PD-ABH192
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U.S. Agency for International Development
MADAGASCAR

FINANCIAL MARKET DEVELOPMENT

Program Assistance Approval Document

687–0120 (PA)
687–0121 (NPA)

August 1993

USAID/Madagascar
Antananarivo, Madagascar

U.S. Agency for International Development
Washington, D.C. 20523
U.S.A

AGENCY FOR INTERNATIONAL DEVELOPMENT
PPC/CDIE/DI REPORT PROCESSING FORM

ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT

1. Project/Subproject Number	2. Contract/Grant Number	3. Publication Date
687-120		08/25/93

4. Document Title/Translated Title

Financial Market Development – Combined Program Assistance Approval Document (PAAD) and Project Paper (PP)

5. Author(s)

1. USAID/Madagascar
2.
3.

6. Contributing Organization(s)

USAID/Madagascar

7. Pagination	8. Report Number	9. Sponsoring A.I.D. Office
193p.		AFR

10. Abstract (optional – 250 word limit)

The goal of the Financial Market Development Program is to increase investment and employment in the private sector to increase the level of domestic financial savings and the share of savings going to the private sector.

11. Subject Keywords (optional)

1. Financial Sector	4. Financial Management
2. Private Sector	5. Savings
3. Policy Framework	6.

12. Supplementary Notes

13. Submitting Official	14. Telephone Number	15. Today's Date
Frank D. Martin, Economist	261-2-254-89	11/17/93

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16. DOCID	17. Document Disposition
	DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

Combined Program Assistance Approval Document (PAAD) and Project Paper (PP)

Annexes:

Figures

Tables

ACTION MEMORANDUM FOR THE ACTING DIRECTOR
USAID/MADAGASCAR

DATE: August 20, 1993

FROM: William Hammink, PDA

SUBJECT: Program Assistance Approval Document (PAAD) Approval and Authorization

PROGRAM: Financial Market Development
NPA No. 687-0121 (687-T-605)
Project No. 687-0120

I. PROBLEM: Your approval is required to: (1) approve and authorize the Financial Market Development (FMD) Program (687-0121) with a four year Life-of-Program and a funding level of $6,000,000; and (2) approve and authorize the FMD Project (687-0120) with a four year Life-of-Project and a funding level of $4,000,000. While being approved and obligated separately, the Program and Project share one Program Assistance Approval Document.

II. BACKGROUND:

Major increases in domestic and foreign investment must take place in Madagascar to have sustainable economic growth. A high level of domestic investment requires significant savings. However, Madagascar's financial system operates in an economy which has one of the lowest savings rates among developing countries and whose financial depth is among the most shallow. Part of this is simply due to the fact that Madagascar remains among the fifteen poorest countries in the world. However, a number of other countries of similar income levels in Africa and especially in Asia exhibit markedly higher levels of aggregate and financial savings. In Madagascar, a major problem is the financial system; the majority of the population have very limited or no access to the financial services of formal financial institutions.

Notwithstanding the reforms of recent years in the financial sector, there persists a problem of confidence in existing financial institutions and instruments, reflecting continued suspicions and fears of the financial system engendered by past policies.

The Central Bank is at the heart of the financial system. Its weaknesses radiate out through the other financial institutions, producing negative impacts in the real economy in terms of low investment and economic growth. A poorly conceived and ineptly implemented monetary policy retards financial sector development and prevents the financial sector from mobilizing the resources for the real economy.

The Government of the Republic of Madagascar (GRM) recognizes this. In 1992 the GRM asked the World Bank to take the lead in organizing technical support to upgrade the ability of the Central Bank to design and implement monetary policy. The World

Bank responded by designing, in collaboration with the Central Bank and three bilateral donors including USAID, its Financial Institutions Development Technical Assistance Project (FINDEP). The project was approved by the World Bank's Executive Board on May 25, 1993. FMD was designed as parallel financing to FINDEP for assistance to the Central Bank. Switzerland and Sweden will also provide parallel financing to FINDEP.

At the same time, USAID is mandated to ensure that its programs lead to sustainable, broad-based economic growth; with particular emphasis to be given to extending the benefits of economic growth to low-income rural and urban households. Central Bank operational efficiency is a necessary, but not sufficient, condition for low-income household access to the services of the financial sector. In Madagascar, the poor's need for safe, reliable and convenient forms of financial savings are inadequately met by formal financial institutions.

FMD will support the only existing financial institution in Madagascar that targets low-income households as its clientele, Caisse d'Epargne de Madagascar (CEM). CEM has a vast network throughout the country capable, in theory, of putting virtually the entire population in touch with the financial sector. Assessments of the CEM undertaken by USAID show obvious ways in which the financial services offered by CEM could be improved.

III. DISCUSSION:

The goal of the FMD program is to increase investment and employment in the private sector. The purpose is to increase the level of domestic financial savings and the share of savings going to the private sector. The Program comprises both non-project Cash Grant and Project Assistance. The Cash Grant component involves disbursement of $6,000,000 in two tranches based on the GRM meeting performance criteria considered essential to achieve FMD Program objectives. The Project component has a total value of $4,000,000 and extends over a period of four years. The Program Assistance Completion Date (PACD) is September 30, 1997.

FMD targets two intervention areas:

(i) FMD will develop the capacity of the Central Bank of Madagascar to implement stable, non-inflationary monetary policies consistent with free market principles.

(ii) FMD will develop the capacity of the Caisse d'Epargne de Madagascar to improve the access, user-friendliness and interest rate incentives for savers at CEM.

The FMD policy framework centers on institutional and operational changes that are essential to permit the Central Bank and the CEM to successfully carry out their functions in the Malagasy financial sector. The policy reforms of FMD are situated in a larger financial sector reform program being carried out by the GRM, and supported by the World Bank and other donors.

Program implementation will involve key players within the GRM, USAID, BCRM and CEM. Within the GRM, implementation of FMD will involve the Ministry of Finance, which will be responsible for the overall oversight and coordination of the Program. BCRM and CEM will be key technical institutions for Program implementation. Within

USAID, the Market and Business Development (MBD) Office will be responsible for overall management of FMD. The Private Sector Officer in MBD will be the FMD Project Officer and will be assisted by a Program Assistant for day-to-day management and coordination.

The Cash Grant will be disbursed by A.I.D. in two separate tranches of $3 million each, expected to occur prior to December 31, 1993 and December 31, 1994, respectively. The GRM will use each tranche disbursement to service eligible debt as approved by USAID.

A summary of the Project illustrative budget appears below.

ESTIMATED BUDGET EXPENDITURE
(in 000's)

EXPENSE CATEGORY	LIFE-OF-PROJECT FUNDING AID	GRM
Technical Assistance	$1,229	0
Training	1,8C7	0
Commodities	310	0
Studies and Analysis	330	0
Program Assistant	65	0
Other Direct Costs	0	2,000
Evaluation and Audit	130	0
Contingency	129	0
Total	$4,000	$2,000

A comprehensive monitoring and evaluation plan is included in the PAAD. There will be two evaluations. The first evaluation will take place 20 to 24 months after project implementation begins and the second will take place 6 to 10 months before the PACD. The Program will also provide for two non-federal audits to ensure that FMD funds have been appropriately utilized.

As part of the design process, the following analyses were conducted: economic, political, institutional, social and environmental. Summaries of each are included in the PAAD, and full analyses are shown as annexes.

IV. PAIP ECPR ISSUES

A. The following issues were raised during the review of the PAIP in April 1993 at the Mission and required certain actions in the PAAD design. They have been addressed as noted:

1. **Should an agreed macroeconomic framework and stabilization program be a pre-condition for FMD approval?**

At the CPSP reviews in Washington in October 1992, the Africa Bureau agreed to give the Mission approval authority for FMD but told the Mission that FMD should be a fourth quarter obligation and that Madagascar should have made progress in the political and economic liberalization fronts. In addition, a critical assumption for significant benefits accruing from the FMD program is that new fiscal policy would lower budget deficits while the tight fiscal control would enable CEM's savings mobilization to increase financial resources for the private sector.

The PAIP ECPR required the PAAD to clearly describe the assumptions for increased domestic savings as a result of program activities and the scenario for stabilization and structural adjustment programs with the World Bank and the IMF. The PAAD contains detailed assumptions on the link to increased domestic savings and credit to the private sector and provides a credible scenario and rationale for expecting agreement on a macroeconomic package.

2. **Is the planned assistance to CEM consistent with AID policy on parastatals?**

A.I.D. guidance clearly favors private sector financial institutions. However, the Development Fund for Africa (DFA) also stresses the need to target assistance to the urban and rural poor. The PAAD addresses this issue by showing that (a) there is no private sector financial institution which has or desires to have low-income households as its target clientele while CEM does, (b) the cost of creating a new private financial institution to serve low-income households under the project would be prohibitive, and (c) the FMD program will lay the groundwork for the eventual introduction of private equity ownership in CEM.

B. The following concerns were also raised at the PAIP ECPR, and have been addressed as follows:

1. **FMD contribution to the Central Bank and overall financial sector liberalization.** The PAAD contains a clear discussion of the impact of the Central Bank component of FMD to the overall financial sector liberalization activities. Also, the PAAD contains conditions for cash transfer specifically related to the Central Bank reforms.

2. **Is FMD contingent on the World Bank's project being approved?** FMD is a parallel financing to the World Bank financial sector project. The World Bank's Executive Board approved their project on May 25, 1993.

3. **People level impact.** The average size of an account at CEM is about $20.00. A survey undertaken during PAAD design found that most savers had an income of less than $50/month. The survey verified that CEM's current and potential customers are sensitive to the quality of service offered by CEM. The expected growth rate at CEM as a result of the program means that an estimated 215,000 additional households, mainly poor, will be receiving services from the financial sector by the end of the program.

V. PROGRAM REVISION FROM PAIP TO PAAD

The major difference between the PAIP and the PAAD relates to the inclusion of policy conditions related to the Central Bank into the list of conditions for NPA cash disbursement and the disbursement of the NPA in two tranches instead of just one. The Mission included significant Central Bank reforms as conditions for cash disbursement in the PAAD to assure that these reforms take place. The Central Bank conditions precedent are related to but different from the World Bank conditions, and are necessary for the attainment of the Central Bank component objectives and the realization of maximum impact from the planned project assistance.

The PAAD design team, after negotiations with the government, decided to disburse NPA funds in two tranches because some of the required reforms could take place soon after the project agreement is signed whereas other conditions would take over one year to be fulfilled.

VI. OTHER REQUIREMENTS

A. Documentation

1. Statutory Checklist. The statutory checklist is included as Annex L to the PAAD.

2. Cash Transfer Approval. The Action Memorandum approved by the AA/AFR is included as Annex H.

3. Approval to Service Eligible Debt. Also included in the Annex H Action Memorandum is the AA/AFR approval to use the cash disbursement to service eligible multilateral debt.

4. Initial Environmental Examination (IEE). The Bureau Environmental Officer and GC/AFR have approved a categorical exclusion in the IEE for FMD. The IEE is included as an Annex to the PAIP.

5. Source/Origin. The authorized A.I.D. Geographic Code for procurement of goods and services, with the exception of ocean shipping, air travel and transportation services, is Code 935 and Madagascar. Shipping and air travel/transportation regulations are specified in the Program and Project Grant Agreements. Pursuant to new source/origin guidance from the Africa Bureau for the use of DFA, the Mission will maximize procurement of goods and services from the U.S. The Procurement Plan is shown in Annex J. With the exception of some limited training in specialized schools in Europe and the possibility of observation tours in other less developed countries, all procurement is planned to come from the U.S. or Madagascar.

6. Technical Reviews. The PAAD has been reviewed by the Regional Legal Advisor, the Contracts Officer, the Mission Controller, the Program Officer and the Project Development Officer. All clearances have been noted on the PAAD clearance sheet.

7. Congressional Notification (CN). The CN for the FMD program expired without objection on July 15, 1993 per State 237549 dated August 5, 1993.

B. Twenty-Five Percent Host Country Contribution. The GRM will contribute the local currency equivalent of at least $2 million, which, with the A.I.D. contribution of $10 million, is about 16% of the total program cost of $12 million. The AA/AFR approved a waiver of the requirement for a full 25% host country contribution on June 21, 1993 (Annex G).

VII. MISSION REVIEW

USAID/Madagascar held an Issues Meeting for the FMD program on July 7, 1993 and a full Executive Committee for Program Review (ECPR) on July 23, 1993, chaired by the Mission Director. The following issues came up and were resolved.

A. Progress on Macroeconomic Framework. At the CPSP review, the Mission agreed to monitor the macroeconomic situation, realizing that standby agreements would not be signed by August 1993 because of the political agenda, keep AFR/W informed on progress, and make a judgement on the commitment of the GRM prior to FMD approval. Based on recent events as outlined in the PAAD, and a letter in mid-July from President Zafy to the heads of the World Bank and the IMF which staked out the new President's commitment to liberal economic reforms and early agreement with the Bretton Woods institutions, the ECPR agreed with the judgement that Madagascar was fully committed to a new macroeconomic framework and early agreement on a macroeconomic program. Also, while FMD would be approving balance of payments support through debt repayment before a macroeconomic framework is in place, the first tranche will be not disbursed before November or December 1993 and by that time we will know for sure if the IMF/WB macroeconomic program is on line. It was also agreed that the PAAD language on progress to date should be strengthened to include discussion of the letter from President Zafy.

B. Contracting/Procurement. About $2.4 million of the total $4 million for project assistance for both components was to be contracted through AID/W buy-ins or IQCs through a series of separate actions. The ECPR discussed possible contracting options which would be less intensive, more efficient, and less expensive. Also, the PAAD made no mention of possible Gray amendment contracting other than the statement that 10% of all buy-ins would be with Gray firms. However, because the needed assistance is targeted and short-term for each component, and the technical assistance from the U.S. is related to specialized financial activities, the ECPR agreed that putting everything into one institutional contractor would not be possible and that Gray amendment firms might not have the necessary specialized financial experience. Instead, the ECPR decided that, as much as possible, short-term technical assistance and training within each component should be grouped together under buy-ins to provide continuity and increase efficiency.

C. GRM Management Responsibilities. The GRM has not yet specifically decided which Ministry should be the lead coordinating Ministry for the Program. They have agreed that each component should be managed separately. The ECPR agreed that USAID would suggest that the Ministry of Finance be the lead coordinating Ministry for the entire Program, with close input from the Central Bank and the CEM. This has been inserted in the draft Project and Program Grant Agreements. On August 18, 1993, the GRM confirmed that the Ministry of Finance would be the lead coordinating Ministry for FMD.

D. Policy Oversight Committee. The PAAD did not include any mention of a Policy Oversight Committee to meet regularly to review progress against the policy conditions. The ECPR agreed that a specific FMD Policy Oversight Committee was not needed because of the nature of the conditions and the two separate institutions under the program. However, the Project Officer will need to closely track progress during regular program monitoring with the Central Bank and CEM. Also, at least bi-annual meetings at the USAID Director and Minister level will be organized.

VIII. DELEGATION OF AUTHORITY

The USAID/Madagascar Mission Director was delegated the authority to approve the FMD PAIP and PAAD up to a total Life-of-Project funding of $14.5 million by the Assistant Administrator for Africa in 92 STATE 346858.

IX. RECOMMENDATIONS

It is recommended that you sign:

1. the attached PAAD Facesheet for the Financial Market Development Program, thereby approving the Program and authorizing the commitment of $6,000,000; and,

2. the attached Project Data Sheet for the Financial Market Development Project, thereby approving the Project, and the attached Project Authorization, thereby authorizing the Project, for a Life-of-Project amount of $4,000,000.

Attachments:

1. PAAD Facesheet/Authorization
2. Project Data Sheet
3. Project Authorization
4. PAAD

Cleared by:

PDA/PR: RGilson	______	Date: 8/23/93
MBD: JThomas	______	Date: 8/24/93
CONT: EHardy	______	Date: 8/24/93
CO: DOsinski	______	Date: 8/25/93
RLA: RSarkar	(FAX)	Date: 8/16/93

Drafted by JRazafindretsa/William Hammink, PDA

c:\wp\fmd\memopaad - 8/20/93

AID 112D-1 PAAD	AGENCY FOR INTERNATIONAL DEVELOPMENT PROGRAM ASSISTANCE APPROVAL DOCUMENT	1. PROGRAM No. 687-0121/687-T-605 2. COUNTRY MADAGASCAR 3. CATEGORY FINANCIAL MARKET DEVELOPMENT 4. DATE August 20, 1993
5. TO Donald R. Mackenzie Acting Director, USAID/Madagascar		6. OYB CHANGE NO. N/A
7. FROM William Hammink Chief, Office of Program Development and Assessment, USAID/Madagascar		9. OYB INCREASE N/A TO BE TAKEN FROM: N/A
9. APPROVAL REQUESTED FOR COMMITMENT OF $ 6,000,000		10. APPROPRIATION DFA 72-113/41014 - BPC: GSS3-93-31687-KG39
11. TYPE FUNDING [ ] LOAN [X] GRANT	12. LOCAL CURRENCY ARRANGEMENT [ ] INFORMAL [ ] FORMAL [X] NONE	13. ESTIMATED DELIVERY PERIOD 9/93 - 9/97 14. TRANSACTION ELIGIBILITY DATE: Fulfillment of conditions

15. COMMODITIES FINANCED

This is a cash transfer grant which the Government of the Republic of Madagascar will use to service eligible multilateral debt rather than to import commodities.

16. PERMITTED SOURCE	17. ESTIMATED SOURCE
U.S. only:	U.S.
Limited F.W.:	Industrialized Countries:
Free World: $6,000,000	Local:
Cash:	Other: $6,000,000 selected Free World

18. SUMMARY DESCRIPTION

See attached text.

19. CLEARANCES	DATE
PDA/PR: RGilson	8/23/93
RLA: RSarkar (FAX)	8/12/93
CONT: EHardy	8/24/94
MBD: JThomas John Thomas	8/24/93

20. ACTION

[X] APPROVED [ ] DISAPPROVED

Donald R. Mackenzie — 8-25-93

AUTHORIZED SIGNATURE — DATE

Donald R. Mackenzie
Acting Director, USAID/Madagascar
TITLE

USAID/Madagascar (5/92) use for PAAD, AID 112D-1

A. PAAD FACESHEET, BOX 18, SUMMARY DESCRIPTION:

The attached PAAD contains justification for a $6,000,000 Program Assistance Grant and a related but independent $4,000,000 Project consisting of technical assistance, training, and commodities, all of which are for the purpose of supporting policy reforms which will create a policy and institutional framework required for the effective functioning of the Banque Centrale de la République de Madagascar (BCRM) and Caisse d'Epargne de Madagascar (CEM), in order to increase the level of domestic financial savings and the share of savings going to the private sector.

