MADAGASCAR – ECONOMIC UPDATE: *When Political Instability becomes Economic Downfall*

World Bank – September 15, 2009

Financial and economic data are increasingly difficult to obtain…..due to the persistent political crisis and continuing instability within the public administration. Any effort to diagnose the state of the economy is therefore necessarily tentative, and the results should be interpreted with caution. However previous trends persisted during July-August: fiscal revenues continued to fall short of projections, public spending remained cautious, monetary policy remained prudent, and the slowdown in economic activities dragged on. Although the official exchange rate and international reserves have remained stable during the past couple of months, signs of pressure are emerging on parallel exchange rate markets, with major foreign currencies commanding a premium of 10-15 percent as it becomes increasingly difficult to purchase them though commercial banks.

Lower revenues and prudent fiscal policy … but clouds on the composition of expenditures

Fiscal policy and management remained conservative over the past couple of months. Constrained by lagging fiscal revenues and restricted access to external aid, total cumulative public spending amounted to only 1,205 billion Ariary by the end of August 2009, about 30 percent less than in the first 8 months of 2008.

During July and August, tax revenues reached only 74 percent of the targets set in the 2009 Law of Finance (Table 1). The shortfall in domestic tax collection was limited, thanks to relatively good performance in VAT collection (only 8 percent lower than initial projections), even though income tax collection was about 18 percent lower than initial projections. Custom revenues were only 2/3 of initial targets, reflecting the slowdown in international trade and efficiency losses in customs administration. Since the beginning of the year, the accumulated shortfall in total tax revenues has reached 411 billion Ariary, or almost 40 percent of collected revenues.

Table 1- Revenue shortfall in July- August

In billion of Ariary	First semester			July-August		
	Actual	Target	Gap	Actual	Target	Gap
Domestic tax revenue	530	631	-101	148.7	177.4	-28.7
Customs revenue	333.0	544.0	-211.0	134.7	206.5	-71.8
Total	862.8	1174.6	-311.8	283.4	383.9	-100.5

The accumulated budget execution rate was only 31 percent at the end of August 2009, against 45.7 percent a year ago. If the overall level of public spending is unambiguously lower (1,205 billion in 2009 vs. 1,703 billion in 2008), the pattern by category of expenditure is rather surprising (Table 2). Official (preliminary) data suggest that during the first 8 months of 2009 the authorities spent almost as much on investment and other current expenditures as they did during the equivalent period in 2008; the rate of spending in those two categories accelerated dramatically during July 2009, more than compensating for the slowdown observed at the beginning of the crisis[1]. Yet during the first 8 months of 2009, wage payments were only one-half as high as those paid during the first 8 months of 2008. These reported patterns by category of expenditure should be interpreted with caution, however, because the numbers might reflect deficiencies in public reporting and accounting systems. Many analysts find it hard to believe that public workers would have accepted a cut by almost one-half of their wage payments during the current uncertain political context.[2] This issue merits further attention and illustrates the point about the possible unreliability of data, but it goes beyond the scope of this short economic update.

Table 2: Comparison of (accumulated) expenditures by categories, in Ariary

	Aug-08	Aug-09	Difference
Debt	150,509,205,231	100,310,500,000	66.6%
Wages	807,955,742,086	431,967,921,046	53.5%
Other current expenditures	376,453,844,625	339,593,366,017	90.2%
Investment[1/]	368,361,013,184	333,753,871,211	90.6%
Total	1,703,279,805,126	1,205,625,658,273	70.8%

1/ Include investment, structural and exceptional expenses.

Public domestic borrowing on the T-Bill market was limited to the financing of reflows of Government notes. Limited demand on the part of the authorities and steadily growing excess liquidity in the banking system (see below) explains the decline by 1-3 points in the T-Bill yield rates, depending on maturities, during July and August.

Table 3: T Bills market in July- August 2009

	10-Jul	24-Jul	07-Aug	21-Aug
Average weighted TBills Yield (in %)				
4 weeks	5.02	4.48	4.2	4.0
12 weeks	6.5	5.75	5.1	4.8
24 weeks	8	6.97	6.0	5.5
52 weeks	9.75	6.89	7.7	6.8
Result of Tbills Auctions (billion of Ariary)				
Announced by the Treasury	34	28	29.0	41.0
Tender submitted	159.6	156.4	148.6	155.0
Auction	34	28	29.0	41.0

Private sector activities: Continuing uncertainty, and no signs of improvement

Critical information is missing on the level and composition of private-sector activity (such as sector reports from the Ministry of Economy), but the incomplete evidence that is available seems to confirm that private-sector activity has continued to be negatively

[1] About 80 percent of investment expenditures in July 2009 were concentrated in the Ministries of Public Works (25 billion), Agriculture (15), Education (7) and Health (6).

