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June 18, 2014

Republic of Madagascar: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

June 3, 2014

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Letter of Intent

Antananarivo, Madagascar

June 3, 2014

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
USA

Dear Madam Managing Director:

1. The past five years of transition and uncertainty have been difficult. However, following the presidential elections and the appointment of a new government, we are determined to start tackling Madagascar's urgent economic and social challenges. The government's objective is to create a solid foundation for faster growth and poverty reduction.
2. Key economic priorities include promoting a stable social and political environment that supports the economic recovery and maintaining macroeconomic and financial stability. We will also work towards developing a medium-term plan to bring the Malagasy economy back on the path of sustainable growth. To assist us in this, we are counting on the financial support of the international community, which is needed if our efforts are to succeed in materially improving living standards and employment prospects in the next few years. We are asking the International Monetary Fund to provide immediate support in the form of a disbursement under the Rapid Credit Facility (RCF) in an amount equivalent to 25 percent of quota, or SDR 30.55 million that would be disbursed to the Central Bank of Madagascar.
3. The attached Memorandum of Economic and Financial Policies (MEFP) describe the policies that we plan to implement over the next six months. The government is convinced that the policies and measures included in this memorandum will help to address our balance of payment difficulties and advance our poverty reduction and growth objectives. It will consult with IMF staff at its own initiative or at the request of the IMF Managing Director prior to the adoption of any additional measures that it may deem necessary or in the event of changes to the policies set forth in this Memorandum. The government also undertakes to cooperate fully with the IMF to achieve its policy objectives and not to introduce measures or policies that would compound Madagascar's balance of payment difficulties. The Central Bank of Madagascar is committed to undergo a safeguards assessment update by the IMF before a successor Fund arrangement is in place.
4. The Malagasy authorities agree to the publication of this Letter of Intent (LOI) and the attached Memorandum of Economic Policies (MEFP) and Technical Memorandum of Understanding (TMU), as well as the IMF staff report related to the request for a disbursement under the Rapid

Credit Facility (RCF) and the Debt Sustainability Analysis. We hereby authorize their publication and posting on the IMF website after approval by the Executive Board of the IMF.

Sincerely yours,

/s/

Mr. Jean Razafindravonona
Minister
Ministry of Finance and Budget
Madagascar

/s/

Ms. Vonimanitra Razafimbelo
Governor (acting)
Central Bank of Madagascar
Madagascar

Attachments: - Memorandum of Economic and Financial Policies
- Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies June 3, 2014

Introduction

1. **Context.** Madagascar has gone through a five-year political crisis with strong disruptions affecting the economy. Economic activity slowed, investment stagnated, and social indicators deteriorated. About 90 percent of the population lives with less than US\$2 a day (adjusted for purchasing-power parity), making poverty a critical issue for Madagascar. Social hardships were aggravated by the suspension of budget support, which forced the authorities to reduce social and infrastructure spending. In addition, domestic arrears were accumulated. However, the transition government has been able to maintain macroeconomic and financial stability thanks to prudent fiscal and monetary policies. Following presidential and parliamentary elections in 2013 and the nomination of a prime minister and appointment of the new government in April 2014, Madagascar stands ready to engage in an economic recovery and social development program with the support of development partners.

Economic Developments 2009–13

2. **In 2009, the country experienced a strong GDP contraction of 3.5 percent due to the uncertain environment and the suspension of budget support from development partners.**

Growth continued to stagnate due to lingering uncertainty, loss of preferential market access, capital outflows, and natural disasters. A modest recovery started in 2011 with average growth of 2.1 percent a year over 2011–13 mainly supported by two large world-class mining projects. Furthermore, most social indicators also stagnated or deteriorated despite the pursuit of some social and humanitarian projects financed by donors. The weak economic growth combined with the deterioration of social conditions resulted in an increasing proportion of the population living below the poverty line.