The PAAD facesheet commits $6,000,000, to be disbursed in two tranches based on the GRM meeting performance criteria considered essential to achieve Program goals. This amount represents the total A.I.D. Life-of-Program Funding.

B. AUTHORIZATION AND DELEGATION:

Pursuant to section 496 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the four-year $6,000,000 Non-Project Assistance Program described herein. The Program Grant Agreement shall contain the following essential terms and conditions together with such other terms and conditions as are deemed appropriate by A.I.D.:

C. CONDITIONS PRECEDENT TO DISBURSEMENT

1. Conditions Precedent to First Disbursement. Prior to the first disbursement of funds under the Dollar Grant, which shall be in the amount of Three Million U.S. Dollars ($3,000,000), or to the issuance by A.I.D. of documentation pursuant to which disbursement will be made, the Grantee will, except as the parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D.:

(1) A statement of the name of the person holding or acting in the office of the Grantee specified in Section 10.6 of the Program Grant Agreement, and of any additional representatives, and representing that the named person or persons have the authority to act as the representative or representatives of the Grantee, together with a specimen signature of each such person certified as to its authenticity.

(2) An opinion of legal counsel that this Agreement has been duly authorized and executed on behalf of the Grantee and that it constitutes a valid, legally binding obligation of the Grantee in accordance with all of its terms.

(3) Documentation confirming that the Grantee has adopted a new governing statute for the Central Bank which specifies: (1) the objectives of the Central Bank; (2) the fixed terms for Governor and Board members and grounds for dismissal; and (3) limitations on advances from the Central Bank to the Treasury.

(4) Evidence that the Board of Directors of the Central Bank has adopted the Strategic Development Plan drafted by the staff of the Central Bank which specifies the responsibilities of each Department and contains a three-year action plan for each Department.

(5) Documentation confirming that the Grantee has deposited into the account of the Caisse d'Epargne de Madagascar held by the Caisse de Dépôts et Consignations the amount of two billion, nine hundred million FMG (FMG 2,900,000,000).

(6) Documentation confirming that the Grantee has published a decree fixing the rate of interest of the deposits of the Caisse d'Epargne at the Caisse de Dépôts et Consignations (CDC) equal to the rate applicable on Bon du Trésor par Adjudication (BTA) (twelve month Treasury Bills). The rate of interest on CEM deposits at CDC will be adjusted every three months. The interest rate for each three month period will be equal to a weighted average of the BTA rate for the previous three months. In the event the BTA market is not functioning, the last published rate will apply unless the parties otherwise agree in writing.

(7) Documentation confirming that the Grantee has established a separate, non-commingled interest-bearing account in a United States bank, and specifying the number of the account in such bank, into which disbursements of U.S. Dollars are to be made.

(8) A schedule of the proposed debts for which the dollars under the first disbursement are to be applied, with reference to both the amounts and timing for payment.

2. Conditions Precedent to Second Disbursement. Prior to the second disbursement of funds under the Dollar Grant, which shall be in the amount of Three Million U.S. Dollars ($3,000,000), or to the issuance by A.I.D. of documentation pursuant to which disbursement will be made, the Grantee will, except as the parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D.:

(1) Documentation confirming that the Board of Directors of the Central Bank has approved the Research Strategy and a first year research work plan.

(2) Evidence that the Central Bank has published an annual report, which includes an externally audited balance sheet and income statement.

(3) Documentation confirming that the Grantee has adopted new statutes for the CEM in a form acceptable to USAID. The new statutes will (1) reduce the size of the Board of Directors; (2) provide for autonomous Board management of the assets of CEM; (3) establish a personnel system that is managed autonomously; and (4) replace the current accounting system with the commercial accounting system (Plan Comptable Général).

(4) A schedule of the proposed debts for which the dollars under the second disbursement are to be applied, with reference to both the amounts and timing for payment.

D. COVENANTS

1. Transfer of Responsibility. The Grantee shall not rescind the decision to transfer responsibility for GRM external debt service from the Central Bank to the Treasury.

2. Continuance of Actions Taken by Grantee in Satisfaction of Conditions Precedent. The Grantee shall not in any way discontinue, reverse or otherwise impede any action it has taken in satisfaction of any condition precedent set forth in the Grant Agreement, except as may be mutually agreed to in writing by the Parties.

XD-ABH-190-A
85406

AGENCY FOR INTERNATIONAL DEVELOPMENT
PROJECT DATA SHEET

1. TRANSACTION CODE: A (A: Add, C: Change, D: Delete) — Amendment Number: ______

DOCUMENT CODE: 3

2. COUNTRY/ENTITY: MADAGASCAR

3. PROJECT NUMBER: 687-0120

4. BUREAU/OFFICE: AFRICA — 06

5. PROJECT TITLE (maximum 40 characters): FINANCIAL MARKET DEVELOPMENT

6. PROJECT ASSISTANCE COMPLETION DATE (PACD)

M	M	D	D	Y	Y
0	9	3	0	9	7

7. ESTIMATED DATE OF OBLIGATION
(Under "B." below, enter 1, 2, 3 or 4)

A. Initial FY 93 — B. Quarter 4 — C. Final FY 93

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 93 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total	2,500	1,500	4,000	2,500	1,500	4,000
(Grant)	(2,500)	(1,500)	(4,000)	(2,500)	(1,500)	(4,000)
(Loan)						
Other U.S. 1.						
Other U.S. 2.						
Host Country					2,000	2,000
Other Donor(s)						
TOTALS	2,500	1,500	4,000	2,500	3,500	6,000

9. SCHEDULE OF AID FUNDING ($000)

	A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	C. 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. 2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	E. 2. Loan	F. LIFE OF PROJECT 1. Grant	F. 2. Loan
(1)	DFA	200				–	4,000	–	4,000	–
(2)										
(3)										
(4)										
	TOTALS						4,000		4,000	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each): 230 | 260

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code							
B. Amount							

13. PROJECT PURPOSE (maximum 480 characters)

To increase the level of domestic financial savings and the share of savings going to the private sector.

14. SCHEDULED EVALUATIONS

Interim MM YY: __ __ / MM YY: 09 95 — Final MM YY: 07 97

15. SOURCE/ORIGIN OF GOODS AND SERVICES

[X] 000 [ ] 941 [X] Local [X] Other (Specify) 935

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a 1 page PP Amendment)

I have reviewed the proposed methods of implementation and financing for this project, and find them to be appropriate. Where necessary, adequate provisions have been made for detailed assessments of financial management capacities. I therefore recommend that you approve this proposed project paper.

Ernest Hardy
Ernest Hardy, Acting Controller

17. APPROVED BY

Signature: Donald R. Mackenzie
Donald R. Mackenzie

Title: Acting Director USAID/Madagascar

Date signed (MM DD YY): 08 25 93

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION

MM DD YY: __ __ __

12

PROJECT AUTHORIZATION

Name of Country: Madagascar
Project Name: Financial Market Development (FMD)
Project Number: 687-0120

1. Pursuant to Section 496 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the Financial Market Development Project for the Government of the Republic of Madagascar (Grantee) involving planned obligations of not to exceed Four Million U.S. Dollars ($4,000,000) in grant funds (Grant), subject to the availability of funds in accordance with the A.I.D. OYB/Allotment process, to help in financing foreign exchange and local currency costs of the Project. The planned Project Assistance Completion Date (PACD) shall be September 30, 1997.

2. The purpose of the Project is to increase the level of domestic financial savings and the share of savings going to the private sector. The Project consists of two components: (i) developing the capacity of the Central Bank of Madagascar to implement stable, non-inflationary monetary policies consistent with free market principles; and (ii) developing the capacity of Caisse d'Epargne de Madagascar (CEM) to improve the access, user-friendliness and interest rate incentives for savers at CEM. The Project will provide technical assistance and training to the Central Bank with emphasis on the research department and professional staff development. Project assistance to CEM will consist of short-term technical assistance, studies, training and commodities.

3. The Project Agreement, which may be negotiated and executed by the Officer to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of Authority, shall be subject to the following essential terms and covenants and major conditions, together with such other terms and conditions as A.I.D. may deem appropriate:

(a) Source and origin of commodities, nationality of services:

Except as A.I.D may otherwise agree in writing,

(a) Commodities financed by A.I.D. under the Project shall have their source and origin in countries included in A.I.D. Geographic Code 935.

(b) The suppliers of commodities or services financed by A.I.D. under the Project shall have countries included in A.I.D. Geographic Code 935 as their place of nationality.

(c) Ocean shipping financed by A.I.D. under the Project shall be financed only on flag vessels of the countries included in A.I.D.. Geographic Code 935 and shall also be subject to the 50/50 shipping requirements under the Cargo Preference Act and the regulations promulgated thereunder.

(d) Air travel and transportation to and from the United States shall be upon certified U.S. flag carriers to the extent such carriers are available within the terms of the U.S. "Fly America" Act.

(e) All reasonable efforts will be used to maximize U.S. procurement whenever practicable.

(b) Conditions Precedent to First Disbursement

Except as A.I.D. may otherwise agree in writing, prior to the first disbursement under the Grant, or to the issuance by A.I.D. of documentation pursuant to which such disbursement will be made, the Grantee shall furnish or have furnished to A.I.D., in form and substance satisfactory to A.I.D.:

a) An opinion of counsel that the Project Agreement has been duly authorized and/or ratified by, and executed on behalf of, the Grantee, and that it constitutes a valid and legally binding obligation of the Grantee in accordance with all of its terms; and

b) A written statement setting forth the names and titles of persons holding or acting in the Office of the Grantee, and of any additional representatives, and representing that the named person or persons have the authority to act as the representative or representatives of the Grantee, together with a specimen signature of each such person certified as to its authenticity.

(c) Covenants

A.I.D. and the Grantee agree to establish an evaluation program as part of the Project. Except as the Parties otherwise agree in writing, the Project will include, during the implementation of the Project and at one or more points thereafter:

a) evaluation of progress towards attainment of the objectives of the Project; and

b) identification and evaluation of problem areas or constraints which may inhibit such attainment;

c) evaluation, to the degree feasible, of the overall development impact of the Project.

(d) **Continued Performance under the Project**

The Parties agree that the disbursement of dollar funds under this Agreement for the purpose of providing technical assistance, commodities or other services in connection with the Project shall be conditioned upon the continued performance of the Grantee under the Project and in accordance with the terms of the Project Agreement.

Approved by: Donald R. Mackenzie

Donald.R. Mackenzie
Acting Director
USAID Madagascar

Date: 8-25-93

List of Acronyms

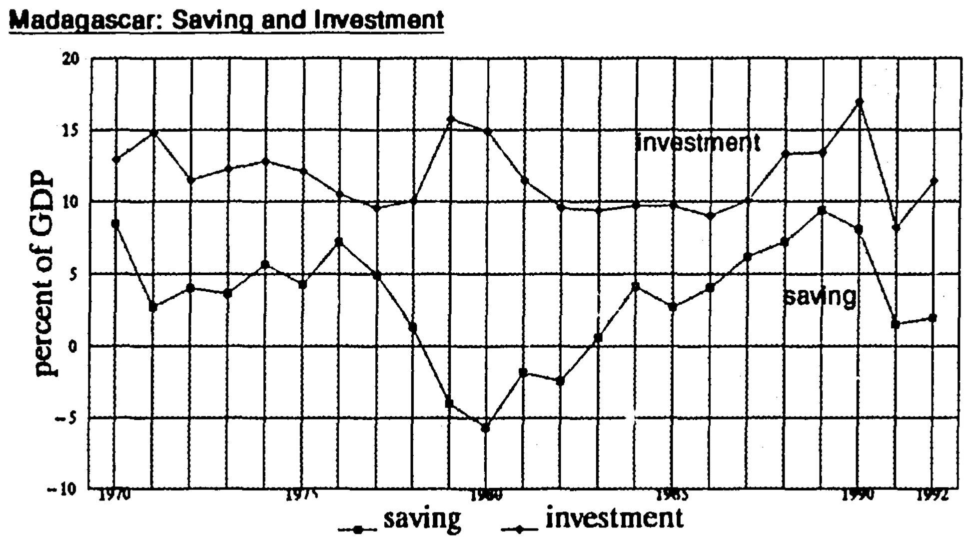
ADP	Automation Development Plan
AEPRP	African Economic Policy Reform Program
APB	Association Professionnelle Bancaire (independent professional banking association)
API	Assessment of Program Impact
ARO	Assurances Réassurances Omnibranches (Insurance Company)
BA	Bankers' Acceptances
BCRM	Banque Centrale de la République de Madagascar (Central Bank of Madagascar)
BEST	Business Expansion Services and Technology Project
BFV	Banky Fampandrosoana ny Varotra (Commercial Bank)
BTA	Bon du Trésor par Adjudication (Short-Term Treasury Bill)
BTC	Bon du Trésor Classique (Medium-Term Treasury Bond)
BTM	Bankin'ny Tantsaha Mpamokatra (Rural Development Bank)
CAER	Consulting Assistance for Economic Reform
CCBEF	Commission de Contrôle des Banques et Etablissements Financiers (Financial Supervisory Commission)
CCP	Centre de Chèques Postaux (postal checking institution)
CD	Certificates of Deposit
CDC	Caisse de Dépôts et Consignations
CEM	Caisse d'Epargne de Madagascar (the national postal savings bank)
CNAPS	Caisse Nationale de Prévoyance Sociale (Social Security Fund)
CP	Condition Precedent
CPSP	Country Program Strategic Plan
DFA	Development Fund for Africa
ECPR	Executive Committee for Program Review
EPIC	Etablissement Publique à caractère Industriel et Commercial (public establishment of industrial and commercial character)
EPZ	Export Processing Zones
FINDEP	Financial Institutions Development Technical Assistance Project
FIRM	Financial Resources and Management
FMD	Financial Market Development
FMG	Malagasy Franc
FRB	Federal Reserve Bank
GDP	Gross Domestic Product
GRM	Government of the Republic of Madagascar
HRD	Human Resource Development
ILO	International Labor Organization
IMF	International Monetary Fund
IQC	Indefinite Quantity Contracts
LCF	Local Consultant Firm
LOP	Life of Project
MBD	Market and Business Development Office
MOF	Ministry of Finance
NGO	Non-Governmental Organization
NPA	Non-Project Sector Assistance

NPCB Nouveau Plan Comptable Bancaire (a new bank chart of accounts)
NY HAVANA - An Insurance Company (Malagasy proper name)
OGL Open General License System (SILI)
OSDBU Office of Small and Disadvantaged Business Utilization
PAAD Program Assistance Approval Document
PAIP Program Assistance Identification Paper
PIC Project Implementation Committee
PIL Program Implementation Letter
PSC Personal Services Contract(or)
PSD Plan Stratégique de Développement (SDP)
PTA Preferential Trading Arrangement
PTT Postal and Telecommunications Services
SDP Strategic Development Plan of BCRM and CCBEF (PSD)
SILI Système d'Importations Libéralisées (OGL)
SME Small- and Medium-scale Enterprises
SOATEG Société d'Assistance Technique et de Gestion (consulting firm)
STTA Short-term technical assistance
TA Technical assistance
UNDP United Nations Development Program

I. EXECUTIVE SUMMARY

The four-year Financial Market Development (FMD) Program marks USAID/Madagascar's entry into the financial sector in Madagascar. It follows from the Country Program Strategic Plan (CPSP) approved by AID/Washington in September 1992. The CPSP identifies seven development challenges confronting Madagascar; one of which is financing the level of investment that will be necessary to put the Malagasy economy on a growth trajectory. The economy will have to do a better job of mobilizing both domestic and foreign savings in order to raise the investment level above 10-15 percent of GDP; where it has been for the past two decades. Current levels of investment and savings are inadequate to the task *(Figure I.1)*.

Figure I.1



The CPSP calls for USAID/Madagascar to intervene in the financial sector. Specifically, one of the targets of the CPSP is "Financial Market Reforms Increase Domestic Resources for the Private Sector". FMD will be the Mission's principal vehicle to achieve this target. The goal of FMD is to increase investment and employment in the private sector. The purpose is to increase the level of domestic financial savings and the share of savings going to the private sector. The FMD program addresses this goal and purpose both at the national level of monetary policy and at the grass roots level of the urban and rural poor. The program will have two collaborators; the Central Bank of Madagascar (BCRM), and the Caisse d'Epargne de Madagascar (CEM - the national postal savings bank). In order to encourage a national financial environment conducive to the growth of private savings, FMD will work with BCRM to improve the capacity of the Bank to implement stable, non-inflationary monetary policies consistent with free market principles. To encourage and enable the rural and urban poor to build financial savings, FMD will work with CEM to improve the access, user-friendliness and interest rate incentives for savers at CEM.

The FMD program will consist of both project assistance and non-project assistance (NPA). The NPA component is essential in order to put into place the institutional framework required for the effective functioning of the two collaborating organizations. The NPA component will include cash transfers to help the Government of Madagascar cope with its external debt service problem and thus facilitate implementation of financial sector reform. The project component will furnish technical assistance, training and equipment to the collaborating institutions.

Madagascar's financial system operates in an economy which has one of the lowest savings rates among developing countries and whose financial depth is among the most shallow. Part of this is simply due to the fact that Madagascar remains among the fifteen poorest countries in the world. However, a number of other countries of similar income levels in Africa and especially in Asia, exhibit markedly higher levels of aggregate and financial savings. The majority of the population still suffers from very limited or no access to the financial services of formal financial institutions.

Notwithstanding the reforms of recent years in the financial sector, there persists a problem of confidence in existing financial institutions and instruments, reflecting continued suspicions and fears of the financial system engendered by past policies.

An analysis of the Malagasy financial system points to at least five major interrelated inadequacies. First, the overall financial system is heavily biased toward short-term finance with very little medium and long-term finance available either as debt or equity. Second, the attractiveness of holding financial assets as a primary form of wealth has until recently been eroding because of uncertainty among economic agents with regard to inflation and the real exchange rate. Third, many economic agents find it difficult to get access to the resources of the formal financial system because of their small size (notably in agriculture and to some extent in construction). Fourth, the financial system is not widely regarded as an effective mechanism for discharging financial obligations and transferring resources in a timely and secure manner. Fifth, both suppliers and users of financial services suffer from a lack of adequate financial information which is compounded by various inadequacies in either obtaining or enforcing the legal protection necessary to ensure confidence among lenders and borrowers. This has contributed to a pattern of finance in which transactions tend to be limited to short maturities and to borrowers either personally known to the lender or able to provide easily attachable collateral.

