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REPORT AND RECOMMENDATION

OF THE

MANAGING DIRECTOR

TO THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

ON A

PROPOSED INTERIM TRUST FUND CREDIT

IN THE AMOUNT OF SDR 48.6 MILLION

TO

THE REPUBLIC OF MADAGASCAR

FOR A

STRUCTURAL ADJUSTMENT CREDIT

February 19, 1997

CURRENCY EQUIVALENT

Currency Unit	=	Malagasy Franc (FMG)
US$ 1.00	=	FMG 4,128 (average 1996)
SDR 1	=	US$ 1.3802 (as of 2/18/97)

WEIGHTS AND MEASURES

Metric System

MALAGASY FISCAL YEAR

January 1 - December 31

ABBREVIATION AND ACRONYMS

AfDB	African Development Bank
CAS	Country Assistance Strategy
CBI	Cross Border Initiative
CIP	Independent Privatization Commission
COMESA	Common Market for Eastern and Southern Africa
CRC	Committee for Reflection on Competitiveness
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
GDP	Gross Domestic Product
IDA	International Development Association
IMF	International Monetary Fund
PFP	Policy Framework Paper
PIP	Public Investment Program
SAC	Structural Adjustment Credit
STA	Technical Secretariat for Adjustment
VAT	Value Added Tax

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MADAGASCAR
STRUCTURAL ADJUSTMENT CREDIT

Table of Contents

MADAGASCAR
STRUCTURAL ADJUSTMENT CREDIT
INTERIM TRUST FUND CREDIT AND PROGRAM SUMMARY

Borrower: Republic of Madagascar

Amount: SDR 48.6 million (US$70 million equivalent)
IDA Reflow: SDR 0.4 million (US$0.6 million)

Terms: Standard IDA terms with 40-year maturity

Program Description: Madagascar is caught in a poverty trap: low investment results in slow growth and declining per capita incomes. To break out of this trap, economic growth must accelerate by more than doubling investment from less than 11 percent of GDP. Attracting foreign direct investment will be the key to significant per capita income growth due to the combination of high external debt which limits the country's ability to borrow (stock over 110 percent of GDP and debt service of 45 percent of exports), and the shortrun constraints to reducing the high annual population growth (close to 3 percent). The proposed single tranche operation would help restore the confidence of investors by providing credibility to the reform program of the Government and thereby bring about growth and poverty alleviation.

The operation builds on significant but fragmented reform efforts since the restoration of democracy in 1993. Despite some reversals along the way, there have been sustained advances, most notably in the flotation of the Malagasy Franc (FMG), the removal of food and petroleum subsidies, the appointment of independent administrators to the two state owned commercial banks and abandonment of the state monopoly in the petroleum sector. The renewed commitment to comprehensive reform follows the coming to power of a stronger and more unified executive determined to forge ahead with structural adjustment. The will to move forward is manifested by up-front actions in four key areas: steps for Government withdrawal from the two state-owned banks; a framework for transparent privatization; specific actions to encourage private sector development including liberalization of air transport, telecommunications and petroleum distribution, allowing foreign investors access to land tenure, liberalizing work, residence and visa requirements and abolishing exit visas; and reformulation of the budget to help maintain financial stability while addressing social concerns. Under the SAC, the main macroeconomic objectives are to achieve low inflation and regularize the external debt situation within a viable balance of payments. The SAC will also support structural reforms to open the economy to tourists and investors by clarifying the rules of the game around the principle that all economic activity is allowed except what is specifically prohibited.

Benefits: The operation would begin the process of unlocking and gradually accelerating foreign direct investment in the magnitude needed for meaningful poverty reduction, by creating employment and income growth opportunities while generating efficiency gains. If the momentum for adjustment is maintained, poverty incidence could be dramatically reduced, from about three-fourths to a third of the population within a generation. The timing and magnitude of poverty reduction will depend on the speed with which the Government opens the economy and the timing of investor response (apart from focused efforts on rural development). After years of inappropriate economic policies, frequent reversals of reforms and current political uncertainties, the initial response of investors will be cautious. The credit would, nevertheless, help restore investor confidence by (i) securing action to open the economy to private investment; (ii) raising the political costs of policy reversal; (iii) laying the foundations for a resolution of the debt overhang; and (iv) supporting a restructuring of the budget while providing much needed financing. The credit would also serve to protect the poor by limiting cuts in public services and/or tax increases (including the inflation tax).

Risks: The chief risk is that the reform momentum will not be maintained. Immediate risks have been reduced because the new Government is committed to get results and reverse the economic decline. However, Madagascar has gone through many previous cycles of opening up and closing itself off. The political infighting and disagreements over economic policy could resume, reflecting some of the doubts on the benefits of foreign investment. On the one hand, the elites oppose opening up for fear of losing the rents that accrue from selectively favoring chosen investors. On the other hand, there is a growing realization, particularly amongst the poor and the emergent private sector that improved employment opportunities, higher incomes and better goods and services at lower prices require opening the economy. The legislative approval required from the National Assembly for the implementation of the agreed reforms under the SAC has been secured. Rents have been dissipated by effectively opening up the country to tourists and investors and introducing real competition in air transport, petroleum distribution and telecommunications. The benefits to the elite now lie in finding opportunities for collaborating with investors rather than in resisting change. Thus, the risks of a reversal have been greatly diminished. The risk is being further reduced by public information campaigns and by strong signals that donor support, particularly for raising public sector salaries, is contingent upon continued good performance. The Bank has sought to minimize its own risk by making the credit a single-tranche operation with the principal adjustment measures completed prior to effectiveness. This approach has the added vital advantage of giving investors concrete evidence of economic opening, rather than only declaration of intent or passage of laws.

Staff Appraisal Report: There is no separate staff appraisal report.

Estimated Disbursements: The proceeds of the credit will be disbursed in one tranche, on credit effectiveness.

Project ID: 1582

REPORT AND RECOMMENDATION OF THE MANAGING DIRECTOR TO THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION ON A PROPOSED INTERIM TRUST FUND CREDIT TO THE REPUBLIC OF MADAGASCAR FOR A STRUCTURAL ADJUSTMENT PROGRAM

1. I submit for your approval the following report and recommendation on a proposed Structural Adjustment Credit (SAC) to the Republic of Madagascar for SDR 48.6 million, the equivalent of US$70 million, financed under the Interim Trust Fund on standard IDA terms with 40 years maturity and a 10 year grace period. The Government has formulated and embarked on a reform program (summarized in its Policy Framework Paper for 1996-1999 which provides the basis for an ESAF with the IMF). The objective is to break out of a poverty trap by achieving and sustaining significant per capita income growth. This will require more than doubling investment from the current level of 11 percent of GDP. In turn, investment can only be rapidly increased by foreign direct investment. The proposed single tranche operation aims to help restore the confidence of the Malagasy population, international investors and donors and to support social programs through much needed financing for a hard pressed budget. The SAC would strengthen an emerging but still fragile consensus amongst key policy makers on the urgency of deep-seated reforms.

2. The credit is an integral part of the Bank's Country Assistance Strategy (CAS). The *CAS,* discussed by the Board on February 18, 1997, details recent economic and political developments, past experience with adjustment, the Government's strategy and the Bank Group assistance strategy to alleviate poverty, including the central role of the SAC in restoring investor confidence and taking the country to a high growth/poverty reduction scenario. In the absence of the Structural Adjustment Credit, even assuming the same policy reform package, there would be insufficient financing to close the Balance of Payments Gap. Moreover, without Bank BOP support, other donors and creditors would be reluctant to provide, respectively, additional financing and debt relief. Thus, external payments arrears would continue to build, undermining the response of investors to the opening of the economy. It is also probable that reformists would be unable to build a sufficiently strong coalition for the reform program in the absence of the credit. Thus, Madagascar would remain on a low growth path leading to a continued increase in poverty. The Government has taken the required actions to trigger a Bank assistance scenario including adjustment lending. As defined in the CAS, these triggers were: compliance with the macroeconomic targets of the IMF program set out in the PFP; implementation (without backtracking) of key structural reforms designed as up-front actions under the SAC; sustained government commitment to poverty reduction; and continued improvement in portfolio performance. The up-front actions included: steps for Government withdrawal from the two state-owned banks; a framework for transparent privatization; specific actions to encourage private sector development; and, while addressing social concerns, a budget to help maintain financial stability.

PART I: FY96-99 ADJUSTMENT PROGRAM

3. **Background, program content and credit design.** Madagascar is a country which could grow rapidly based on tourism, mining, agriculture and export oriented industrialization. Due to inappropriate economic policies, over the last quarter century, per capita income has instead declined to US$230, just over half the value at independence in 1960. Poverty now afflicts over 70 percent of the population (compared to 43 percent in 1960). The design of the FY96-99 adjustment program is based on Government's analysis of the decline of the 1970s and 1980s, and the lessons of the brief experience of reform in the late 1980s. Specifically, the economic failure is traced to the legacy of the 1975 socialist revolution: widespread nationalization; extensive controls; and large unproductive public investments in the late 1970s. The proposed program is the result of intensive preparatory work over the last two years and extensive consultations with four successive Governments over the same period. The PFP reflects the policy statement made by the Prime Minister to the National Assembly in May 1996, and was prepared in close collaboration with the Technical Secretariat for Adjustment (STA), set-up in March 1995.

4. There have been previous attempts to reverse Madagascar's decline. After half-hearted attempts at reform, by 1988 the leadership became convinced of the need for foreign investment and the importance of an open economy, to help create employment opportunities and increase export earnings. The exchange rate was adjusted to realistic levels in 1987 and an export processing zone was set up to attract export-oriented investment. Foreign investment responded from zero to almost US$22 million (close to 1 percent of GDP) in 1990 and non-traditional exports almost doubled in value from 1986 to 1991, yielding US$233 million (70 percent of total exports from 31 percent). Over the same period, manufacturing exports almost tripled to US$125 million. For the first time in many years, per capita GDP growth was positive, averaging more than half a percent annually over the years 1988-1990.

5. The economic recovery was interrupted in mid-1991 by demonstrations and strikes in support of political liberalization. A new democratic regime took office in 1993 after a lengthy transition. Economic recovery was blocked, however, by political factionalism and policy differences on economic reform. In 1994, the first full year after the transition to democracy, the economic situation deteriorated and GDP stagnated, reflecting populist measures adopted by the incoming Government. After floating the exchange rate in May (resulting in a nominal devaluation of about 50 percent in foreign currency terms against the French franc), the Government allowed inflation to mount to 61 percent at end-1994 through lax monetary management and large rice, flour and petroleum subsidies that increased the overall budget deficit (excluding grants) to over 11 percent of GDP. Foreign direct investment, which remained close to the 1990 peak during the transition to democracy, collapsed to US$6 million in 1994, reflecting investor disappointment at the failure to move ahead with economic liberalization.