3. **The difficult economic environment had negative effects on fiscal indicators.**

In addition to declining support from our development partners (who financed 40–50 percent of the budget before 2009), tax revenue performance was weak. Strict budget control resulted in a compression of fiscal spending. However, given lack of cash resources, arrears were accumulated. Preliminary estimates, pending the result of an ongoing comprehensive audit, suggest that the stock of central government domestic arrears amounted to 3.8 percent of GDP at end–2013. The stock of public debt at end–2013 amounted to 35 percent of GDP.

4. **Tax revenue collections have underperformed significantly compared to previous years.** Total tax revenue declined from 11.8 percent of GDP in 2008 to an estimated 9.3 percent of GDP in 2013, after taking into account VAT refund obligations. This reflects weak economic activity, an increasing informal economy, and significant challenges in tax and customs administration. Direct taxes declined steadily over the period while indirect taxes stagnated.

5. **Expenditure cuts have been significant with negative impacts on social and development indicators.** Against a background of limited fiscal resources, infrastructure projects and social protection programs have had to be curtailed, setting back progress on many of the Millennium Development Goals (MDGs). This has also had a significant effect on the functioning of government, including in terms of governance institutions.
6. **To mitigate the negative impact from rising international oil prices, the government froze prices of fuel products at the pump starting in 2011.** The associated annual budgetary subsidy cost is about 1.5 percent of GDP to compensate importers for the shortfalls. In addition, the national utility company JIRAMA (electricity and water) has been operating at a significant loss for many years due to operational inefficiencies, tariff adjustments that have remained below cost recovery, and a deteriorating capital stock. As a result, arrears have accumulated to electricity suppliers in 2011, which have added to the fiscal pressures of the central government.
7. **Monetary aggregates have been kept broadly in check and inflation has by and large remained in single digits for the period.** After peaking at 16.4 percent in 2011, broad money growth (M3) declined rapidly to 5.5 percent in 2013. While subdued demand kept credit to private sector growing more or less in line with nominal GDP through 2012, it accelerated in 2013 mainly due to overdrafts, including those related to imports of petroleum products, and to a lesser extent medium-term (working capital) and long-term (working capital and financing of housing construction) borrowing. The banking sector has remained reasonably profitable and liquid.
8. **The mining sector is an important component of balance of payment flows.** The current account deficit peaked at 21 percent of GDP in 2009, on the back of associated imports of investment goods, financed by FDI inflows. It has since declined to 5.3 percent of GDP at end-2013. After peaking at 3.7 months import cover at end-2011, foreign exchange reserves started to decrease in 2012. The decline accelerated in 2013 due to agreed subsidies on petroleum product imports and rapidly increasing food imports. This took place against a background of decreasing FDI and persistent net outflows from private sector transactions that increased ahead of the 2013 elections. As a result, foreign exchange reserves fell to 2.2 months import cover at end-March 2014.
9. **The real effective exchange has appreciated in recent years,** as price increases have been faster compared to price increases in trading partner countries. While the nominal effective exchange rate depreciated by about 19 percent between end-2008 and end-2013, it appreciated by about 5 percent in real terms.

Policies for 2014

10. **The government's immediate objective is to create a solid foundation for faster growth and poverty reduction.** In this context, priorities for 2014 are: (i) promoting a stable social and political environment that supports the economic recovery; (ii) maintaining macroeconomic and financial stability; (iii) enhancing food security and the safety of people; (iv) expanding access to health services and education; and (v) strengthening social protection. A medium-term plan will

also be developed to bring the Malagasy economy back on the path of durable growth conducive to sustainable and inclusive development and to re-engage with the international community. Improved coordination with our development partners and disbursements of external financing will help support the reform process.

11. **The overall resource envelope of the 2014 budget is insufficient to address Madagascar's urgent expenditure needs.** The budget law envisages an overall deficit of 1.6 percent of GDP in 2014, based on continued expenditure compression (a steady trend decline in capital spending and budgeted non-wage current spending 40 percent less than expenditure commitments in 2013). The resource envelope does not allow for the clearance of arrears, including VAT refunds, fuel subsidies, JIRAMA-related arrears, and debt owed to the central bank.