Formal financial institutions in Madagascar are presently limited to the Central Bank, five commercial banks, CEM, the postal checking system, two insurance companies, the Social Security Fund, and two venture capital firms. The financial system of Madagascar is still at an early stage of development. The system is dominated by the commercial banks and their transactions are substantially focused on short-term trade financing. The range of specialized institutions found in developed financial systems do not exist in Madagascar, for example in housing finance, leasing or discounting of trade bills.

Section III of this document provides a financial sector overview and a strategic approach to the development of the sector. A great deal of technical work and investment remains to be done if all of the weaknesses in the financial sector are to be eliminated. It is clear that the scope of activity required is too awesome to consider a program to simultaneously address all of the issues. In fact, the analysis suggests a natural or logical sequencing of much of the work; especially in terms of which institutions should receive priority attention. Weaknesses in critical existing institutions argues for improving their effectiveness before moving on to creating and supporting the specialized financial institutions that will fill out the structure of the financial sector. Indeed, the analysis suggests that private investors can be expected to provide much of the technical expertise and capital needed to create these specialized institutions once the policy framework and sufficient demand for the services of these institutions exist.

The Central Bank is at the heart of the financial system. Its weaknesses radiate out through the other financial institutions, producing negative impacts in the real economy in terms of low investment and economic growth. A poorly conceived and ineptly implemented monetary policy retards financial sector development and prevents the financial sector from mobilizing the resources for the real economy.

The GRM recognizes this. In 1992 the GRM asked the World Bank to take the lead in organizing technical support to upgrade the ability of the Central Bank to design and implement monetary policy. The World Bank responded by designing, in collaboration with the Central Bank and three bilateral donors including USAID, its Financial Institutions Development Technical Assistance Project (FINDEP). The project was approved by the World Bank's Executive Board on May 25, 1993. FMD was designed as parallel financing to FINDEP. Switzerland and Sweden will also provide parallel financing to FINDEP. The scope of FINDEP is the Central Bank, the Financial Supervisory Commission (CCBEF), commercial bank auditing and accounting regulations and the two commercial banks with majority state ownership. The project is more fully described in Section III.D. USAID/Madagascar believes that there is a compelling rationale for including the Central Bank as a target institution in FMD.

USAID is mandated to ensure that its programs lead to sustainable, broad-based economic growth; with particular emphasis to be given to extending the benefits of economic growth to low-income rural and urban households. Central Bank operational efficiency is a necessary, but not sufficient, condition for low-income household access to the services of the financial sector. Section III documents both the virtual nonexistence of financial services to these target households and more generally, the difficulty all developing countries have in extending financial services to low-income households. In Madagascar, the poor's need for safe, reliable and convenient forms of financial savings are inadequately met by formal financial institutions. Their needs for credit are not met at all by these institutions. Given the higher costs and risks of serving these households relative to trade financing and other alternatives available to private financial institutions, it is unlikely that the private sector will move into this market in the near term. Therefore, providing funds and technical resources to the private sector for this purpose is probably premature.

FMD proposes to work with the only existing financial institution in Madagascar that targets low-income households as its clientele, Caisse d'Epargne de Madagascar (CEM). CEM has a vast network throughout the country capable, in theory, of putting virtually the entire population in touch with the financial sector. Assessments of the CEM undertaken by USAID show obvious ways in which the financial services offered by CEM could be improved. CEM management is well aware of these possibilities. They have made progress commensurate with the level of resources available to them. Institutional limitations and limited resources inhibit full exploitation of CEM's potential. FMD will provide CEM with the institutional structure and resources to accelerate its development.

AID guidance cautions missions against working with parastatals where private sector support is more appropriate. USAID/Madagascar has carefully considered this guidance as CEM is a parastatal. The mission has chosen to include CEM in the FMD program as the best option available to assist low-income households obtain access to financial services. The existing financial system does not have any private sector institution with a low-income household clientele, or even a desire to attract such a clientele. Commercial banks intentionally exclude low-income households by imposing minimum deposit levels on accounts. Only BTM, one of the five commercial banks, offers a branch network that extends beyond the six provincial capitals and it too is a parastatal, and a troubled one at that.

The mission assessed the feasibility of the privatization of CEM during the four-year life of FMD. It was judged to be infeasible. The current operations of CEM are integrated with the Post Office. Establishing a fee-for-service system needs to precede privatization. CEM accounting is based on public and not commercial accounting. The changeover will occur under FMD. The legal system in Madagascar does not have provision for a corporate entity which is fully state-owned but which can take on private capital. The approach proposed in FMD is to require the adoption of a new statute for CEM which will enhance its commercial status as an interim measure. During the life of the program, CEM will be restructured in such a way as to be attractive to private capital participation in the future. The partial privatization of CEM in the future will be fully consistent with the Government of the Republic of Madagascar (GRM) Statement of Financial Sector Reform and Development Policy.

The two components of FMD will contribute to both the efficiency of the financial system and to USAID's equity goal.

The Program Conditionality of FMD will provide the two collaborating institutions with basic frameworks (legal statutes and operating decrees) that ensure operating autonomy sufficient to carry out their core functions. Conditions Precedent (CP) regarding the BCRM are consistent with but not identical to the conditions for effectiveness of FINDEP. There are four CPs regarding BCRM.

1. The Government of the Republic of Madagascar adopts a new governing statute for the Central Bank. The statutes will specify: (1) the objectives of the Central Bank; (2) the fixed terms for Governor and Board members and grounds for dismissal; and (3) limitations on advances from the Central Bank to the Treasury.

2. The Board of Directors adopts the Strategic Development Plan drafted by the staff of the Central Bank. The Strategic Development Plan will specify the responsibilities of each Department and will contain a three-year action plan for each Department.

3. The Board of Directors of the Central Bank approves the Research Strategy and a first year research work plan.

4. The Central Bank publishes an annual report, which includes an externally audited balance sheet and income statement.

CPs regarding CEM will ensure that the negative net worth on the balance sheet of CEM is eliminated, that CEM receives a competitive market-determined interest rate on money it lends to the Treasury and that its new statutes make it a more commercial operation and less an appendage of the postal system. There are three CPs regarding CEM.

1. The Government of Madagascar deposits into the account of the Caisse d'Epargne de Madagascar held by the Caisse de Dépôts et Consignations the amount of two billion, nine hundred million FMG (FMG 2,900,000,000).

2. The Minister of Finance publishes a decree fixing the rate of interest of the deposits of the Caisse d'Epargne at the Caisse de Dépôts et Consignations equal to the rate applicable on Bon du Trésor par Adjudication (twelve month Treasury Bills). The rate of interest on CEM deposits at CDC will be adjusted every three months. The interest rate for each three month period will be equal to a weighted average of the BTA rate for the previous three months. In the event the BTA market is not functioning, the last published rate will apply unless USAID and the GRM otherwise agree in writing.

3. The Government of the Republic of Madagascar adopts new statutes for the CEM in a form acceptable to USAID. The new statutes will (1) reduce the size of the Board of Directors; (2) provide for autonomous Board management of the assets of CEM; (3) establish a personnel system that is managed autonomously; and (4) replace the current accounting system with the commercial accounting system (Plan Comptable Général).

Satisfaction of the CPs will trigger the release of $6 million in two equal tranches. The dollar resources will be used for external debt service (on debt owed to eligible multilateral financial institutions).

The project component of FMD will provide technical assistance and training to the Central Bank with emphasis on the Research Department and professional staff development ($2.8 million). Project assistance to CEM will consist of short-term technical assistance, studies, training, and equipment ($0.85 million).

Three issues, raised at the FMD PAIP review, have been resolved during program design. The first issue is whether sufficient progress has been made by the Government of Madagascar in preparing a macroeconomic framework within which the FMD Program will operate. Since the PAIP review, the President has appointed an eight person committee to oversee the elaboration of a macroeconomic framework and to prepare for negotiations with the World Bank and the IMF. The committee is made up of qualified individuals with extensive economic and financial experience. They are currently reviewing the government's fiscal policy and they are expected to recommend mid-year adjustments in the 1993 GRM Budget. The IMF is on record that the first economic priority of the new government should be the fiscal deficit. USAID/ Madagascar expects the GRM and the IMF to agree on a macroeconomic framework before the end of 1993. In addition, in June 1993 President Zafy, in a letter to the heads of the World Bank and the International Monetary Fund (IMF), confirmed his commitment to a liberal economic regime, to pursuing economic reform, and to reaching early agreement with the World Bank and the IMF.

The second issued raised in the PAIP review concerned the wisdom of working with a parastatal (CEM) in light of A.I.D. policy favoring private sector institutions. The FMD Program includes a financial sector parastatal as a collaborating institution because (a) there is no private sector financial institution which has or desires to have low-income households as its target clientele while CEM does, (b) the cost of creating a new private financial institution to serve low-income households under the project would be prohibitive and (c) the FMD Program will lay the groundwork for the eventual introduction of private equity ownership in CEM.

The third issue raised at the PAIP review was whether the program would have sufficient verifiable "people-level impact". A survey undertaken during PAAD design verified that CEM's current and potential customers are sensitive to the quality of service offered by CEM. The design team estimates that annual client growth during the program will be on the order of twenty percent compared to the pre-program growth rate of five percent. The growth rate difference means 215,000 additional households will be receiving services from the financial sector by the end of the program. The number of beneficiaries will continue to grow after the program because CEM will have been put on a firm financial footing.

II. MACROECONOMIC OVERVIEW

A. Macroeconomic Overview

In the late 1980s, Madagascar embarked upon a comprehensive adjustment program that was designed to further the transformation toward an open and market-oriented economy. The major elements of this strategy included far-reaching structural reforms in the areas of internal and external trade, the financial and public enterprise sectors, and public expenditure programming, in addition to demand management policies. This approach soon began to yield results. Economic activity, which had remained sluggish in 1986-87, recovered, and real GDP growth averaged 3.5 percent per annum during 1988-90, allowing real income per capita to increase for the first time in almost a decade. The GDP deflator posted an uninterrupted decline from 23 percent in 1987 to 11 percent in 1990. Developments in the public finances played an important role. The fiscal imbalances were contained, despite higher capital expenditures associated with the public investment program; the overall fiscal deficit rose slightly, from the equivalent of 4.2 percent of GDP in 1986 to 5.1 percent in 1990. Moreover, the cancellation of a substantial proportion of Madagascar's external debt allowed the Government to effect substantial repayments to the banking system. In line with these trends, broad money grew at a slightly lower rate than did nominal GDP between 1986 and 1990. Strengthening the balance of payments proved more difficult. Certain areas (nontraditional exports and tourism) did thrive. However, the performance of traditional export commodities faltered, and, together with an increase in imports, contributed to a widening of the external current account (excluding official transfers) from 6.3 percent of GDP in 1986 to 11.8 percent in 1990; in the same period, the overall balance of payments deficit more than doubled to $290 million. This deterioration was in part attributable to an expansionary credit policy in 1990.

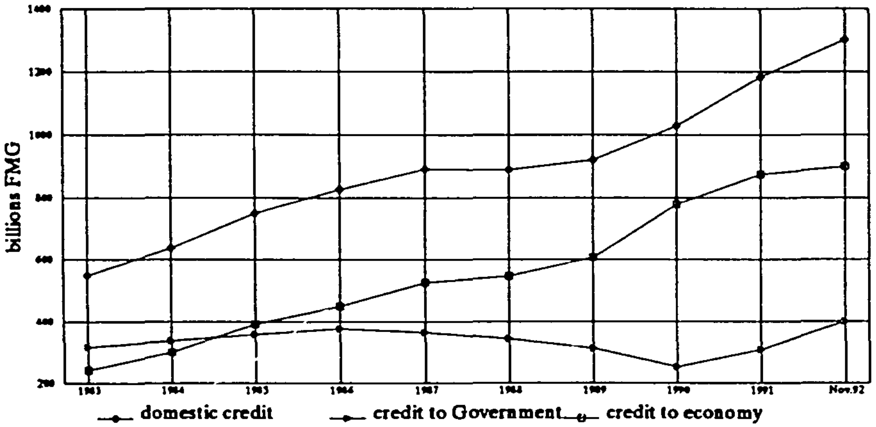
In June 1991, widespread political disturbances and strikes broke out and in the following months were to have a severe impact on the economy. The economic and financial progress that had been recorded in the previous three years was reversed, and structural reform largely came to a halt. Real GDP contracted by 7 percent in 1991, while inflationary pressures built up, especially toward the end of the year. The public finances deteriorated significantly, with the overall fiscal deficit on a commitment basis increasing to 7.8 percent of GDP. Domestic revenue plummeted, mainly because of the civil unrest, but current expenditure was not reined in, and instead, grew rapidly. Partly reflecting the significant recourse of the Government to domestic bank financing, broad money expanded by 25 percent. The external position of Madagascar weakened further, as evidenced by a worsening shortage of foreign exchange and the renewed accumulation of external payments arrears, which had been cleared at end-1990. The widening financial imbalances led to the depletion of the freely available reserves of the Central Bank and the suspension of the open general license (OGL) system for imports in October 1991. Tighter payment restrictions on current transactions led to a sharp compression of imports, and in turn to a decrease in the external current account deficit to 10.6 percent of GDP. Moreover, owing to a substantial increase in drawings on external loans that had been delayed from 1990, the overall balance of payments deficit fell from $290 million in 1990 to $225 million in 1991.

During the period 1986-90, growth in aggregate supply came mostly from agriculture (together with forestry, livestock, and fishing) and the services sector. The contribution of agriculture to growth, about one third over the entire period, waned in 1990 as adverse weather conditions limited the increase in agricultural value added to 2.1 percent. Meanwhile, the services sector accounted for almost one half of the growth, with a particularly strong showing in 1990 on account of increased banking activities and a rapid expansion in tourism. In 1991, the political turmoil had a profound impact on the economy, with the services sector among the hardest hit. Moreover, agricultural production stagnated owing to damage in rice growing areas caused by a cyclone in early 1991 as well as a drought in the south. Throughout the period, developments in industry had a limited impact on growth; value added in the industrial sector, which represents less than 15 percent of GDP, increased at a slow pace, constrained in part by inefficient production methods and by competition from imported goods.

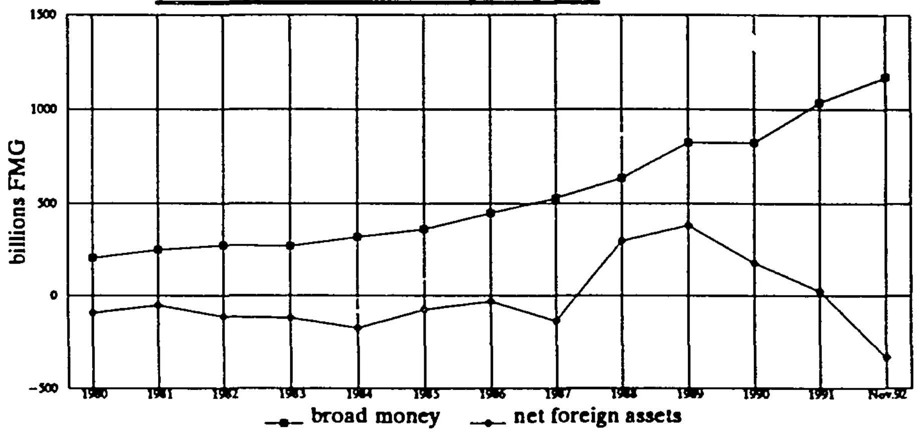
The increase in domestic demand in 1986-90 was driven mainly by investment. Public capital spending grew significantly as a three-year rolling public investment program was introduced in 1989. Extensive stock accumulation also took place, particularly in 1990 when bank credit to the private sector financed a large increase in imports, including consumer goods. In 1991, fixed investment plummeted, and stocks were drawn down, thereby mitigating inflationary pressure.

The economy in 1993 continues to feel the repercussions of political events. GDP growth in 1992 was one percent; growth was positive -- but slight -- in agriculture and services but negative in the industrial sector. Inflation in 1992 was fifteen percent. GRM estimates for 1993 project a continuation of the economic stagnation; GDP growth is projected at 1.4 percent, inflation at fifteen percent. Weak agricultural growth is attributed to unfavorable rainfall patterns in the last quarter of 1992 and the first quarter of 1993. The industrial sector is grinding to a halt because of the lack of spare parts and intermediate inputs caused by the shortage of foreign exchange. The foreign exchange situation is presented in the following section.