6. In January 1995 the Government declared its intention to implement adjustment policies, replaced deficient management of the Central Bank, and agreed on a stabilization plan with the IMF (under a staff monitored program) to bring down the inflation rate. For 1995 as a whole, real GDP increased modestly by 2 percent, albeit below the population growth rate, monetary conditions were tightened significantly, the budget deficit (excluding grants) was reduced to 9 percent of GDP, the rate of inflation was lowered to 37 percent (at end-1995), and the real exchange rate depreciated, in a free market, by about 9 percent. Some complementary positive steps were also taken including: lowering import tariffs; eliminating the commodity subsidies introduced in 1994; measures to lift the monopoly of the state in electricity and put in place a new legal and regulatory framework to open the sector to private investors; issuance of a decree liberalizing the import, transformation, storage and distribution of petroleum products; steps to establish a private, non-profit drug procurement unit; launching of a pilot program to improve quality and delivery of primary education at the local level; setting up of a delegated contracting agency for infrastructure works in Antananarivo (AGETIPA); passage of a new banking law; and, the appointment of independent administrators to the two state commercial banks, whose operations were threatening to derail macroeconomic stability.

7. A national referendum in September 1995 shifted authority to choose the PM from the National Assembly to the President of the Republic. After the referendum, the new Government rolled back some reforms. Steps were taken towards reactivating controls on private sector activity, including prices, margins and inventories; Government planned intervention in the import and marketing of rice; the regulations for entry, work permit and residence requirements for foreigners were tightened; liberalization of petroleum distribution and air transport was stalled and expansion of tourist facilities slowed; the 1996 budget included unproductive expenditures at the expense of the social sectors; and revenue performance further deteriorated as the Government cut VAT rates without adopting compensatory measures recommended by the IMF and the Bank, including strengthened tax administration.

8. Meanwhile, political infighting persisted and in May 1996 over two-thirds of the parliamentary deputies adopted a motion of no confidence in the Government. This opened the way to the appointment of a non-political Prime Minister, the former head of the Constitutional Court. In September 1996, President Zafy was impeached, and President Ratsiraka won the subsequent elections. The economic program, presented to the National Assembly in June 1996, is consistent with the policy advice from both the IMF and the World Bank. Moreover, in August 1996 the National Assembly adopted the necessary legislation for implementation of the reforms agreed under the Structural Adjustment Credit.

9. The Government's central objective is to achieve poverty reduction. But poverty in Madagascar is so pervasive that it cannot be dented without strong economic growth. The Government recognizes that this will require (a) macroeconomic stability, (b) incentives for private investment in exports and labor-intensive activities, and (c)

refocusing the public sector on its core functions of ensuring basic health, education and infrastructure with the return to the rule of law and security for people and property.

A. Macroeconomic Management

10. The Government recognizes that macroeconomic stability is the foundation for attracting private sector investment. The main objectives are to bring the rate of inflation down from 37 percent at the end of 1995 to 3 percent by the end of 1999, and to reduce the balance of payments current account deficit (including official transfers) from 7.2 percent of GDP in 1995 to 2.9 percent in 1999. The improvement in the current account requires a reduction in the gap between savings and investment. However, increased savings by the private sector are expected to be fully committed to expanding investment. Thus, the improvement in the current account will need to be supported by improved public savings through a reduction in the budget deficit which is projected to decline from 6.1 percent of GDP in 1995 to 2.1 percent in 1999.

11. **Fiscal Management.** The deficit objectives will be underpinned by expenditure restraint and a gradual increase in the tax to GDP ratio, in line with a recovery of per capita income, from 8 percent in 1995 to 11 percent in 1999. On the expenditure side, the priority will be to restructure towards foreign financed capital expenditure and the social sectors. Taking account of slightly higher grants, the deficit targets will limit expenditure to 16.3 percent of GDP in 1997, rising to 16.9 percent in 1999 (down from 17.4 percent in 1995). External debt rescheduling is expected to result in about a 2 percentage point reduction in scheduled interest payments. Thus, non-interest current expenditure and the domestic counterpart to donor financed projects could increase from 7.6 percent of GDP in 1995 to 8.5 percent of GDP in 1999, with counterpart funds absorbing most of the increase. Increased donor support will raise capital expenditure from 6.2 percent of GDP in 1995 and 1996 to 7.2 percent in 1997, rising to 7.5 percent in 1999.

12. There is little scope to increase current expenditure significantly in the short term although it is recognized that such expenditure is at a depressed level (6 percent of GDP excluding interest on public debt). Current expenditure will be concentrated on improving public services, particularly primary education and basic health care. Moreover, budgetary rules will be strictly applied to limit transfers to local Governments and public entities that can justify the development impact and social benefits from such funds. The principle of budget neutrality on transfers to local Governments will be strictly applied. Moreover, wage increases will increasingly be geared to supporting civil service reform. These reforms are expected to involve (i) moving staff to the Local Governments from Central Government, and (ii) more reliance on performance-related pay.

13. **Monetary and financial policies.** The Government has decided to support fiscal discipline by an active monetary policy. The base lending rate of the Central Bank, as well as the lending rate to the Treasury were increased from 22 to 33 percent early in 1995. In line with this increase, the penalty rate for failure to constitute required reserves

was raised from 26 percent to 48 percent, while reserve requirements on FMG deposits were raised to 25 percent. In 1996, monetary policy has remained tight in view of the need to absorb excessive liquidity. The Central Bank will complete the transition to the use of indirect instruments to control monetary growth during 1997. To this end, it is paramount to divest the two state-owned commercial banks. Meanwhile, the Central Bank will continue to use an indicator of anticipated inflation as an anchor for setting the Central Bank's reference rate, in line with its targeted reduction of inflation. Broad money growth was limited to 8 percent in 1996 compared to 16 percent in 1995 (and 49 percent in 1994). Over the period 1996 to 1999, Government will not be a net user of credit from the banking system.

14. **Exchange rate policies.** The Government recognizes the key role of exchange rate management in providing incentives for export, and the advantages of having the rate guided by market forces. In a major departure from previous policies, since May 1994, the exchange rate has been determined by a daily interbank foreign exchange market, whose participants are the five commercial banks and the Central Bank. This mechanism has served well in maintaining relatively free access to foreign currency for current account transactions. The Government will continue to float the Malagasy franc and, to improve competition, will encourage the opening of exchange bureaus.

15. **External trade**. Supported by the liberalization of the exchange rate, the Government also terminated practically all import prohibitions and reduced the maximum import tariff from 50 percent to 30 percent. Moreover, as a participant in the Cross Border Initiative (CBI), Madagascar will further reduce its tariffs in line with the recommendations expected from a ministerial meeting in 1997. It is expected that by 1998, the harmonized tariff will be in place with three rates, a top rate of 20-25 percent and an average rate of 15 percent (down from 18 percent at present). Also under the CBI, as of October 1, 1996, Madagascar is granting an 80 percent preference to its partners in the Common Market for Eastern and Southern Africa (COMESA) as the first step to free trade by 1998.

B. Incentives for private investment in exports and labor-intensive activities

16. Policies to promote the private sector revolve chiefly around clarifying the rules of the game around the principle that all economic activity is allowed except what has been specifically prohibited. The Government recognizes that inefficient public enterprises in the productive and financial sectors represent a threat to macroeconomic stability, and an added cost to the operations of the private sector, as these enterprises dominate key sectors of the economy (telecommunications, energy, transport) and provide important services to the private sector.

17. **Divestiture of Public Enterprises.** ***A divestiture law was adopted in August 1996, based on the recommendations of the Independent Privatization Commission (CIP),*** established in January 1995. The law supports an implementation strategy that

encourages foreign investment, ensures transparency and promotes local private sector participation, while allowing the poorest sections of the population to benefit from the process. The Bank plans to support the privatization process through the proposed Private Sector Capacity Building Project. The scope, timetable and modalities for the privatization effort are being defined in that context.

18. **A Framework for Private Sector Incentives.** In 1995, the Government appointed a joint private/public sector group (the Committee for Reflection on Competitiveness, CRC) to develop recommendations to mobilize private investment. ***In August 1996, the overall framework was adopted***, taking account of advice from the Bank to introduce more automaticity in the investment process and further relax Government controls. ***The relevant implementation decrees are now in place. These reforms are at the heart of the Credit and include (i) abolishing exit visas; (ii) liberalizing visa regulations to allow tourists entry to the country at the point of entry for 1 to 3 months without needing a visa issued abroad; (iii) arranging for businessmen to have 3-year multiple entry visas; (iv) automatically granting work permits and rights to residency for the immediate family of foreign technical and managerial staff, subject only to a valid employment contract; (v) the liberalization of land tenure rules with respect to foreign investors; (vi) tax reforms to promote exports; (vii) the effective lifting of legal monopolies in the power, petroleum, telecommunications and air transport sectors; and (viii) the opening-up of the investment regime - replacing prior investment approval with the incorporation of fiscal incentives into the general tax code.***

19. **Tax incentives.** The revised 1996 budget announced and began implementing a tax reform program in line with recommendations from the IMF and the Bank. ***The fiscal incentives in the investment code were rolled into the general tax code and provisions were introduced to reduce the taxation of inputs designed for export production.*** The remaining reforms aim at taxing all economic agents and sectors at a low rate and according to clear rules. They involve (i) strengthening tax and customs administration, particularly setting up a service to monitor large taxpayers; and (ii) reforming the VAT by extending it to cover all activities above a threshold while limiting zero rating to exports and eliminating exemptions.

20. **Banking**. The financial system in Madagascar remains rudimentary both in terms of coverage and the range of services provided. The Government has given priority to the problem of the two state-owned commercial banks (BTM and BFV), which dominate the banking system, accounting for about 60 percent of total assets. Inappropriate, mostly politically motivated lending, has led these two banks to continually disregard credit ceilings and more recently reserve requirements, which resulted in substantial unprogrammed monetary expansion in 1994 and 1995. State ownership of these banks remains the single greatest obstacle to financial sector reform, the effective application of monetary controls and the creation of a stable environment for private sector investment. The weakening financial position of the state banks also prevents the functioning of an inter-bank market, key to the development of market-determined interest rates. The

independent administrators for these banks are expected to remain in place until divestiture (through sale or liquidation) is completed by the end of 1997. Under the administrators, the financial performance of both banks has markedly improved, with both banks now respecting prudential rules. ***Experienced negotiators have been appointed to design and carry out the divestiture***. There will be no injection of new capital into the state-owned banks prior to divestiture.

