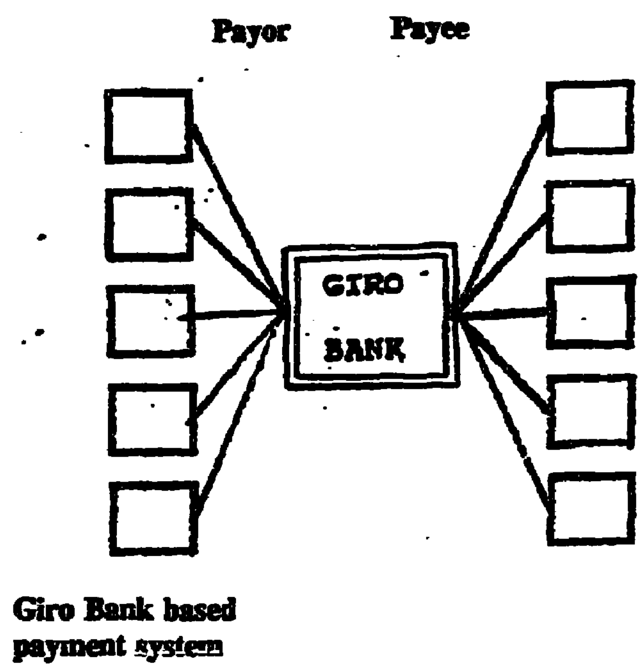
CONCEPT AND FUNCTIONS OF A GIROBANK SYSTEM AND APPLICABILITY TO MADAGASCAR

Giro systems have over a long period of time proven to be efficient systems for handling large numbers of payments. Such systems have been in use in Europe for more than 60 years and have proven their reliability and efficiency. A giro system not only transfers money but also provides vital information on the amounts being paid. A well functioning giro depends on information which is accurate and which can be handled both in the giro as well as in the payment procedures of the recipients of funds.

Functions of a Girobank System

To help explain the nature of a girobank system, the figure below schematically shows two payments systems with and without a giro. In the first (solely check-based) system, all payors directly make individual payments to each payee to whom they have a financial obligation. In a giro system, these payments are aggregated by individual payor, centralized in the giro system and aggregated again for payment to individual payees.





At the heart of the Girobank is the Giro account. Here, all transactions are collected and the balances kept. To the account file system is attached a system for producing statements and the transaction delivery system which contains the information on each transaction the recepient needs for the book keeping of payments made.

A Giro system is in principle built up of three types of payments:

- In-payments to accounts
- Out-payments from accounts
- Transfers between accounts

The efficiency of a Girobank based payment system is highly dependent on the number of outlets in which payments can be made through the Girobank.

Types of Giro Systems

Basically there are two types of Giro systems. The first system is only a clearing facility in which accounts are maintained by the participating banks to which the Giro facility is attached. It requires that all banks cooperate and share the operating costs for the giro (clearing) center. The benefits would be the possibility of keeping money within the entire banking system as is the case with payments through checks.

This Giro system, based on accounts operated by the participating banks, is preferable in cases where there are other payment systems operating outside the banking system. In such cases, banks would have an incentive to design a system for payments, enabling them to keep the flow within the banking system.

This is not the case in Madagascar. Here, there is already an embryonic institution acting like a girobank which is the postal checking system (CCP). In combining the Girobank facility with the postal savings institution (Caisse d'Epargne de Madagascar), an efficient network could be put in place to facilitate payments covering the entire country.

Procedures for an operating Malagasy giro system

In Madagascar, the first area of priority would be to facilitate in-payments. Here, utilities and government payments such as telephone bills, tax payments, electricity and other similar payments are ideal areas to start with.

An example of a Girobank in-payment transaction would be the telephone bill. The bill is sent out as normal by the telephone company to the payor. To the bill should be attached a payment form of a standardized design decided by the Girobank. The payor uses the preprinted payment form as payment document in the Post Office (or CEM) and makes his payment. It could also be envisaged that the payor could make his payment in the branch of a bank if the banks were to participate in the girobank system. The latter would increase the possibilities for the payor to make his payment in a convienient place and manner.

At the same time other bills could be paid in this manner in the same instance, thereby avoiding the use of several checks and/or visits to several institutions for different payments. At the end of the day all these payments (in this example the telephone bills) are lumped together and sent to the Girobank centre for processing. Here, the communications are crucial and the better they function, the higher the efficiency of the Girobank system. In an ideal situation the payment forms should reach the Girobank centre the following day, which in Madagascar would be true for Antananarivo and possible some nearby locations including larger cities with efficient postal service (probably covering more than 50% of all payments).

At the Girobank centre, the incoming payment forms are processed the same day, which is possible thanks to standardized forms and the use of computer techniques. At the end of the processing day, a statement is produced containing all necessary information to the payee such as amount paid, telephone number and/or reference number and date paid.

The telephone company would receive the statement the following day for its own accounting purposes. The statement could be produced in virtually any form required by the telephone company and delivered in any media such as magnetic tape, on-line or paper.

The Giro accountholder, in this example of in-payment, is the telephone company only. It would also be possible for the Girobank centre to accept checks as payment, should this be required.

The second area of girobank acitvity mentioned above is the out-payments. A girobank is an ideal payments system for such payments going in the other direction in large numbers such as pension, social security and salary payments. Here the giro accountholder, say the pension agency, issues instructions to the Girobank centre to issue payments in the other direction.

