International Monetary Fund

Republic of Madagascar and the IMF

Press Release:
IMF Executive Board Completes Sixth and Final Review Under Madagascar's PRGF Arrangement and Approves US$17.2 Million Disbursement
February 18, 2005

Country's Policy Intentions Documents

Republic of Madagascar: Letter of Intent

February 3, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Antananarivo, February 3, 2005

Dear Mr. de Rato,

1. Discussions for the sixth and final review of the arrangement under the Poverty Reduction and Growth Facility (PRGF), approved by the IMF Executive Board on March 1, 2001, were held in Antananarivo over December 6-20, 2004. Discussions focused on economic and financial developments in 2004, implementation of structural reforms, and economic perspectives and policies for 2005. All quantitative performance criteria at end-September, as well as the structural performance criterion and benchmarks at end-December 2004, were met, and understandings were reached on quarterly macroeconomic and fiscal targets for 2005.

2. Successive monetary-tightening measures and a prudent fiscal policy, as well as the introduction of the continuous interbank foreign exchange market, have led to the desired reduction in liquidity and to the stabilization of the foreign exchange market, and the criterion on the accumulation of net foreign assets at end-September was met. However, inflationary pressures remained strong in the second half of the year, with the CPI rising by 27 percent year-on-year at end-December 2004, and continue to be fueled by high prices for petroleum products and rice, which account for about 25 percent of the CPI basket. Excluding petroleum products and rice, CPI inflation has remained fairly stable over the last months. These developments have led to upward revisions in nominal GDP growth and in average inflation to 20.3 percent and 13.8 percent, respectively, for the year as a whole.

3. Nominal tax revenue at end-September 2004 was higher than programmed, thus allowing the corresponding performance criterion to be met. The tax revenue target for the year as a whole has been revised upward by FMG 65 billion on account of the good expected performance of customs revenue. However, in view of the low revenue elasticity with respect to GDP, this revision only partially compensates for the upward revision in nominal GDP growth, and the revenue-to-GDP target for the year as a whole is now expected to reach 11 percent of GDP, against an original target of 11.2 percent. The resolution approving the installation of the new ASYCUDA++ software at customs—a structural performance criterion under the program at end-December 2004—was issued by the Minister of Economy, Finance and Budget on December 29, 2004.

4. Budget execution at end-September was broadly on track. However, revised projections for end-December 2004 foresee a widening of the domestic balance of 0.2 percent of GDP, reflecting the difficulties encountered in budget execution during the

fourth quarter. Problems stemming from the underbudgeting of certain expenditures discussed in the September 29, 2004, Memorandum of Economic and Financial Policies (MEFP) worsened, and unanticipated budgetary needs led to expenditure overruns. These overruns reflect, in part, frequent recourse to emergency spending procedures. Overall, current primary expenditure was 0.6 percent of GDP higher than programmed; however, the impact of this increase on the domestic balance was mitigated by additional efforts on the revenue side and the downward revision of domestically financed investment expenditure. The impact of the widening of the fiscal deficit on bank financing was dampened by the rise in the contribution of the non-banking sector to the financing of budgetary operations and higher-than-anticipated privatization receipts. The government is firmly committed to implementing the measures identified in the September 2004 MEFP to strengthen expenditure control significantly, including through better control of the military wage bill, and to taking the required additional measures to prevent the resurgence of similar problems in the future. A table detailing these additional measures is attached (Attachment I).

5. Macroeconomic policy for 2005 will be geared toward limiting the second-round effects of the supply and exchange rate shocks that affected the Malagasy economy in 2004. In this context, the main economic policy objectives will be to (i) achieve real GDP growth of 6.4 percent, (ii) limit inflation to 5.5 percent on a year-on-year basis, and to 13.9 percent on average, and (iii) ensure a level of foreign exchange reserves equivalent to at least three months of imports by end-2005. To meet these objectives, the government intends to implement the policies described in the following paragraphs.

6. Fiscal policy will remain prudent in 2005, thus helping meet the inflation objective. The fiscal balance (on a commitment basis) should move to a small surplus (FMG 7 billion) in 2005, a 1.6 percent of GDP improvement from 2004, reflecting both a prudent expenditure policy, as laid out in the 2005 finance law, and the upward revision of the nominal revenue objective. The tax revenue-to-GDP ratio should reach 11.6 percent of GDP in 2005 (an improvement of 0.6 percentage points of GDP over end-2004), consistent with the objectives of the poverty reduction strategy. To ensure that this objective will be met, the 2 percentage point reduction in the VAT rate (from 20 to 18 percent) will not become effective until September 1, 2005, and additional measures aiming at, among other goals, strengthening ex post controls and intensifying the fight against fraud at customs, as well as improving cooperation between various fiscal administrations, will also be implemented. A table laying out these measures is also attached (Attachment II). The government will also start assessing measures that could increase the contribution of the mining sector to fiscal revenue, in consultation with its main development partners—in particular, the International Development Association (IDA). In the area of public expenditure management, the government will continue to implement the recommendations of the HIPC Assessment and Action Plan report, as well as the measures discussed in paragraph 4 above.