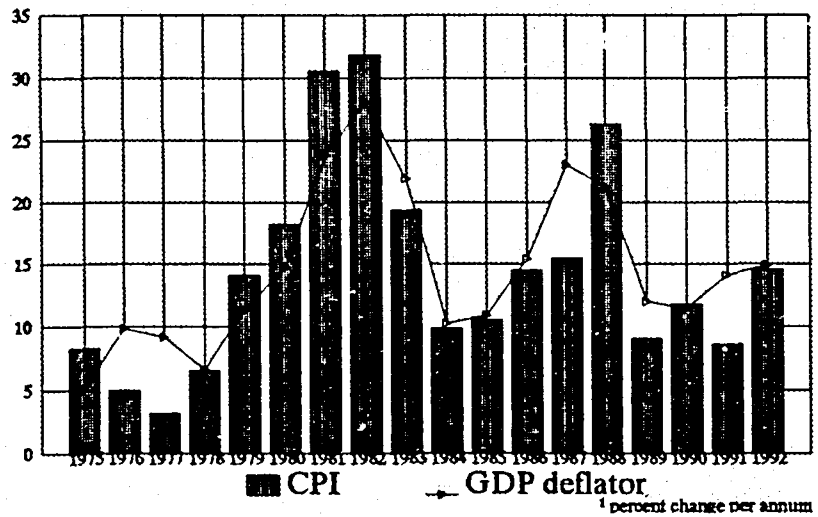
Madagascar: Credit



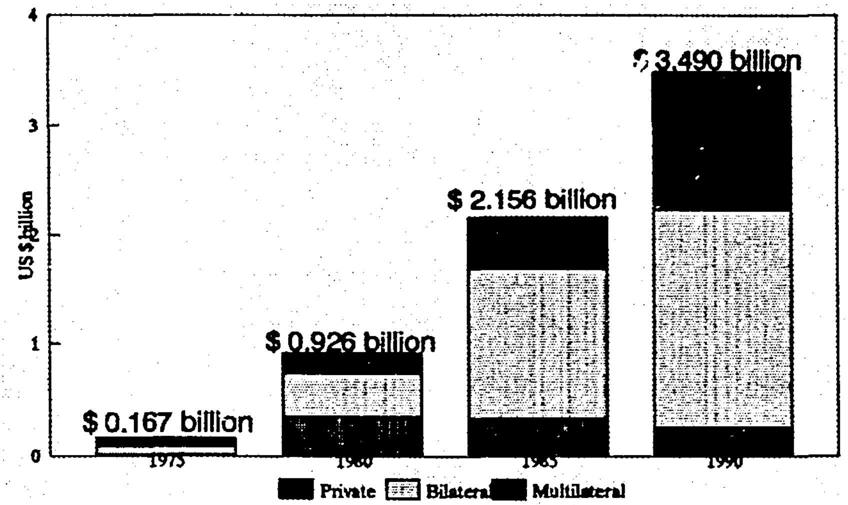
Madagascar: Money Supply



Madagascar: Inflation [1]



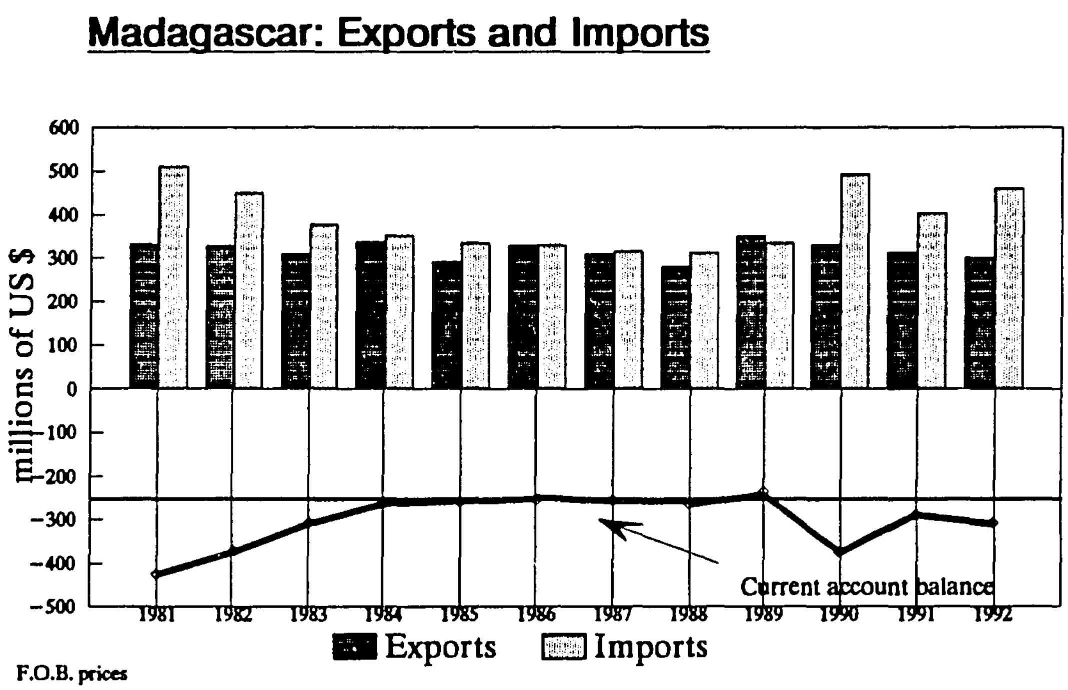
Madagascar: Debt by type of Creditors



B. Balance of Payments Analysis

Madagascar's external position has deteriorated sharply since 1991. During the late 1980s the trade balance (exports minus imports) had two years of positive balance and two years of negative balance. The trade balance has remained negative since 1990. Thus, export revenue is increasingly insufficient to pay for imports. The problem of financing the excess of imports over exports is compounded by a high negative balance in the service account (freight, travel, investment income -- including interest payment). The service account is traditionally negative due to foreign debt service payments. Currently net service payments are in excess of $200 million annually.

Figure II.1



The trade balance and the service balance together make up the current account balance. This (negative) balance has been about ten to fifteen percent higher in the 1990s than it was in the late 1980s. The deficit on the current account is, or can be, offset by inward flows in the capital account; borrowing from abroad, foreign grants, foreign direct investment, etc. These flows have been between $40-$100 million annually; the variability is attributable to fluctuations in the flow of foreign assistance since foreign investment and commercial borrowing are small. Throughout the period under review capital inflows have been inadequate to cover the current account deficit. This gives rise to the need for "exceptional financing", generally in the form of debt relief. Annual debt relief in the late 1980s was not less than $220 million per year.

program. The inability of the Government of Madagascar to formulate a credible program for 1992 or 1993 has denied Madagascar access to the Paris or London Clubs rescheduling process. Debt relief fell from $180 million in 1990 to $65 million in 1991 to $3 million in 1992. Foreign exchange reserves were used up (i.e. drawn down to virtually zero) by mid-1991. Once these reserves were gone the country was devoid of means to meet its foreign obligations. Consequently, beginning in 1991 arrears (unpaid bills) began to accumulate - $176 million in 1991, an additional $280 million in 1992. Arrears are continuing to accumulate in 1993.

Where does this recent history leave the economy today? Malagasy businesses are unable to get foreign exchange from their banks, even if they have the local currency to pay for it. As a result, their firms (factories or trading companies) are operating at low levels of capacity. This is the principal reason for the expected continued contraction of the industrial sector. At the same time, the build-up in arrears is damaging Madagascar's credit rating. Foreign financial institutions are increasingly leery of accepting trade financing commitments from Malagasy banks. Trade financing is beginning to move to a cash and carry basis, raising costs further for Malagasy importers. Government arrears to official creditors put the country at risk of being cut off from future loans.

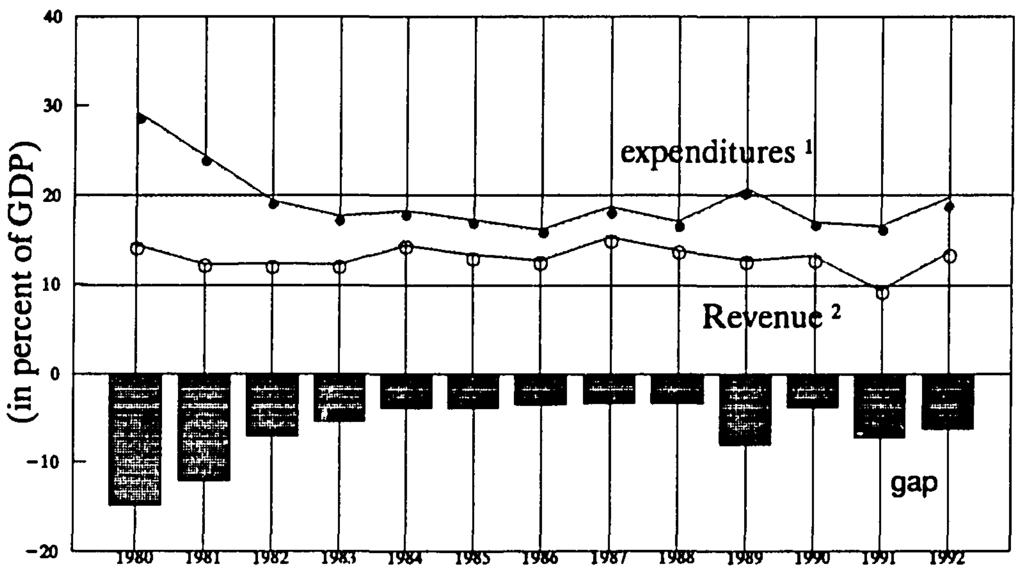
Foreign trade and payments will remain precarious until the government is able to present a credible macroeconomic framework. This would open the way for an IMF program, Paris Club debt relief and perhaps donor financing for restoration of the Open General License system for financing imports.

C. Fiscal Analysis

The fiscal position of the Government is weak. In a manner similar to the balance of payments position described above, the political events of 1991 threw the fiscal accounts out of balance. Revenues fell by 31 percent in 1991, while current expenditures rose by 13 percent. The overall deficit rose from 35 billion FMG in 1990 tc 276 billion FMG in 1991. The 1991 deficit was financed by increasing drawings on foreign loans (100 billion FMG) and by borrowing 60 billion FMG in the domestic market (compared to 55 billion FMG repayments to the domestic market in 1990).

Figure II.2

Madagascar: Government Financial Operations



1 : Current and Capital Expenditures
2 : Current Revenue

The drift in economic policy making since 1991 has resulted in a continuing deterioration of fiscal policy. The overall budget deficit in 1992 reached 346 billion FMG. The financing of the deficit is becoming increasingly ad-hoc; arrears to local firms who have sold goods and services to the Government exceeded 60 billion FMG.

The 1993 budget does not come to terms with the structural imbalances in the fiscal accounts. Estimates of budgetary receipts are high compared to 1992, without adequate rationale; the investment budget does not reflect realistic estimates of local financing available; and arrears to the local private sector is now treated as a planned means of financing!

D. Medium-term Economic Prospects

On June 1, 1993 President Zafy established an eight-member economic and financial coordination commission to develop an economic program and move forward on discussions with the IMF and the World Bank. The mission of the commission is to coordinate the preparation of all documents, economic reports and negotiating positions of the GRM for its dealings with the Bank and the Fund. The members of the committee were chosen on the basis of their technical competencies and prior experiences negotiating with international organizations.

Until a new government is formed and begins to articulate its views on economic policy, one can only speculate about medium-term economic prospects. The FMD design team prognosis is based on recent presidential decisions, the evolving political debate, the stance of donors, and the assumption that by the end of August the GRM will be ready and able to address the country's economic problems. The GRM will need to bring together its economic policy makers, the donors and the IMF to solve the following timing conundrum: the donors want an IMF program before committing themselves to balance of payments or budget support, the IMF wants a feasible reduction in the deficit before signing a Stand-by, the GRM needs donor financing (especially for its external debt service) in order to close the 1994 financing gap. Given everyone's interest in jump starting the economy the GRM should be able to put a program together by November. After a Stand-by is in place, the World Bank will be ready to open discussions with the GRM on a new adjustment credit. Such a credit could be expected to attract co-financing from among the French, the European Community and the African Development Bank. With rapid progress on the immediate issues of the fiscal deficit and the external account, the donors are likely to be receptive to a Consultative Group meeting to discuss medium-term economic policy within the next nine months.

III. THE ANALYTICAL FRAMEWORK

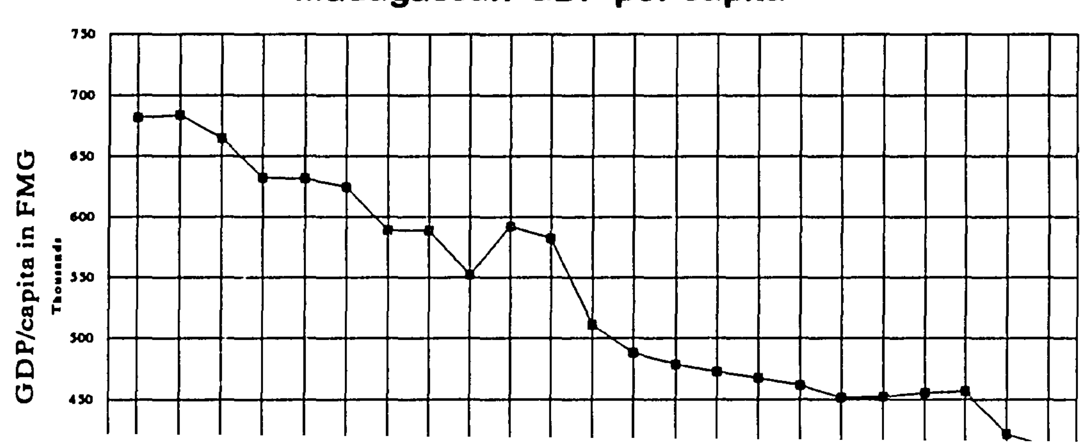
A. Financial Sector Overview

This section concentrates on the two weaknesses in the financial sector which will be addressed by FMD: government financing by the Central Bank and financial services for small scale economic agents. A broader review of the financial sector is contained in Annex C, Financial Sector Assessment. The section begins with a brief resume of Annex C.

After almost a decade and a half of socialist economic policies characterized by heavy state intervention in both the financial and real sectors, Madagascar began significant financial liberalization in the latter part of the 1980s *(fig. III.1, Madagascar: GDP per capita)*. Among the key aspects of this liberalization was the opening of the banking sector to private capital in 1988, resulting in the entry of two new private banks and subsequent partial privatization of two of three government-owned banks. There has been progressive liberalization of interest rates which, since November 1990, have been fully freed. Selective credit policies have also been progressively dismantled. At the same time, substantial restructuring and clean-up of loan portfolios has moved the banking system from its state of quasi-insolvency in 1986 to one of improved soundness and profitability. Madagascar has been one of the pioneering countries in the Africa and Indian Ocean region to begin moving away from direct to indirect instruments of monetary control. In addition, it does not show any unduly discriminatory taxation of the financial sector found in some other countries where high unremunerated reserve requirements are coupled with explicit forms of taxation.

Figure III.1

Madagascar: GDP per capita [1]



Madagascar's financial system operates in an economy which has one of the lowest savings rates among developing countries and whose financial depth is among the most shallow. Part of this is simply due to the fact that Madagascar remains among the fifteen poorest countries in the world due to declining income per capita (Figure III.1). However, a number of other countries of similar income levels in Africa and especially in Asia, exhibit markedly higher levels of aggregate and financial savings. The majority of the population still suffers from very limited or no access to financial services. Notwithstanding the clearly visible reforms of recent years there persists a problem of confidence in existing financial institutions and instruments, and partly reflecting continued suspicions and fears of the financial system engendered by past policies.

Monetary, regulatory and supervisory policies remain inadequate for the market-oriented vocation that the government has now chosen for the economy. The Central Bank's move toward indirect instruments of monetary control remains hampered by its continued involvement in financing activities that should normally be borne by the government budget. An adequate supervisory and regulatory framework for the financial system has not yet been developed , reflecting the long-standing past neglect of this key policy area. At the same time, the basic infrastructure for financial transactions, notably the texts and practices of relevant laws, accounting, audit and financial disclosure, requires substantial improvements before new financial institutions and instruments could be expected to operate effectively.

Significant imbalances persist between the demand and supply of financial resources. These imbalances are compounded by strong biases in the sectoral allocation and term structure of lending. Between 1987 and 1990, the consolidated balance sheets of banks showed high credit-deposit ratios, generally in excess of 90 percent. Such high ratios have been symptomatic of high rates of non-performing portfolios in the past and continued over-stretching of bank resources. To a significant extent, this situation reflects the inability of banks to place their resources in alternatives other than customer loans because of poorly developed financial markets. As the economy is further liberalized and increased growth stimulates demand for financial resources, this imbalance will grow unless the financial system improves deposit mobilization and the financial system is widened and deepened. At the same time, the maturity structure of both bank deposits and lending remains significantly biased towards the short-term, making term finance less developed in Madagascar than many other Sub-Saharan or low-income countries. Partly as a result, bank lending favors commercial and trading activities much more than activities in primary and industrial sectors which require longer-term funds. To some extent, a previous bias towards allocation of financial resources to the public sector has been mitigated since the latter half of the 1980s. However, continued improvement in public expenditure management and resource mobilization should improve the scope for releasing more financial resources for the private sector. Credit is a key constraint for a majority of firms in the country; none but the larger firms have access to formal credit sources.

The existing financial system in Madagascar is heavily dominated by banking institutions which by themselves cannot be expected to satisfy the full range of needs of an expanding and diversifying economy. In addition to banks, there is usually a need for an intermediate layer of financial institutions and instruments which can also eventually act as a bridge between the short-term money market and the longer-term capital markets. Without this continuous array of financial institutions and instruments acting for the diverse maturities of funds on the financial markets, the free market determination of equilibrium interest rates and auctioning of the Treasury bills, for example, cannot be completely effective. At the same time, surveys of users of financial needs and the examination of the financial system confirm that several special financing needs are not being adequately met. These needs mainly pertain to individual sectors (agriculture and housing), term finance (medium- and long-term finance), and certain other types of finance (trade finance, leasing and equity financing). In all these and other areas, adequate financial services to small-scale economic agents are especially lacking.

- **Government Financing by the Central Bank**

Government finance can influence the financial sector through its impact on money supply, credit and interest rates. The main impact comes through the means by which the deficit is financed. In analyzing the impact of deficit financing on the Malagasy financial system, the particular definition of the fiscal deficit must be clarified. The fiscal deficit is conventionally defined as the central government financing gap that is covered by net government borrowing, including borrowing from the Central Bank. The financing gap results from the excess of total government cash outlays, including interest payments but excluding amortization on public debt, over total cash receipts, including tax and non-tax proceeds but excluding borrowing. At the same time, in Madagascar as in many other developing countries, certain government finance activities that are usually undertaken by the central government have been instead assigned to the Central Bank. These operations which are not strictly carried out with the purpose of implementing monetary policy, are referred to as quasi-fiscal operations of the Central Bank. The consolidation of the conventional fiscal deficit and quasi fiscal deficit produces a broader measure of government financing needs.

BCRM has engaged in a number of "quasi-fiscal" activities which entail explicit or implicit financing of the government. Like BCRM, Central Banks in many other developing countries have gone beyond their strictly monetary functions by undertaking such quasi-fiscal activities which tend to eventually create Central Bank losses. These losses either alone or together with other Central Bank financing of the deficit often end up being monetized. Central Bank quasi-fiscal activities have a potential for adverse effects on liquidity and money supply.

Under Chapter 3 of its statutes, BCRM can extend advances to the Treasury. These advances are limited to a ceiling equivalent to 15 percent of ordinary budget revenues of the previous fiscal year and should be statutorily reimbursed within six months of the closing of fiscal year in which these advances are made. In practice, advances to the Treasury have well exceeded the prescribed 15 percent limit. The actual ratio at the end of 1990, for example, was about 291 percent of ordinary budget revenues of the previous year; even net of government deposits, the ratio of advances was 78 percent of the previous year's ordinary budgetary receipts.