12. **A supplementary budget will be submitted to the National Assembly in July 2014.** This supplementary budget law takes into account additional tax revenue that can be realistically mobilized as well as additional budget support by our development partners. On the revenue side, we have initiated internal diagnostics of both the tax and customs administrations (supported by technical assistance). Measures that we intend to take in the short term include:

- Improved controls to reduce the under invoicing of imported goods (in accordance with WTO rules), after prior consultations with private sector representatives, in particular GEM, SIM, and FIVMPAMA;
- Increased scanner detection and physical inspection of imported goods to deter fraudulent declarations;
- Enhanced enforcement of invoiced sales and licensing of commercial and sectoral activities, primarily through increased inspection on the ground and enforcement of excise obligations;
- Increased collaboration and information sharing between the tax and customs administrations.

Taking into account these measures, we expect overall tax collections (cumulative from the beginning of 2014) to amount to MGA 1,114 billion at end-June, 1,707 billion at end-September, and MGA 2,834 billion at end-December 2014.

13. **This supplementary budget envisages a spending increase on infrastructure as well as on essential government services in line with our priorities.** We attach particular importance to ensure that social outlays are adequately provided for. In particular, we are committed to ensure that outlays on education, health, and nutrition will be at least (cumulative from the beginning of 2014) MGA 64.8 billion at end-June, 108.7 billion at end-September, and MGA 215.4 billion at end-December 2014.

14. **The government is committed to avoid the accumulation of new domestic budgetary arrears and to settle the stock of existing arrears as soon as practicable.** Given the size of existing arrears, a three-year strategy to repay existing arrears will be developed, which includes an appropriation in the 2014 supplementary budget of MGA 200 billion for partial clearance of arrears.

Bilateral discussions with creditors have started to ensure that repayment agreements are consistent with this overall strategy. In addition, a strategy to finance a repurchasing of this debt will be considered, while respecting the concessionality guidelines. With regards to the central bank, it was agreed to settle outstanding obligations through securitization and issuance of a debt instrument with 15 years maturity, 3 years grace period, and at an interest rate equal to the central bank's policy rate. With respect to government debt owed to ARO and SPAT, the Treasury has issued special Treasury bonds to settle these obligations.

15. **Overall, the 2014 supplementary budget aims at an overall budget deficit (commitment basis) of 2.1 percent of GDP.** Revenues would amount to 11.1 percent of GDP, current spending would amount to 10.8 percent of GDP, and capital spending would amount to 6.1 percent of GDP. Bank financing of the fiscal deficit would be kept to no more than 1.3 percent of GDP.

16. **As part of the longer-term objective of addressing Madagascar's public finances and ensuring their sustainability, the government will also focus efforts on improving public financial management (PFM).** In line with the findings of the 2013 Public Expenditure and Financial Accountability (PEFA) assessment and the recent PFM diagnostic mission from the Fund, the government will take actions in several areas:

- Improving transparency, accountability and governance of public finances. An action plan to finalize the settlement laws for fiscal years 2008–13 in accordance with the legal timeline will be prepared by July 2014. There will be a strengthening of capacity and resources at key governance institutions (General Inspection of the State, General Directorate of Financial Control, Inspection of the Treasury, and BIANCO) and broadening of their authority to ensure accountability. In addition, the setting up of the Council for Budgetary and Financial Discipline will be effective by October 2014 and the High Court of Justice will be operational within the next 12 months.
- Improving budget execution monitoring and control, through modernization of the information management system in order to better track spending through the cycle, strengthen embedded internal control devices and fasten the production of financial statements.
- Formulating a medium-term strategy to modernize the PFM system with the support of our development partners.

17. **The government has announced the return to market-determined prices of fuel products at the pump.** The current fuel-price subsidy is very costly (1.5 percent of GDP per year) and is not well targeted. Consequently, starting July 1, 2014, gradual increases of the prices will be undertaken every three months by an amount of at least MGA 100 (one hundred MGA), adjustable depending on the circumstances until government subsidies are no longer necessary. At that point, the minimum price will be determined by the OMH automatic pricing mechanism. This process should take no longer than 12 months from the effective implementation of the supporting measures elaborated in paragraph 18. Studies show that the inflationary impact of this measure

would be relatively modest and short-lived. As part of this process, it has been agreed with the petroleum companies to increase the quality of diesel to international ultra-low-sulfur standards of 50 ppm.