7. The objective of monetary policy is to contain inflation. The government is confident that it can meet its inflation objective for 2005 (5.5 percent at end-2005, on a year-on-year basis). Monetary growth (as measured by M3) is expected to grow by 19.2 percent in 2005, slightly lower than nominal GDP growth. To meet these objectives, the BCM will (i) further strengthen its ability to forecast and manage liquidity and foreign exchange cash flow; (ii) broaden its instruments to mop up excess liquidity, including by increasing access to treasury bill auctions, which should widen the investor base; (iii) further improve coordination between the treasury and the BCM; and (iv) develop the money market. Furthermore, banking supervision will be strengthened, in particular following the recommendations by the recent MFD technical assistance mission, with a view to preserving the soundness of the banking system.

8. On the external front, the government is cognizant of the challenges to the textile sector resulting from the termination of the MFA in early 2005 and of the third-party apparel provision of AGOA in early 2007. It will closely monitor the situation and will strive to improve Madagascar's overall competitiveness. It will also develop policies aimed at diversifying Madagascar's export base, including through an accelerated implementation of recommendations of the Diagnostic Trade Integration Framework. The government will also seek to identify specific measures designed to improve competitiveness and reduce regulatory burdens.

9. Regarding debt sustainability, the government is committed to maintaining the sustainable external debt position achieved as a result of reaching the completion point under the enhanced HIPC Initiative. To this end, it will borrow only on concessional terms following a careful analysis of Madagascar's debt burden and repayment capacity.

10. The new interbank foreign exchange market (MID) is functioning smoothly with marginal central bank intervention. The publication of the BCM-audited financial statements for 2003 and the issuance of operational guidelines for BCM interventions in the MID, which constituted structural benchmarks under the program at end-December 2004, have been met.

11. Privatization of the management of the public utilities company (Jirama) should become effective in the first half of 2005; however, the medium-term strategy for the development of the sector has not yet been finalized. The government also intends to make progress toward the privatization of the two major public insurance companies (Aro and Havana).

12. We are finalizing a time-bound capacity-building plan for several government institutions, including in the area of public debt, fiscal, and monetary management, as well as interventions in the interbank foreign exchange market. The government intends to approach its main development partners to discuss possible support to the plan's implementation.

Sincerely yours,

/s/
Benjamin Radavidson
Minister of Economy, Finance, and the Budget
Antananarivo, Madagascar

/s/
Gaston Ravelojaona
Governor
Central Bank of Madagascar
Antananarivo, Madagascar

ATTACHMENT I—LIST OF MEASURES TO STRENGTHEN BUDGET EXECUTION AND CONTROL

- Prepare terms of reference and launch the recruitment procedure for a technical assistant in the area of budget execution.

- Abolish the procedure of "spending by requisition" in the 2005 note on budget execution (*circulaire d'exécution budgétaire*).

- Establish a system strictly limiting the possibility of recourse to emergency spending procedures in the 2005 budget execution note by (i) limiting possible recourse to the emergency spending procedure to a list of pre-identified ministries and institutions; (ii) setting a system of rolling *caisses d'avances* for eligible ministries and institutions; and (iii) strictly applying the principle of non-replenishment of the *caisses d'avances* in case expenditures are not regularized within the regulatory deadline.

- Issue a communication to the Council of Government on the new procedures for emergency spending.

- Prepare terms of reference for the audit by the General State Inspectorate (IGE) of expenditure incurred through the requisition procedure in 2004.

- Ensure that the IGE transmits its audit report to the Budgetary and Financial Discipline Council.

- Accelerate the setting up of the General Finance Inspectorate (IGF) to make it operational during the first semester of 2005.

- Transfer oversight responsibility for the military wage bill to the Ministry of Economy, Finance and Budget as of January 1, 2005.

ATTACHMENT II—LIST OF ADDITIONAL MEASURES TO STRENGTHEN TAX REVENUE COLLECTION

- Intensify tax verifications through the systematic use of data generated by other financial administrations, in particular customs, the Treasury, and the public procurement office (Tax Directorate).

- Intensify verification and strengthen collection procedures on excise tax goods (Tax Directorate).

- Strengthen taxation of real estate transactions (Tax Directorate).

- Increase the rate of the Petroleum Product Tax (TPP) to offset the revenue loss stemming from the 2 point reduction of the Value Added Tax on Petroleum Products (TVAPP), starting September 1, 2005 (Customs Directorate).

