MADAGASCAR – ECONOMIC UPDATE: A Transition… but Challenges are coming soon

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So far the dialogue between the main political parties has failed to produce an agreement on the way forward for a return to a democratic Government. Meanwhile, while continuing to deteriorate, the economy has shown some resilience due to (i) the strict fiscal policy pursed by the authorities that helped stabilize key financial indicators, and (ii) the differentiated impact of the crisis on private activities and households, affecting the middle class in urban areas but leaving unaffected most of the poorest groups in the country. Two short-term issues have to be closely monitored: (i) the payment of community teachers when classes will open in September; and (ii) the reaction of textile companies to the uncertainty surrounding the US decision to maintain Madagascar as part of the African Growth and Opportunity Act (AGOA).

Fiscal Discipline…..no way out

May 2009 was another month of low public spending. The Government spent around Ariary 116 billion; i.e., 2.5 times lower than a year ago or in February 2009. In other words, essentially wages were paid, whereas public investment and no-priority current expenditures were almost entirely cut for the second month in a row.

Tax revenues continued to underperform with a cumulative shortfall since the beginning year exceeding Ariary 280 billion (US$140 million) compared to the pre-crisis projections (Table 1). The revenue gap reached as much as 40 percent in May. Customs revenues were only half of the monthly objective as a result of the decline in imports including oil, while domestic revenue collection was only 66 percent of the monthly objective. Prospects are alarming because the impact of lower activities on tax payments will increase over time (firms pay their taxes with a lag) and custom administration suffers from multiple internal conflicts, the most recent and visible one being the strike at the port of Tamatave (which accounts for about ¾ of imports) in the first two weeks of June.

Table 1: Deepening of the revenue shortfall in May 2009

In billion of Ariary	Jan-April 2009			May-09		
	Actual	Target	Gap	Actual	Target	Gap
Domestic tax revenue	292.1	338.1	-46.0	128.0	193.1	-65.1
Customs revenue	219.9	347.8	-127.9	42.9	87.5	-44.6
Total	512.0	685.9	-173.9	170.9	280.6	-109.7

Source: Ministry of Finance (provisional figures)

The Government continued to curtail expenditure in response to the revenue shortfall; the cumulative overall execution rate was only 17 percent at the end of May 2009 when it was over 30 percent in May 2008. In May 2009, wages and other current expenditures accounted for more than 80 percent of total spending. Nevertheless, it is worth noting that public investment outlays increased marginally (they were close to zero in April) in a few strategic sectors, including in the Ministry of Foreign Affairs, Ministry of Education, Water and Sanitation, Public Works. Yet, overall investment expenditure (around Ariary12 billion) was only equivalent to 1/3 of the amount spent in May 2008.

Table 2: T Bills market in May 2009

	04-May	15-May	29-May
TBills Yields (%)			
4 weeks	5.2	5.6	5.5
12 weeks	8.1	8.1	7.8
24 weeks	9.2	9.2	9.0
52 weeks	10.8	11.2	10.4
Tbills Amounts (billion of Ariary)			
Tender submitted	95.8	91.4	82.3
Auction/Announced by Treasury	50.0	46.0	44.0

The severe fiscal adjustment pursued by the authorities reflects their explicit decision to privilege short-term financial stability over the stimulation of aggregate demand, by limiting domestic borrowing and monetary financing. During May, the Treasury only borrowed to finance reflows falling due and half the amounts submitted in the tenders (Table 2). As a result, T-bills yields remained stable over the past couple of months around 5.5 percent for short-term maturities and 10.5 percent for long-term maturities. The trade-off of this stringent fiscal policy is that the stimulus on the economy is rather limited, thereby feeding the recession and the potential negative impact of the crisis on the private sector and households.