Another quasi-fiscal function of the Central Bank is the performance of foreign exchange operations and transactions on behalf of the government and the servicing of the external debt without full compensation by the Treasury. This function became very important during the 1980s after BCRM assumed external liabilities from the government and the private sector in the context of Paris and London Club debt rescheduling agreements. The financial repercussions of this quasi-fiscal activity have dramatically reshaped the Central Bank's balance sheet and income account.

These losses have become very large, amounting in 1990 to 60.5 percent of the stock of reserve money at the end of 1990. In other words, BCRM in its reserve money management had to compensate for a 60.5 percent autonomous increase of reserve money or accept the inflationary consequences. However, such compensation did not occur by design between 1984 and 1990 but rather inadvertently. During this period the potentially inflationary consequences of BCRM losses were compensated by large net inflows from the Treasury to BCRM arising from the mismatch of debt servicing under the original and rescheduled payment profiles and the substantial accumulation of counterpart fund deposits. This situation underscores the precarious position of monetary management if and when such offsetting factors cease to compensate for the inflationary impact of BCRM operating losses.

Restoring BCRM to a sound financial footing will require compensation for BCRM for all existing claims on government and transfer of all debt servicing responsibilities on external liabilities to the Treasury. This would render the financing of government operations, and specifically those presently related to the quasi-fiscal deficit, more transparent. This transfer of responsibilities from BCRM to the Treasury would however leave external debt servicing burdens for the country as a whole unchanged. The benefits of this arrangement lie in the greater transparency of government financial operations and the ability of BCRM to conduct independent monetary policy. At the same time, this new arrangement obviates the potential of monetizing government financing needs. Transfer of servicing responsibilities on external liabilities from BCRM to the Treasury took place in the first half of 1993.

- **Financial Services for Small-Scale Economic Agents**

A majority of economic agents in Madagascar are "small-scale" both in terms of the volume of their savings and their finance needs. These small-scale economic agents comprise smallhold farmers, owners of micro-enterprises or small- and medium-scale enterprises (SMEs), artisans, small traders, landless laborers and migrant workers. Some 1.5 million of the 1.6 million rural families in Madagascar work small, mainly subsistence farms of about one hectare or less and account for 75% of the total population in

Madagascar. It is also estimated that there are well over 30,000 microenterprises which are widespread throughout the country including a variety of artisanal and informal sector activities and in addition to some 300 SMEs in the formal sector. Together, these small-scale economic agents represent the largest number of actual and potential users of financial services in Madagascar as well as a potentially significant source of financial savings.

Sustainable and equitable long-term growth in Madagascar cannot be envisaged without the active participation of this overwhelming majority. Yet, many of them have little or no access to the existing financial system and are therefore unable to effectively contribute to resource mobilization nor to fully avail themselves of payment services, working capital, term loans or equity finance from existing financial institutions. One of the biggest challenges for the future will be to improve financial services to this category of the population and better integrate them within the overall financial system.

There is much evidence to suggest that substantial savings exists in Madagascar among small-scale economic agents, particularly in rural areas which tend to generate net surplus resources. However, for various reasons, the financial system in Madagascar has not captured the bulk of savings among small-scale economic agents who tend to prefer real assets to financial assets. At the same time, their demand for financial services (both debt and equity finance as well as depositary and payment services) is high but is known to be largely unmet by formal financial institutions and believed to be inadequately provided by informal institutions. The fundamental problem remains one of access of small-scale economic agents both to financial services and information.

One institution does have a wide network of offices for the collection of savings: the Caisse d'Epargne de Madagascar (CEM). CEM already attracts the business of every fourth inhabitant in Antananarivo and hence, has a good foundation form which to grow further. Apart from its one outlet in the capital, CEM operates 220 windows in post offices in 208 towns throughout Madagascar, giving it the widest financial network in the country. The vast majority of its accounts are held by individuals; the rest are held by a handful of enterprises, local governments, educational institutions, and religious as well as other associations. Individual accounts however average only about FMG 40,000 (much lower than the minimum deposit required by commercial banks for a checking account). Thanks to its widespread network, the CEM could form an excellent base for establishing the necessary link between informal and formal financial activities. With an access rate to the market of one account for every four persons in Antananarivo, it makes it a formidable platform to be the link to the formal banking system. At the same time, a large portion of the small-scale finance initiatives could be both initiated and operated through the CEM. Notwithstanding this potential, however, the CEM remains hampered by organizational and other problems.

At present, CEM provides only very limited service to its customers. Its financial management is hampered by its dependence on the Treasury with which it is required to place all its funds and which pays a below market interest rate on its accounts. Delays in making funds available to customers reduce the attractiveness of the CEM as a major agent for mobilization of resources. There is no clear-cut marketing strategy through which the CEM could better adapt and design financial products so as to broaden its clientele and enlarge its deposit base. The revenue generating capability of the CEM is constrained in its present form, making it difficult to make the necessary investments for CEM to play a more active role as a financial institution.

CEM has a diversified clientele. Individual depositors who number about one quarter of a million are drawn from artisans, traders and farmers, mainly in urban areas. Despite a relatively passive promotion effort, CEM manages to open 700 new accounts on average every month. This underscores the substantial scope for developing CEM as a savings bank. However, its attractiveness to depositors will remain limited by relatively cumbersome service, among other factors. For example, interest on passbook savings must be updated at the CEM center in Antananarivo and personally certified by a public accounting agent, creating delays for customers.

Another problem faced by small-scale economic agents (particularly SMEs which need capital equipment) is a lack of equity financing. One potential vehicle for such financing which is yet to fully develop in Madagascar is venture capital. Venture capital is equity financing based on the principle that a partnership can be forged between the entrepreneur and the investors. This is still a relatively new financial instrument in both industrial and developing countries. The impact of venture capital companies in Madagascar on the growth of private enterprise has been so far very limited, both generally and particularly for SMEs. Venture capital companies can only grow at the pace at which private enterprise thrives and matures, and a capital market develops. The main incentives for venture capital companies will come from policies that improve the profitability of real sector activities and which facilitate entry of SMEs into new spheres of activity.

B. Towards a Financial Sector Strategy

A listing of what needs to be done, drawn from the financial sector assessment, would appear daunting; and indeed a great deal must be done to endow Madagascar with a financial sector responsive to its economic operators and to its people. The World Bank report on the Financial Sector, which was the source of much of Section III.A., provides a framework for organizing interventions in the financial sector. This framework is helpful in that it groups interventions around three key objectives. Secondly, it situates the interventions proposed under FMD in the full context of what needs to be done. Finally, it previews the priority areas for World Bank intervention.

The three key objectives form the basis of a medium-term approach to a financial sector strategy. The World Bank project, described below, and FMD will begin the process of operationalizing the strategy. It is clear from the table at the end of this section that there will have to be subsequent interventions in the financial sector in order to fully accomplish the objectives. The activities being jointly undertaken by the World Bank and USAID will be followed by other public and private interventions once the impacts of these projects materialize. A revitalized financial sector can meet the challenges it confronts by further improvements in three closely related areas:

(i) Increasing the level of financial savings: Channeling available savings through the financial system can help ensure that capital is most productively used. This requires measures to increase confidence of savers in the value and safety of financial assets which can increasingly substitute for the significant share of savings in Madagascar that is unmonetized. Furthermore, there appears to be promising potential in two areas to encourage savings through financial assets: (a) among the vast majority of small-scale economic agents who have not yet accessed the existing financial system; and (b) through long-term financial contracts such as insurance and social security.

(ii) Increasing the efficiency of investment: As the key ingredient for increasing efficiency of investment and promoting rapid economic diversification in Madagascar, increased private investment requires that financial savings be effectively channeled to its most productive uses. A well functioning financial system will help promote high-yielding projects by: (a) fostering competition among lending institutions which disciplines their lending decisions on which their profits and survival depend; and (b) ensuring that risks and returns of investments are appropriately balanced through financial markets which help price the cost of capital and distribute the risks of investment.

(iii) Lowering the costs and risks of financial transactions: Effective intermediation of savings and investment through the financial system in Madagascar depends fundamentally on reducing the costs and risks of transferring resources from savers to borrowers and from payers of financial obligations to recipients of funds. Improvements in the legal, accounting and payments system are needed to lower these costs and risks, thereby encouraging use of the financial system to settle economic obligations, to channel savings and to finance investment.

These objectives are the basis of a financial sector strategy developed by the Government of Madagascar in collaboration with the World Bank. The key measures making up a strategy responsive to the three objectives are presented in Table III.1.

Table III.1 Financial Sector Strategy

KEY OBJECTIVE	KEY MEASURES
INCREASING FINANCIAL SAVINGS **Operational goals:** **Increase real returns of financial assets and confidence of depositors** **Small-scale savings mobilization** **Boosting contractual savings**	Increased credibility and effectiveness of Central Bank monetary policy Strengthened supervision and regulation of financial institutions Revamping postal savings and checking systems Improving operating incentives and regulatory framework of insurance and social security
ENHANCING EFFICIENCY OF INVESTMENT **Operational goals:** **Increase share and level of private investment** **Promoting high-yield investments** **Improving pricing of capital**	Averting crowding out of private investment Enhancing competition within financial sector including divestiture of remaining government shareholdings Building money and capital markets to price and distribute financial risk
LOWERING COST AND RISKS OF FINANCIAL TRANSACTIONS **Operational goals:** **Improving financial intermediation and payment services**	Strengthening legal framework to protect financial contracts Improving accounting, auditing and financial disclosure Increasing speed, accuracy and reliability of financial payments and transfers

FMD and World Bank supported activity

World Bank supported activity

FMD-supported activity

C. Rationale for the Program

Section III.A presents an overview of the financial sector in Madagascar in terms of its strengths and weaknesses (See Annex C for the complete financial sector assessment). Section III.B organizes the work to be done in terms of three key objectives and seven subsidiary operational goals. This section presents the rationale for the specific approach chosen by USAID/Madagascar for its intervention in the Malagasy financial sector drawing on the information and analysis of Sections III.A and B.

A great deal of technical work and investment remains to be done if all of the weaknesses in the financial sector are to be eliminated. It is clear that the scope of activity required is too awesome to consider a program to simultaneously address all of the issues. In fact, the analysis suggests a natural or logical sequencing of much of the work; especially in terms of which institutions should receive priority attention. Weaknesses in critical existing institutions argues for improving their effectiveness before moving on to creating and supporting the specialized financial institutions that will fill out the structure of the financial sector. Indeed, the analysis suggests that private investors can be expected to provide much of the technical expertise and capital needed to create these specialized institutions once the policy framework and sufficient demand for the services of these institutions exist.

The Central Bank is at the heart of the financial system. Its weaknesses radiate out through the other financial institutions, producing negative impacts in the real economy in terms of low investment and economic growth. A poorly conceived and ineptly implemented monetary policy retards financial sector development and prevents the financial sector from mobilizing the resources for the real economy.

The GRM recognizes this. In 1992 the GRM asked the World Bank to take the lead in organizing technical support to upgrade the ability of the Central Bank to design and implement monetary policy. The World Bank responded by designing, in collaboration with the Central Bank and three bilateral donors including USAID, its Financial Institutions Development Technical Assistance Project (FINDEP). The project was approved by the World Bank's Executive Board on May 25, 1993. FMD was designed as parallel financing to FINDEP. Switzerland and Sweden will also provide parallel financing to FINDEP. Each donors' participation is described below in Section III.D. The scope of FINDEP is the Central Bank, the Financial Supervisory Commission (CCBEF), commercial bank auditing and accounting regulations and the two commercial banks with majority state ownership. USAID/Madagascar believes that there is a compelling rationale for including the Central Bank as a target institution in FMD. Until the Central Bank is able to implement a non-inflationary, market-based monetary policy, it would be premature to attempt to improve other elements of the financial system (for example, the term structure of credit or foreign trade financing).

40

USAID is mandated to ensure that its programs lead to sustainable, broad-based economic growth; with particular emphasis to be given to extending the benefits of economic growth to low-income rural and urban households. Central Bank operational efficiency is a necessary, but not sufficient, condition for low-income household access to the services of the financial sector. Section III.A. documented both the virtual nonexistence of financial services to these target households and more generally, the difficulty all developing countries have in extending financial services to low-income households. In Madagascar, the poor's need for safe, reliable and convenient forms of financial savings are inadequately met by formal financial institutions. Their needs for credit are not met at all by these institutions. Given the higher costs and risks of serving these households relative to trade financing and other alternatives available to private financial institutions, it is unlikely that the private sector will move into this market in the near term. Therefore, providing funds and technical resources to the private sector for this purpose is probably premature. USAID/Madagascar is channeling a modest amount of technical support to the commercial banks in Madagascar via the Africa Bureau's "Training for Bankers" grant to the International Fund for Education and Self-Help.

FMD proposes to work with the only existing financial institution in Madagascar that targets low-income households as its clientele, Caisse d'Epargne de Madagascar (CEM). CEM has a vast network throughout the country capable, in theory, of putting virtually the entire population in touch with the financial sector. Assessments of the CEM undertaken by USAID show obvious ways in which the financial services offered by CEM could be improved. CEM management is well aware of these possibilities. They have made progress commensurate with the level of resources available to them. Institutional limitations and limited resources inhibit full exploitation of CEM's potential. FMD will provide CEM with the institutional structure and resources to accelerate its development.

AID guidance cautions missions against working with parastatals where private sector support is more appropriate. USAID/Madagascar has carefully considered this guidance as CEM is a parastatal. The mission has chosen to include CEM in the FMD program as the best option available to assist low-income households obtain access to financial services. The existing financial system does not have any private sector institution with a low-income household clientele, or even a desire to attract such a clientele. Commercial banks intentionally exclude low-income households by imposing minimum deposit levels on accounts. Only BTM, one of the five commercial banks, offers a branch network that extends beyond the six provincial capitals and it too is a parastatal, and a troubled one at that.

The mission assessed the feasibility of the privatization of CEM during the four-year life of FMD. It was judged to be infeasible. The current operations of CEM are integrated with the Post Office. Establishing a fee-for-service system needs to precede privatization. CEM accounting is based on public and not commercial accounting. The accounting changeover will occur under FMD. The legal system in Madagascar does not have provision for a corporate entity which is fully state-owned but which can take on private capital. The approach proposed in FMD is to require the adoption of a new statute for CEM which will enhance its commercial status as an interim measure. During the life of the program, CEM will be restructured in such a way as to be attractive to private capital participation in the future. The partial privatization of CEM in the future will be fully consistent with the GRM Statement of Financial Sector Reform and Development Policy.

The two components of FMD will contribute to both the efficiency of the financial system and to USAID's equity goal.

D. Other Donor Assistance

This section begins with a description of the World Bank's Financial Institutions Development Technical Assistance Project (FINDEP) including donor-financing which is parallel to FINDEP and then describes other projects operating in the financial sector.

FINDEP's objectives, taken from the Staff Appraisal Report are:

> to facilitate investment and growth in the productive sectors by improving the functioning of the financial system. The project supports key financial institutions and financial markets in Madagascar to enhance public trust in them, thereby enabling them to mobilize savings to meet the financing needs of the private sector. The project is to be implemented in the context of a clear financial sector strategy reflected in a Government statement of financial sector reform and development. Specifically the project would aim at: (i) improving the Central Bank's ability to effectively formulate and execute its monetary policy; and (ii) improving the prudential supervision environment through the strengthening of the Financial Supervisory Commission and the formulation and enforcement of accounting, audit and financial disclosure for banks based on international norms.

The project will consist of:

(a) strengthening the Central Bank, principally through improvements in its research, open market, treasury, internal audit and accounting operations, and through the implementation of information technology and human resource development plans;

(b) strengthening CCBEF, the Financial Supervisory Commission, with technical assistance to create an effective supervision structure, training for inspectors and equipment for on- and off-site surveillance; and

(c) strengthening the banking environment by: implementing transparent international accounting and audit procedures for banks through the adoption of a uniform accounting plan and strengthening of prudential supervision, and providing technical assistance to facilitate the privatization of the two remaining state banks.

The governments of Sweden, Switzerland and the United States and the International Monetary Fund participated in the design of the project with the World Bank. Total project costs are estimated at $10 million. The World Bank will provide $6.1 million. Bilateral donors will finance the remainder via parallel financing. USAID, under the FMD program, will provide $2.8 million for technical assistance and training support for the Research Department and human resource development at the Central Bank and $3 million cash transfer to reinforce policy reform performance and ease external debt payment. Switzerland will provide $0.65 million for technical assistance, training and equipment for foreign exchange and internal audit operations. Sweden will provide $0.5 million for project management assistance. The Monetary and Exchange Affairs Department of the IMF will provide technical assistance in developing CCBEF and in recruiting a qualified bank inspector to direct its development plan.

FMD was designed as an integral part of this coordinated support to the Central Bank. GRM approval of the FMD Program Agreement is one of the conditions for effectiveness of FINDEP. Conversely, the Central Bank component of FMD could not achieve its objectives without FINDEP. FINDEP was approved by the Executive Board of the World Bank on May 25, 1993. Implementation is to begin in October 1993.

The only other significant institution-building project in the financial sector is the World Bank's Rural Finance Technical Assistance Project. The project, which is just getting underway, aims to promote rural mutual savings and credit associations. It is a four-year pilot operation, with a budget of $4.6 million. The project aims to reach about 10,000 households, or about 65,000 people. The budget and beneficiary size are indicative of the absence of existing institutions catering to the need of small-scale savers and borrowers. There is a possible linkage between this project and the CEM component of FMD, in that the CEM could target these associations as potential clients for the savings facilities of CEM. The likely impact on CEM would be small as the Bank project will be working in four small geographical areas in Madagascar.

Several organizations, including French Cooperation, UNDP and the World Bank, operate special credit programs for private enterprises. These programs are implemented through the commercial banking system and are conceived and perceived as credit windows and not initiatives to alter the structure of the financial system.

IV. THE PROGRAM DESCRIPTION

A. The Program Goal and Purpose

The goal of the Financial Market Development Program is to increase investment and employment in the private sector. The purpose of the program is to increase the level of domestic financial savings and the share of savings going to the private sector. The program will augment the capability of two financial institutions (the Central Bank and the Caisse d'Epargne de Madagascar) to fulfill their objectives.

B. The Policy Framework of the GRM

The policy framework of FMD centers on institutional and operational changes that are essential to permit the two target institutions (BCRM and CEM) to successfully carry out their functions in the Malagasy financial sector. The policy reforms of FMD are situated in a larger financial sector reform program being carried out by the GRM. This program is guided by the GRM Statement of Financial Sector Reform and Development Policy (Annex I).