[2] Part of the explanation for the significant gap in the wage bill is due to the large commitment made in the first semester of 2008 --the gap was already equal to almost 200 billion Ariary at the end of March between 2008 and 2009. Yet, the authorities continued to pay less wages between April and August 2009, down by about 100 billion Ariary compared to the same period a year ago.

affected during the past quarter by the global crisis, the uncertain political context, restrictive fiscal policy, and lack of external financing. Particularly hard hit have been the tourism and textile sectors, which are also suffering from the global economic crisis, as well as the construction sector, which has been heavily affected by the slowdown in public investment projects. During the European summer travel season, the occupancy rate of hotels was much lower than in previous years, generating a drop in revenues estimated between 70 to 90 percent and putting at risk around 30 000 jobs.[3] Although a modest rebound in tourist arrivals has been observed in the Nosy Be area following the resumption of direct flights to Europe, the total number of arrivals recorded a year ago is far from being attained. Prospects for the textile sector remain similarly bleak. The future of Madagascar's membership in AGOA is subject to a decision by the US authorities at the end of the year but there is evidence that US-based customers have already started to diversify their orders away from Madagascar and some firms established in the free-trade zones are trying to shift their production directed to the US market to other locations, such as Mauritius and Tanzania. Even though production has slowed and employment has dropped, thus far no firms have closed their doors. The sector remains extremely fragile, however, because it was already in distress during the first semester of 2009, when total textile exports declined by 30 percent in comparison to the first semester of 2008 because of the global crisis (Table 5). As emphasized in our economic update of July 2009,[4] textile exports to the US market account for about 40 percent of all textile exports, so any further contraction of the sector resulting from eventual loss of membership in AGOA could threaten the approximately 100000 textile linked jobs, raising the prospect of a significant rise in unemployment and associated social instability in the areas of Antananarivo and Antsirabe.

Activity in the public works sector has plummeted because of the steep decrease in public investment due to the continuing political uncertainty. According to the «*Syndicat des Entrepreneurs du Bâtiment et des Travaux Publics* », which collects information from the vast majority of companies active in the sector, the combined value of signed contracts reached MGA660 billion in 2007 and 914 billion in 2008. A decline of 38 percent is projected for 2009 compared to 2008, and possibly 94 percent in 2010 if development agencies continue to suspend disbursements on existing projects and delay launching new projects. The steep decline in public works spending has had a marked impact on employment in the sector, as shown in the table below:

Table 4: the projected decline in jobs in public works

	June 30, 2008	*Dec 31, 2008*	*June 30, 2009*	*Dec 31, 2010 (forecast)*
# of employees	13,203	12,720	6,400	4,400
Variation / mid 2008	n/a	-3.6%	-51.5%	-66.6%

Source: *Syndicat des Entrepreneurs du Bâtiment et des Travaux Publics*

The decrease in private investment has been reflected in a number of intermediate indicators. First, energy consumption declined by about 8 percent (by value) and 4

[3] Source: Groupement des Entreprises de Madagascar (GEM).
[4] MADAGASCAR – ECONOMIC UPDATE: Unexpected but fragile stability in the economy World Bank – July 17 2009

percent (by volume) in July and August, compared to the same period one year ago. At the same time, significant differences can be found between energy categories: in August 2009, consumption of diesel and jet fuel declined by 6 percent and 28 percent respectively compared to levels registered in August 2008, while gasoline consumption increased by about 1 percent, perhaps indicating a rebound in the transport sector and in domestic trade. Electricity consumption also decreased in July in comparison to a year ago, with the notable exception of the mining sector, in which the rate of electricity consumption had increased nine-fold compared to one year earlier as the result of QMM's activities.

Second, banking credits to the private sector decreased by about 77 million Ariary (or 2.4 percent) between end June and end August 2009. This decline stands in sharp contrast to the steady upward trend that took place over the previous two years (total credits to private firms increased by almost 4 percent between June and August 2008). The reversal can be attributed to the lack of demand by large private firms (notably in the construction and export sectors), but also to the prudent behavior of commercial banks, many of which have increased their liquidity (in August alone, the average excess liquidity ratio increased from 14 to 38.5 percent).

