

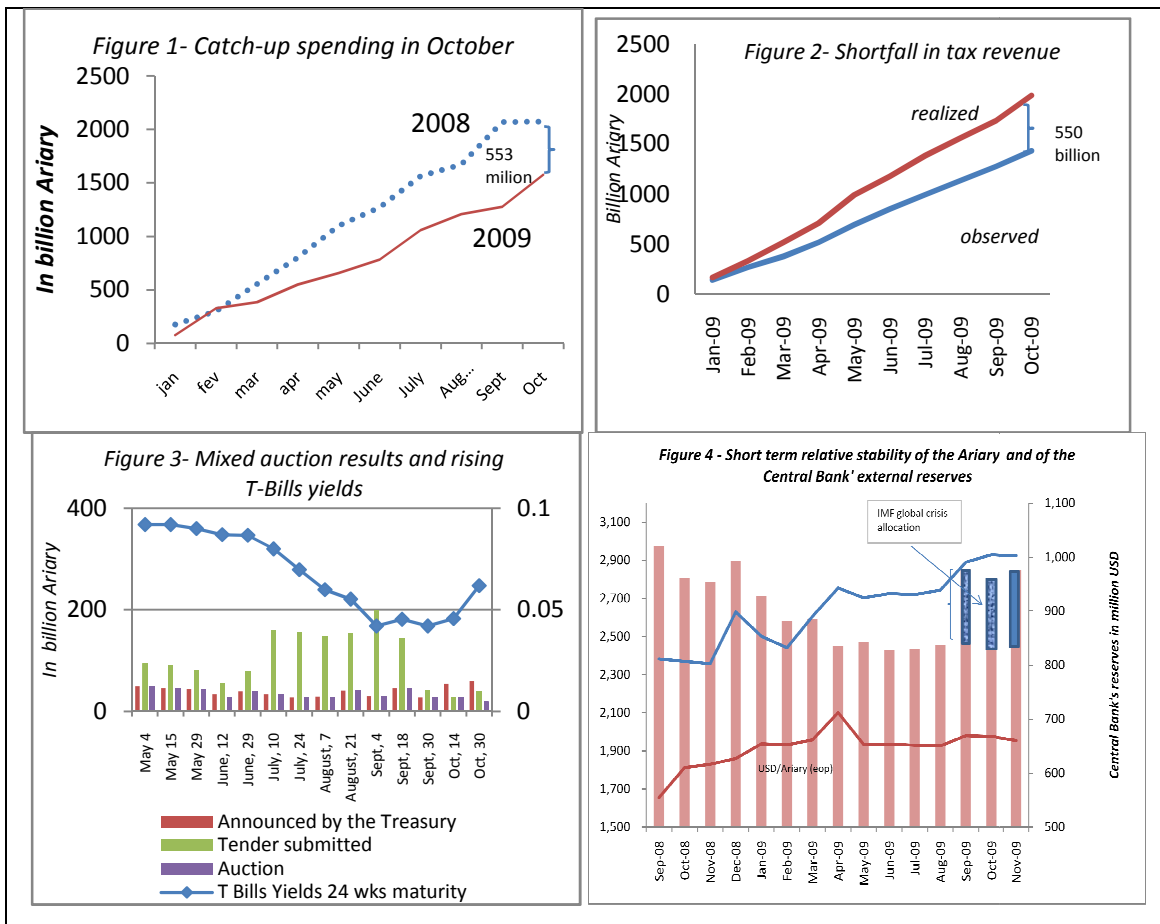
MADAGASCAR – ECONOMIC UPDATE: Growing public spending and more to come

World Bank – November 21, 2009

For the first time since the beginning of the crisis, the Government spent massively through a combination of debt-service and investment outlays in October. Other trends remained approximately the same with lower fiscal revenues, stable monetary and financial indicators, and lower economic activities.

Significant increase in public spending in spite of lower fiscal revenues and limited access to domestic borrowing

During October 2009, public spending increased significantly, reaching about 300 billion Ariary, which is about the double than the monthly level observed since the beginning of the crisis (Figure 1). The Government fulfilled its external obligation by paying more than 100 billion Ariary in debt-service. Concurrently, investment spending increased by 114 billion Ariary against a monthly increase of 54 billion Ariary between June and September. This surge in capital spending occurred in the Ministry of Public work (25% of total public investment), the Ministry of Finance (15%), the Ministry of Health (12%), and the Ministry of Education (5%). Current expenditures remained approximately at the same level than in September.



Higher public spending was not financed by improved fiscal revenues. The fiscal shortfall in October was larger than the one observed in the past few months since total realized revenues were only 60% of the ones projected in the 2009 Law of Finance (against 73% between June and September). As a result, the cumulative gap between observed and targeted revenue has now reached 550 billion Ariary since the beginning of 2009 (Figure 2). Contrary to the recent trend, domestic tax revenues were below targets in October, pulled down by lower income tax receipts that reached only 31% of their monthly objective. Custom revenues continued to be at 60% of initial projections, reflecting declining international trade flows and administrative inefficiencies.

In the quasi-absence of external financing, the Government attempted to turn to the domestic financial market. During October, the authorities announced three T-bill auctions for more than 100 billion Ariary (25% more than the monthly average between June and September) but were only capable of issuing 47 billion Ariary, in spite of increasing yields from 4 to 6% (Figure 3). This might reflect decreasing confidence from the non-banking and banking system that have started to adjust their portfolio by holding 5 % less of T-bills than in the previous month. The Government has nonetheless limited its borrowing from the Central Bank (which declined in October) in contrast to September when it borrowed significantly for the first time over the past six months.

