After being hit by cyclones, the food and energy crisis as well as the global financial turmoil, Madagascar is today in the middle of a severe political crisis. As a result, GDP growth could turn to be negative in 2009 – the first time since 2002 when the economy shrank by 12.7%. Three major economic risks are emerging: (i) inability of the public sector to manage its budget, and notably pay salaries, without excessive use of domestic borrowing; (ii) rising unemployment in visible and strategic sectors (tourism and textiles); and (iii) financial pressures on the local currency and/or a rapid decline in the Central Bank’s reserves.

Political update

Following weeks of political turmoil, President Marc Ravalomanana was forced to resign on March 17, 2009. The leader of the opposition, Andry Rajoelina, ex-Mayor of Antananarivo, became “President of the Transition Authority” with the support of the army. The transition – increasingly being referred as a coup by the international community – marks the culmination of a pitched power struggle that began in mid-January 2009, has put development on hold, and taken over 150 lives.

The Transition Authority proposed in early April a calendar for local, legislative and presidential elections to be concluded before October 2010. Political uncertainty is nonetheless likely to remain until a clear consensus on the way forward emerges among the political forces in the country – and the subsequent recognition by the international community.

Economic update

The impact of this crisis is difficult to predict, more so that Madagascar is also being affected by the global financial turmoil. Preliminary estimates indicate that the GDP growth rate is likely to be negative in 2009 – down from a pre-crisis projection of 7.5%. This negative impact will emerge through the combination two forces: (i) the slowdown of private activities in the industrial and service sectors, and (ii) fiscal adjustment of public spending.

General decline in economic activities will generate unemployment, notably in urban areas

Many private operators were already exposed to the lower demand for their products and services on international markets before being hit by the political crisis at the end of January. Security issues and unstable conditions have led to a drop in production that is estimated as high as 70% for hotels and restaurants. Detailed figures by sector are not
yet available for the first quarter of 2009, but all indicators underscore the severity of the recession in industry and services.

A recent survey conducted in the area of Antananarivo revealed that 48 enterprises employing 35,000 workers, suspended their activities during February. Other firms have reduced their workforce or put their employees on temporary layoffs, notably in the tourism and export-oriented sectors. Two textile companies operating in export processing zones have closed, resulting in 800 job losses over the past few weeks. Increasing unemployment is and will concentrated in urban areas, leading to urban poverty, as was the case during the 2002 crisis when GDP shrank by almost 13%, and lead to political and social tensions.

Constructions, one of the fast growing activities before the crisis, have decelerated due to the combination of lower execution of public investment projects and a slowdown in mining investment. Such a decline is visible through the 25% cut in the demand for cement during the first quarter of 2009 compared to the same period of last year.

Lower demand for energy also reflects the decline in economic activities notably in sectors such as transport and electricity. The sales of gas oil declined by 27% in February 2009 compared to a year ago.

Two factors will however help mitigate the negative impact of the current crisis on GDP growth. First, the agricultural sector has remained relatively isolated from recent external and internal disturbances, with a large majority of farmers operating in the informal sector. The weight of this sector is predominant in employment (with about 70% of the active population reporting an activity linked to the primary sector). Second, the projected increase in mining production and exports will occur since QMM/Rio Tinto will start its operation by April 2009, as initially scheduled, even tough the convention signed by this company and Madagascar could be renegotiated in the future.
The slowdown in economic activity, combined with lower commodity prices on world markets explains the relative stability in prices observed during the first quarter of 2009. Inflation increased by 1.9% in February 2009 and by 10.3% year-on-year. The most significant increases were observed in housing, water and electricity, while food prices remained stable despite a sudden but short-lived escalation when several shops were destroyed in Antananarivo and some provincial towns at the end of January. Inflationary pressure may rise in the coming months if the government finances the growing fiscal deficit through monetary creation.

**Growing public deficit could lead to a severe adjustment in public spending**

The slowdown in economic activity and the quasi-paralysis of public administration have resulted in a significant decline in domestic tax and customs revenues (respectively 20% and 35% lower than initially expected during the first quarter). More worrisome is that this gap grew to 36% and 50% respectively for domestic tax and customs revenues in March 2009 (Table1). Total revenue shortfall mounts to Ariary 146 billion or about US$73 million during the first quarter.

![Inflation Chart](image)

Source: National Statistical Office

**Table 1: Shortfall in domestic tax and custom revenues during the first quarter 2009**

<table>
<thead>
<tr>
<th>In billion of Ariary</th>
<th>Jan-09</th>
<th>Feb-09</th>
<th>Mar-09</th>
<th>Q1 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Initial objective</td>
<td>Gap</td>
<td>Actual</td>
</tr>
<tr>
<td>Domestic tax revenue</td>
<td>76.7</td>
<td>79.3</td>
<td>-2.6</td>
<td>64.1</td>
</tr>
<tr>
<td>Customs revenue</td>
<td>56</td>
<td>84.1</td>
<td>-28.1</td>
<td>64.9</td>
</tr>
<tr>
<td>Total</td>
<td>132.7</td>
<td>163.4</td>
<td>-30.7</td>
<td>129</td>
</tr>
</tbody>
</table>

1/ Preliminary figures.