21. **Petroleum**. In mid 1995, in a major policy move carried out within the framework of the IDA-financed Petroleum Sector Reform Project, the Government (i) issued a decree liberalizing the import, transformation, storage, transport and distribution of all petroleum products and (ii) established a legal and regulatory framework to foster competition in the petroleum sector. Also, on a monthly basis the Government is adjusting prices of refined-product prices in line with an import-parity formula, and set higher and less distortionary petroleum product prices. ***The Government will take all necessary steps to allow new entrants to be operational, including the issuance of all necessary authorizations to qualified applicants.*** To facilitate new entry, an entity has been set up for joint management by all oil companies of the facilities for storage, pipelines and unloading of oil.

22. **Telecommunications**. The poor state of telecommunications has become a major impediment to economic and social development. The Government has developed a strategy based on transferring operating responsibilities to the private sector, developing competition, and building up its regulatory capacities. The aims are to improve service in terms of access and lower prices, increasing teledensity to 2% by 2002. To this end, the ***Government has amended the 1993 Telecoms Law to abrogate the monopoly provisions, strengthen interconnection rules, create an independent regulatory body, and place a time limit on utilized concessions. Moreover, the Government has awarded two new cellular licenses, including international calling, based upon competitive bidding***. Finally, to promote competition, ***Telma (the state owned company) will not offer cellular services until at least one other operator is offering basic services.***

23. **Vanilla**. Madagascar's share of the world market fell from 70 percent in the early 1970s to 30 percent in the 1990s, largely as a result of regulated prices, multiple taxation and export quotas. In parallel, vanilla lost its role as the main earner of foreign exchange behind coffee. Vanilla exports have declined from a peak of US$89 million in 1987 (27 percent of merchandise exports) to US$41 million in 1996 (8 percent of merchandise exports). In pursuit of a strategy to liberalize the sector, in July 1996 the Government rejected requests to inject FMG 15 billion (US$3.8 million) into IVAMA, the vanilla parastatal (although FMG 3 billion had already been paid) and asked that past advances be accounted for and repaid. In addition, the vanilla export tax will be abolished as of May 1, 1997.

24. **Air Transport.** Air access policy has been modified to reduce the cost of air travel and help to develop tourism. The objective is to increase annual arrivals from 70,000 to 700,000 over the next ten years. On the international network, the Government

is actively seeking to encourage the arrival of new airlines. ***It has abrogated the exclusivity previously enjoyed by Air Madagascar for the air rights of Madagascar.*** As of now, these rights will be given by the Government to Air Madagascar and/or other existing or new air carriers. ***The Government is inviting the regional airlines (from Eastern and Southern Africa and the Indian Ocean) to serve Madagascar with flights to any Malagasy city with no restrictions on the number of flights. New airlines will be allowed to operate other international routes.*** As a first step, in August 1996 the Government reinstituted authorization for a private carrier on the Antananarivo-Marseilles route in direct competition with Air France. A charter company began operations from France in November 1996. To develop the internal network, regional airlines have been requested to explore the possibilities of collaborating with Air Madagascar and/or other existing or new Malagasy air carriers to serve the domestic market. ***To facilitate the entry of new airlines, the monopoly of Air Madagascar for ground handling facilities has been ended.***

C. Refocusing Public Expenditures

25. The overall objectives and financial constraints within which public expenditure will be executed are summarized in paragraphs 10-12. Public expenditures in Madagascar are characterized by low outlays on basic health, education and infrastructure, inadequate allocations for operations and maintenance, and a poor monitoring and control mechanism. Public expenditure management has improved in recent years, with support from the annual public expenditure reviews. The PIP has been cleaned-up, and the number of projects reduced from 600 to 250. Budget formulation and execution has been made more efficient through a reform of the procedures for funds release and control. However, resource allocation to priority sectors is still inadequate. Health expenditures between 1989 and 1994 stagnated at about 1 percent of GDP. Similarly, public expenditure on primary and secondary education was generally between 1.6 and 1.8 percent of GDP. Moreover, 41 percent of education expenditure and 27 percent of health spending benefits the top 20 percent of households while only 8 percent and 15 percent, respectively, goes to the bottom 20 percent. ***In response, the Government revised the 1996 budget to increase the allocations to health and education by FMG 10 billion (US$2.5 million) each at the expense of the munitions factory (FMG 22 billion--US$5.5 million or 0.1 percent of GDP).***

26. In addition, with the revised 1996 budget (i) a tight monitoring mechanism was instituted to ensure that allocative decisions are effectively implemented; (ii) commitments and payments will only be allowed in line with budgetary and financial regulations, particularly for transfers to local Governments and public institutions (close to 1 percent of GDP); (iii) pending an audit, public institutions will only benefit from budgetary allocations if they are under the financial supervision of the Ministry responsible for the Budget and have up-to-date accounts; (iv) an effort is being made by the Treasury to recover the proceeds of previous advances and loans which are due; and (v) quarterly reports of the budget and PIP execution will be prepared with a maximum two-month delay.

D. Medium Term Prospects and Financing Requirements

27. Madagascar has not participated fully in the international economy even though it is increasingly dependent on international trade and capital flows. The share of imports covered by exports of goods and non factor services (US$741 million in 1996) has fallen to 70 percent in recent years from three quarters ten years ago. Moreover, with a debt service burden equivalent to about 45 percent of exports of goods and services in 1996, the country cannot pay its way without exceptional donor financing. However, even assuming Naples terms rescheduling, debt relief would only partially address the financing needs of the country. This is due to the large amount of arrears (US$2.1 billion out of a total debt of US$4.4 billion). Excluding the initial stock effect due to rescheduling of arrears, debt relief would initially provide about US$75 million of financing, declining to about US$60 million in 2000 and US$12 million in 2005. In contrast, reaching and sustaining growth rates close to its potential would require net financing of about US$400 million and gross financing of about US$600 million. About half the gross financing requirements could be met from a combination of debt relief and increased donor support, to levels close to historical peaks. Thus the key to the economic development of Madagascar will be how quickly it can mobilize close to US$300 million of annual foreign direct investment.

28. Prospects would have been bleak if Government had not embarked upon its reform program to promote macroeconomic stability and an outward-orientated enabling environment for the private sector. In the non-adjustment scenario, net capital inflows are assumed, at best, to shrink to near zero by the end of the century. This outcome is consistent with a continued accumulation of arrears on external debt, limited foreign investment (at the levels of 1994) and a tapering off of official development assistance (an average of about US$200 million over the next decade and about US$150 million the following decade to reach US$125 million by 2015). Under these circumstances, import growth would decline to zero by early next century and imports would slowly contract thereafter. Economic growth could, at best, remain around 2.0 percent, below the population growth rate of 2.8 percent. Poverty would steadily increase from about 71 percent of the population in 1995 to 84 percent by 2015. Continued economic failure could result in a social explosion.

Table 1: Key Economic Indicators

Indicator	1995	1996	1997	1998	1999	2000	2005	2010	2115
WITHOUT ADJUSTMENT									
Gross Domestic Product (GDP growth rates)	1.8	2.0	2.3	2.2	2.0	1.8	1.5	1.0	0.9
Percent below poverty line	71	72	72	73	74	75	77	81	84
WITH ADJUSTMENT RESULTING IN RESTORED INVESTOR CONFIDENCE AND DEBT RELIEF									
Gross Domestic Product (GDP growth rates)	1.8	2.0	3.0	3.5	4.5	5.5	9.5	9.5	9.5
Percent below poverty line	71	72	72	73	74	73	67	52	35
OTHER INDICATORS									
Private Per capita consumption in 1996 US$	272	269	263	260	258	260	295	388	525
Exports G&NFS/GDP (%)	23	18	19	20	21	21	22	24	28
Imports G&NFS/GDP (%)	31	24	26	26	26	27	28	27	30
Gross Domestic Savings/GDP (%)	3	4	5	7	10	11	19	22	24
Private Investment (including public enterprises)/GDP (%)	5	4	5	6	8	10	18	18	17
Tax revenue/GDP (%)	8.2	7.8	9.0	9.7	11.0	11.4	13.3	14.9	16.6
Overall deficit including grants/GDP (%)	-6.1	-5.4	-3.6	-3.2	-2.1	-1.6	-0.6	-1.0	-1.1
Primary Government Balance/GDP (%)	-1.1	-1.1	-0.6	-0.4	0.6	0.6	-0.1	-0.2	0.3
Inflation--GDP deflator (% change)	46.8	21.1	10.2	6.2	5.2	3.6	3.0	3.0	3.0
BOP Current Account Balance (including grants)/GDP (%)	-7.2	-4.0	-3.7	-3.7	-2.9	-4.1	-4.0	-2.3	-1.1

29. In the short term, the difference between the adjustment and non-adjustment scenarios is small due to the lag before private investors respond to the new policies (Table 1). Per capita consumption may decline by a cumulative 4 percent over the next four years. A turnaround, assuming strong adjustment building on the SAC, could more than double per capita consumption within twenty years. Indeed, over the medium term the picture could be bright with a restoration of investor confidence, sustained adjustment (Schedule B), Naples terms debt rescheduling and a recovery of aid to the levels during the 1988-90 reform episode. As discussed in the CAS, sustained adjustment under a ***high-case*** scenario would include the abolishment of remaining monopolies in key sectors, rapid divestiture of major public enterprises, and further efforts to transform the regulatory regime into one of the most investor-friendly among developing countries. Under this scenario, the availability of foreign financing should be able to support an increase in the growth rate from 2 percent in 1996 to 5.5 percent by 2000 and 9.5 percent by 2005, and Asian style "growth with equity" could significantly roll back poverty within a generation. By 2005 the proportion of the population under the poverty line could be reduced to two thirds and the proportion could further diminish to just over half in 2010 and about one third in 2015.