Briefly, the statement comprises seven goals. First, the Government will pursue a public expenditure program consistent with a significant lowering of the deficit in the short to medium term, and will relieve BCRM of all its quasi-fiscal obligations. Second, a full range of institutions, markets and instruments will be developed over time to ensure that all segments of the population have access to financial services, which effectively mobilize financial savings and efficiently transfer them into the real economy. Third, over time the financial system will promote a market determined set of key prices, notably interest rates that remain positive in real terms and, eventually, an exchange rate that is market determined. At present, despite monetary reforms, interest rates are extremely rigid and thus fluctuate in real terms from negative to positive without any reference to demand and supply for resources. It is recognized, however, that this can only be achieved if macroeconomic stability is restored and fundamental institutional weaknesses in the banking sector are resolved.

A fourth goal of the financial sector strategy is the development of a rigorous and effective prudential supervision which also implies an appropriate framework of accounting, auditing and financial disclosure for financial institutions. At the core of many of the financial sector problems experienced in Madagascar over recent years has been the lack of reliable financial information, combined with a deficiency in the prudential supervision of financial institutions. A strategy to raise standards in financial information and strengthened supervision is, therefore, essential to the financial sector reform. Fifth, that there is an eventual shift to indirect instruments of monetary control so that the objective of allowing market determined allocation of resources is pursued, and direct controls are removed. Sixth, that state ownership and control in all bank and non-bank financial institutions will be removed and a sound institutional framework with strong and competitive financial institutions be promoted. Finally, that the appropriate financial infrastructure (legal system, payments system) exist to ensure the efficiency and security of all financial transactions (payments, deposits, loans, etc.).

The first phase in the implementation of the overall sector strategy will focus on the immediate priorities of reforms in the BCRM, the CCBEF and the CEM. This phase will be supported by USAID via the FMD program, the World Bank via the Financial Institutions Development Technical Assistance Project (with co-financing from Switzerland and Sweden) and The International Monetary Fund via long-term technical assistance. The contribution of each partner was described in Section III.D.

C. Description of the Program Performance Criteria and Project Activities

1. The Central Bank

The operations of the Central Bank will be transformed during the FMD Program. A major initiative is the revision of the 1973 statutes of BCRM, which will give BCRM a clearer and more independent role in the formulation and execution of monetary policy. Under the new statutes, the BCRM will guide the transformation by following the Strategic Development Plan (SDP). It is intended to enable BCRM to overcome two organizational weaknesses. First, BCRM has an inappropriate structure in both primary (e.g. research) and support functions (e.g. accounting) to conduct monetary policy through indirect controls. Second, the Bank's human and information technology resources need to be improved and adapted so that they are better equipped to meet the demands of a market-oriented financial sector.

The SDP will constitute a business plan for the Bank's organizational development over a three- to five-year period. The plan has four elements: (a) a statement of key policy and business objectives, (b) action plans for department strengthening and for restructuring BCRM, (c) more effective application of information technology systems, and (d) human resource development. The SDP represents the beginning of a strategic planning and development function in BCRM. BCRM will form a steering committee comprised of senior BCRM management and department managers to continually review the implementation of the SDP and approve organizational and information technology plans. The steering committee will consult with outside advisors on worldwide organizational practices in central banking.

Under its SDP, BCRM statement of objectives will be categorized into "business objectives" and "institutional objectives". The business objectives comprise : (a) price stability through the pursuit of monetary policy, eventually based on indirect instruments, and (b) legal, administrative and financial independence of the Central Bank through the revision of its statutes and the removal of all quasi fiscal obligations. Institutional objectives include: (i) strengthening the budget and internal control functions within BCRM through improved accounting systems and procedures and their harmonization with a new charter of accounts for banks; (ii) development of an internal audit function; (iii) development of a fully-fledged research and statistics department; (iv) strengthening of capacities in foreign exchange management, with the Central Bank ultimately playing a supervisory rather than a clearing role in the foreign exchange market; (v) strengthening capacity to implement monetary policy through indirect instruments and, ultimately, open market operations; (vi) increasing capacities to monitor credit-worthiness of banks going hand in hand with the elimination of the review of individual bank loans for BCRM refinancing; (vii) enhancing domestic currency management by improving planning and communication capacities; (viii) development of modern information systems for the generation, processing, storage, transmission, and retrieval of operational and management information in all departments; and (ix) improvement of human resource functions especially in the areas of recruitment, training, and promotion.

The FMD Program will support the BCRM's restructuring by linking the cash transfer disbursement to the following performance criteria:

1. The Government of the Republic of Madagascar adopts a new governing statute for the Central Bank. The statutes will specify: (1) the objectives of the Central Bank; (2) the fixed terms for Governor and Board members and grounds for dismissal; and (3) limitations on advances from the Central Bank to the Treasury.

2. The Board of Directors adopts the Strategic Development Plan drafted by the staff of the Central Bank. The Strategic Development Plan will specify the responsibilities of each Department and will contain a three-year action plan for each Department.

3. The Direction of the Central Bank approves the Research Strategy and a first year research work plan.

4. The Central Bank publishes an annual report, which includes an externally audited balance sheet and income statement.

The first two conditions precedent for first tranche disbursement will give concrete form to the GRM commitment to reorient BCRM toward its proper function which is maintaining price stability through the pursuit of monetary policy. Satisfaction of these CPs will equip BCRM with both the legal status and the operational plan it will need to fulfill its function. Satisfaction of the third and fourth CPs will indicate that BCRM has used its new status and the donor-provided assistance to begin to fulfill its new mandate. It is expected that the third and fourth CPs will be satisfied within one year of commencement of the program.

The FMD project technical support will concentrate on the Research Department and the development of human resources. With the requirement for BCRM to have access to macroeconomic and policy related data on a systematic basis so that it can fulfill its role in formulating and executing monetary policy, the SDP provides for the development of the Research Department exercising specific data analysis and policy functions. The FMD program will support: (i) the work of an expatriate technical advisor to help implement a three-year action plan for this department, along with a local director and core staff, to ensure the flow of critical information in the formulation of monetary decisions; (ii) strengthening, through specific training and technical assistance, BCRM capacity to formulate monetary policy as well as act as advisor to the Government; and (iii) improvement of BCRM ability to keep the public informed through the regular publication of statistical, policy and research informat.on. Actions will then result in: (a) the preparation of an annual review of the economic and monetary environment; (b) enhancement of the quarterly statistic bulletin; and (c) the publication of occasional research papers.

A human resource development plan will ensure that the skills requirements of the restructured and strengthened BCRM departments, and more generally the evolving personnel needs of BCRM, are met. The program will provide assistance to: (i) develop and implement an improved personnel policy including systems for staff classification, career planning and promotion and job-rotation; (ii) review personnel needs in different departments and to define the complementary training needed for redeployment; (iii) define training modules for various occupational streams such as economist and financial analyst; (iv) support training programs to meet the skills requirements of the restructured bank over a three-year period; and (v) assist in the development of the personnel management function to improve staff classification, rotation, promotion and training.

The BCRM will develop new and more efficient internal policies in three areas: personnel administration, staff development and information processing and management. The idea of redesigning the personnel administration system originated from consultancies provided by the Federal Reserve Bank (FRB) of New York. Under the current BCRM personnel system, an employee's grade, or professional level, is uniquely determined by the employee's highest educational degree. Once classified, an employee can advance to the next grade only by obtaining a higher educational degree. Experience cannot substitute for eduction. As a result, employees' professional advancements are severely limited and mid-career employees are often unmotivated and unproductive. Compounding this problem is the absence of any systematic program of staff rotation which limits professional staff development. The senior staff of BCRM received briefings from FRB New York staff on FRB's personnel system during program design. BCRM senior staff has decided to develop a new personnel system incorporating the concept of professional development within "cones", such as financial analyst or economist. Under this system, career advancement will be determined by experience and performance as well as education. The personnel management system will encompass recruitment criteria, functional specialty position classification and advancement criteria.

The new personnel system will be complemented by a new staff development program. Staff development will also be based on the concept of professional cones. Each cone will have a career path, orientation training, in-service training, rotation through different BCRM departments and advancement criteria. In-service training will be a combination of in-house courses taught by BCRM staff and short courses abroad. Training subject areas will include technical specialties, management, and foreign language training. Both the personnel management system and the staff development program will be developed in the next year.

The specific inputs that will be provided by the FMD project to BCRM include:

a. Research Department. Within the framework of the SDP, the FMD project will provide an expatriate research advisor for a period of three years.

The advisor will be responsible for assisting in the development of the major focuses of the work of the Research Department with a view to reinforcing its analysis and forecasting capacities and its ability to collect and organize statistics.

The advisor will assist in:

(i) improving the structural organization and the working methods of the Research Department;

(ii) training of the Research Department staff, and maintaining them at a sufficient level of technical quality to carry out the terms of reference of the Research Department;

(iii) training of staff responsible for examining and using statements, documents, and statistics submitted by banks and financial institutions, ministries, other public agencies and other bodies, including international organizations, with the support of other experts or instructors who may be required for specific activities; and

(iv) preparation, for the Governor and General Management, of economic and financial studies and recommendations pertaining to monetary policy and the procedures necessary for their implementation.

The advisor will be responsible for coordinating and monitoring the research done by short-term advisors funded under FMD.

The advisor will ensure that before he or she leaves, the Department has acquired the know-how to carry out its functions correctly and to handle any responsibilities which may not have been specifically addressed.

To achieve these goals, he or she will participate in all meetings concerning monetary policy management and pertaining to the collection of economic, monetary, and financial statistics, and will receive all information necessary to carry out his or her duties and to allow the advisor to propose the improvements which he or she deems appropriate for the research function of BCRM. In particular, the advisor will participate in the development of the Research Department's annual work plan.

As regards the training of research staff, the advisor will supervise missions assigned to insufficiently experienced staff and will supervise those led by more seasoned staff, possibly in the form of individual activities at different stages of supervision. The advisor will ensure that the methods and techniques proposed by him or herself or by other instructors have been sufficiently assimilated and the staff involved are able to use them on their own and if applicable to convey their knowledge to their colleagues. More generally, the advisor will take every opportunity (such as the discussion of the reports which have been filed, organization of training sessions on difficult topics, etc.) in order to enhance the knowledge of the Research Department staff and to improve their working methods, so as to make ongoing training a spontaneous activity, thus guaranteeing that the goals of excellence are pursued after the advisor leaves, to ensure that the Research Department operates properly.

The advisor will have a doctorate in economics; ten years of experience in a central bank, university or research institution; a record of publications in fields relevant to central bank research needs; and facility in French at the FSI 3+/3+ level.

In addition, the project will provide fourteen person-months of short-term technical assistance (STTA) to the Research Department. The STTA will be integrated into Department working groups responsible for specific research areas (e.g. balance of payments, rural finance, credit policy analysis). Each STTA will provide advice to the working group on research methodology, analysis and presentation of results. The resident research advisor will coordinate, on behalf of BCRM, the work of the STTAs.

A total of nine in-country training courses will be provided for Research Department staff (three per year for three years). The subject matter of each course will be determined by the research to be undertaken and the skill deficiencies of the staff. Courses during the first year will review the economic and statistics principles underlying applied research.

The project also budgets $60,000 for software and technical books for the use of the Research Department staff.

b. Human Resource Development. The SDP will contain a human resource development plan which will insure that the skill requirements of the restructured and strengthened Central Bank Departments, and more generally the evolving personnel needs of the Central Bank are met. FMD will support this effort in three ways: (i) providing a short-term technical assistance team to advise the Central Bank in personnel management systems at the beginning of the program and again in the second year of the program, (ii) providing a short-term technical assistance team to carry out a staff training needs assessment in the first year of the program with a follow-up consultancy in the second year, (iii) providing twenty-four in country seminars, thirty-nine short courses abroad and in-country English-language training to the staff. The amount of training and technical assistance provided to Central Bank staff will not exceed what can be absorbed taking into account the workload of the staff.

2. CEM

The organizing idea behind the modernization of the CEM is to first do better what they do now; and once that is accomplished expand their operations into new areas. For convenience, mastering their current operations will be called phase one; phase two will be the period of business expansion. The manual recordkeeping system at CEM is operating at capacity. Any increase in their business activity now would lead to further deterioration in customer service quality. Phase one will begin with the computerization of CEM records and the automation of their daily operations. Computerization began at CEM in 1988 with the preparation of their Information Plan. The pace of computerization has been slow because of the modest level of resources that has been available. With existing equipment and staff, full computerization of the CEM's records would take eighteen months. Existing equipment is adequate to equip six of the forty-six sections. The CEM intends to progressively automate the twenty-five largest sections during phase one. Full automation of the remaining sections will depend on each section's level of activity during phase two. Computerization of the CEM system will make it possible to automate the calculation of interest and decentralize its posting. This change will eliminate one of the biggest complaints customers voice about CEM.

CEM will change its accounting system from one based on public accounting principles and methods to one based on commercial practices (the Plan Comptable Général of 1987). This commercial-based accounting system will make it possible for CEM to develop, implement and monitor a financial plan for phases one and two.

CEM will develop and implement a staff training plan. Priority areas for training will be accounting and bookkeeping, computer skills, marketing, and management. There will be some modest staff expansion in the areas of information systems, personnel and marketing.

The organizational structure of CEM will be modified in accordance with a proposed reorganization prepared by consultants during program design.

CEM will prepare a marketing plan during phase one. The marketing plan will be based, in part, on a market study of CEM clients and non-clients that was conducted during program design.

The final element of phase one work will be the preparation of new governing statutes for the CEM. The new statutes will be an interim step in the process of preparing CEM to be able to accept and attract private sector participation in ownership as envisioned in the GRM Statement of Financial Sector Reform and Development Policy. The new statute will allow CEM to invest its assets outside of the treasury, set the interest rate for depositors' accounts and operate a personnel system independent of civil service regulations. Also, the composition of the Board of Directors will be changed to reflect CEM's emerging status as a financial institution.

During phase one, two major changes in CEM's financial position will take place. Firstly, the GRM Treasury will reimburse the CEM for the interest the CEM did not receive on its deposits at the Central Bank during the period 1975-1985. This action will reestablish a positive net worth on CEM's balance sheet. Secondly, the Treasury will begin to pay a market-based interest rate on CEM deposits at the Treasury. The actions taken together will enable the CEM to self-finance a portion of its modernization program.

The principle activities of phase two are the implementation of the marketing plan, including the introduction of new savings instruments, and the exploration of the feasibility of introducing credit operations. It is anticipated that the actions accomplished in phase one will be sufficient to enable the CEM to capture a much larger share of the savings of low-income households than it has done in the past.

The FMD Program will support the restructuring of CEM into a viable financial institution by linking the cash transfer disbursement to the following performance criteria:

1. The Government of Madagascar deposits into the account of the Caisse d'Epargne de Madagascar held by the Caisse de Dépôts et Consignations the amount of two billion, nine hundred million FMG (FMG 2,900,000,000).

2. The Minister of Finance publishes a decree fixing the rate of interest of the deposits of the Caisse d'Epargne at the Caisse de Dépôts et

Consignations equal to the rate applicable on Bon du Trésor par Adjudication (twelve month Treasury Bills). The rate of interest on CEM deposits at CDC will be adjusted every three months. The interest rate for each three month period will be equal to a weighted average of the BTA rate for the previous three months. In the event the BTA market is not functioning, the last published rate will apply unless USAID and the GRM otherwise agree in writing.

3. The Government of the Republic of Madagascar adopts new statutes for the CEM in a form acceptable to USAID. The new statutes will (1) reduce the size of the Board of Directors; (2) provide for autonomous Board management of the assets of CEM; (3) establish a personnel system that is managed autonomously; and (4) replace the current accounting system with the commercial accounting system (Plan Comptable Général).

The first CP will redress the balance sheet of CEM. Once the transfer has been made, the CEM will have sufficient assets to cover all depositor claims and a positive net worth. The second CP will put CEM on an equal footing with other, mostly private, institutions that make loans to the Treasury. The CEM, acting as judiciary agent for its low-income clients, will obtain a market-based return on their savings. The third CP will equip CEM with the legal status appropriate to an emerging financial institution and will pave the way for eventual private sector capital participation.

In addition to the policy changes, the FMD technical support will concentrate on assisting CEM with its modernization and staff development plans.

To this end, FMD will provide technical assistance, training and commodities to the CEM. All technical assistance to CEM will be short-term. Expatriate STTA will provide advice on strategic planning for a financial institution and will be expected to serve as a "critical eye" on the modernization program. They will assist CEM to set up a financial reporting system useful as a management tool. A total of seven person-months of STTA will be provided.

Malagasy STTA will be furnished in the areas of information system design, financial planning and accounting, service delivery (simplifying procedures for customers at the CEM service windows), staff development and marketing.

Three types of training will be provided to CEM staff. Participation at international seminars for senior staff will be funded by FMD (three seminars per year). Local training institutions will be hired to prepare and provide tailored courses for the rest of the staff. Over the life of the project all CEM staff will receive training to improve their performance. CEM will identify current staff who have exhibited potential for greater responsibility. These employees will receive additional training to increase their upward mobility. This training will allow the CEM to "promote from within" which should benefit staff morale and productivity. The third type of training is study tours. The project will fund two

62

study tours for CEM staff to visit successful savings banks in other countries.

Approximately thirty percent of the funds allocated for CEM in the project will be used to purchase computers, software and other office equipment. The project will purchase sufficient computer equipment to allow CEM to automate twenty-five of its branch offices and fully automate its headquarter's back-office operation.

D. Discussion of Key Assumptions

▸ **Assumption #1. Investment in Madagascar is constrained by a lack of financing.**

The goal of FMD is to increase investment and employment in the private sector. The program posits that this can be done by increasing the level of domestic financial savings and the share going to the private sector. Available financing does not alone guarantee that investments will take place. The economy must offer opportunities for new economic activities that will yield an adequate return to investors.

USAID/Madagascar's CPSP describes the unexploited potential of Madagascar's natural and human resources. The country's agricultural potential is analyzed in detail in _Regional Specialization and Agricultural Growth in Madagascar_ done by Associates for International Resources and Development for the World Bank in 1993. It finds that opportunities for marketing a greater variety of agricultural products are increasing both domestically and overseas. Madagascar's well-trained and inexpensive labor force has already begun to attract labor-intensive operations from Mauritius and Asia. Local investors are also creating and expanding industrial capacity in labor-intensive manufacturing. For the most part, these new operations in manufacturing and agriculture are self-financed by the operators. Bank financing is the preserve of large, established firms. The logic of financial sector development is that a healthy financial sector will attract new banks and non-bank financial institutions. Higher levels of domestic savings will facilitate this growth. Competition among the new and established banks will force banks to seek out new clients and to develop more attractive credit instruments. FMD and FINDEP will improve the environment for commercial bank operations. This should reduce the extent to which investments in Madagascar are self-financed and increase the total amount of investment that takes place.