In the example of the pension, the agency issues payments forms and a single payment order for the total amount to be debited to the Giro account. The Girobank centre processes these outpayments when received and debits the account. The out-payment forms (standardized) are sent out to the receivers through the ordinary postal services and the beneficiaries could cash them in any post office or bank office or deposit the amount into an account, whichever is preferable.

The third area of girobank activity would be transfers between accounts. This acivtity would open up the giro system to a wider group of accountholders, enabling private persons to operate Giro accounts.

An example of the use of transfers could be a company which has to make payments of bills. For these transfers to work efficiently the use of giro accounts should become widespread among companies and others to which payments are made (suppliers etc.).

The paying company receives bills to which is preferably attached to an inpayment form (the standardized version). All bills which are to be paid are lumped together and summarized on <u>one</u> transfer payment form. (Payments with cheques would require one check per bill and possibly also a covering letter per bill). The transfer payment form and the in-payment forms are sent (or delivered otherwise) to the Girobank centre for processing. In the ideal situation with efficient postal services, the instructions are received by the Girobank centre the following day for processing the same day.

At the end of the processing day, two statements are produced; (i) one to the payor indicating that the Giro account has been debited, the new balance and the payments made; and (ii) one to each payee indicating amount paid, invoice or other reference number (who has paid) and date paid.

In the transfer payment operation it is also possible to make payments to non-giro account holders at the same time, using the same procedure as with out-payment transactions described above.

Advantages and implementation of a giro system in Madagascar

The Girobank system offers a complete and efficient payment system both to individuals and companies alike. The efficiency is based on the use of highly standardized routines and modern computerized techniques. It offers substantial advantages over systems based on individual payments effected by each financial agent and exploits economies of scale in settling payments throughout the economy. This would also allieviate the burden of banks the often costly handling of many small transactions and limit the use of checks which have a tendancy of straining banks operating costs when their use reaches high volumes. Unlimited use of checks has in many countries forced the banks to introduce charges over and above the normal handling costs for transactions.

Furthermore, a Girobank system offers substantial savings and improved efficiency for companies handling larger volumes of payments as the Girobank centre will be in a position to provide services tailored to the individual accounting procedures of the companies. For individuals, payments are made much easier as the Girobank offers a one-stop solution to all payments in a fully developed Girobank system.

In the case of Madagascar, there appears to be much promise for a Girobank centre based on the existing postal checking system (CCP) which could be operated by a reconstructed postal savings institution in order to make full use of the postal network. This could enable payments to be made virtually everywhere in the country. A fundamental prerequisite to realize this potential is a strong commitment by the government to use the CCP as the basic mechanism for handling salary payments of civil servants as well as tax, utility, and social security payments and other payment obligations of the Treasury.

Commercial bank participation in this giro system should also be considered and could be achieved in many ways. One way would be to allow partial ownership by the commercial banks in the Girobank or simply to have an agreement whereby Girobank transactions can also be handled through the commercial banks. The Girobank would be self sustaining and draw the major income from the float it will be operating in the system. The float would be substantial and could be invested in the money market or even with commercial banks, thereby providing the banking system with an additional source of short terms funds. Over time, the float would be predictable and a certain amount could also be invested in longer term instruments depending on the investment facilities available. The girobank would thus have the potential of becoming a significant player in emerging domestic financial markets in Madagascar. A second source of income could be a nominal fee charged for the transactions and fees charged to account holders for extra services rendered such as automatic invoicing.

In Madagascar, the timing for development of a giro system appears appropriate. A clear need exists; modern computerization techniques have begun to be introduced in many areas; and an embryonic giro system already exists within the postal checking institution (CCP). A giro could be built in Madagascar with a modern, computerized design from the beginning. Some complicated systems that can be found in most European Giros, which began when modern techniques were not available, can be avoided in Madagascar. This would ensure cost effectiveness.

Further study would be needed to more conclusively establish the profitablity of a Girobank in Madagascar and define its scope of operations. However, the considerable experience of the giro systems in both industrial and developing countries suggests that such an institution is likely to have a promising future within the payments and financial system in Madagascar.

ANNEX 3.6

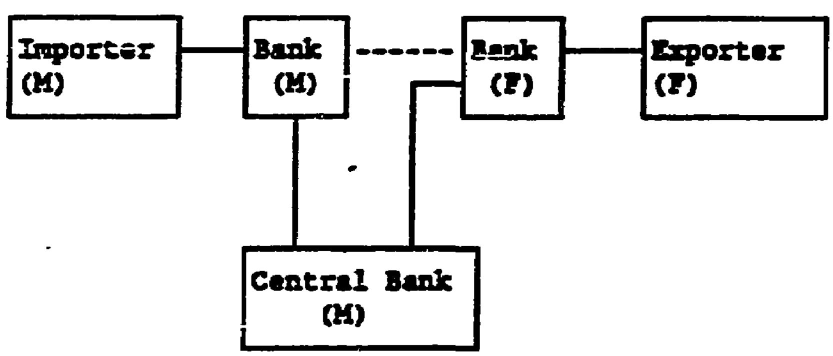
OVERVIEW OF THE EXTERNAL PAYMENT SYSTEM IN MADAGASCAR

The existing currency regulation in Madagascar does not authorize anyone but the BCRM to deal with foreign currencies. Consequently, neither banks nor companies are allowed to deal with foreign exchange, or have foreign currency accounts, and all payments transactions to a foreign country have to go through the BCRM. This has been the case since the commercial banks were nationalized in 1975. Furthermore, the Malagasy currency is not convertible.

Thus, whenever an importer or exporter wants to sell or buy goods, his bank has to apply to the BCRM to buy or sell foreign exchange, as is the case when somebody has money transferred from another country or wants to transfer money to abroad.