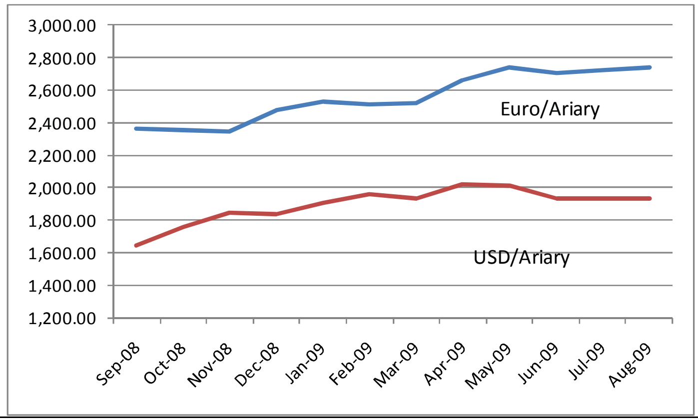
Third, the slowdown in private activity has been reflected in falling local prices. The annual inflation rate declined from 10 percent in December 2008 to 7.9 percent in August (the latest monthly increase was only 0.8 percent). Prices of foodstuffs have fallen because of a boom in food imports (food imports were 9 times higher in June 2009 than in June 2008), which have more than offset the continuing quasi-paralysis of several large food industry conglomerates owned by ex-President Ravolomanana. Falling food prices have brought substantial welfare gains to many consumers, notably in urban centers. The de-facto liberalization of certain segments of the food industry threatens to be counterbalanced, however, by Government interventions elsewhere. In particular, authorities have taken initiatives or signalled their intention to set minimum prices in the vanilla sector, introduce export quotas for lychees, sell rice at subsidized prices , and limit competition by undermining participation of new investors in some sectors such as beverage and telecommunication after heavy investments had already taken place. These signals have further undermined confidence in the business environment and increased the uncertainty concerning the authorities' motivations in terms of economic policies. The lack of visibility or predictability of the sectoral policies leave space for the "ad hoc" functioning of the institutions especially in the area of regulations, enforcement and justice. Recent media and NGOs reports about accelerated illegal logging in the national parks is another example.

Stable exchange rate and international reserves, but emerging pressures on parallel markets

On the official market, the Ariary remained roughly stable against the US dollar and Euro over the past couple of months, consolidating the relative stability observed since mid-April 2009 (Figure 1). During this period, the Central Bank was a net buyer in foreign exchange markets, purchasing 3 million Euros and 16.5 million USD in July, and 3.7

million Euros and 10 million USD in August. The Central Bank's international reserves increased slightly (up 0.7 percent) from July to August, partially reversing the 13 percent decline observed since the beginning of the year.

Figure 1: Exchange trends on the official market over the past 12 months



The apparent stability observed in the market for foreign currency masks growing pressure on the balance of payments. It has in fact become increasingly difficult to purchase foreign currencies through local commercial banks. The use of quantitative restrictions has translated into a significant drop in the number and volume of transactions on the MID–the volume of transactions denominated in US dollars fell by as much as 35 percent during August 2009 compared to August 2008. Concurrently, the gap between official and parallel exchange rates has risen, reaching as much as 10 percent for the Euro and 15 percent for the US dollar in early September. [5] These developments suggest that many operators are anticipating further depreciation of the Ariary in the near future. Further depreciation of the Ariary would not be surprising given recent changes in underlying economic fundamentals, most notably the deceleration in export revenues (see Table 5) and capital inflows, and it would help generate a re-equilibrium of the balance of payments though improved competitiveness. [6]

Table5: Drop in Exports between 2008 and 2009 (millions of SDRs)

	2008		2009	
	Q1	Q2	Q1	Q2
Food	28.6	30.0	29.7	30.1
Mining	12.7	23.7	11.9	14.8
EPZ	94.7	132.7	89.8	71.2
Others	68.9	41.5	46.9	29.1
Total	204.9	227.9	178.4	145.2

Looking forward

As long as political uncertainty remains, it will be difficult to predict future economic developments. The current climate of fiscal austerity is likely to persist, given the continuing shortfall in tax revenues and the quasi-absence of access to new sources of funds from the international community.

The combination of political uncertainty and fiscal austerity have impacted negatively on the private sector and adversely affected the population as a whole, through several

[5] The exchange rate used in exchange houses and in the streets was around 2950 for the EURO and 2200 for US dollar in the first week of September against, respectively, 2737 and 1930 on the official market.
[6] For a fuller discussion on the exchange rate management, see our economic policy update of May 17, 2009.

channels. First, political instability has directly discouraged tourists and foreign investors, depriving the economy of two major revenue sources. Second, the discontinuation of aid by the international community is leading to a sharp decline in public spending and investments which will affect employment and future growth prospects. Third, the political crisis and the overall deterioration of the governance environment casts doubts about the outcome of the AGOA membership and the future of textile exports (down by almost half in the second quarter of 2009). Fourth, the slowdown in public spending has reduced the volume of business going to local firms, notably in the construction sector, with attendant negative multiplier impacts throughout the economy. Most recent projections anticipate that GDP growth will be negative, not only in 2009 but also in 2010. Facing severe resource constraints, the Government will be challenged to deliver social goods and services. Its capacity to respond to exogenous shocks such as cyclones will also be seriously undermined.

These negative impacts of the political and financial crisis could actually be exacerbated during the coming months, by at least three factors. First, as emphasized in our previous notes, social unrest could erupt because of rising unemployment in the construction and textile sectors, two highly visible and employment-heavy sectors whose activities are concentrated in urban areas. Second, pressure on public finances is also expected to mount in October when teachers will have to be paid by the Government, possibly without the support of external funds. Third, concerns are raising that if the private grain traders are discouraged from importing rice to make up projected domestic production shortfalls, affordably-priced rice may not be available during the upcoming lean season (*soudure*) that will start in December 2009.