▸ **Assumption #2. GRM will take policy measures to improve the investment climate.**

The investment climate in Madagascar needs to be improved. A USAID-funded study entitled _Environment for Investment in Madagascar: Institutional Reform for a Market Economy_ details major flaws in the existing regulatory system. The study was undertaken at the request of the Ministry of the Economy. The ministry requested USAID to widely circulate the report within the government and the private sector. This was done in April and May, 1993. Follow-up work will be undertaken in July and August. It is expected that this work will result in a public debate on ways to improve the investment climate and concrete action by the new Malagasy government. The recent change in government in Madagascar frees the authorities from the need to defend past policies. The flaws in the system are acknowledged. The assumption that the government will take the necessary steps seems valid. USAID/Madagascar will support the GRM in this area via its Business Expansion Services and Technology (BEST) Project; a FY 1994 new project.

▸ **Assumption #3. GRM pursues a fiscal policy which limits the fiscal deficit to a level which can be financed without recourse to excessive monetary expansion.**

The FMD program cannot succeed unless the GRM reduces the fiscal deficit below its current level. FMD was designed under the assumption that the following scenario will play out by the end of 1993. A new Prime Minister and Cabinet will be in place by the end of August. The new government will immediately address the country's economic predicament. An Economic and Financial Coordination Committee has already been appointed by the President and is working under the direction of the Finance Minister. By October the new government should have the main elements of its 1994 Budget established. This work will be reviewed by the IMF, the World Bank and the bilateral donors. If the GRM presents reasonable short-term measures to increase revenue and contain spending and if the donors provide the level of budget support that appears to be available, the IMF can be expected to approve a one-year Stand-By. This arrangement will give Madagascar access to the Paris Club for the first time since 1990 and the opportunity to reduce its debt service payments, which are part of the government's current expenditures.

Over the medium-term, the GRM will have to restructure its revenue sources and expenditure patterns in a way which is more supportive to economic growth. We believe that pressure from the IMF and the donors as well as the government's own commitment will ensure that this is done without jeopardizing the fiscal balance.

V. PROPOSED IMPLEMENTATION ARRANGEMENT

A. Managing the Program and Project Assistance

1. Joint GRM/Mission Responsibilities

The GRM has decided that the Ministry of Finance will be the lead coordinating Ministry, in close consultation with the Central Bank and CEM. The two components will be managed separately within each institution. Periodic meetings between the USAID Director and the Minister of Finance, along with the Governor of the Central Bank and the Director General of CEM, will assure high level joint discussions.

2. GRM Management Responsibilities

BCRM. The Secretary General of the Central Bank will be responsible for the overall implementation and coordination of the Central Bank component of the FMD Program. Within the Central Bank, the Research Department will be responsible for determining the research strategy and agenda that will be followed during project implementation. The Director of Administration and Personnel in the Central Bank will be responsible for human resource development activities to be carried out under the FMD program. He will work with the FMD Program Assistant and the Mission Private Sector Officer in the Market and Business Development (MBD) Office to procure the necessary short-term technical assistance and training needs. The Personal Services Contractor (PSC) Research Advisor will provide technical oversight of the STTA.

CEM. The Director General of the CEM will be responsible for implementing the planned changes at CEM and for overall coordination and management of the CEM component of the Program.

3. USAID Management Responsibilities

Private Sector Officer. Within the USAID Mission, the Private Sector Officer in the MBD Office will be responsible for the overall management of FMD. These responsibilities include day to day project management and coordination activities, procuring necessary short-term technical assistance and training, following progress toward meeting program conditionality and monitoring project progress. The Private Sector Officer will also supervise a Malagasy Program Assistant hired under a local PSC who will provide assistance in the carrying out of project responsibilities. The Private Sector Officer will chair an FMD Project Implementation Committee (PIC). The Mission Director will designate the members of the PIC.

Short-term technical assistance and training to the Central Bank will be provided through buy-ins to centrally funded AID/W projects or to AID/W Indefinite Quantity Contracts (IQC). Expatriate short-term technical assistance envisioned for the CEM will also be provided through buy-ins or IQCs. International training and study tours for the CEM will be organized directly by USAID from such institutions as the International Institute of National Savings Banks located in Geneva, Switzerland or would be part of a buy-in to a centrally-funded project. The project will minimize the number of separate procurement actions by grouping required STTA and training under buy-ins as much as possible and where it makes the most sense. The project will provide minimal commodities such as audio-visual and library materials to the Central Bank. These will be procured directly by the Mission. An IQC procurement contract will be used to procure computer and office equipment for the CEM. The Private Sector Officer will be responsible for processing the necessary procurement documents through the Mission and for overseeing performance according to the terms of the procurement documents.

Potential central AID/W projects that FMD could use for buy-ins include:

- Consulting Assistance for Economic Reform (CAER)
- Financial Resources and Management (FIRM)
- Financial Sector Development II

The Controller along with the Private Sector Officer will be responsible for the financial management of the program. The Controller will be responsible for requesting the disbursement of funds when program conditionality is met. The Mission Contracting Officer will support all contracting activities. He will issue contracts to local consulting and training firms on behalf of the CEM or BCRM for necessary locally-procured short-term technical assistance, training needs and commodities.

B. Proposed Financial Management Arrangements

1. The NPA Dollar Disbursement

USAID financing for FMD totals $6,000,000 of nonproject assistance. This assistance will be provided in two tranches as specific conditions are satisfied and will be provided on a cash disbursement basis. As required by Agency guidelines, USAID requested and received authorization from AID/W to use this mechanism and to use the cash transfer for multilateral debt repayment (see Annex H).

The GRM will use FMD NPA dollars for debt servicing payment. Eligible debt consists of all outstanding debts to multilateral organizations such as the World Bank, the International Monetary Fund, and other international organizations such as the African Development Bank. Madagascar is burdened with the same debt overhang that many developing countries suffer; the debt service ratio in 1992 equalled 90 percent and total outstanding debt equals approximately 124 percent of GDP. The total eligible debt is equivalent to $1.413 billion.

It is reasonable to assume that the GRM will use the FMD nonproject assistance to service existing debt rather than retire debt principal in light of recent decisions among official bilateral creditors, especially the Paris Club, to cancel or reschedule official debt under increasingly concessionary terms. Notwithstanding these debt reschedulings, service requirements on multilateral debts which cannot be rescheduled according to the terms specified by the World Bank and the IMF remain significant. Agency guidelines require AID/W authorization to use nonproject assistance to service eligible multilateral debt. USAID requested and obtained the required authorization as indicated in Annex H.

The following table shows the debt eligible for payment through FMD.

Table V.1

MADAGASCAR's ELIGIBLE DEBT
(Millions of US $ equivalent)

	AMOUNT			
	as of end 1990		as of end 1992	
	Million SDR	Million US $	Million SDR	Million US $
World Bank group				
IBRD	13.03	18.6	11.32	16.2
International Development Agency	552.05	789.4	634.01	906.6
International Finance Corporation	13.23	18.9	11.76	16.8
International Monetary Fund	100.98	144.4	88.67	126.8
Other International Organizations				
African Development Bank	42.98	61.5	42.88	61.3
African Development Fund	83.34	119.2	94.29	134.8
CEE/BEI	49.96	71.4	53.68	76.8
FIDA	19.22	27.5	20.1	28.7
Other (BADEA, Ligue arabe, OPEP)	21.32	30.5	18.4	26.3
Export-Import Bank	13.4	19.1	7.7	5.6
TOTAL	909.5	1300.5	982.8	1400.0

Source: Central Bank of Madagascar, June 1993, USAID staff calculation

In order to track the use of NPA dollars, the GRM will be required to submit a schedule of eligible debt to be serviced with the release of each tranche disbursement. The schedule will indicate the creditor, amount due and due date. The GRM coordinating ministry will send a letter to USAID requesting tranche disbursement based on proof that required conditions have been met along with the eligible debt schedule to be paid. USAID will then send a Program Implementation Letter (PIL) that conditions have been met and debt service approved. The USAID Director will then sign a Financing Request which the Controller will transmit to AID/W for disbursement.

The U.S. Treasury is then notified to disburse the funds to a bank in the U.S., at which the GRM has set up its account. The Ministry of Finance must establish a separate, non-commingled, interest-bearing account at a U.S. bank acceptable to USAID. The Ministry of Finance will instruct the U.S. bank to release the funds for direct payment of the specified debt as approved by USAID. The Ministry of Finance will then submit proof to USAID that the debt has been paid. Any interest accrued in the U.S. account will also be used for debt payment and will be indicated in the list of debts paid after each tranche disbursement. USAID will receive periodic statements from this account to monitor funds flow.

The schedule and amount of each tranche disbursement are as follows: Tranche One - December 1993 for $3 million and Tranche Two - December 1994 for $3 million.

2. Project Financial Plan

The total A.I.D. Life of Program (LOP) funding will be obligated with the signing of separate Program and Project Agreements in August or September 1993. The following table illustrates the summary illustrative program budget for both the nonproject assistance and the project assistance. As reflected in the table, the majority of expenditures are expected during the first three years of implementation of the program. Refer to Annex K for a detailed illustrative budget.

Host Country Contributions. The GRM will provide the equivalent of not less than $2,000,000 which has a value of 16 percent of total Life-of-Program funds of $12 million. The GRM contribution will comprise at least $1 million paid by the Treasury to the CEM as compensation for interest not paid during the 1975-1985 period and $1 million in increased interest paid by the Treasury to the CEM. The Assistant Administrator for Africa in AID/W approved a waiver of the required 25 percent host country contribution for the FMD Program on June 21, 1993. A copy of this waiver is included for reference in Annex G of the PAAD.

The host country in-kind contribution will include seven hundred person-months of salaries for Central Bank trainees, operating costs of the Research Department and the Administration Department of the Central Bank and the operating costs of the CEM. As a result of the financial situation described above, salary levels and other operating cost budgetary allocations are very low. For example, the monthly salary of a middle-grade civil servant is seventy-five dollars. Because of extremely low wage rates the in-kind contribution will not increase the total contribution of the GRM to the level necessary to reach twenty-five percent of total project cost. The GRM will also provide office space, furnishings and normal office supplies for the long-term research advisor at the Central Bank.

Table V.2

FINANCIAL MARKET DEVELOPMENT PROGRAM
SUMMARY ILLUSTRATIVE BUDGET
ESTIMATED EXPENDITURES
($)

	YEAR 1 1994	YEAR 2 1995	YEAR 3 1996	YEAR 4 1997	TOTAL
A. NPA CASH TRANSFER	3,000,000	3,000,000	0	0	6,000,000
B. PROJECT ASSISTANCE:					
BCRM:					
1. LONG TERM TA	258,805	155,426	187,117	0	601,348
2. SHORT TERM TA	326,400	205,632	95,962	0	627,994
3. TRAINING	475,000	535,500	523,687	0	1,534,188
4. COMMODITIES	40,000	20,000	0	0	60,000
TOTAL – ASSISTANCE BCRM	1,100,205	916,558	806,766	0	2,823,529
CEM:					
1. STUDIES AND ANALYSIS	50,000	50,000	50,000	0	150,000
2. LOCAL STUDIES	105,000	50,000	25,000	0	180,000
3. TRAINING	99,000	61,950	111,563	0	272,513
4. COMMODITIES	250,000	0	0	0	250,000
TOTAL – ASSISTANCE CEM	504,000	161,950	186,563	0	852,513
PROGRAM ASSISTANT	30,000	34,500	0	0	64,500
AUDIT	0	25,000	0	25,000	50,000
EVALUATION	0	40,000	0	40,000	80,000
CONTINGENCY	65,368	35,490	28,600	0	129,458
GRAND TOTAL	4,699,573	4,213,498	1,021,929	65,000	10,000,000

3. Methods of Financing

USAID/Madagascar has selected the following A.I.D. methods of financing: cash disbursement, A.I.D. direct payment, buy-ins to centrally funded AID/W projects, and AID/W Indefinite Quantity Contracts (IQC).

Table V.3
METHODS OF FINANCING

ITEM	IMPLEMENTATION	FINANCING	EST. AMOUNT
NPA	USAID	Cash Disbursement	$6,000,000
Research Advisor	U.S. PSC	Direct Payment	600,000
Program Assistant	Local PSC	Direct Payment	65,000
Short–Term TA–BCRM	AID/W / Buy–ins / IQC	Direct Payment	625,000
Training – BCRM	AID/W / Buy–ins / IQC	Direct Payment	1,535,000
Commodities – BCRM	USAID Procurement	Direct Payment	60,000
Studies and Analysis – CEM	AID/W / Buy–ins / IQC	Direct Payment	150,000
Local Studies, Expenditures, Training – CEM	USAID	Direct Payment	255,000
Int'l Training – CEM	USAID	Direct Payment	200,000
Commodities	USAID	Direct Payment	250,000
Audit	IQC	Direct Payment	50,000
Evaluation	IQC	Direct Payment	80,000
Contingency			130,000
TOTAL			$10,000,000

C. Monitoring and Evaluation Plan

1. Anticipated Program Impact

The anticipated impact of the two components of FMD will be considered separately.

The immediate impact of the reform of the CEM will be felt by its current 260,000 clients in the form of a higher rate of interest on their savings and an improvement in the quality of customer service. The current clients of the CEM are drawn primarily from the poorer populations in both urban and rural areas. In popular parlance, CEM is known as the "poor people's bank". As knowledge of CEM's improvements become more widely known by word of mouth and CEM advertising, there should be a reallocation of household savings toward the financial instruments of CEM and away from low return and/or risky household investments (mattress savings, livestock, etc.) and the attractiveness of CEM savings instruments may induce an increase in the level of household savings. As these new financial deposits flow into the Treasury the extent to which the Treasury will need to borrow from commercial banks to finance its deficit will be reduced, resulting in higher credit levels going to private sector investments.

The impact of the FMD Central Bank component cannot be isolated from the impact of the multi-donor program to strengthen the Central Bank. The most important consequence of a fully competent Central Bank will be the putting into place of a prudent monetary policy. The impact of a prudent monetary policy on the vulnerable groups that are of special interest to AID is that the "inflation tax" will be taken off low-income households. The inflation tax is the loss in purchasing power by households unable to protect themselves from the government's debasement of the currency. It has been called "the cruelest of all taxes". Inflation rates as high as twenty-five percent were experienced in the 1980s. More recently, these rates have averaged between ten and fifteen percent. GRM success in reducing the inflation rate, combined with market-determined interest rates, will combine to protect the real value of low-income household's financial savings and offer a positive rate of interest on those savings. An independent monetary policy will impose greater discipline on public finances and thus improve the quality of governance via greater financial transparency.

Strengthening the Central Bank will bring a variety of improvements in the longer-term. A growing confidence in the capability of the Central Bank to manage monetary policy and clearer rules and regulations for non-bank financial institutions will facilitate the emergence of new financial institutions and instruments. Such institutions as leasing and housing finance companies will provide new systems to channel savings into productive investments. Stock certificates, negotiable Treasury bills and notes, and corporate bonds are among the types of financial instruments that will emerge in a stable monetary environment. These types of institutions and instruments will make it possible to channel savings to groups and economic subsectors that are not served by current financial institutions.

2. Strategy for Monitoring and Assessing Program Impact

The strategy for monitoring and assessing program impact encompasses four levels of program implementation and progress: inputs, outputs, purpose-level indicators, and goal-level indicators. Each is discussed briefly below. The first step is to monitor the disposition of inputs associated with the reform program and the complementary project activity. The second step (and the first step in measuring impact) is to establish whether the resources provided as inputs have accomplished anything; in particular, whether performance criteria have been met and whether anything of significance has happened as a consequence. These are output-level indicators. The next step is to determine whether implementation of the FMD performance criteria has increased the level of domestic financial savings and the share going to the private sector. These are purpose-level indicators. The last step is to establish the effect that these intermediate outcomes may have had on increasing investment and employment in the private sector, which entails an assessment of goal-level indicators.

As with all monitoring and evaluation activities, this will require (a) a long term perspective, (b) good baseline data, (c) a comprehensive monitoring system which is embedded in the implementation process, and (d) willingness to accept that many causal linkages might be difficult or impossible to prove, especially at the purpose and goal levels. The indicators chosen and the means for monitoring them are discussed in turn below. Input monitoring is probably the most straightforward, and monitoring of goal-level impacts is most complex. A final section outlines the program evaluation strategy.

Input Monitoring. In the four years of FMD, the program encompasses the following inputs:

Central Bank:

- Development of staff skills to undertake data collection and analysis, and to undertake operational tasks in monetary management
- Establishment of a new personnel management system

CEM:

- Computerization of daily operations
- Staff development system established
- Accounting system established
- Marketing plan developed and implemented

The Mission Private Sector Officer will be responsible for monitoring and reporting on the disposition of program and project inputs, which will be documented through the normal correspondence associated with program and project implementation. This includes Memoranda of Understanding with the GRM, Project Implementation Letters, Project Implementation Orders for technical assistance and training, financial reports, and Program Implementation Reports. Input monitoring as laid out here appears routine, but is an essential element in the overall monitoring plan since it will provide an answer to this question: What specific resources has A.I.D. provided that might account for the success of financial market reforms increasing domestic resources for the private sector?

Output Monitoring. The program anticipates a range of outputs which are summarized in the Program Logframe. Each of these outputs is straightforward and measurable. The Central Bank will implement a non-inflationary market-based monetary policy as demonstrated by price stability, an increase of the ratio of money to GDP and reduced Treasury borrowing from commercial banks. The CEM will provide low-income households with a reliable formal financial system through expansion and improvement of operations as demonstrated by client growth and growth in deposits. Three questions can be asked about each of these outputs. First, has the output been formally met? If so, has on-the-ground implementation taken place effectively? And if so, what has been the impact on the financial sector?

The Private Sector Officer will be responsible for monitoring and reporting on the status of individual outputs; for the most part, this can be documented through routine Central Bank publications and CEM reports. A Research Advisor will assist the Central Bank in the development of a monetary policy which is considered critical to the success of the FMD Program.