Import

The following steps can be distinguished when an importer is to buy foreign currency to pay for his goods:



(M) Madagascar
(F) Foreign country

Day D: The importer goes to his bank, Bank (M), with his import documents.

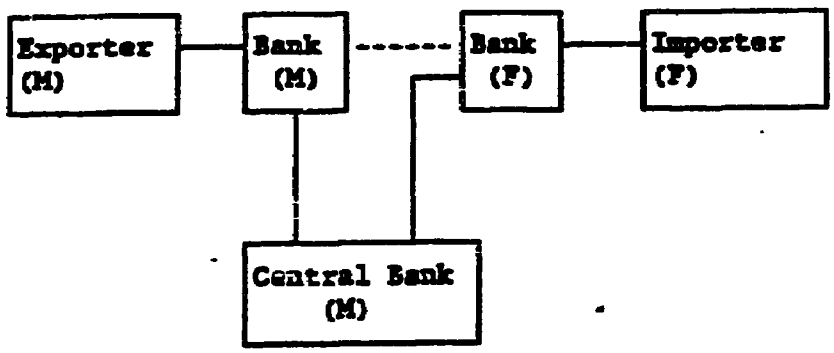
D+1: The following day the bank collects all the import applications belonging to its customers. The bank then once a week sends in applications to the BCRM to buy foreign currency, which is requested by the BCRM. Thus, if an importer is unaware of this fact, his application might take an extra five working days before it is forwarded to the BCRM, i.e., day D+1 suddenly becomes day D+6.

D+3 to D+8: The BCRM then takes two days to verify that all the documents are in order, i.e., on day D+3 (to D+8) the bank receives a notification that its account with the foreign corresponding bank, Bank (F), is to be credited in eg FRF.

Despite the fact that the exchange transaction is not settled until day D+3 - D+8 the importer always get the exchange rate as of the day the bank sends in the application (D+1 to D+6).

Export

In an export situation the procedures are more or less the reverse of those of an import transaction.



(M) Madagascar
(F) Foreign country

However, the commercial bank, Bank (M), does not get credited until three days after it has been notified by its correspondent, Bank (F), that the payment was made. The exchange rate applied is the rate as of the day the bank is notified.

Transfers

Money transfers in foreign currencies to and from Madagascar are dealt with in the same manner, as when the banks send export receipts or import documents to the BCRM. The time it takes for a transfer to reach the payee is, as for imports and export transactions, dependent on whether the transfer is to go by telex or mail. A telex is normally handled rather quickly. However, as previously mentioned telex systems do not always work adequately. On the other hand, transfers by mail may take a week or two.

Free Trade Enterprises

Free Trade Enterprises are an exception to the current currency regulation. Following the "Loi sur les Zones Fransches Industrielle", a law adopted in 1989, domestic and foreign investors have the possibility to invest in export-oriented industries with considerable tax benefits. These companies, Free Trade Enterprises, are allowed to open and hold accounts in foreign currencies abroad. They are also allowed to borrow money abroad. (There are few limitations to what kind of transactions these accounts can be used for.) Presently, there are approximately 10-13 functioning Free Trade Enterprises in Madagascar, mainly active in the textile industry.

Impact of the SWIFT System

As from March 1992, Madagascar will be connected to the worldwide SWIFT system for dealing with foreign currencies. This will enable the participating partners - the commercial banks and the BCRM - to instantly receive and send transfer orders. This will to a certain extent shorten the existing delays. However, SWIFT does not effect the present currency regulation, and banks will still have to apply to the BCRM to sell or buy foreign currencies.

The SWIFT system will give access to all countries connected to SWIFT. It has in several cases been shown that activity to and from a country connected to SWIFT increases, simply because of the increased accessibility to foreign banks. SWIFT is not only an efficient system for dealing with foreign currencies, as there are also other services connected to the system which enable participants to send, for example, telexes in SWIFT format through the system.

ANNEX 4.1

THE COST OF INTERMEDIATION

The cost of intermediation is computed by dividing the operating income or the gross earnings margin by average total assets. The gross earnings margin is equal to the interest margin plus other operating income(including commission income, foreign exchange profits, and other operating income). The cost of intermediation has three components: operating costs, other net costs that include depreciation costs, net loan loss provisions, and other non-operating costs less non-operating or exceptional income) and gross profits. In a competitive system, the cost of intermediation tends to be low (i.e., less than 3.5 percent in developed countries with efficient banking systems), while in countries with exchange and selective controls and consequently, restrictive financial systems, the cost of intermediation tends to be higher.

ANNEX 5.1

CONTRACTUAL SAVINGS IN A WORLDWIDE PERSPECTIVE: APPLICATIONS TO MADAGASCAR

Classifications of contractual savings institutions: Regardless of the type of contractual savings institution being discussed, there are two basic types of classifications. The first, direct contribution (DC) plans where regular contributions are made by the participant or on his behalf and where the final benefits depend on the total contributions made during the period of employment and the investment accumulation for the same period. In this type of a program there is a direct link between the contributions made by the individual and the benefits received. This plan is completely transparent as there are no vesting restrictions (unless the contributions are made on behalf of the individual by the employer), and there is portability in case of employee mobility. The second, defined benefit (DB) plans where individuals are granted certain future benefits and contributions are made in light of investment performances of the plan and other factors. Direct benefit plans usually require certain vesting provisions and also limit the portability of benefits in case of employee mobility. Certain justification exists for these provisions, the case in point being the employee who has undergone extensive training or has acquired job skills not otherwise available in the open market or when the employee has, through job related activities, acquired privileged information.