Dual impact of the crisis on the private sector and households

The current political crisis (in addition to the global economic recession) has produced a differentiated impact on private activities in Madagascar. A segment of the economy has been seriously affected such as tourism, textile and construction. Those sectors are vulnerable to the decline in demand on international markets and to the domestic political uncertainty. The quasi-paralysis of public investment has also reduced public works, leading to a slowdown in construction and infrastructure projects. The negative impacts are significant and visible, but difficult to quantify in the absence of detailed information on the ground and in the national accounts, even though some order of magnitude (from partial surveys) were reported in our previous updates.[1] Some activities indicators such as electricity consumption declined by 5 percent and 1 percent in April and May 2009 compared to the same period one year ago. The most alarming figures are the decline of electricity consumption by 55 percent in the textile sector and by 20 percent in the chemical industry. On the other hand, gasoil consumption was only 1 percent below its level of April 2008. At this stage, our main message is that those sectors are likely to remain in distress over the next few months because of the lag between the political crisis and its impact on investment and production decisions (see box for the textile industry). Up to now, their volume of operations showed some resilience because most investment and strategic decisions were taken at the end of 2008, such as orders in the textile industry and capital purchases in construction (many new hotels were almost finished in

[1] See, World Bank. Economic Updates, April 19 and May 15, 2009

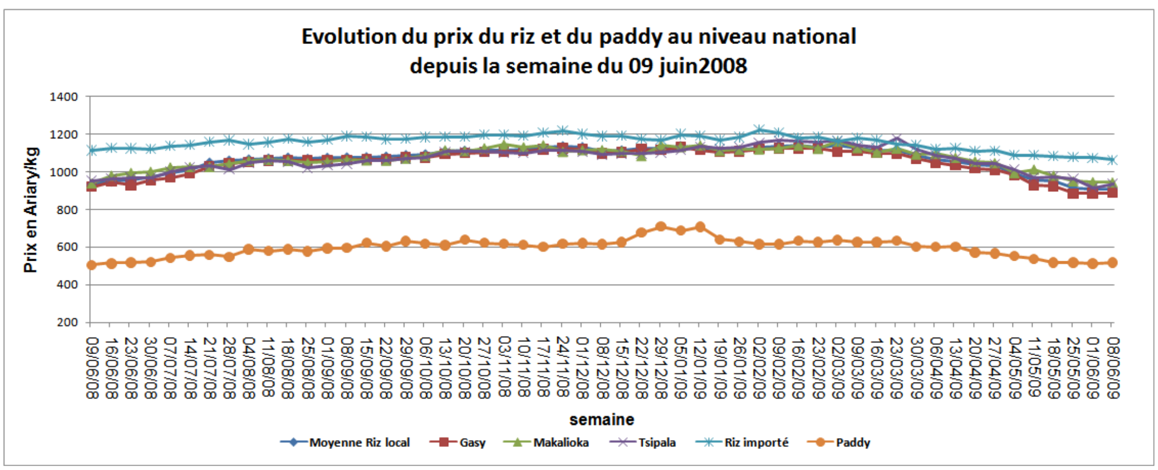
anticipation of the African Union summit) and in the mining sectors. The full negative impact of the crisis will be felt in the second semester of 2009.

The textile industry: The worst to come?

Since the beginning of the year, the textile industry has been affected by the combination of the political crisis and (above all) the global recession. It is reported that 3 firms have closed or partially closed leading to about 1,000 job losses.

The full impact of the crisis is yet to come because there is a lag between order decisions and production, estimated at 4-6 months depending on the market and the product. Today, many international firms operating in Madagascar are reluctant to take new orders because of the uncertainty surrounding AGOA, which provides tax-preferential treatment for Malagasy exports to the US. There is indeed the possibility that Madagascar will not qualify when the U.S. authorities will take their decision at the end of 2009. While the weight of the textile industry is relative low in the Madagascar economy, it accounts for 42 percent of exports and for an estimated 100,000 jobs, highly visible in the urban centers of Antananarivo and Antsirabe.