- Strengthen the risk-management system at customs through improved cooperation of the pre-shipment inspection agency (systematic use of Valuenet and Profiler databases, and systematic cross -checking of customs declarations with inspection reports) (Customs Directorate).

Table 1. Madagascar: Quantitative Performance Criteria and Indicative Targets
for 2004 under the PRGF Arrangement
(In billions of Malagasy francs, unless otherwise indicated 1/

	2004										
	March Performance Criteria			June Indicative			September Performance Criteria			Is the PC or target met?	December Indicative
	Program 2/	Adjusted	Actual	Program 2/	Adjusted	Actual	Revised 3/	Adjusted	Actual		Program 3/
I. Quantitative performance criteria											
(a) Ceiling on external arrears (in millions of SDRs) 4/	0.0		0.0	0.0		0.0	0.0		0.0	Yes	0.0
(b) Floor on net foreign assets (NFA) of the central bank 4/ 5/ 6/ 7/	221.8	215.1	166.9	80.9	103.0	-139.9	1,132.1	1,197.8	1,320.6	Yes	918.7
(c) Ceiling on net domestic assets (NDA) of the central bank 6/ 7/ 8/	23.5	30.2	-176.1	249.0	226.9	13.7	-463.8	-529.6	-787.0	Yes	-219.6
(d) Ceiling on domestic financing of the government 8/ 9/ 10/	-83.3	-76.6	-2.3	108.7	94.2	68.7	-550.3	-508.6	-610.7	Yes	-659.5
(e) Ceiling on contracting or guaranteeing of external debt on nonconcessional terms 11/	0.0		0.0	0.0		0.0	0.0		0.0	Yes	0.0
(f) Floor on tax revenue	1,010.5		997.6	2,164.3		2,125.6	3,191.3		3,222.9	Yes	4,417.9
(g) Ceiling on accumulation of domestic arrears	0.0		7.0	0.0		0.0	0.0		0.0	Yes	0.0
II. Indicative targets											
(h) Ceiling on reserve money	236.3		-92.9	320.9		-137.5	-79.5	124.9	-31.9	Yes	-49.5
(i) Ceiling on broad money (including foreign currency deposits) (M3)	617.6		164.1	838.1		356.9	980.1		1,160.8	No	1,071.7
(j) Floor on arrears payments	140.8		230.0	175.3		271.6	287.0		216.9	No	347.3
III. Memorandum item:											
(k) Budget support grants and loans (in millions of SDRs)	18.0		18.0	30.1		32.1	118.7		121.1		139.7
(l) External cash debt service (in millions of SDRs)	8.2		8.9	24.9		25.2	29.3		34.75		42.4
(m) External privatization proceeds	0.0		0.0	0.0		7.5	7.5		115.0		7.5
(n) Total privatization proceeds	2.2		10.1	23.4		127.1	127.1		128.9		136.1
(o) External privatization related costs	0.0		0.0	0.0		0.0	0.0		0.0		0.0

Sources: Malagasy authorities; and Fund staff estimates and projections.
1/ Cumulative change since end-December.
2/ IMF Country Report No./04/91.
3/ IMF Country Report No./04/404.
4/ Excludes all debt service outstanding that is subject to rescheduling. During the program period, the government will not accumulate any new arrears.
5/ Defined as gross reserves minus all foreign liabilities of the BCM, both long and short term, including use of Fund credit, evaluated at the program exchange rate.
6/ Adjusted for any excess disbursements of external budget support (grants and loans; in millions of SDRs) relative to the cumulative amounts indicated in III.
7/ Adjusted for any deviation from programmed amounts of privatization receipts from abroad, net of privatization-related outlays.
8/ Adjusted for the impact of exchange rate changes.
9/ Defined as bank and nonbank financing plus treasury correspondent account (net), privatization receipts, and net accumulation of arrears.
10/ Adjusted downward to fully reflect any excess disbursements of external budget support (grants and loans, in millions of SDRs converted at the program exchange rate) relative to the cumulative amounts indicated in III, and upward up to an agreed capping amount in the event of a shortfall of external budget support, as defined above.
11/ Excluding normal import-related credits.

Table 2. Structural Performance Criteria and Benchmarks
for the Sixth Review Under the PRGF-Supported Program

	Timing	Status
Structural Performance Criteria		
No tax and tariff exemptions will be granted beyond those specified in the 2004 budget law	Continuous	Met
Issue a resolution approving the newly installed ASYCUDA ++ software and setting a date for the use of the software by customs	End-December 20004	Met
Structural Benchmarks		
Issue a resolution by the Board of Executive Directors of the Central bank (BCM) establishing the operational guidelines for BCM intervention in the interbank foreign exchange market (MID)	End-December 20004	Met
Publish the BCM's complete audited financial statements for 2003	End-December 20004	Met