18. Conscious of the social implications resulting from the fuel subsidy removal, the government will put in place mitigating policies, with the support of our development partners, to include:

- Targeted subsidies for public transport in urban areas. These subsidies, of a temporary nature, will help moderate the pass through of fuel price increases to urban transport fares. This program will be put in place in the context of the 2014 supplementary budget.
- An expansion of the “cash-for-work” program in rural areas.
- An extension of the pilot program of cash transfers conditional on school participation.
- An expansion of the school-kits program to a larger number of regions.

Information campaigns on these supporting measures have been planned.

19. It is essential to scale up infrastructure spending over the medium term, while preserving debt sustainability. A medium-term investment and debt management strategy will be prepared to ensure that public and external borrowing remains within limits that maintain debt sustainability. As such, external public sector borrowing that is undertaken will be limited to concessional sources. That said, if all possibilities for concessional external financing are exhausted, Fund and World Bank staff will be consulted in advance to consider the option of non-concessional borrowing to meet critical infrastructure needs. As part of the reinforced dialogue with development partners, a donor conference to discuss medium-term priorities is planned for the last quarter of 2014. A private-public partnership (PPP) framework will also be prepared.

20. Monetary policy will aim to maintain single-digit inflation. To this end, the Central Bank is committed to maintain a prudent monetary stance anchored on the agreed indicative targets on net domestic assets and net foreign assets for the remainder of the year. The Central Bank will begin to rebuild its reserve cover, while letting the official exchange rate be determined by market conditions. By end-2014, the foreign exchange reserve stock will amount to at least SDR 529 million (2.3 months of import cover). The monetary authorities will not engage in activities or take measures that could introduce or intensify exchange and trade restrictions.

21. An inclusive financial sector and financial deepening will require comprehensive reforms. Against this background, the reform agenda will comprise: (i) the establishment of a framework for the development of the financial market; (ii) central bank internal audit and control functions; and (iii) banking system supervision and financial regulation. The legal framework will be reviewed to ensure that it incorporates best international practice in the area of anti-money laundering and combating financing of terrorism, which in turn would complement anti-corruption efforts. Madagascar will join the regional institution Eastern and Southern African Anti-Money

Laundering Group (ESSAMLG) and will pursue a prompt consideration by the National Assembly of the Law on Combating the Financing of Terrorism. The Central Bank is committed to continue addressing weaknesses identified by the last safeguards assessment, including making the Central Bank accounting framework compliant with IFRS norms, and would welcome an updated assessment in the near future. Following Parliamentary approval by the National Assembly, the Central Bank will continue the publication of the annual audited financial statements. Technical assistance from the IMF and other development partners will be important for progress in these areas.

Other issues

22. **Structural reforms are essential to bring the Malagasy economy back on the path of sustainable and inclusive growth.** In particular, this involves reforms advancing good governance and the rule of law, creating a level playing field for the private sector, and encouraging foreign investment. In this context, the government is preparing a new poverty reduction and growth strategy (PRS) to be completed in October 2014. On this basis, we would aim to present a macroeconomic program and an agenda of structural reforms that could be supported by an IMF arrangement under the Extended Credit Facility.

23. **The government will elaborate a plan to revitalize the public utility company JIRAMA.** Short-term measures include management and operations reforms, in particular to eradicate theft. In the medium term, the government envisages to take measures to control the price and volume of fuel products and to reduce the amount of electricity losses. It will also address issues related to electricity tariffs, increase in operational efficiency, and compliance by JIRAMA with the provisions of the law on commercial companies.

24. **Close engagement with development partners is essential.** The Malagasy Government looks forward to a further strengthening of the ongoing collaboration on key issues aimed at addressing the challenges of Madagascar. The Malagasy Government seizes this opportunity to encourage development partners to move quickly and provide essential concessional financing, ideally in the form of budget support.