Types of contractual savings institutions: Throughout the world, there are four basic types of contractual savings institutions: national provident funds, social pensions insurance funds, life insurance companies and occupational pension funds. There are also variations on the personal pension or savings plans which are administered by a variety of agents such as commercial banks, savings banks, life insurance companies and certain types of managed pension and mutual funds. Contractual funds however are differentiated by the fact that they are defined essentially as long-term institutions and the other savings plans are usually short-term in nature. Reviewed below are the key operating characteristics of various types of contractual institutions, their economic implications and relevance for Madagascar.

Life insurance companies and products: Three types of companies offer life insurance products. Stock companies, owned by their shareholders; mutual companies, owned by the policyholders; and state-owned companies. Internationally and in most developed countries there are more stock companies than mutual of state-owned companies. Life companies cover the risk of premature death as well as the risk of excessive longevity. Premature death is covered by whole life or term policies whereas excess longevity is covered by various kinds of annuity policies. An additional service is the management and the insuring of occupational pension schemes that combine the accumulation of reserves during an individuals working life and the payment of regular pension benefits during retirement. Life company products must also be distinguished between individual and group policies with the former incurring higher operating and marketing costs. Group policies, on the other hand, are often negotiated directly with the employer and are subject to lower operating and marketing costs, have fewer information problems and avoid the inefficiencies caused by the problems of adverse selection.

Demand for life insurance: For the most part, the life insurance business is not well established in developing countries. This can be attributed to both demand and supply factors. The general level and distribution of wealth and income is a key factor. In countries where inflationary expectations and foreign currency overvaluation is prevalent, wealthier individuals often benefit from lower premiums available in foreign markets in currencies less affected by the inflationary trends and the devaluations of the local currency. This in turn can create an adverse selection problem for local insurers who may be left covering the higher mortality rate of the lower income segments of the population, therefore being forced to raise their premiums in order to cover the additional risk, reducing further the level of effective demand for the product. Overall demand for life insurance in low-income countries as Madagascar tends to be low not simply because poorer people are unable to afford insurance premiums, but rather because they have little real financial wealth and therefore are exposed to little risk of financial loss. In many developing countries, the extended family or the local community becomes the insurer of last resort by making informal arrangements for individuals who have suffered a misfortune or who are unable to care for themselves.

Social security systems: Table A shows that most countries in the world have developed some form of social security system. Social security systems administer a wide variety of social programs, including unemployment benefits, family allowance and health benefits. It i s interesting to note in the following table the steady increase of social security programs being offered worldwide. The basic difference between social pension systems and national provident funds is that the former are defined benefit schemes, while the latter operate as defined contribution plans. In many developing countries such as Madagascar, the social security plans are on an unfunded, pay-as-you-go basis. Three types of social security systems offer old age pensions: (i) universal benefit schemes which provide general pension coverage for all residents over a specified age regardless of income, assets or employment status; (ii) universal social assistance schemes limit pension coverage to underprivileged residents, falling under asset and income ceiling levels; and (iii) social pension insurance schemes distribute pension benefits to participants under age, past employment and contribution requirements and limitations. The government funds the first two programs from its general revenue budget while the third program is primarily funded through contributions from employers and employees. In many developing countries such as Madagascar, only a small fraction of the population is covered with the majority of the large rural population engaged in subsistence farming and the informal artisanal sector in urban centers are virtually excluded from coverage.

Table A. NUMBER OF COUNTRIES WITH SOCIAL SECURITY PROGRAMS

	1949	1967	1981	1985
Any Type	58	120	139	142
Old Age/Invalidity	44	92	127	132
Sickness/Maternity	36	65	79	83
Workers' Compensation	57	117	136	136
Unemployment	22	34	37	40
Family Allowance	27	62	67	64

Source: Social Security Administration (1986)

Problems in financial management of social security system: Social pension and insurance schemes have a highly centralized management and are mostly national or regional institutions. Their operations are decentralized and administered on a local basis. The nature of the social pension insurance makes it highly susceptible to political interference in reference to the nature of the investments as well as with regard s to the make-up of benefits and the payment of benefits. The lack of institutional autonomy has also created an administrative weakness in the ability to enforce compliance, to keep accurate and up-to-date records and monitor and enforce the prompt payment of contributions tc the scheme. The penalties imposed during these periods must be swift and of substance to avoid creating incentives for delaying compliance. Administrators must also be willing to pursue full compliance so as to safeguard the integrity of the system. This will also keep employers and employees from colluding in the understatement of wages earned or by establishing an unusual amount of non-taxable fringe benefits as part of the compensation package or in the worst case scenario, making under-the-table payments of wages in cash. These practices become more prevalent when there is a weak link between contributions and benefits.

Economic features of social security management: An additional problem for countries having undergone periods of high inflation, as was previously the case with Madagascar, recently is the erosion the real value of the benefits or pension payments. The net effect tends to be a redistribution of benefits from workers with long tenure and higher incomes to those of shorter tenure and lower incomes. Unless such a situation is addressed so as to re-establish a parity between contribution and benefits, it leads to a perception that contributions are seen more as a tax on labor rather than a system of contractual savings. It should also be noted that setting rates of contribution and collecting the contributions are quite a different matter. Compliance among private employers requires constant policing and even this will not result in a timely payment of contributions and/or payroll deductions. During inflationary and/or periods of high interest rates substantial incentives to postpone payments for as long as possible can become tremendously acute causing undue stress on the system if there is a particular shortage of reserves on hand.