30. Macroeconomic aggregates would also improve in parallel to poverty reduction. Both domestic savings and tax revenues may be expected to rise, from the 1995 level of 3 percent and 8.2 percent, respectively, to 5 percent and 9.0 percent in 1997; 11 percent each in 2000; and 24 and 16.6 percent in 2015. Moreover, with reduced interest payments on the restructured external debt, better control over public expenditures, and some reallocation of expenditures toward the social sectors, the budget deficit (including grants) is expected to decline from 6 percent of GDP in 1995 to 1.6 percent in 2000. Within this overall situation, the primary deficit[1] of 1 percent of GDP in 1995 would convert to a surplus of 0.6 percent of GDP in 1999. Assisted by a monetary program combining credit ceilings to the economy and maintaining real positive interest rates, inflation is expected to decline to the level of Madagascar's main trading partners by 2000. The immediate effect on per capita income, while positive, will still be inadequate to make a dent on poverty; aggregate growth rates of above 5 percent per year--the level considered necessary for poverty reduction--will not be achieved until 2000 and thereafter. However, with accelerating growth driven by continued strong foreign direct investment, by 2010 the economy would treble to about US$9 billion (at 1995 prices).

31. In the short term, pending regained investor confidence, the role of official development assistance including debt relief will be critical. Gross external financing requirements between 1997 and 2000, not counting arrears reduction, will average US$350 million per year. Project financing and private investment are estimated to cover about US$250 million on average, while debt relief would provide about US$18 million per year over 1997-2000. Thus, an average of about US$80 million of annual BOP support would be required for 1997-2000 (of which the IMF ESAF will contribute about US$120 million in total for the period 1996-1999). In 1997, the financing gap (before debt relief and adjustment support but including IMF support of US$39 million) is expected to be US$2.3 billion, in large part due to US$ 2.163 billion of arrears to be paid off. An amount of about US$2.091 billion of debt relief is expected to be achieved through Paris Club rescheduling on Naples Terms and rescheduling of other debt on similar terms. The assumed rescheduling would reduce the debt service ratio from almost 60 percent in 1994 to under 20 percent in 1997-2000. The remaining gap of about US$204 million in 1997 is expected to be fully covered by adjustment support from the Bank and other donors, particularly the EU, AfDB and France. The SAC will contribute US$70.6 million, Japan US$15 million and the EU has committed at least US$31 million. Bilateral donors and the AfDB are expected to cover the remaining gap of US$88 million.

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1 Defined as Government revenue less non-interest current expenditures less domestically-financed capital expenditures.

PART II: THE PROPOSED STRUCTURAL ADJUSTMENT CREDIT

A. Credit Description

Objective

32. The proposed credit aims to break Madagascar out of a poverty trap by helping to restore the confidence of investors. It will provide credibility to the reform program of the Government by (i) underpinning a fundamental relaxation of controls and restrictions facing investors and tourists; and (ii) setting the stage for a resolution of the external payment problems of Madagascar (debt rescheduling at the Paris Club and mobilizing exceptional donor financing). Without a lasting solution to the payment problems, private investors would have doubts concerning the sustainability of the reforms.

33. A one tranche operation is proposed based on the lessons of past experience. Technical and political uncertainties make the timing and nature of needed reform difficult to predict, while tying resource transfers to specific actions may jeopardize the macroeconomic program. Under these circumstances, a single tranche maximizes the credibility of the policies by avoiding doubts over the implementation of agreed future policy changes. It allows the dialogue between the Bank and Madagascar to concentrate on actions believed to be necessary to restore private confidence rather than negotiating on conditions of tranche release. Thus, the credit is being presented for approval once enough has been done to convince investors, and new entrants are observed in key sectors. Indeed, the focus of the dialogue for further policy reform will henceforth concentrate on outcomes rather than Government actions. Future balance of payments support would be predicated on actual performance in areas such as budget implementation, private investment and export growth (including tourism). The precise indicators to be monitored are defined in the Country Assistance Strategy presented to the Board on February 18, 1997. The need for additional balance of payments support for the remainder of the program period will be assessed when the macroeconomic framework is updated in 1997, taking account of donor pledges at a planned Consultative Group meeting soon after presentation of the Structural Adjustment Credit for approval.

34. **Actions taken for Project Preparation**. In pursuit of the above approach, as has been detailed in previous sections, the Government had already taken key actions prior to discussions on the current adjustment operation:

(a) flotation of the FMG in 1994;

(b) elimination of subsidies on flour and rice;

(c) appointment of independent administrators to the two state-owned banks;

(d) lowering the maximum tariff from 50 percent to 30 percent;

(e) reorienting expenditures to primary education, basic health services, and social fund community projects;

(f) inviting a formally-constituted private sector group to participate in policy discussions and draft an incentives framework for private sector development; and

(g) appointing an Independent Commission for Privatization to draft the privatization law.

B. Conditions of Presentation of the Credit for Approval and Tranche Release

35. The following conditions have already been met, namely:

(a) liberalizing entry, work permit and residence requirements for investors, and visas for tourists and abolishing exit visas for nationals and foreign residents (paragraph 18);

(b) granting foreign managerial and technical staff automatic work permits and rights of residence for their families subject only to a valid employment contract (paragraph 18);

(c) allowing foreign investors access to land tenure through 99-year mortgageable leases to be approved within 2 months of application (paragraph 18); and

(d) removing the requirement for prior authorization to invest and integrating the fiscal incentives of the investment code into the tax code (paragraphs 18 & 19);

(e) abolishing prior approval for equity capital contributions by foreign investors (above a threshold of 20 percent of a company's authorized capital) (paragraph 18).

(f) appointing experienced negotiators to design and carry out the divestiture of the two state owned commercial banks (paragraph 20);

(g) ending the monopoly in telecoms and selecting at least one company based on an international competitive bid for cellular operation (paragraph 22);

(h) liberalizing air access by allowing regional airlines from Eastern and Southern Africa and the Indian Ocean access to all Malagasy airports, allowing new airlines to operate on other international routes, canceling the designation of Air Madagascar as the sole beneficiary of Malagasy air traffic rights and opening ground handling facilities for airlines to competition (paragraph 24);

(i) opening the petroleum sector to competition and taking the necessary steps to allow at least one oil company to compete with SOLIMA; issuing the legal instruments to give effect to the decree liberalizing the import, transformation, storage, transport and distribution of all petroleum products and setting up an entity to be jointly managed by all oil companies to control storage, pipelines and unloading of oil (para. 21);

(j) adopting the legal framework for the divestiture of the hundred or so remaining public enterprises (paragraph 17);

(k) reorienting the 1996 budget and the 1996-99 PIP to strengthen the contribution of Government expenditure to poverty reduction (paragraphs 11 & 25);

(l) completion of an independent audit on the satisfactory implementation of the social safety net (paragraphs 25 & 26);

(m) submission of a signed letter of Development Policy (Schedule C);

There are no specific release conditions for the single tranche.

C. Procurement and Disbursement

36. Procurement and disbursement arrangements will follow the simplified procedures approved by the Board on February 1, 1996. The Borrower will open an account in the Central Bank of Madagascar. The proceeds of the credit will be deposited in this account at the request of the Borrower. If after deposit in this account, the proceeds of the credit are used for ineligible purposes (i.e., to finance items imported from non-member countries, or goods or services in the standard negative list), the Borrower will be required to either (a) return the amount to the account for use for eligible purposes, or (b) refund the amount. Although a routine audit of the account will not be required, IDA--as the administrator of the Interim Trust Fund Credit--reserves the right to require it.

D. Implementation, Monitoring and Supervision

37. The reform effort is being implemented under the overall supervision of a Steering Committee chaired by the Prime Minister and composed of the key economic Ministers and the Governor of the Central Bank. This Committee is assisted by a Technical Secretariat for Adjustment (STA), composed of three full-time high-level officials. This Secretariat, supported by the Public Sector Management Capacity Building project, is responsible for: i) the monitoring of the structural adjustment program including macroeconomic indicators and sectoral reforms; ii) the coordination of all Government agencies involved in the adjustment process and keeping them informed; and iii) the preparation of public information campaigns on the adjustment program (see para. 44). The overall reform effort will be reviewed by regular missions and the

Resident Mission in close coordination with the IMF to ensure continued economic liberalization within a sound macroeconomic framework.

E. Coordination with IMF and other Donors

38. The African Development Bank, Japan, the European Union and France, have expressed interest in co-financing the adjustment program. The IMF participated in the negotiation of the PFP in August 1996 and its Board approved a three year ESAF in November 1996. An informal donor meeting is planned soon after approval of the SAC to help close the financing gap. Beyond financing, the Bank is working with other donors, particularly the EU, to mobilize the necessary expertise to enable important issues to be addressed in a timely fashion.

F. Benefits and Risks

39. This operation aims to help revive investor confidence in Madagascar and set off the quantum leap in investment and economic activity needed for meaningful poverty reduction. If sustained, successful adjustment (possibly supported under a second adjustment credit) will have a high payoff: reduction in poverty incidence to a third of the population, within a generation. In view of the past record and current uncertainties in the political environment, the response of investors to the new economic policies will be cautious. Thus, recovery will be slow and the achievement of significant per capita income growth will be gradual. Under these circumstances, the credit would help restore investor confidence by (i) securing action to open the economy to private investment; (ii) raising the political costs of reversal; (iii) laying the foundations for a resolution of the debt overhang; and (iv) supporting a restructuring of the budget while providing much needed financing. The credit would also serve to protect the poor by limiting cuts in public services and/or tax increases (including the inflation tax). In turn, these reforms should begin the process of unlocking and gradually accelerating foreign direct investment while generating efficiency gains from the reforms. The discussion of paras. 29 to 31 also emphasized the importance of debt relief to Madagascar's continuing ability to implement its reform program. Moreover, the prospect of the credit has enabled the Government to take far-reaching action in opening up the economy, beyond the proposals of the domestic private sector committee that recommended looser and more efficient controls on foreign investors and tourists. Finally, the support of investors and donors, unlocked by the SAC, will help give hope to the Malagasy population that their children will be better off than they are and thus contribute to ease social tensions.

40. The support of the IMF and the Bank is crucial to achieving the needed debt service reductions from the Paris Club and other official creditors, thereby eliminating a major all-encompassing uncertainty regarding backtracking on the liberalization of the economy. There are risks, however, that despite an improved resource position--resulting from donor inflows and debt rescheduling--the reform momentum will not be maintained. These risks stem from (i) continued doubts about the benefits of foreign investment based on a fear that opening the country to foreign investors will result in the exploitation of

Madagascar's natural resources at the expense of its citizens; (ii) an uncertain political climate; and (iii) weak implementation capacity.