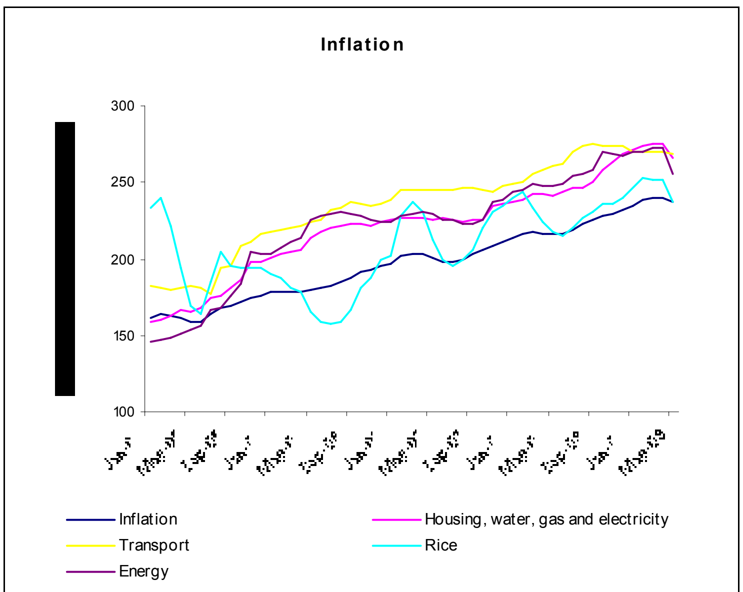
In contrast to these vulnerable sectors, a large fraction of the Madagascar economy has been isolated from the current recession (likewise they benefited less from the fruits of growth in good times). The agricultural sector (mostly rice) depends on climatic conditions and factors that are not directly linked to international markets and the domestic political climate. Fortunately, market trends indicate that the April-June harvest is good and market arrivals are high (volume of rice being sold and number of market participants) as well as the availability of imported rice. With imports of 35,000 mt (20,000 mt of which remain unsold) the market is exhibiting little or no shortages and tends to indicate that Madagascar is close to achieving self-sufficiency for rice. As a result, local market prices are falling (see figure) – in some major markets they are now even below the market prices of this period last year and low enough to relieve some pressures on consumers.



Falling domestic prices of rice have helped to mitigate the impact of the current political crisis in the short term. Not only have most rural households more rice to consume (self-consumption account for a large fraction of local production) but urban households can also purchase rice (which accounts for as much as one-third of the consumption basket for a poor household) at reasonable prices, reducing economic and social tensions in urban centers in a very volatile political environment. A recent U.N. study has showed that poverty did not increase significantly in Antananarivo between November 2008 and May 2009 because most vulnerable households have been able to access food at reasonable prices during this period.[2] However, the next challenge is already around the corner: investment and planting decisions for the counter-season have to be taken in the next few weeks at the time when lower producer prices (paddy prices went down from 600 Ar/kg in June 2008 to 450 Ar/kg in June 2009) might reduce rice intensification efforts by small commercial producers. This risk is exacerbated by the Government's intervention which has been subsidizing prices (at times of excess supply) and eliminating tariffs as well as Value Added Tax on imported rice (at times of rapidly declining international prices) that have favored imports at the expense of local production. There is an urgent need to review those policies and send clear messages to local producers.

Mixed signals in the financial sector but inflation under control

The decline in private activities and international trade, has started to affect the banking sector. The overall credit to the private sector rose between end-December 2008 and April 2009, but at a slower pace than during the same period a year ago (13 percent vs. 17 percent). Furthermore, trade and crop credits declined by 20 percent and 37 percent, respectively, over the first five months of 2009. Difficulties faced by several formal firms have contributed to an increase in nonperforming loans by 3 percent in May on top of the cumulative increase of 17 percent since end-December 2008. Also, the level of excess liquidity of the banking system fell by 14 percent between mid-January and mid-May 2009.