National provident funds: Contributions here are fixed by supervisory authorities with payment normally made by both employer and employee under specific rules and regulations. The benefits, which are usually paid out in lump sum payments but which could also be converted into annuities, depend on the amount of contributions paid in and the earnings generated during the duration of the wage earner's involvement in the program. A careful balance must be kept in the required amounts of the contributions relative to the total wage structure since a high level of contributions are usually seen as forced savings and adversely this could lead to the understatement of wages. However, since contributions and benefits are not linked to specific employers, there is no restrictive effect on labor mobility and there is no distributional effect between lifters and mid-career switchers. National provident funds are also seen as paternalistic institutions which are subject to substantial political interference. The reserves generated by the institution are substantial and governments have been known to use these reserves to fund government projects and debt. There is a definite possibility that the final benefits could be less than expected because the contributor undertakes all risks of inflation, investment return and replacement value. Unwise government interference can affect the solvency and integrity of the fund affecting administrative efficiency and the real rate of return produced by the fund.

Occupational Pension funds: The same arguments for defined benefits and defined contributions hold fast in regard to occupational pension schemes. The major shortcoming of the DB plans is the poorly defined financial contract that the employer has with the employee and the unilateral rights that the employer retains to terminate plans and convert accrued benefits to a DC plan. The problem being that a certain expectation by the employee for their retirement benefits can be obliterated.

The problem of non-funded plans, when firms face insolvency or are unable to meet their pension obligations, is consequential and employees stand to lose a considerable amount of personal investment. When investment is mentioned, employee decisions must be included in the formula because long-term determinations to forego mobility, higher pay scales, advancement and other changes in the employee's career are weighed against presumed benefits the employee is led to believe he will enjoy after a specific length of service with the sponsoring firm. Vesting periods vary from firm to firm but averages indicate that three to ten years is normal and that partial vesting can begin almost immediately. Further weaknesses with a DB plan are apparent in reference to employee dismissal prior to acquiring vesting rights for the accrued benefit. Employer consideration could be opportunistic in these cases breaching the long-term agreements with employees. Immediate vesting and portability are the most beneficial aspects that a DC plan offers the employee. There are no intentional redistributions between groups of workers and the plans are much simpler to operate. DC plans also rely on the solvency and financial integrity of the financial institution managing the funds. Investment risks however, are borne by the individuals participating in the program. Regular contributions to the program are usually fixed in direct relation to salaries. Pensions depend on the amount and the duration of time spent contributing to the program along with the accumulation of investment income earned during the same time frame. In developing markets, such as Madagascar, DC plans should have access to indexed financial instruments, for investment purposes, in order to increase their ability to hedge the portfolios against inflation erosion. The same argument holds for devaluation risk.

Personal pension plans: Much the same as other pension schemes, personal plans are defined contribution plans and therefore do not suffer the vesting or portability restrictions of DB plans. Individuals can choose the institutions that will manage their funds and they can transfer their funds or redirect the types of investments to suit their particular needs. Younger participants might prefer capital appreciation plans which are more likely to create investments in the equity field while older participants might shift their investments more appropriately into dividend paying instruments as they are more in tune with the particular needs of individual investors and often 'tailor' the portfolio to meet these requirements. The argument can be made that since there are no restrictions to the time frame of the investment these plans are short-term investments, but its has been noted in more developed countries where specific tax advantages apply, that these investments become long-term savings schemes in the majority of cases. Personal pension plans can be established with insurance companies, commercial banks, marketable securities (including bonds, equity, and unit trusts) and mortgage societies. In many case these personal pension plans are established to supplement the occupational or other pension funds which were deemed insufficient to cover individual retirement requirements. In developing countries, especially Latin America, the introduction of personal pension plans alongside existing social security and company-based plans, in the early 1980s seems to have received wide approval. In Chile, the system of compulsory personal pension plans was introduced after the reform of the social security system of 1981. Management of the funds is entrusted with a number of approved pension companies (Administradoras de Fondos de Pensiones - AFPs). Employees make mandatory contributions equal to 10% of earnings (up to a specified inflation- indexed ceiling), though they are allowed to make additional voluntary contributions up to a total of 20% of total income. Employees are also required to buy life term and medical insurance, which are provided on a group basis. On retirement, employees can either buy an annuity from a life insurance company or come to a similar arrangement with the AFP. This plan is government mandated but privately managed adding to its transparency and credibility. This model could certainly have applications in Madagascar once the financial infrastructure is adequately developed to accommodate its key elements.

<u>Redistributive effects in promoting contractual savings</u>: In considering a strategy for long-term development of contractual savings in Madagascar, policy makers must be aware of the perception of redistributive effects on incentives to participate in such schemes. Strong and direct links between contributions and benefit where there are no redistributive effects are viewed by the participants as forced or voluntary savings and not as a tax on labor. There is no disincentive on labor mobility and thus there is a limited effect on labor market efficiency. Intentional redistributive effects are usually seen as direct taxes on the labor market and there is a weak link between contributions and benefits. Redistribution often reflects the country's desire to meet certain social equity objectives. Labor market incentives linked to these effects are seen as a desire to keep mid-career switchers on board and convert them to lifer status and the same can be said of slow-track and fast-track individuals reference to company based pension schemes. Unintentional redistributive effects are usually caused by inflationary pressures and/or currency devaluations, in respect to the distribution of benefits, within and across generations and also due to changes, over time, in the performance or provisions of pension schemes.