41. Regarding implementation capacity, the following steps are proposed to mitigate risks: (a) weak institutional capacity is being addressed through the capacity building components of the Public Sector Management Capacity Building project and the Private Sector Development project (under preparation); (b) taking into account weak capacity, the SAC focuses on a limited number of key actions, all of which have been set in motion well before presentation of the credit for approval; and (c) divestiture should enable the government to do fewer things better.

42. Risks stemming from fear of foreign domination and political uncertainties have been reduced because all major Presidential candidates championed reform during the campaign and the Government has continued to implement the reforms. The measures enacted are likely to be maintained because, in Madagascar, the inertia that constrains major policy changes works both against reform and its reversal. Thus, while anti-reformists had the upper hand in Government, they were unable to implement the reversal of key policies such as floating the exchange rate or removing the external administrators from the State owned commercial banks.

43. Nevertheless, some risks remain that losers under the reform program may mobilize sufficient support for political infighting to resume. The losers are the established elite, who will see their relative power decline even as their absolute wealth rises. The future of the economic elite will depend on greater dynamism compared to relying on the rents offered by the status quo. Meanwhile, the political and bureaucratic elites, including key civil servants and employees of state owned enterprises, are likely to lose opportunities for sharing rents with favored entrepreneurs, with little prospect for compensation through a fast recovery in official salaries. The strength and unity of this potential opposition has been hard to gauge. However, the risk is mitigated by the major battles having already been waged and won by the reformists. Rents have been dissipated by effectively opening up the country to tourists and investors and introducing real competition in air transport, petroleum distribution and telecommunications. The benefits to the elite now lie in finding opportunities for encouraging and collaborating with new investors rather than in resisting change.

44. To further reduce the risks of reversal, a public information campaign, run by the STA, has been launched and will be continued. The aim is to mobilize the public--particularly the poor and the emergent private sector who are the clear winners if the economic reform program is successful. The campaigns will deal with doubts concerning foreign investment and fears concerning the exclusion of the majority from the benefits of economic activity. A central theme is that without foreign investment and donor support Madagascar is caught in a poverty trap: low investment yields low growth which results in low savings and therefore low investment. Moreover, the campaigns will suggest that an economic recovery fueled by foreign investment will open opportunities to all Malagasy, allowing the relative wealth and income disparities to be closed without

lowering the incomes of the current elite. The campaigns will demonstrate the link between the reform measures and employment creation, income generation, increased purchasing power, the provision of better goods and services at lower prices. The messages will counteract attempts to portray the reforms as "selling the country to foreigners". Also, strong signals that future donor support, particularly for wage increases, is contingent upon continued good performance should strengthen the hand of reformists.

45. The Bank has sought to minimize its own risk by making the credit a single-tranche operation with the principal adjustment measures completed prior to effectiveness, as discussed in para. 33. This approach has the added vital advantage of giving investors concrete evidence of economic opening, rather than only declaration of intent or passage of laws.

PART III: RECOMMENDATION

46. Recommendation. I am satisfied that the proposed Interim Fund Credit would comply with Resolution No. 184, adopted by the Board of Governors of the Association on June 26, 1996, establishing the Interim Trust Fund and I recommend that the President approve it.

Gautam S. Kaji
Managing Director

Attachments

Washington, D.C.
February 19, 1997

Madagascar - Key Economic Indicators

Indicator	Actual			Estimate			Projected					
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2005 1/	2010 1/	2015 1/
National accounts (as % GDP at current market prices)												
Gross domestic product	100	100	100	100	100	100	100	100	100	100	100	100
Agriculture[a]	31	31	32	37	31	33	32	33	32	28	22	18
Industry[a]	13	13	13	13	13	12	12	12	12	14	18	22
Services[a]	49	49	49	45	49	49	48	48	47	48	49	47
Total Consumption	101	97	98	97	97	96	95	93	90	81	78	76
Gross domestic fixed Investment	11	11	11	11	11	10	12	13	15	25	25	26
Government investment	6	8	8	6	6	6	7	7	7	7	8	8
Private investment (includes increase in stocks)	5	4	4	5	5	4	5	6	8	18	18	17
Exports (GNFS)[b]	17	17	15	22	23	18	19	20	21	22	24	28
Imports (GNFS)	26	25	25	30	31	24	26	26	26	28	27	30
Gross domestic savings	-1	3	2	3	3	4	5	7	10	19	22	24
Gross national savings[c]	-3	3	3	1	0	3	5	7	10	19	22	24
Memorandum items												
Gross domestic product (US$ million at current prices)	2,677	3,001	3,371	2,979	3,198	4,083	4,103	4,165	4,320	7,376	12,299	19,698
Gross national product per capita (US$, Atlas method)	200	210	220	232	231	245	272	292	292	419	600	840
Real annual growth rates (%, calculated from 1984 prices)												
Gross domestic product at market prices	-6.3%	1.2%	2.1%	0.0%	1.8%	2.0%	3.0%	3.5%	4.5%	9.5%	9.5%	9.5%
Gross Domestic Income	-7.8%	1.4%	2.1%	0.4%	1.5%	0.0%	2.2%	3.8%	4.7%	9.5%	9.4%	9.4%
Real annual per capita growth rates (%, calc. from 1984 prices)												
Gross domestic product at mp.	-8.8%	-1.5%	-0.6%	-2.7%	-0.9%	-0.7%	0.2%	0.8%	1.7%	6.6%	6.6%	6.6%
Total consumption	-2.7%	-4.9%	0.0%	-2.5%	-1.2%	-3.0%	-2.0%	-0.8%	-1.1%	6.3%	6.0%	6.2%
Private consumption	-1.9%	-5.0%	0.4%	-2.0%	-1.3%	-2.7%	-2.1%	-1.5%	-1.9%	5.7%	5.2%	5.5%

(continued)

Madagascar - Key Economic Indicators
(Continued)

Indicator	Actual				Estimate				Projected			
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2005 1/	2010 1/	2015 1/
Balance of Payments (US$m)												
Exports (GNFS)[b]	480	496	516	653	746	741	769	821	892	1645	2969	5535
Merchandise FOB	334	324	332	447	502	493	508	539	577	1007	1802	3402
Imports (GNFS)[b]	681	733	816	874	987	988	1051	1083	1127	2065	3360	5857
Merchandise FOB	440	465	510	546	628	612	654	672	699	1300	2142	3719
Resource balance	-200	-237	-300	-221	-241	-247	-282	-262	-236	-420	-391	-322
Net current transfers (including official current transfers)	144	163	184	90	92	136	115	93	94	100	101	102
Current account balance (after official capital grants)	-216	-150	-176	-208	-231	-164	-153	-155	-124	-298	-280	-220
Net private foreign direct inv.	14	21	15	6	10	14	29	35	41	233	300	390
Long-term loans (net)	-91	-101	-110	-149	-132	-85	197	58	29	100	44	-14
Official	-56	-90	-96	-138	-126	-53	139	154	105	79	132	178
Private	-35	-10	-14	-12	-6	-32	58	-96	-76	21	-88	-192
Other capital (net, including errors and omissions)	309	247	288	352	414	301	-73	76	80	9	2	-19
Change in reserves[d]	-17	-17	-16	0	-60	-67	0	-13	-26	-43	-66	-137
Memorandum items												
Resource balance (% of GDP at current market prices)	-7.5%	-7.9%	-8.9%	-7.4%	-7.5%	-6.0%	-6.9%	-6.3%	-5.5%	-5.7%	-3.2%	-1.6%
Real annual growth rates (1984 prices)												
Merchandise exports (FOB)	6.1%	-0.8%	6.1%	12.8%	3.9%	11.9%	4.8%	4.9%	5.0%	9.3%	10.2%	11.4%
Primary	-3.3%	3.7%	-1.3%	20.9%	-8.3%	11.7%	3.1%	3.8%	4.2%	5.4%	5.7%	5.9%
Manufactures	21.6%	-15.1%	0.8%	9.3%	6.3%	9.7%	3.8%	4.9%	5.2%	13.2%	10.9%	12.4%
Merchandise imports (CIF)	-14.1%	2.5%	12.7%	5.3%	7.6%	-1.7%	3.7%	4.2%	4.7%	8.8%	8.0%	9.9%
Public finance (as % of GDP at current market prices)[e]												
Current revenues	9.3	10.9	10.7	8.7	8.6	8.7	9.8	10.6	11.8	14.0	15.4	17.0
Current expenditures	9.8	11.8	12.1	12.8	11.2	10.4	9.1	9.3	9.4	9.1	9.6	10.3

(Continued)

Madagascar - Key Economic Indicators
(Continued)

Indicator	Actual				Estimate		Projected					
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2005 1/	2010 1/	2015 1/
Current account surplus (+) or deficit (-)	-0.5	-0.9	-1.5	-4.1	-2.5	-1.7	0.7	1.3	2.4	4.9	5.9	6.7
Capital expenditure	6.6	8.3	8.5	7.0	6.2	6.2	7.2	7.4	7.5	7.3	7.9	8.5
Foreign financing	5.2	5.1	5.5	4.3	4.5	1.4	54.0	5.2	4.8	2.6	1.4	0.5
Monetary indicators												
M2/GDP (at current market prices)	21	22	24	26	20	17	17	18	19	20	20	20
Growth of M2 (%)	25	20	26	49	16	8	12	15	18	13	13	13
Private sector credit growth / total credit growth (%)	15	-4	79	53	168	9	99	99	99	54	95	95
Price indices(1984 =100)												
Merchandise export price index	86	84	81	97	105	92	91	92	94	107	119	132
Merchandise import price index	111	115	112	112	122	120	124	122	122	140	157	175
Merchandise terms of trade index	77	73	73	87	87	77	73	75	77	76	76	76
Real exchange rate (US$/LCU)[f]	45	48	53	47	42	35	37	38	40	42	44	48
Real interest rates												
Consumer price index (% growth rate)	8.9%	13.8%	9.4%	39.0%	49.0%	24.0%	11.5%	5.8%	4.8%	3.1%	3.2%	3.0%
GDP deflator (% growth rate)	13.9%	12.5%	13.0%	41.6%	46.8%	21.1%	10.2%	6.2%	5.2%	3.0%	3.0%	3.0%

a. If GDP components are estimated at factor cost, a footnoote indicating this fact should be added.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Should indicate the level of the government to which the data refer.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.
1/ Assumes that Madagascar will expand adjustment efforts initiated under the SAC to create a climate for foreign investors far superior to that of most developing countries.