Table 1. Madagascar: Indicative Targets 2014¹

	Jun. Proj.	Sep. Proj.	Dec. Proj.
(Billions of Ariary; unless otherwise indicated)			
External			
Ceiling on accumulation of new external payment arrears (millions of SDRs) ²	0	0	0
Central bank			
Floor on net foreign assets (NFA) of BCM (millions of SDRs)	0	18	40
Ceiling on net domestic assets (NDA) of BCM	41	119	130
Fiscal			
Ceiling on net bank credit to central government (ceiling)	106	210	348
Floor on tax revenue	1,114	1,707	2,834
Floor on social priority spending	65	108	215
Memorandum items			
External budget support (millions of SDRs)	0	38	120
Capitalization of BCM losses as a result foreign exchange subsidies	113	113	113
Sources: Madagascar authorities; and IMF staff projections.			
¹ Cumulative figures from the beginning of the year.			
² This target will be monitored on a continuous basis starting from end-May, 2014.			

Attachment II. Technical Memorandum of Understanding on Monitoring Indicative Targets

1. This technical memorandum of understanding (TMU) defines the variables used to establish the indicative targets for 2014, how they are calculated, and any adjustments that may be necessary. Unless otherwise indicated, flow variables are measured as cumulative from the beginning of the calendar year.
2. The definition of the central government (CG) corresponds to the scope of operations of the treasury, as shown in the *opérations globales du Trésor* (or OGT).

A. Ceiling on External Payments Arrears

3. These arrears consist of overdue debt-service obligations (i.e., payments of principal and interest) related to loans contracted or guaranteed by the government or the Central Bank of Madagascar (BCM). Debt service obligations (including unpaid penalties and interest charges) are overdue if they have not been paid by the due date or within a grace period agreed with, or unilaterally granted by, each creditor before the due date. They exclude arrears resulting from nonpayment of debt service for which rescheduling negotiations are under way or that are in dispute. This indicative target should be observed on a continuous basis.

B. Non-concessional External Borrowing

4. If the CG has a special need for external non-concessional financing, consultations with IMF staff should take place well in advance of signing of a loan contract or loan guarantee.

Definition

5. Non-concessional external debt has a grant element of less than 35 percent. The commitment to consult with IMF staff applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (IMF Executive Board Decision No. 12274–00/85, August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. Non-concessional debt includes financial leasing and any other instrument giving rights to a current financial liability, under a contract or guarantee by the CG of Madagascar (defined in paragraph 2), but it excludes debt contracted under rescheduling agreements and normal import-related credits of less than one year.

Calculation

6. Calculation of the degree of concessionality of new external borrowing is based on a 5 percent discount rate.

C. Floor for Net Foreign Assets of the Central Bank of Madagascar

Definition

7. The net foreign assets (NFA) of the Central Bank of Madagascar (BCM) are defined as the difference between its gross foreign assets and total foreign liabilities, including debt to the IMF.

Calculation

8. The change in NFA will be measured in SDRs. Assets and liabilities denominated in other currencies than SDRs are converted to SDRs at the exchange rate prevailing at the time of outcome. If budget support (external grants and loans) falls short of projections, the indicative target for NFA will be adjusted downward by the difference, for up to SDR 60 million.

D. Ceiling on Net Domestic Assets of the Central Bank of Madagascar**Definition**

9. The net domestic assets (NDA) of the BCM are defined as the difference between reserve money and the NFA of the BCM measured in MGA. It includes net credit to the government, credit to enterprises and individuals, claims on banks, liabilities to banks (including the proceeds of BCM deposit auctions—*appels d'offres négatifs*, and open market operations), and other items net.

Calculation

10. When calculating NDA, NFA is converted to MGA at the fixed exchange rate of:

$$1 \text{ SDR} = 3,455.1 \text{ MGA.}$$

E. Ceiling on Net Bank Claims on the Central Government (CG)**Definition**

11. Net bank claims on the CG are measured by net credit to government in the monetary survey, which consists of BCM and commercial bank claims on the CG, including auctioned treasury bills (BTAs) and other securities and liabilities, net of CG deposits with the BCM and commercial banks, including foreign currency deposits.