<u>Compulsory participation and risk allocation</u>: Compulsory participation in contractual saving schemes often times creates negative results as participants try to evade mandated contributions and try to manipulate the system to their own benefit. The most common example is the understatement of wages or the partial payment of wages outside traditional payroll methods. Adverse selection is more of a problem with voluntary participation schemes because individuals in a higher risk situation will be more prone to purchase life insurance contracts rather than annuity policies. Informational efficiency makes a system easier and simpler to operate. The transparency factor makes compulsory schemes more likely to be perceived as deferred compensation and forced savings rather than a tax on labor. Allocation of risk in a contractual savings plan had always been a primary consideration since the integrity and solvency of the plan hinge on the decisions of the providers. The three risk factors to identify with contractual savings plans are as follows: replacement risk, investment risk and inflation risk. Replacement risks deal with the level of benefits relative to needs at retirement. Investment risks deal with the choices which have been made in portfolio selection and the performance of these investments. Inflation risk refers to the protection level against inflation which was made during the life of the investment protecting it against a lowering of estimated or promised benefits at retirement. The most important factors concerning the efficacy of contractual savings plans must in the end deal with the level of protection the plan has provided for expected benefits. The solvency and integrity of the plan will determine the acceptance and compliance of the plan on a broader scale.

<u>Choosing the degree of centralization</u>: Operating costs have traditionally been lower in centralized management of contractual savings institutions. Lower marketing and operating costs are sometimes offset by bureaucratic inefficiencies which tend to create a slow and cumbersome system with a greater exposure to political pressures and intervention. Manipulation of assets, due to political overtones, may lower the return on investments and thereby causing changes in the benefit structure without reasonable necessity. Many of these problems can be mitigated through the use of a highly decentralized management structure but this will entail higher regulatory, operational and marketing costs. Whichever method of management is chosen, total transparency is the preferred course of action. There is also a definite effect on the country's capital markets orientation and the promotion of new and innovative financial structures and products. Decentralized management usually encourages investments which are bottom line oriented while at the same time risk aversive. Centralized management on the other hand may encourage the direction of investment funds through government mandate thereby possibly limiting capital markets development while at the same time redirecting the funds to the government's benefit. These tradeoffs must be carefully made by Malagasy policy makers in deciding how best to promote contractual savings and their potential for promoting financial market development.

<u>Mobilizing financial savings through pension schemes</u>: The creation of funded pension schemes can generate substantial long-term financial savings even in a relatively short period of time. In countries where labor incomes represent 50% of national income, a compulsory scheme covering 40% of the labor force and imposing 10% contribution rate would accumulate annually funds equal to 2% of national income. If the nominal rate of return on fund balance is equal to the nominal rate of growth of GNP, and since in the early years of operation pension benefits would be minimal, these pension schemes would accumulate resources equal to 10% GNP over 5 years and 20% over 10 years. After the first 10 years, the pace of accumulation will be affected by the growing volume of benefit payments. On the other hand, expanded coverage and an increase in the share of labor income in total income will tend to accelerate the pace of accumulation. The experience in Singapore, Malaysia, and, more recently, Chile shows that once a credible and well run system is in place, it can accumulate long-term resources at a very fast pace.

The promotion of contractual savings will create an effective mechanism for channeling such savings through the financial system to finance an expansion in the supply of productive capital. Efficient contractual savings institutions can help enhance investment productivity, stem, and perhaps even reverse, capital flight, and lower the real rate of interest. Achieving these benefits depends entirely on removing regulations and practices that use contractual savings entities as captive sources of finance for government debt instruments at low interest rates, as is now the case in Madagascar. Such restrictions not only affect the financial performance of pension funds, life insurance companies, social security trust funds and government owned and regulated commercial banks, but also inhibit the positive contribution that such institutions make to the development of a domestic capital market.

ANNEX 6.1

POSTAL SAVINGS BANKS IN AFRICA: LESSONS FOR MADAGASCAR

There is a trend in many developing countries to "convert" Post Office Savings Banks into fully fledged banks. One such example is in Zambia where the National Savings and Credit Bank (NSCB) was formed through an act of parliament from the previous Post Office Savings Bank. The NSC' was given a charter of its own and entered into an agreement with the Post Offices to carry out NSCB services. It was also given the right to issue loans from its Head Office. Unfortunately the NSCB never took off as intended due mainly to political reasons and the unstable economy of the country. Another contributing factor was that the NSCB did not benefit from any technical assistance program to upgrade its capacity, mainly its managerial capacity. To this day it is still considered a very weak banking institution in the Zambian banking community. The NSCB has issued few loans since its inception, but on the whole the bank is riddled with problems still awaiting to be resolved. The bank has, however, continued to operate on its own and plays an important role in the Zambian economy but its full potential is still to be utilized. The lesson which can be learned from this case is that a legal change alone does not constitute the required package of changes needed to transform a Post Office Savings Bank into a fully fledged bank. Another lesson is that the agreement with the Post Offices also needs careful attention as the NSCB case has demonstrated that certain shortcomings exist regarding the remittance of funds from the Post Offices to the NSCB. The NSCB is now pursuing development assistance in order to implement a training program as well as computerizing its accounting procedures. It has also embarked upon a program to establish branches of its own in certain parts of the country in order to provide better services more in line with other banks and as a complement to the services of the Post Offices.

The Post Office Savings Bank of Zimbabwe (POSB) is a well managed institution which in very recent years has experienced a downward trend in its deposits. This has been found to be attributable to the stiffening competition among the banks in Zimbabwe, whereby the POSB has lost market shares due to inefficiency in its service. Here two factors have been found to be of utmost importance: i) the present manual system has been unable to maintain the same levels of speed and efficiency as the other computerized banks; and ii) POSB is not able to provide any other services than its savings account and the fixed deposits account which is considered too limited in a market where other banks offer a more versatile service.