MADAGASCAR: THE GOVERNMENT'S MEDIUM-TERM ADJUSTMENT PROGRAM - FY96-99

Sector	Objectives and Policies	Strategies and Measures	Timing
		I. Macroeconomic Policies	
1. Fiscal Policies			
Tax and customs administration	Strengthen tax and customs administration, reduce tax fraud, and increase revenue	Create a Large Taxpayer Unit in Antananarivo	End-1996
		Harmonize the taxpayer identification system between the customs and tax administrations	1997
		Enhance supervision of operations of investment code and export processing zone enterprises	December 1996
		Arrange domiciliation of all export processing zone enterprise operations	December 1996
		Establish a staff recruitment and training program	1996-99
		Improve the computerization of central and decentralized tax units	August 1997
		Simplify declaration and payment procedures	1997
		Simplify taxation for small enterprises (*impôt synthétique*)	1997
Tax policy	Broaden the tax base, improve efficiency and fairness of taxation, and increase the tax effort	Harmonize the system of penalties and surcharges for all taxes	Completed
		Require a 3-5 percent advance payment on imports and wholesale purchases	1997
		Extend the VAT base to all activities above a high tax liability threshold (to exempt small enterprises)	1997-99
		Make large taxpayers subject to filing and monthly payment of VAT	December 1996

Sector	Objectives and Policies	Strategies and Measures	Timing
		Reduce import exemptions	1997
		Eliminate customs codes that differentiate by product destination or use	January 1997
		Increase receipts from the tax on petroleum products (TUPP) to FMG 180 billion	1997
		Eliminate vanilla export tax	From 1997 crop
Public expenditure	Improve current expenditure management	Revise procedures for monitoring, accounting, and computerization of the payroll	1996-97
		Adjust the pace of expenditure commitment to revenue performance	1996-99
		Use monthly performance indicators (commitment and cash bases) based on the budget nomenclature	January 1997
		Present financial accounts of public institutions	1997
		Pass the final accounting bill (*loi de règlement*) annually and publish audits by the Audit Office	1996-99
	Improve management and structure of capital expenditure	Increase expenditure on social services, basic infrastructure, and public security	1996-99
2. Monetary Policy			
Monetary control system	Use indirect monetary control instruments	Develop open market operations using treasury bills	1997
		Keep interest rates positive in real terms	1996-99
Financial system	Improve services to small borrowers	Develop the credit union system (*crédit coopératif*) to provide micro-loans	1996-99
3. Exchange and payments			
External debt	Restore normal relations with creditors	Negotiate with the Paris Club and other creditors	March 1997
		Eliminate all external payments arrears, and avoid accumulating new arrears	End-1996

Sector	Objectives and Policies	Strategies and Measures	Timing
	Conduct prudent debt management policy	Contract only loans on concessional terms, and no non-program financing	1996-99
Exchange arrangements	Liberalize external payments	Maintain the floating exchange rate system for the Malagasy franc	1996-99
		Reduce the minimum capital required to open exchange bureaus	Completed
		Abolish all restrictions on current payments and transfers and accept obligations of Article VIII of the Articles of Agreement of the Fund	Completed
		Relax and then eliminate the requirement to surrender export receipts	1996-97
Other areas		Adopt measures consistent with the Cross Border Initiative (CBI), including the simplification of the schedule of import taxes	1997-98
		II. Institutional reforms	
1. Government operations	Civil service reform designed to attract, train, and retain a skilled work force	Assign former national service volunteers (ex-VSN) and short-term employees (ECD) to the new civil service (State and Territorial)	1997
		Redefine the essential tasks of the principal ministries; reassign staff to local authorities; and increase pay according to performance and revenue	1996-97
		Finalize the reform strategy and timetable	June 1997
	Reform of the judicial system	Improve working conditions for judges, upgrade their status, and ensure that they receive adequate training	1997-99
		Promote the work of the Business Law Reform Commission (*Commission de Réforme du Droit des Affaires)* in order to coordinate the reform and publish legislative texts	1997-99
	Implementation of decentralization	Define clearly the distribution of authority and resources between the central government, the regions to be established, and the communes	1996-97

Sector	Objectives and Policies	Strategies and Measures	Timing
		Complete the process of decentralization and localization at no cost to the public authorities	1997-99
2.. Private sector development	Remove regulatory constraints on private investment to establish a conducive environment for private sector development	Revise laws and regulations governing land ownership, property rights, and commercial activities	Completed
		Revise the Investment Code	Completed
		Institute a one-stop shop to handle enterprise establishment procedures	End-1996
		Simplify procedures for registering companies	1997
		Negotiate double taxation treaties with countries that are potential sources of private capital	1996-98
		Establish a legal and institutional framework to fight anti-competitive practices	1997
		Eliminate public enterprise monopolies in energy, hydrocarbons, telecoms, air transport sectors, and encourage the entry of private companies	1996
		Eliminate the fiscal monopoly (RMMF)	1997
		Eliminate monopolies in the sugar, wheat, flour, cotton, meat, coastal shipping, ports, water supply, insurance, oilseed products, and airport management sectors	1997
3. Government divestiture	Reduce the burden of public enterprises on the budget, improve their productivity, and increase private investment through State divestiture	Approve the law on State divestiture from public enterprises	Completed
		Create a holding and privatization fund (FPP) and define a divestiture program and publicize them to the public at large	Completed

Sector	Objectives and Policies	Strategies and Measures	Timing
4. Data base	Improve the capacity to monitor economic and financial trends	Divest the state from the two public commercial banks	December 1997
		Divest the state from enterprises representing at least 15 percent of the turnover of public enterprises	1997
		Divest the state from most other enterprises	1998-99
		Improve external debt statistics	1997-99
		Improve external trade statistics	1997-99
		Improve national accounting statistics	1997
		Establish a national consumer price index	1997
III. Poverty alleviation			
Poverty alleviation	Provide access to basic services for the most disadvantaged	Increase social spending, in particular on basic health care and primary education	1996-99
		Create a central drug purchasing organ	End-1996
		Rehabilitate school infrastructures and reassign teachers	1997-99
	Improve public security	Strengthen policing in the field	1997
IV. Environment			
Sustainable development	Fight over-exploitation of natural resources	Implement the second phase of the national environmental action plan	1997

Sector	Objectives and Policies	Strategies and Measures	Timing
		V. Sectoral policies	
1. Infrastructure			
Road transport	Improve roads	Decentralize construction and maintenance work and simplify public contracting procedures	1997-98
		Maintain a 15,000 km priority network	1996-99
		Establish a National Road Maintenance Fund	1997
Telecommunications	Provide the country with a modern state-of-the-art system by fostering competition	Amend the law to authorize new operators to enter the market	Completed
		Select at least one new mobile telephone company	Completed
Air transport	Reduce the cost of international transport	Abolish provisions designating Air Madagascar as the sole user of Madagascar's international air traffic rights	Completed
		Authorize a new regular company and a charter company to provide flights between France and Antananarivo	November 1996
		Authorize regional companies to provide service to all cities, without restricting the number of flights, and to form joint ventures with domestic companies to operate regional and domestic air services	Completed
		Open ground handling services to competition	Completed
Maritime transport	Improve the productivity of Malagasy ports and reduce international transport costs	Separate the different functions at the port level, open management to private operators, and privatize handling operations	1997
		Liberalize the shipping market	1997
Water and sewerage services	Improve the quality of water and reduce pollution	Present new legislation on water in the National Assembly	End-1996
		Implement the Sectoral Strategy and Action Plan (SSAP)	1997-99

Sector	Objectives and Policies	Strategies and Measures	Timing
2. Productive sectors			
Agriculture	Improve agricultural productivity	Eliminate subsidies, liberalize markets for inputs, and provide ongoing support for agricultural extension	1996-99
		Auction donated fertilizer	January 1997
		Divest from the rice market without creating any incentive to import	1996-99
		Liberalize the vanilla sector:	1996-97
		• transform IVAMA into an interprofessional group with no State participation	Completed
		• eliminate the vanilla export tax	May 1997
		Divest the State from the cotton (HASYMA) and sugar (SIRAMA) sectors	1997
Mining	Liberalization of the sector and State divestiture	Introduce free competition, while ensuring that the current regulatory texts are applied	1996-99
		Ensure application of mining legislation centered on promoting large mines, while appealing to domestic and foreign investors	1997-99
		Rehabilitate the sector at the central and regional government level	1997-99
		Divest gold mines directly operated by the state	1997-98
		Provide national geological data to investors, mine operators, researchers, and students	1996-99
Tourism	Upgrade and develop the sector	Simplify formalities for obtaining tourist visas	Completed
Energy	Liberalize the oil and electricity sectors	Seek a partnership arrangement for SOLIMA and a restructuring of JIRAMA with an injection of private capital	1997-98
		Select several oil companies to become established in Madagascar	1996-97
		Promote rural electrification in areas having exploitable economic potential	1996-99

REPUBLIC OF MADAGASCAR

LETTER OF DEVELOPMENT POLICY

November 12, 1996

This Letter of Development Policy, drawn up by the Government of the Republic of Madagascar, focuses on the implementation of measures to ensure significant sustainable improvement in the purchasing power of the Malagasy population. With this same objective in view, the Prime Minister submitted an economic and social recovery program to the National Assembly on June 11, 1996. The measures proposed here are designed to: (i) move the country back toward broad macroeconomic balance, and therefore toward greater control over inflation and government spending; (ii) revitalize private investment, a necessary condition for renewed growth; (iii) restore the rule of law; and (iv) alleviate poverty.

MACROECONOMIC FRAMEWORK

The Government's priority will be to reduce inflation from its 1996 level of 20 percent to 3 percent in 1999. To achieve this, it will take steps to control the fiscal deficit while following a prudent monetary and credit policy. The goal of fiscal policy is to reduce the deficit (including grants) from 5.4 percent of GDP in 1996 to approximately 2 percent of GDP in 1999. While real GDP growth will probably remain moderate in 1996 (2 percent), given the uncertainties prevailing during the first half of the year, it should accelerate subsequently to exceed 5 percent by the year 2000. Private investment will increase, while public investment will remain steady at an average level of about 7 percent of GDP. The success of this scenario is dependent on a doubling in domestic and foreign private investment to reach 8 percent of GDP by the year 2000.