Source: National Statistics office

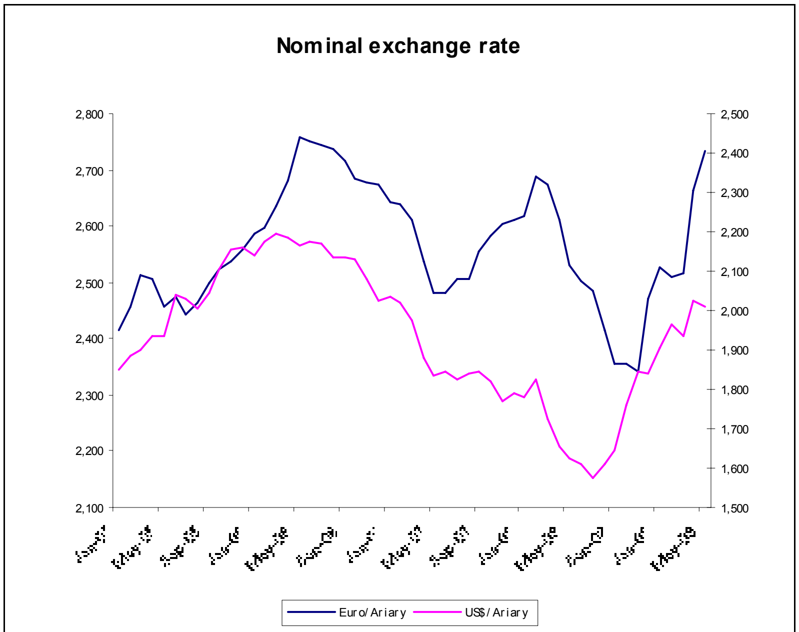
The monetary authorities have adopted a prudent policy. Notably, the Central Bank's credit to Government remained roughly stable (even down by 1 percent) between end-2008 and May 2009.

The inflation rate remained under control, declining by 0.7 percent in May compared to April, and up 9.9 percent on a year-on-year basis. Food prices as well as housing, water, gas, electricity, and transport prices all fell in May 2009. This is mainly due to the seasonal impact of the good harvest, as well as the impact of the decline in oil price.

[2] UN, Evaluation de l'Impact des crises économique et sociopolitique dans les ménages de la commune urbaine d'Antananarivo, June 2009.

The external balance appears under relative control even though the Central Bank continued to lose reserves

We have not been able to update export and imports figures beyond the first quarter of 2009.[3] Yet, it seems that the balance of payments was not under significant pressure in May, as reflected by the relative stability of the exchange rate. The local currency lost about 3 percent compared to the Euro, but gained around 1 percent vis-à-vis the US dollar. This last result partly arises from the US$ depreciation on international market, since it lost about 6 percent of its value compared to the Euro between end-April and end-May. The cumulative depreciation of the local currency amounts to 11 and 10 percent, respectively, compared to the USD and the Euro since the beginning of the year.



Source: Central Bank of Madagascar

The reserves of the Central Bank declined by 7.3 percent in May 2009 compared to its end-April level. This means that the stability of the exchange was partially preserved through Central Bank interventions. It sold more than US$15 million and Euro 2 million over the last 30 days. The cumulative decline of international reserves reached 17 percent since the end of 2008.

Looking forward

The economic performance was mixed over the past month. On the positive side, the fiscal deficit remained under control thanks to a severe adjustment in investment and non-priority spending. The key financial indicators (exchange and inflation rates) remained relative stable, reflecting prudent monetary policy and confidence in the local financial market. The good rice harvest helped to reduce pressures on poor households, both through self-consumption in rural areas and lower prices in urban areas. This buffer has given a window of opportunity for politicians to find a solution to the current political crisis.

[3] See Economic Update, May 19, 2009 for export and import figures.

This window of opportunity is nonetheless closing rapidly. Bad news includes the deterioration of several key sectors such as textile, construction and tourism. Worst, those sectors are likely to remain in distress due to the lag between the political climate and investment/order decisions, leading possibly to massive job losses in urban centers. Layoffs of workers in the textile industry might contribute to growing economic and social tensions in the coming months. In parallel, the lack of capacity of the Government to increase tax revenues (aggravated by the expected slowdown in economic activities) as well as the absence of external financing will continue to put public finances under a tight budgetary constraint. The Government has refrained from domestic monetary financing but such commitment will be tested in the near future. The main challenge will be at the beginning of the next school year (mid-September) when teachers might have to be paid without the recourse to external assistance, which was expected to cover 1/3 of teachers' salaries. Will the Government be able to pass those tests in the absence of a political agreement?