The POSB has its own Board of Directors, its own management and operates its own business; it also purchases services from the Post Offices, including staff, and pays a cost per transaction for these services. The Post and Telecommunications Corporation (PTC) has signed an agency agreement with POSB to offer such services as deemed necessary to operate the POSB including computer services. POSB, however, is a legal entity of its own. In recent years, the POSB has also opened up branches of its own called "banking halls". These now number 11 in total and another 3-4 are planned in the near future. In other places, the design of the Post Offices has been made in such a way that the entrance to the POSB is from one side of the building and the entrance to the Post Office is from the other.

The POSB has now embarked upon a plan to computerize its operations, both in the banking halls as well as in the Post Offices (most of them). This development will make it possible to offer the same quality of service as one would find in other banks. This will also lay the foundation for a new corporate strategy whereby diversification of its services will be dealt with. It has also been recognized that the most valuable asset of POSB is its network through the Post Offices. This will be the future foundation of the new corporate strategy to be formulated.

The Post Office Savings Bank in Botswana has recently started to diversify its services to the public. First, it has participated in some government credit schemes and thereby began to learn loan handling and processing. It has only one branch of its own and operates mainly through the Post Offices.

All these three postal savings banks are granted the right to invest their funds freely in government bonds, commercial banks and/or other papers in the money and capital markets. Botswana is probably the most positive example where lending has been introduced in a successful manner and the postal savings bank more and more takes on the shape of a fully fledged bank. The Zambian experience could have been more favorable were it not for the political and economical difficulties within Zambia which affected the NSCB.

Tanzania has also recently drafted a new constitution for its Post Office Savings Bank aimed in the same direction as the three examples mentioned above.

One common lesson learned is that it takes time to transform a Post Office Savings Bank with limited operations into a fully fledged banking operation. Also, in order to make it as swift and fast as possible, a technical assistance program is needed to institute training needed in the initial phases and to design new operational strategies based upon new policies so as to achieve a concerted effort in the transformation process.

In Madagascar, it would be very useful for officials of the Caisse d'Epargne (CEM) to make study visits to these countries in order to see in detail how the transformation process is working and to draw on lessons learned. CEM should also consider applying for membership in the International Savings Banks Institute (Geneva) in order to make it possible for the CEM to have access to latest knowledge and experience in this field and to be able to participate in conferences and seminars held mainly dealing with these issues.

ANNEX 7.1

THE FOREIGN EXCHANGE RETENTION SCHEME IN MAURITIUS

Even before Mauritius entered its export boom phase in the 1980s, its foreign exchange controls began evolving from an automatic surrender requirement for all foreign exchange receipts to a more flexible foreign exchange management system allowing exporters and commercial banks greater scope for receiving and managing foreign currency, Like other developing countries, Mauritius maintains a requirement upon exporters that foreign exchange proceeds should be repatriated and surrendered in exchange for local currency. However, this requirement has for more than a decade been flexibly administered to facilitate export transactions. In practice, exporting enterprises need foreign exchange to foot their import bills associated with the exports. For this reason, exporting companies are permitted to retain foreign exchange balances in diverse currencies with domestic commercial banks so as to meet their foreseeable foreign exchange commitments on imports. This system helps the enterprises avoid the payment of spreads to commercial banks on the associated foreign exchange transactions. Nonetheless, to a limited extent, this system, by allowing commercial banks to take a position in foreign currency, enables them to generate income from foreign exchange management.

Commercial banks in Mauritius have traditionally been permitted to maintain foreign exchange balances with their correspondents in keeping with their requirements. The added retained foreign exchange balances by exporters place banks in a position to manage foreign exchange. They consequently take positions in diverse currencies and up to the amount of balances held by the exporters. There is also the fact that retention of foreign exchange balances is permitted by Exchange Control on the foreign exchange balances being retained by exporters and data reported by banks to the Central Bank on their month-end foreign exchange positions help to keep track of balances held.

The Central Bank in Mauritius stands ready to buy and sell foreign exchange from and to commercial banks as required. Thus, exporters who have not accumulated adequate foreign exchange balances may purchase additional requirements from the Central Bank through their commercial banks. This mechanism introduces the element of confidence in the operation of the payments system in so far as foreign exchange dealings are concerned. Even at the worst times, banks in Mauritius have not been forced to surrender all foreign exchange which materializes to the Central Bank. Working balances maintained by commercial banks abroad have been considered as normal. As exporting activity gathered momentum, there was a tendency for exporters' foreign exchange retention to rise but the net inflow of foreign exchange from these activities more than justified the retention policy stance adopted.

In principle, however, Mauritian export enterprises are permitted to engage in forward cover transactions through their own banks on international markets. They may also enter into currency options as an alternative hedging techniques. Banks report their foreign exchange positions to the Central Bank at the end of each month.

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ANNEX 7.2

CAPITAL MARKET DEVELOPMENT IN MAURITIUS: LESSONS AND PITFALLS

General Context

The Stock Exchange of Mauritius Limited opened in July 1989 with five companies on the official list. After nearly two years, the number of listed companies increased to 17. In parallel, there is an Over The Counter market (marche hors-cote) which, in fact, comprises principally those companies which were traded in the former Chamber of Brokers.