On the expenditure side, a contrasted behavior has been observed. On the one hand, political spending has accelerated as reflected by the relatively high execution rate in the Prime Minister Office (36% of its total budget had been committed at the end of February), the Ministry of decentralization (26%), the Presidency (13%), the Senate and National Assembly (10%) and Public Security and National Defense (almost 10%). On the other hand, economic spending has been slow with most of the other ministries executing less than 5% of their allocated budget by the end of February.
The rapid and significant decline in public revenues, coupled with the lack of access to external financing, is expected to lead to a severe adjustment in the public sector. Aid flows to the public sector have been severely cut by the decision of almost all donors to suspend their disbursements following the change of government on March 17. Furthermore, the execution rate of existing projects has been negatively affected by changes within the administration, including Ministers and top level technicians, and uncertainties among implementation units. Madagascar is heavily dependant on external resources since grants and credits account for about half of total public budget or 3/4 of the public investment budget.

Given that the government will have to prioritize the payment of civil servant salaries and external debt service (about 30% of total budget), the fiscal adjustment is likely to concentrate on public investment that can be cut by as much as 30-40% compared to initial figures presented in the 2009 budget. Unfortunately, this cut would accelerate the recession since public investment has been the driver of growth between 2002 and 2008.

In the absence of access to external financing, the severity of the fiscal adjustment will depend on the Government’s capacity or willingness to borrow on the domestic market. So far, the T-Bills market has remained stable with even declining yield maturities. T-Bills outstanding total Ariary 705 billion at the end of March 2009, equivalent to 21% of M2. Considering the limited size of the local financial market and the small number of potential buyers, public borrowing could rapidly lead to pressures on interest rates, shortened maturities, and/or the crowding out of the private sector.

**Financial sector is over liquid but delinquent loans are on the rise**

The domestic banking sector appears to be in relatively good shape, as a result of prudent management even if detailed information is still missing on commercial bank’s balance sheets. However, two risks seem to have emerged over the past few weeks: (i) the monthly accumulation of excess liquidity by commercial banks declined by almost 40% between mid February and mid-March, thereby reducing their capacity to purchase T-bills (see above); and (ii) the amount of non-performing loans has increased by 6% between end-December 2008 and February 2009.

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1 Recently, commercial banks account for about 60% of T-Bills purchases, and this ratio has increased. Traditional non-banking buyers seem to be increasingly reticent to purchase T-bills.
Lower exports coupled with a decline in capital inflows may lead to pressures on the Balance of Payments

Trade data are not yet available but the combination of the global financial crisis and the domestic political uncertainty has severely affected exports from Madagascar. About 80% of Malagasy exports are concentrated on the recession-hit EU and US markets. The tourism sector is in disarray, with the cancellation of tours, leading to rise in layoff estimated at 80% of the workforce. The decline in imports generated by lower production and investment will limit the negative impact on the current account. Preliminary information on import and export activities can be captured by the decline in number of trade declarations in the main ports of Madagascar, which were respectively 60% and 50% lower in January and February 2009 compared to the same period in 2008. While no figures are available for exports, preliminary estimates from the customs office shows a decline of import volume by 33% and import value by 22% during the same period.

Prospects on capital inflows are gloomy. The uncertain political situation and the global crisis have pushed foreign investors to revisit their plans. Accordingly, the mining company Sheritt—by far the largest investors in Madagascar—has already announced that it will postpone some of its investments in 2009. Concurrently, as explained earlier, most donors have mothballed their project execution and new operations are on hold until the recognition of a new government by the international community.

Early signs of pressure on exchange rate and Central Bank’s reserves

During March, the Ariary depreciated by 7% compared to the EURO but remained relatively stable versus the US$. This depreciation reinforces the trend observed since the last quarter of 2008. The Central Bank has continued to intervene in the FX market as a net buyer especially of US$ since the beginning of the year.

At the end of 2008 gross foreign reserves at the Central Bank were equivalent to only 3 months of imports. Those declined by 12% (in dollars terms) between end-December 2008 and end-March 2009, reversing the trend observed over the past two years, up by almost 20% in 2008 and 60% in 2007.

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2 Source: National Office of Tourism.
3 Mainly Tamatave and Majunga ports
4 Source GASYNET, data on export and import from the Central Bank are not available.
Looking ahead

Over the next few weeks, the resolution of the political conflict will remain on top of the agenda in Madagascar. Political insecurity is the main source of economic instability but economic difficulties can also precipitate the political crisis. For example, massive job losses in the private sector (especially in EPZ) and delays in the payment of civil servants can push these two groups in the streets. The quasi-paralysis of public administration is gradually preventing the delivery of basic social services, generating poverty and growing discontent among the population.

To assess the short-term economic risks faced by Madagascar, and in spite of major information gaps, a close monitoring of the following variables is proposed: (i) capacity of the Government to pay public wages, which in turn requires a specific look at tax revenues and T-bills borrowing on a weekly basis; (ii) trend in unemployment and sales in visible and strategic sectors (tourism and textile); and (iii) financial pressures on the exchange rate (through a depreciation of the local currency) and/or on the Central Bank's international reserves. A serious deterioration in these three variables would mean growing financial difficulties, possibly imminent fiscal and balance of payment crisis, as well as further recession and poverty in the country.