PRIVATE SECTOR DEVELOPMENT

Deregulation: Various legal, regulatory, and tax improvements will be introduced to facilitate the creation and running of business enterprises. The Government has already instituted the following reforms in 1996: (a) real estate legislation has been made more flexible by extending the long-term lease period on land to 99 years and adopting procedures guaranteeing conclusion of the lease agreement within two months; this type of lease will henceforth be mortgageable, and may be transferred to domestic and foreign lessees after their investments have been made; (b) public enterprise monopolies in the fields of electricity, petroleum, telecommunications, and air transportation have been eliminated; (c) regulations on the issuing and duration of visas for foreign investors and tourists, and residency and work permits for foreign experts, have been relaxed, while the exit visa requirement for nationals and foreign residents has been eliminated; and (d) prior approval for equity capital contributions by foreign investors (above a threshold of 20 percent of a company's authorized capital) has been abolished.

In 1997: (a) the procedures will be defined for transforming land leases into freeholds on the basis of investment in the land; (b) the procedures for registering companies will be simplified and made less costly; (c) a simple and effective legal and institutional framework will

be established to combat anti-competitive practices; (d) monopolies on sugar, wheat flour, cotton, meat, coastal shipping, ports, water supply, insurance, oilseed products, and airport management will be eliminated; and (e) the procedures for granting licenses in the fishery and forestry sectors will be simplified and will reflect environmental concerns.

Taxation: In August 1996, the Government improved tax incentives by: (a) eliminating the tax provisions set out in the investment code; (b) revising the general tax code with regard to the IBS and IGR (nonwage) investment regime; (c) standardizing the duration of the loss carry-over for all sectors; (d) introducing the VAT exemption system for all exporters; and (e) establishing the flat-rate drawback system, equivalent to a tax credit granted to small- and medium-sized export enterprises (except in the case of traditional export goods, which continue to benefit from the temporary admission system). In addition, the introduction of tariff measures under the Cross-Border Initiative (CBI)[1] will be a first step toward a system of low, uniform tariff protection. The 1997 Budget Law will eliminate the customs tariff subheadings that differentiate by end use (pp. 30-46 of the 1996 Budget Law). Over the period 1997-1999, the Government will seek to sign treaties eliminating double taxation with countries that are potential sources of private capital flows.

Divestiture by the State: The public banks (BTM and BFV) will continue to be managed by their appointed independent administrators until divestiture before end-1997. The negotiators in charge of selling them have already been appointed. In 1996, the Government will also launch a new program for the divestiture of other public enterprises in order to: (i) reduce their burden on the budget; (ii) improve their productivity; and (iii) promote private investment. With this in view, the National Assembly has enacted legislation prescribing divestiture methods and procedures, and the associated implementing decrees have been adopted. Provision is made for: (a) creation of a holding and privatization fund to hold and subsequently resell shares in public enterprises and thereby facilitate equity investments by domestic investors and small savers; and (b) creation of a social and regional development support fund, and establishment of retraining/reintegration programs to alleviate problems related to employment and public participation. The Government is committed to launching a public awareness campaign. The divestiture process will be spread over a five-year period (1996-2000).

Exchange arrangements, external payments, and regional cooperation: Freedom of access to foreign exchange for current operations will be enhanced by significantly lowering the minimum capital required for the opening of exchange bureaus. Moreover, the requirement to surrender export receipts has been eased and will be eliminated in 1997. The Government has lifted all restrictions on current payments and has accepted the obligations of Article VIII of the IMF Articles of Agreement. The Government has appointed a committee for the regional dimension of adjustment (CODRA) to facilitate the implementation of measures adopted jointly with regional partners, particularly those of the Cross-Border Initiative.

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1 These measures are aimed at harmonizing external tariffs so that by 1998 all CBI participating states will have virtually the same tariff, with three nonzero rates, an average of 15 percent, and a maximum of 20-25 percent.

RETURN TO THE RULE OF LAW

Rehabilitation of the judicial branch: The creation in October 1996 of an *École nationale de la magistrature et des greffes* (ENMG) will facilitate the recruitment of new judges and provide ongoing training for both judges and clerks of court, in conjunction with phasing in of judicial reforms, the legislative instruments for which are currently before the National Assembly. In addition, the Government plans to improve judges' working conditions and remuneration, and to support the work of the Law Reform Commission, the body responsible for coordinating legislative reform and publishing related texts.

Rationalization of government operations: The proposed civil service reform program will aim to attract, train, and retain qualified personnel. It will emphasize: remuneration and incentives linked to performance, particularly in the case of judges and officials with responsibilities for financial administration; redefinition of the basic responsibilities of the principal ministries and supervisory bodies; and reassignments of personnel to local governments. Preliminary proposals will be finalized in the course of national sectoral and regional workshops to be held during the first half of 1997. At the same time, the Government has initiated a thorough reorganization of payroll management (responsibility for which will be transferred to the Ministry of Finance), to be based on the results of a review of monitoring, accounting, and computerization procedures.

Decentralization: The first priority is to define clearly the distribution of responsibilities and resources between the central government, the regions to be created, and the communes. The Government plans to complete the decentralization and devolution process with no increase in aggregate cost. Decentralization and devolution should be coordinated in such a way as to preclude creation of central government territorial units to exercise functions that should be transferred to local authorities, and to eliminate existing territorial units after their functions are decentralized. The Government has incorporated provisional criteria in the 1997 budget to facilitate coordination of these transfers. Beginning in 1997, administrative and financial tribunals are to be established. A series of eight studies on the various aspects of decentralization will be completed by end-1997. Training for local government officials, to begin in January 1997, will facilitate gradual implementation of the recommendations on ways to strengthen the sustainability of the decentralization process.

Return to orthodox budgetary and financial rules: The circular containing instructions on the 1997 budget recalled the applicable budgetary principles: (i) no off-budget expenditure will be honored by the Treasury; (ii) public institutions must submit up-to-date accounts to the Ministry of Finance in order to be considered for a budget appropriation; (iii) decentralized units must submit up-to-date accounts to the Ministry of the Interior and Decentralization in order to be considered for transfers; and the Treasury will take steps to recover advances and loans in arrears.

Government expenditure will be monitored by means of monthly performance indicators (commitment basis and cash basis). Quarterly and annual reports conforming to budget nomenclature, and including complete lists of loans guaranteed and backed by the Government,

will be published within two months of the end of each period. The annual drafting and approval of a final accounting bill (*loi de règlement*), and preparation and regular publication of audits performed by the Audit Office, will complete this process.

Beginning in 1997, preparation of the Public Investment Program will be improved to ensure better resource allocation and limit expenditure not directly related to gross fixed capital formation. The key steps taken for these purposes will be: the establishment in 1996 of an interministerial project studies fund to promote more rigorous selection of projects and better assessment of their impact, and to allow their in-progress or ex-post evaluation at the national and regional levels; formulation or reformulation of development policies in the major sectors, starting with education, health, agriculture (where this process has already been under way for several months), public works, and internal security; and provision—with assistance from the departments of the Directorate General of Planning—of technical support for the programming and monitoring units of the technical ministries.

In the programming arena, allocations for expenditure not directly related to gross fixed capital formation will henceforth be limited to 20 percent of total annual appropriations. This limitation entails a reduction in the domestic financing of autonomous projects and an equivalent decrease in support expenditure under jointly financed projects i.e. project personnel expenditure will be confined to the wages of project staff.

POVERTY ALLEVIATION

The Government will restructure its spending in such a way as to promote growth and enable the most disadvantaged social groups to participate in the country's development. Investment projects in the social sectors (basic health care, primary education, and public security) will be given priority.

Health: The Government's objective is to provide the public with access to high-quality basic health care. The strategy for achieving this calls for development of the private sector in tandem with improvement of public services. Emphasis will be placed on upgrading basic health facilities in the health districts, and also on establishing a privately operated central procurement office by end-1996 with a mandate to supply public and private health facilities on a non-profit basis and to enter into the corresponding government contracts. In conjunction with this reform, the public will be asked to contribute financially to the cost of medicines, as part of a community management plan of the "village pharmacy" type. The strategy will also involve an increase in budget appropriations to the health sector, as well as a retargeting of public expenditure toward the most disadvantaged population groups. The Government will allocate the necessary resources for the prevention and treatment of diseases such as malaria, diarrheal illnesses, tuberculosis, and STD/AIDS.

Education and training: The top priority is to ensure that primary education becomes generalized and to improve its quality by: rehabilitating school infrastructure; reassigning teachers in accordance with actual needs (determined in consultation with local governments); increasing incentives for teachers; upgrading teacher qualifications; and improving school

administration. The adult literacy campaign will be resumed and rural community actions resumed. The Government plans to establish vocational training that facilitates access to employment and help improve the performance of businesses. These efforts will be geared to demand by strengthening the presence of the private sector on the National Technical and Vocational Training Board (CNFPT). At the same time, the Government will strive for a turnaround in higher education. Higher education expenditure will be examined with a view to gradually increasing financial participation by students.

Public security: For the next three years, additional budget appropriations will be made to the police and the national constabulary (*gendarmerie*) to strengthen their staffing and physical resources. The Government will develop a new security strategy, focusing particularly on the opening of new police stations or surveillance posts and new constabulary units. In conjunction with these measures, a prison policy will be defined that is both stricter and more humane.

Supplementary measures: Proposed supplementary measures for the alleviation of poverty will include: (a) rehabilitation of the regular and farm road networks; (b) development of a more appropriate land policy and implementation of programs to make property rights and land tenure arrangements more secure; (c) access for farmers, artisans, and traders to entities providing savings, mutual credit, and banking services; and (d) promotion of micro-enterprises and occupational and economic interest groups. The Government will also promote the activities of associations and NGOs.

SECTOR POLICIES AND STRATEGIES

The objectives here are to increase investment, execution capacity, and operational effectiveness. To achieve them, the Government will create the conditions conducive to private investment and at the same time increase the productivity of public investments. It has already liberalized the air transport sector, abolished monopolies in the telecommunications and petroleum sectors, and developed a partnership with the private sector through the privatization and subcontracting of construction and maintenance works. It is now a question of reinforcing the effectiveness of such policies by ensuring that private sector competitors enter all these sectors.

Telecommunications: The Government's objective in this sector is to improve service, lower costs, expand user access, increase the economy's competitiveness, and attract private capital. To this end, the Government recently amended the legislative and regulatory framework governing the sector to authorize the unrestricted entry of new providers. Following an international call for bids launched for the purpose of identifying several mobile telephone service providers with access to the international network, two enterprises have already been authorized to operate.

Air transport: The main objective is immediate liberalization of the air transport sector in order to encourage development of the country's tourism potential, increase the number of arrivals, lower transportation costs, and facilitate exports. The Government has annulled the

provisions designating Air Madagascar as the sole operator authorized to exercise Madagascar's international air traffic rights. Ground handling services have been opened to competition. A new company with regularly scheduled flights and a charter company will begin operations in November 1996. In addition, regional airlines have been invited to serve all Malagasy airports without limits on the number of flights. They have also been invited to submit proposals for cooperation with Air Madagascar and/or existing or new private companies to service domestic routes.