Although the Chamber of Brokers had been in existence for more than a century, its impact on the economy was insignificant since only a handful of investors was aware of its existence and functions. The dealings were made on an auctioneering system where the shares were sold to the highest bidder. Prices were thus not determined by demand and supply. What could have been considered an asset turned out to be somewhat of a liability. The majority of existing brokers who were used to these dealing practices were reticent to move to a modern stock exchange where they perceived they might lose through lack of familiarity with the new methods of dealing in shares. Therefore, most of them adopted a wait-and-see attitude, especially since they considered the stock exchange as a concept imposed upon them by government.

Government's role in pushing forward the establishment of the stock exchange was pivotal. In June 1987, the Ministry of Finance had already published a White Paper on the Stock Exchange to provoke a debate in the public,among legislators and enterprises. Without this political commitment, it is unlikely that the Stock Exchange would have materialized.

The political will was guided by hard economic realities and was attuned to the desire to modernize the Mauritian economy, especially the financial sector, so as to sustain a relatively high rate of growth. The overall strategy aimed at making Mauritius a regional offshore financial center and sought to make the country a free port and the hub of the Indian Ocean by the end of this century. At the same time, the government was conscious that inflation had to be kept in check if Mauritius were to remain competitive in the international market. The danger that prices might be pushed up was quite real with the massive salary hike awarded in 1987. The Stock Exchange was therefore considered to be one instrument which could attract the excess liquidity which was bound to emerge in the economy as salaries were increased by 40 % on average.

In addition to the economic context, there was a political desire to liberalize and democratize the economy. The government believed that shareholding should not be restricted to a small group of individuals or families but that the maximum number of Mauritians should be afforded the opportunity of investing in a company of their choice.

Establishment of the Stock Exchange

French assistance was sought to work out the rules and regulations. In May 1988, a workshop was organized on the concept of Stock Exchange and was open to all those interested (existing brokers as well as bankers, the press, accountants, economists and other professionals). Following another one-week training course held in August 1988, a written examination was held and 24 individuals were accepted.

In the meantime, the Stock Exchange Act of 1987 was passed but was to be replaced in 1988 by another Act based more on Singaporean practice. The Act provides for the setting up of an appropriate institutional and regulatory framework within which dealings in securities have to be carried out.

As a first step, the government set up the Stock Exchange Commission (SEC) composed of a Chairman, a Vice-Chairman and five other members, two of whom are government nominees. In addition, the Commission may co-opt up to three other members, subject to the approval of the Minister of Finance. The SEC, as an emanation of government, has played and continues to play a key role in the proper functioning of the exchange. In addition to being a watchdog (its principal function), it has in the initial stages taken an active role in ensuring that the appropriate framework was in place, especially since there was resistance from the established brokers. It organized the training courses and the examinations and issued licenses to 10 stockbroking companies which constitute the shareholders of the Stock Exchange of Mauritius Limited (SEM).

The stock exchange is, therefore, a private company engaged in the dealing of shares, debentures, gilts (government bonds, Treasury bills, Treasury Certificates etc.) and bonds as well as units issued under a unit trust scheme approved by the Minister.

Evaluation

From July 5, 1989 to May 8, 1991, the number of companies on the official list has gone up from 5 to 17 with 21 shares being offered (some companies offer ordinary as well as preference shares). Market capitalization has risen from Rs. 1,074 million to Rs. 4,404 million which represents 11% of GDP as compared to 3% in 1989. Dealings take place once a week. Total transactions amounted to the following : Rs. 14.6 m in 1989; Rs. 88.7 m in 1990; and Rs. 31.9 m in 1991 .

The companies on the official list are from the following sectors : (i) five from finance - investment firms, insurance, banking; (ii) four from industry - fertilizer, vegetable oil, printing, building materials; (iii) four from the sugar sector; and (iv) four from trade and commerce.

The Over-The-Counter market started operating in April 1990. The principal purpose of the OTC market is to enable investors to buy or sell shares of public companies at their own risks. Even if trading is regulated in this market, the companies are not subject to particular obligations imposed by the Stock Exchange authorities. There are at present 68 companies on the OTC (or Unlisted Securities Market). Dealings take place once a week.

The Mauritian experience of the capital market became a reality because there was a political commitment to turn the country into a financial center. The timing of the move can be questioned when viewing the sluggish pace at which the market has been moving. One explanation for the general lack of interest in the stock exchange is that the general public is not well informed about dealings in shares as opposed to putting their money in the banks. The speed with which the stock market was launched did not allow for much publicity regarding the true nature and functioning of stock exchanges. In fact, a major shortcoming was that the stockbrokers were not sufficiently trained in stockbroking practices since none was exposed to the operations of a modern stock exchange. The SEC members were the ones who visited other exchanges and decided on the way the SEM would have to be structured. This resulted in the development of a dependent attitude among stockbrokers who viewed the stock exchange as a parastatal body rather than as their own private company.

Another possible cause is the fact that there is a predominance of family-owned companies. Many such companies fear that if they get listed they might gradually lose control. Therefore, a combination of lack of commitment on the part of stockbrokers, uncertainty about the public's reactions to the trading of shares, reluctance of companies to issue shares to the public, and a general ignorance of the objectives and relevance of the stock exchange has led to a sluggish market.

To avoid these important pitfalls, it is necessary that: (i) potential stockbrokers/actors on the capital market be involved in the process of developing the framework from the start; (ii) an intensive promotional campaign is carried out among the major companies; (iii) the public is made aware of the possibilities of capital gains; and (iv) the monetary policies are in harmony with the objective of promoting dealings on the exchange. Many of these lessons would be applicable to Madagascar when it decides to establish a stock market of its own.

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