Calculation

12. The ceiling on Net Bank Claims on the CG will be adjusted downward by any shortfall in capitalization of Central Bank of Madagascar foreign exchange losses due to petroleum price subsidies.

F. Floor on Tax Revenue**Definition**

13. Tax revenue includes all domestic taxes and taxes on foreign trade received by the CG treasury.

G. Floor on Priority Social Spending**Definition**

14. Priority social spending includes spending primarily related to interventions in nutrition, education, health, and the provision of social safety nets.

Calculation

15. Priority social spending is calculated as the sum of spending defined above related to (i) the Presidency; (ii) the Prime Minister's Office; (iii) the Ministry of Finance and Budget; (iv) the Ministry of Health; (v) the Ministry of Population and Social Affairs; and (vi) the Ministry of National Education. (See table 2).

H. External Budget Support**Definition**

16. External budget support is defined as cash budget loans and grants (i.e., not linked to projects) that are provided as financing and result in funds available to the treasury.

Calculation

17. External budget support is converted to SDRs at the exchange rate prevailing at the time when the transaction takes place.

Table 2. Madagascar: Social Spending in 2014 by Ministry
(Billions of Ariary)

01. Présidence (Presidency)

031. Coordination de la lutte contre le sida	
068. Appui au développement des localités cibles	
069. Renforcement de la sécurité présidentielle	10.6
071. Renforcement de la lutte contre le blanchiment de capitaux	
070. Service civique au service développement humain et durable	

05. Primature (Prime Minister's Office)

066. Cellule de prévention et gestion des urgences (CPGU)	1.5
095. Projet d'urgence de sécurité alimentaire et de reconstruction	

21. Ministère des Finances et du Budget (Ministry of Finance and Budget)

189. Appui d'urgence aux services essentiels d'éducation, de santé et de nutrition	
190. Projet d'urgence pour la préservation des infrastructures et la réduction de la vulnérabilité	
192. Projet UE - gouvernance - finances publiques	85.4
193. Appui aux couches défavorisées	
194. HIMO - Développement	

71. Ministère de la Santé (Ministry of Health)

022. Appui à la politique de survie de la mère et de l'enfant (ex bien être de la famille)	
024. Appui au système hospitalier de référence	
025. Appui aux programmes de lutte contre les maladies transmissibles	
026. Appui aux districts sanitaires	
028. Equipes sanitaires mobiles	22.0
041. Projet de développement d'un système de santé pérenne (swaps)	
044. Utilisation accrue sces et produits de santé sélectionnés (ex appropop)	
045. Appui aux programmes de lutte contre les maladies non transmissibles	
046. Appui aux programmes de lutte contre les maladies epidemo-endémiques	

76. Ministère de la Population et des Affaires Sociales (Ministry of Population and Social Affairs)

031. Droits et protection des enfants (ex: services urbains de base)	
032. Appui au regroupement communautaire	
040. Appui aux ménages en difficulté	
043. Appui à la promotion de la participation des ONG dans les projets sociaux	
046. Amélioration de la condition de vie des personnes âgées	
056. Appui aux services sociaux de base	
066. Fonds social de développement VIII	2.0

81. Ministère de l'Education Nationale (Ministry of National Education)

104. Appui à l'enseignement primaire en matière de nutrition	
105. Redynamisation de l'enseignement primaire	
107. Education pour tous (volet MINESEB)	
110. Appui aux écoles endommagées par les cyclones	
130. Construction/rehabilitation des bâtiments administratifs	
131. Appui à l'intégration des tics	
135. Amélioration de la qualité de l'éducation à Madagascar (AQUEM)	
138. Programme d'appui aux services sociaux de base - éducation (PASSOBA)	
136. Projet d'appui d'urgence à l'éducation pour tous (PAUEPT)	93.9

Total	215.4
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Source: Malagasy authorities.