Maritime transport: With a view to increasing the productivity of the country's port facilities, the different port functions will be considered separately, with the Government: (a) opening the management of ports to private firms; (b) privatizing handling operations; and (c) liberalizing the shipping market.

Petroleum: The liberalization begun in the oil sector will be completed. The relevant decree was approved in 1995 and the implementing regulations have been published. Following an international call for bids, oil companies will be authorized to establish themselves in Madagascar. These companies, together with SOLIMA, have been invited to participate on an equal footing in an infrastructure management entity (storage, unloading of vessels).

Mining: In the mining sector, the strategy adopted is focused on: (a) elimination of direct government intervention through OMNIS; (b) implementation of mining legislation designed to promote large-scale mining operations by attracting both domestic and foreign investors; (c) development of a partnership for small- and medium-sized operators; (d) rationalization of sector management at both the central and regional government levels; (e) privatization of gold mining; and (f) making geological information available for the benefit of investors, mine operators, researchers, and students.

Agriculture: In this sector, the emphasis is on increasing producers' participation in the market economy. Improvements in the management of food aid and agricultural inputs are planned to minimize disruptions in the domestic market. To this end, the Government, in consultation with interested donors and the World Bank, will develop an action plan by end-October 1996 to withdraw from the sale and distribution of fertilizers, which will thereafter be sold at auction. The Government will no longer be involved in the rice market and will not take steps to encourage rice imports. As of January 1997, the authorities will be withdrawing from the vanilla industry and will cease all interventions affecting it, especially where prices are concerned. The export tax on vanilla is to be eliminated, beginning with the 1997 harvest.

ENVIRONMENTAL POLICY

Madagascar's biological diversity makes it unique in the world. This biological wealth, which is an integral part of both the national and the world heritage, must be protected. Aware of the seriousness of the matter, the Government has made the ministries in charge of agriculture, livestock, and water and forest resources responsible for formulating national environmental policy, for drawing up the legislation, regulations, and administrative texts required to put this policy into effect, and for coordinating all environmental projects and programs. This national

environmental policy takes its inspiration from the National Charter on the Environment, and incorporates the results of current studies concerned with sector policies on sustainable ecological development (management of brush fires, fishing, aquaculture, industry, mining, tourism, local community management of natural resources, energy, roads). The National Environmental Action Plan, to be implemented over the course of 15 years, is about to move from its first five-year execution phase, known as "Environmental Program 1," into its second phase.

CONCLUSION

The economic reform program of the Government of Madagascar has already begun to show positive results, particularly the reduction of inflation. However, efforts must be kept up to return to lasting growth and achieve sustainable development. Nevertheless, the heavy debt burden of Madagascar and the size of its needs will not allow the country to successfully implement its economic program on its own. The Government anticipates that the program, as formulated in this letter of development policy, will trigger the indispensable support of the international community, including that of the Bretton Woods institutions, particularly the World Bank Group which is expected to provide support in the form of a Structural Adjustment Credit from the International Development Association (IDA).

Schedule D

Supplementary Credit Data Sheet

Section I: Timetable of key processing events

Time taken to prepare:	19 months
Appraisal:	July/August 1996
Negotiations:	October 4, 1996
Meeting of the Committee of Executive Directors:	March 14, 1997
Closing Date:	December 31, 1997

Section II: Special conditions

Actions taken for Project Preparation

Please see para. 34 of the MOP.

Conditions of Presentation of the Credit for Approval and Tranche Release

Please see para. 35 of the MOP.

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REPUBLIC OF MADAGASCAR

Note on Portfolio and Disbursement Performance

1. In August 1993, Madagascar completed a two-year process of political transition from a single party regime to a pluralistic democracy. Implementation and disbursement of the IDA-financed portfolio, which had been slow during the transition, have now improved. While the continued poor economic and financial situation in the country had the potential to hamper portfolio progress, efforts were made during annual public expenditure reviews (PERs) to ensure adequate counterpart resources for priority projects. The April 1994 country portfolio performance review (CPPR) addressed key generic problems which were affecting the portfolio, and set action plans to speed parliamentary ratification of projects, to guarantee timely availability of counterpart funds and eliminate roadblocks to requests for disbursements of IDA funds, to limit procurement delays, and to improve accounting and audit procedures. The government decided to systematically monitor portfolio performance, and empowered a monitoring committee in the Ministry of Finance and Budget to monitor implementation and report regularly, both to the government and the Bank. A May 1995 CPPR reviewed the progress achieved and remaining steps to be taken. It also focused, on a project-by-project basis, on the achievement of results on the ground and project objectives. This CPPR benefited from the participation of a number of beneficiaries who reported on their perceptions of how the projects are implemented, how they are useful, and how they might be improved. A June 1996 CPPR extended participation to NGO representatives, donors and mayors; in order to get more involvement from the regions, consideration is being given to hold the 1997 CPPR outside the capital city.

2. The efforts to improve project implementation are paying off. The percentage of unsatisfactory projects in the portfolio dropped from 27 percent in FY92 to 10 percent in FY95 as regards implementation progress, and from 27 percent to 5 percent as regards development objectives. Disbursements for investment projects increased substantially from US$23 million in FY92 to US$72 million in both FY95 and FY96. This represented an increase in the disbursement ratio from 7 percent to 21 percent. For FY97, at mid-term review (December 1996) disbursements have increased by 17 percent compared to FY96 figures. At the end of this schedule is a table which shows project-by-project disbursement for FY95 and FY96.

3. While significant progress has been made on portfolio performance, much remains to be done. The political and economic/financial situations in Madagascar still have the potential to derail project implementation, and continuing efforts will be made to monitor closely and follow up the actions identified during the CPPRs, both for generic issues and for individual projects.

4. **Disbursement Lags**. Even though disbursements have been reasonably robust, the undisbursed balance for some projects has diminished more slowly due to the strengthening value of the SDR versus the US$ between the time of approval and the present, a trend which has only started to reverse recently. There are also projects which are now performing well,

but which because of initial delays, show lags when compared to original expectations. Three projects show significant disbursement lags.

- The **Antananarivo Plain Development Project (Cr. 2117-MAG)** has achieved substantial progress toward its institutional objectives; in particular, the government has created the entities charged with the future operation and maintenance of the drainage and flood control and sewerage utilities. However, suspension of disbursements for downstream portions of the drainage system (pumping station) by the key co-financier, due to payment arrears, has delayed IDA's ability to proceed with the upstream works. A solution has now been found which allows the pumping station to be completed and the IDA-financed works to resume.

- Despite a difficult start, linked both to political and management uncertainties, the **Financial Institutions Development Project (Cr. 2497-MAG)** is now showing progress. Overall, management of the Central Bank (BCM) has improved considerably, and key policy and institutional decisions have been taken. BCM has played a more active role in the conduct of monetary policy -- establishment of a mechanism linking its reference rate for the price of money to inflation; raising reserve requirements; placing the two state-owned banks under holding management and selecting sale advisors; and removal of credit ceilings and reliance on instruments of indirect control. The adoption of new BCM statutes has given it real independence from the government. Finally, important progress has been made in banking supervision. The recent promulgation of a new banking law will reinforce this effort. Concerning project implementation itself, a coordination unit has been established to take day-to-day management decisions within parameters of general priorities defined by a supervision committee. The BCM has agreed to introduce a new accounting system for 1997; the newly recruited project manager is going to launch the pre-selection process for new software.

- Effectiveness of the **Petroleum Sector Reform Project (Cr. 2538-MAG)** was slow owing to a lengthy process of ratification by the National Assembly. After a slow start, project implementation is picking up momentum with the recruitment of the project management consultant. Also, in line with its decision to liberalize the import of refined petroleum products, the government opted for opening up immediately the capital of the refinery to the private sector and requested that the project be restructured so as to eliminate the rehabilitation of the refinery and related investments. Amendments to the Development Credit Agreement (DCA) and the Project Agreement have been signed by the Government on January 6, 1997 and January 14, 1997, respectively. Investments under the amended project relate to: (i) the restructuring of SOLIMA, the creation of an open access system to certain key facilities by all operators and the establishment of a regulatory authority (the selection of consultants for these studies is being finalized); and (ii) physical investments in infrastructure to improve safety and protect the environment.

- A fourth project which previously was highlighted in this category - **the Health Sector Improvement Project (Cr. 2251-MAG)** - has been restructured and the DCA amended. The project is now performing well and disbursements have significantly improved.

5. **Effectiveness.** The **Energy Sector Development Project (Cr. 2844-MAG)**, approved by the Executive Directors on April 16, 1996, was signed on May 29, 1996. The Credit became effective on August 28, 1996.

Madagascar Portfolio
Disbursement Trends
(US$ millions)

Cr. No.	Project	Credit Amount	Disbursed FY95	Disbursed FY96	Disbursed FY97 a/
1967	EMSAP	22.00	4.28	4.75	2.76
2042	Agr. Research	11.69	2.07	1.57	0.25
2094	Education Sector	39.00	8.01	9.34	4.30
2104	APEX	48.00	5.79	9.50	4.85
2117	Tana Plain	30.50	4.77	2.27	1.08
2125	Environment	26.00	5.15	5.53	4.60
2243	Livestock	19.80	2.49	1.67	1.92
2251	National Health	31.00	4.37	6.38	5.21
2382	Vocational Education.	22.80	3.45	4.10	2.01
2459	Rural Finance	3.70	0.91	0.85	0.52
2474	Food Security	21.30	3.51	7.50	3.60
2497	Financial Institutions	6.30	0.64	0.55	0.43
2538	Petroleum Sector	51.90	1.19	0.37	0.08
2591	Urban Works	18.30	3.67	8.23	3.14
2625	Cyclone Rehabilitation	13.10	2.78	5.50	2.23
2644	Irrigation II	21.20	0.62	1.99	0.54
2729	Agr. Extension	25.20	0.00	0.78	1.23
2778	Social Fund II	40.00	0.00	0.00	2.34
2844	Energy Development	46.00	0.00	0.00	1.33
2911	Public Sector Capacity Building	13.80			0.08
		511.59	**53.70**	**70.88**	**42.50**
	Closed Projects		***18.66***	***0.76***	
	TOTAL		**72.36**	**71.64**	**42.50**

a/ Through December 31, 1996

IMAGING

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