Apparent stability on the foreign exchange market but possible realignment ahead

After the sudden but short-lived acceleration of the depreciation of the Ariary during the last week of October, the local currency reverted to its average value observed during the period from August to mid-October (Figure 4). This movement initially occurred without large intervention from the Central Bank, and might have reflected the regained confidence of the market in the aftermath of the political agreement reached in Addis-Ababa on November 4. The monetary authorities sold respectively Euro5.5 million and US\$6.9 million in the first week of November - only 1.5 % of their total international reserves.

Pressures on the balance of payments are nonetheless expected to mount in view of the persistent decline in exports (e.g., the total Malagasy exports to the US declined by 16% between September 2008 and September 2009 in value terms), lower tourism receipts (see below), and declining FDI and aid inflows. This has been only partially compensated by lower imports.

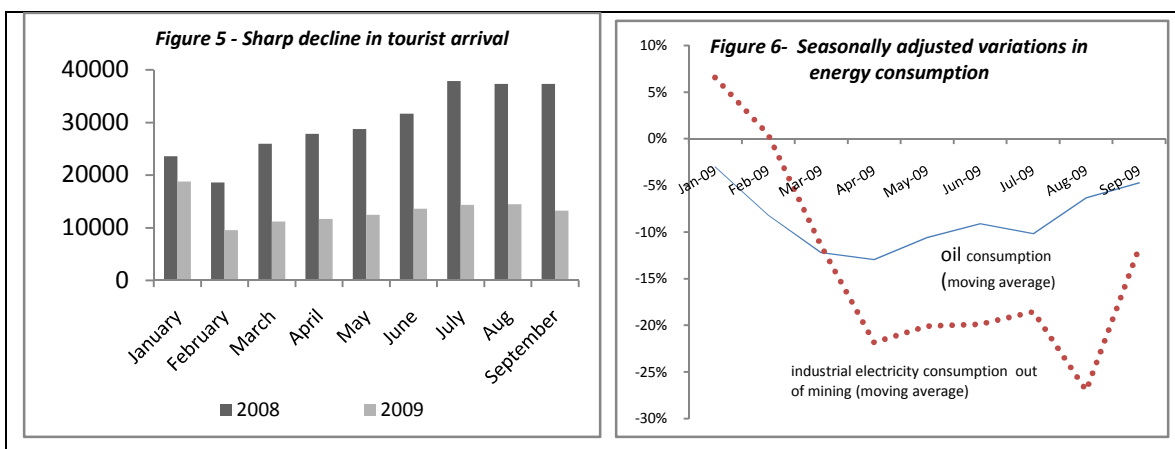
Prudent monetary policy and inflation under control

Monetary aggregates weakly increased between end-August and end-September (*M3* up by 1.6%), reflecting prudent behavior from the Central Bank and the banking system. The Central Bank's reserve money declined by 3.8% during September (and increased by only 3% during October). The banking system continued to be cautious in granting credit to the private sector, only up by 2.6% on a monthly basis between June and September (against 5.4% during the same period a year ago). This prudent banking behavior is explained by lower economic activity and increasing difficulties by firms to repay their existing loans, since non-performing loans have surged by 18% since the beginning of the year. The combination of limited credit supply and lower T-bill purchase led to excess liquidity in the banking sector that reached 24% in mid-October.

In October, inflation increased slightly by 1.1% on a monthly basis and by 7.7% on yearly basis. Only the price of rice (3.3%) and education spending (5%) increased faster as the result of seasonal adjustments due to the beginning of the school year and lean (*soudure*) season.

Slowdown in main economic activities at the exception of the mining

There is no recent detailed update available on real sector activities, except for tourism. The number of tourist arrivals reported by the Ministry of Tourism declined by 2/3 in the first 9 months of 2009 compared to the same period in 2008. The gap persisted during the last quarter (Figure 5), which will continue to impact negatively on the 25,000 (direct) jobs still employed by the tourism sector in September.¹ This pressure on formal employment will cumulate with the uncertainty surrounding Madagascar's AGOA membership, potentially putting at risk around 100,000 jobs in the textile sector.



Seasonally-adjusted variations in energy consumption provide indirect information on the recent evolution of economic activities. The overall oil and industrial electricity consumption levels remained lower than one year ago, but the year-to-year gap shrunk to 5% and 10% respectively in September (Figure 6). At the sector level, the main loser are textile (-35%), electric industry (-31%) and agro-industry (-12%); while winners are printing (35%), and mining (33%). The electricity consumption level in transport, communication, construction and services remained approximately the same than in 2008.

Looking Ahead

The political agreement concluded in early November has paved the way toward a return to a democratic order. Political parties are now working on its implementation. Over the next few months, the new Government is expected to face three daunting challenges: (i) organizing institutions and the electoral process; (ii) managing humanitarian vulnerabilities to climatic and external shocks; and (iii) minimizing the economic slowdown and job losses. These three challenges will have significant financial implications: international know-how indicates that each election might cost around US\$10-20 million (and an additional US\$5-7 million per month to run the institutions); cyclones might lead to annual recovery costs over US\$40 million based on previous experiences; and an economic stimulus package might require significant budget support, especially if the political crisis remains unresolved because firms will be reluctant to hire

¹ Source: Official statistics communicated by the Ministry of Tourism, November 2009.

and invest in an uncertain environment. Those amounts would come on top of programmed resources in the 2009-10 budgets and will produce tensions, possibly imposing trade-offs for both national authorities and donors.