Purpose-Level Monitoring. The FMD program purpose is to increase the level of domestic financial savings and the share going to the private sector. Achievement of this purpose will be associated with concrete indicators: an increase in commercial bank credit to the private sector and an increase in the ratio of national savings to GDP. The same three questions asked in evaluating output progress can be applied to purpose-level monitoring. The problem from an impact-monitoring perspective is not in assembling the necessary information, but rather in making sound judgements about the extent to which A.I.D.'s efforts have helped increase the level of domestic savings. By its very nature, this indicator will be influenced by a large number of other factors.

It will be difficult to separate out the effects of USAID's interventions on empirical measures of change, but this is not a flaw in the proposed monitoring system. The monitoring system is designed to collect information on key indicators which will shed light on changes in and performance of financial sector policies in Madagascar, and will therefore provide a basis for adjusting the course of program implementation in accordance with empirical circumstances. This will also provide a basis for making careful judgements about the progress of the program at the purpose level. The USAID Private Sector Officer will be responsible for preparing interim progress reports at regular intervals that present such judgments for review by Mission management and Madagascar implementing agencies.

Goal-level Monitoring. The goal of the FMD program is to increase investment and employment in the private sector. USAID/Madagascar will have three other projects contributing to the goal. Monitoring at the goal level will be done as part of the Mission's on-going Assessment of Program Impact (API).

As with purpose-level monitoring, the results of goal-level monitoring will be inconclusive to a degree and subject to debate. This is an inevitable outcome. This monitoring plan is not designed to resolve all foreseeable issues associated with implementation of this policy and institutional reform activity; rather, it is designed to keep USAID management in close touch with the evolution of key indicators of progress in the financial sector. This is the most important reason for undertaking the monitoring effort.

Evaluation and Audit. A comprehensive monitoring plan of the sort outlined above reduces but does not eliminate the need for program evaluations. Accordingly,it is anticipated that two program assessments/evaluations will take place during the life of the program. The first will take place 20 - 24 months after implementation begins. This evaluation will be designed to (a) test the underlying design assumptions, (b) summarize implementation progress at the input level, (c) summarize the empirical results of the program by reviewing progress at the output, purpose, and goal levels, to the extent that information is available, and (d) suggest any modifications necessary to assure progress in implementation. The second evaluation will take place 6 - 10 months before the close of the activity, to provide a comprehensive assessment of results, which will feed into the design of possible follow-on or second generation policy adjustment efforts. Each evaluation will cost approximately $40,000.

Finally, provision is made for two non-federal financial audits in years two and four to ensure that program and project funds have been appropriately utilized. $50,000 is budgeted to cover audit costs.

D. Implementation Schedule

General Activity	Planned Date
Program and Project Agreement signed	09/93
Program Launch Workshop (in conjunction with FINDEP)	10/93
Tranche One released	12/93
Program Assistant FSN hired	10/93
Tranche Two released	12/94
Mid-term evaluation	10/95
Final evaluation	03/97

Central Bank Component

Research advisor selected	12/93
English training begins	11/93
Personnel policy consultancy	11/93
Buy-ins for Research Department advisors and training	11/93
Training need assessment begins	01/94
Preliminary Research Department work plan drafted	01/94
STTA researchers arrive	01/94
Buy-ins or local contracts for in-country training	03/94
In-country training begins	05/94
Research strategy adopted	06/94
First Research Department Economic Review published	06/94
Follow-up personnel policy consultancy	11/94
Research Department Annual Work Plan prepared	01/96
First HRD follow-up consultancy	01/95
Second HRD follow-up consultancy	01/96

CEM Component

Accounting system change-over begins	10/93
Computer Equipment ordered	11/93
Local Consultant Firm (LCF) hired for ADP services	11/93
Revise organization chart	11/93
Develop staffing plan	11/93
LCF hired to study PTT transfer pricing	12/93
Staff training plan prepared	12/93
LCF hired for service improvement program	12/93
1994 Budget prepared (with performance targets)	12/93
CEM develops decentralized interest posting procedure	01/94
Staff training begins	01/94
LCF hired to draft new statutes	01/94

Computers arrive	02/94
Computerization of records completed	06/94
New statutes approved	07/94
First study tour	08/94
Marketing plan activated	09/94
1995 Budget prepared (with performance targets)	12/94
Continue service improvement program	1995-1997
Continue staff training	1995-1997
Continue market campaign	1995-1997
1996 Budget prepared (with performance targets)	12/95
Second study tour	08/96

VI. FINAL FEASIBILITY ANALYSES

A. Economic Analysis Summary

As required by Non-Project Sector Assistance (NPA) Guidance a cost/benefit analysis has been undertaken to determine whether the FMD investment of $10 million is economically feasible.

The analysis is based on the costs and benefits expected to accrue to the CEM component of the program. The design team was unable to develop a methodology to quantify the benefits of the Central Bank component. Estimates of the cost/benefit ratio were calculated based on attributing one-half of the cash transfer ($3 million) to the CEM, and on the notion that one-half of the cash transfer is attributable to the Central Bank. Estimates of the cost/benefit ratio were also calculated based on attributing the full amount of the cash transfer to CEM. The analysis showed that the program is economically feasible even if the full cash transfer is attributed to CEM. Thus, only those results are presented as the one-half attribution has higher benefit/cost ratios.

The key element of the analysis is the essential growth of new deposits resulting from the AID investment in improving efficiency of CEM financial intermediation. Improved efficiency will be achieved both through technical assistance ($1 million) and policy reform ($6 million of NPA).

Economic benefits will result principally from increasing household preferences for formal sector savings and placement of those savings by CEM in high rate of return private sector investments.

The results of the analysis showed the CEM component of the FMD project to be economically feasible at 15% average annual growth of new CEM deposits. Based on the record of the past several years, annual average growth of new CEM deposits would be about 5% without the project.

At 10% average annual growth of new deposits, the CEM component would be feasible if the AID NPA investment was cut back by $1 million or if assumptions were made that income redistribution impacts of the CEM investment favor the poor and the cost benefit analysis then weighted the stream of benefits to take this impact into account. At present, most CEM investors are poor and receive negative real interest rates on their deposits.

At rates of growth of new CEM deposits of less than 10% the project is infeasible.

While the growth rate of new CEM deposits is an unknown, the scope for improvement of CEM services, including the interest rate offered, is so large that an average annual growth rate of new CEM deposits of between 15% and 20% with the CEM component of the FMD project appears reasonable. The Design Committee considers the program to be economically feasible.

B. Political Analysis

The Council of Ministers unanimously approved a letter of development policy for the financial sector on March 3, 1993. The policy directions in the letter are based on a World Bank 1992 financial sector report. Of particular interest to FMD the letter states the government's intention to give the Central Bank statutory independence from the Ministry of Finance. Further, it commits the government to a modernization of the institutions providing financial services under the aegis of the Ministry of Post and Telecommunications, including the CEM. A copy of the letter of development policy is annexed to the PAAD.

The CEM reforms and the independence of the Central Bank will take away discretionary power enjoyed by the Treasury. In negotiations with the Ministry of Finance, USAID has convinced ministry officials that the savings mobilization potential of the CEM is sufficiently important to the government and the economy to outweigh the advantages of a captured, albeit low yield, source of cheap deficit financing.

The Minister of Post and Telecommunications has advised USAID that the proposed reforms are acceptable to PTT and are in accordance with the ministry's reorganization plan. Other interested political entities, such as the economic ministries and the Ministry of Agriculture are expected to actively support the program. There is no political faction or other group opposed to the reforms to be undertaken as part of FMD.

Given the lack of political opposition to the FMD reforms, the Design Committee considers the program to be politically feasible.

C. Institutional Analysis

Both of the beneficiary institutions have been assessed externally. The Central Bank's external assessment began in 1991 and continued through March 1993. It was conducted by World Bank staff, USAID staff, Swiss Cooperation staff, and consultants financed by these institutions. The CEM underwent an external assessment by Price Waterhouse in January 1993, a vulnerability assessment by Price Waterhouse in May 1993 and several studies concerning legal status, human resource development, marketing analysis, financial and information systems done by Malagasy consulting firms in May 1993.

1. Central Bank

The core functions of the Central Bank of Madagascar (BCRM) are consistent with those of a modern day Central Bank, namely: issuing legal tender and assuring price stability through monetary controls. However, as is the case with many countries in the developing world, BCRM has taken on a number of other functions, notably quasi fiscal activities (described in Section III-B), which are inconsistent with its development into an independent institution ensuring stability in money and financial markets. To better identify institutional development needs of the BCRM, the scope and results of its primary functions (domestic and foreign operations, credit, research), as well as support (accounting and audit, information systems, human resources) are reviewed below:

(a) Formulating and Executing Monetary Policy

There are major weaknesses in the monetary operations of the BCRM which have resulted in a rigid money market and the maintenance of a number of direct controls on the market. The first weakness is a lack of research capacity to formulate monetary policy based on an analysis of developments in the real and financial sectors. The second weakness is the lack of coordination with the Treasury on Government financing and open market operations. Institutional strengthening through the development of (i) research capacities, (ii) open market operations and (iii) improved coordination with the Government financial operations, would give the BCRM more confidence in allowing the market to function. BCRM would, therefore, be better prepared to remove credit ceilings and other direct controls, once macroeconomic stability has been established and fundamental institutional weaknesses in the commercial banks resolved.

(b) Government Banker

Apart from acting as Government's banker, BCRM has also been implicitly obliged to finance the public sector deficit, which is illustrated by the mounting operating losses of BCRM in the 1980s. This financing took three forms: (i) taking direct liability for the exchange rate risk on Government and private sector external debt during the London and Paris Club rescheduling negotiations in the 1980s which, in the case of Government, effectively meant recording losses on the BCRM's balance sheet that should have been ascribed to the national budget; (ii) providing advances to the Government well above the statutory limit; (iii) providing the advances at virtually zero percent interest until 1991. Since Government does not systematically respect its obligations to compensate foreign exchange and operating losses, three fifths of BCRM's operating assets represented unremunerated claims on Govern-ment by the end of the 1980s.

The resolution of this problem centers on legally enshrining the independence of the BCRM and restructuring its balance sheet. Initiatives involving the IMF in both these areas are already underway. With regard to the independence of BCRM, amendments to the 1973 BCRM Ordi-nance and the 1988 Banking Act are being explored to: (i) clearly limit the objective of BCRM to the stability of the currency; (ii) increase its authority in formulating monetary policy; (iii) increase the independence of the Governor and Board through fixed-term appointments and clear dismissal criteria; and (iv) ensure the regular publication of BCRM's accounts. A first step towards the restructuring of the balance sheet was undertaken when the non-interest earning assets of BCRM repre-senting claims on Government and associated liabilities were recorded in specific new accounts which now render these quasi fiscal operations more transparent.

Increased legal and financial independence are key to general financial sector reform and critical to the successful application of any technical assistance provided to the BCRM, and consequently the inde-pendence of the BCRM and the elimination of its fiscal obligations consti-tute explicit objectives of Government policy for the financial sector which need to be forcefully pursued.

(c) Primary Functions

Research. A fully fledged research and statistics function does not exist in any true sense at BCRM. Currently, a unit consisting of four staff is engaged in collecting macroeconomic data, mainly in preparation for Bank/IMF missions. There is a multitude of research and policy-related data gathering and processing efforts through BCRM which are uncoordi-nated and which result in numerous redundant data requests from various departments of the BCRM to the outside (commercial banks and financial institutions, ministries, etc.). The research function suffers from a fundamental problem of lacking until very recently a director and, as a result, the authority to coordinate and streamline data requests from the outside and data flows within the BCRM. Consequently no monetary programming is carried out. Furthermore, no research is done for strategic or policy purposes, for example for helping formulate monetary policy or better understanding links between the financial system and the real economy.

Credit. The credit department in the BCRM has primary responsibility for the implementation of direct monetary controls, and in the last few years had been responsible for reforming a number of these instruments and for implementing new money market instruments to manage the level of liquidity in the market. While some progress has been made in dismantling some of the direct controls, notably in abo-lishing all prior credit approval and in developing reserve requirements as a tool of monetary control, the operation of the money market remains rigid and credit is still largely micro-managed by the BCRM. Notwith-standing that credit ceilings will need to be maintained until fiscal problems and institutional weaknesses in the commercial banks are resolved, a great deal of institutional strengthening is required over the transition to improve the flexibility, responsiveness and effectiveness of the nascent money market and the monetary instruments.

Foreign Exchange Operations. The BCRM monitors all foreign currency operations and manages all foreign currency transactions on behalf of Government. Until September 1991, when the Open General License System (OGL) was abolished, all foreign currency receipts had to be surrendered to the BCRM. Currently the commercial banks are permitted to keep 60% of the foreign currency receipts and cede 40% to the BCRM, while the latter maintains its role of monitoring all foreign currency transactions. Given the existing foreign exchange shortage and the need for commercial banks to conduct foreign exchange transactions at an overvalued official rate, this system effectively puts the burden of rationing on commercial banks. A strategy, cognizant of present fiscal and monetary problems, needs to be developed with the long term objec-tive of the BCRM playing a supervisory role in a market where foreign currency is freely traded. Furthermore, institutional weaknesses in managing and monitoring foreign currency operations have to be addressed to prepare the BCRM for the implementation of this strategy and to increase the efficiency of existing operations.

External Debt Management. The BCRM manages on behalf of the Government all external public debt, and has been obliged to bear exchange rate losses on external debt that should have been borne by the Treasury. A strategy to ensure that all exchange rate losses on foreign debt contracted by Government are correctly attributed to the Treasury was developed in 1992 as part of the overall strategy to eliminate quasi fiscal activities from the BCRM's balance sheet. This resulted in the creation in early 1993 of a distinct department within the BCRM to implement this strategy and to manage all external debt. Technical assistance is required to develop the capacities of this department in the accounting for and managing of these external debt operations.

Circulation of Bank Notes. Activities associated with the circulation of bank notes at the BCRM center on national currency management and the provision of central banking services to the local statutory financial institutions. Major problems center on the BCRM's poor capacity to forecast and control demand for national currency and poor communications with both BCRM's domestic correspondents and the commercial banks. These issues need to be reviewed together with a study on the domestic payments system.

(d) <u>Support Functions</u>

Accounting. Whereas BCRM appears to have managed to maintain and prepare accounts on a regular basis, the internal organization of the accounting function suffers certain weaknesses. These results, principally, from an unsatisfactory segregation of responsibilities, and the fact that there is no separate unit which is primarily responsible for the accounting and for reporting on financial matters directly to management. Currently, departments or units are also responsible for recording them, thus bypassing the fundamental principle of adequate internal control within the institution. Furthermore this situation inhibits the preparation and diffusion to general management on a timely basis, of the financial information necessary to effectively execute their managerial responsibilities. The absence of regular external audits of the BCRM's accounts is an additional shortcoming in the overall control exercises over the bank's operations.

Internal Audit. Within the BCRM the activities normally attributed to an internal audit office or unit are currently carried out by the Inspection Department. This includes routine verification and internal control functions which are more properly handled by a separate accounts unit. The inspection department also carries out a variety of other activities (review of applications for the banking licenses, on-site and off-site inspection of financial institutions) which should now be the responsibility of the Commission de Contrôle des Banques et d'Etablissements Financiers (CCBEF - Bank Supervisory Board). Moreover, the Inspection Department is not directly responsible to the Board of Directors of the BCRM and does not, therefore, enjoy the independence usually associated with the function of internal audit.

Information Technology. Information processing plays an important role in the day to day operations of the BCRM, though a number of activities lack required computer support due to the scarcity of data processing resources. Likewise there is a need for more active general management participation in data processing planning and follow up. Furthermore, in a changing environment with a progressive shift to using indirect instruments to execute monetary policy, the role of information technology will become increasingly important in attaining BCRM objectives. Strengthening strategic capacities in the area of information technology should therefore constitute a central part of BCRM's development.

Information processing at the BCRM relies on an outdated mainframe computer system for which the supplier has discontinued maintenance. Although spare parts can still be procured from places as far away as Europe, it often entails a wait of up to ten days. This constitutes a considerable operational risk for some of the basic data processing functions. High priority should, therefore, be accorded to moving the most important systems, accounting and payroll, to other hardware. Despite the relatively high quality of BCRM computer staff, compared to that of other countries at a similar stage of development, the number of qualified systems analysts and programmers is limited. Significant emphasis on training programs is therefore required to meet the information technology skill requirements of the BCRM.

Human Resources. While the quality of staff in the BCRM is quite high on average, there appears to be a lack of broad-based understanding of the functions of central banking. Most staff have only very limited knowledge of the operations of departments other than the one in which they are working.

There is virtually no systematic planning for staff rotation on long-term training. BCRM senior management have also expressed the need to review the present system of classifying personnel to improve incentives and prospects for horizontal and vertical mobility. BCRM is examining the possible introduction of occupational streams (economists, financial analysts, etc.) to guide future recruitment, training and promotion.

(e) Recent BCRM Reforms

BCRM senior management and staff have generally been conscious of the problems and the need for improvements within the institution. A number of steps have been recently initiated to strengthen BCRM's capabilities to more effectively meet its responsibilities in an increasingly market oriented economy. A major initiative is the revision of the original statutes of BCRM enacted in 1973, which would give BCRM a clearer and more independent role in both the formulation and execution of monetary policy. Drafting of the revised statutes is complete and the Government has indicated in its Statement of Financial Sector Reform and Development Policy that it will adopt these statutes.

Furthermore, BCRM began preparing in August 1992 a Strategic Development Plan (SDP) which will constitute a business plan for its organizational development over a 3 to 5 year period. The plan has four elements described below: (i) a statement of key policy and business objectives; (ii) action plans for department strengthening and restructuring the BCRM; (iii) more effective application of information technology systems; and (iv) human resource development. The SDP represents the beginnings of a strategic planning and development function. Although the SDP will remain a working document to be continually reviewed, a first completed version of the text is expected to be adopted by the Board of BCRM to commit the institution to a more strategic approach to its organizational development. The Secretary General of BCRM has been given oversight responsibility for implementation of the SDP. The Secretary General is expected to help the senior management of BCRM to more effectively plan and coordinate organizational changes and the use of information technology. BCRM will also form a steering committee comprised of senior BCRM management and department managers to continually review the implementation of the SDP and approve organiza-tional information technology plans. The steering committee will continually consult with outside advisors on worldwide organizational practices in central banking with a possible view to developing systematic information sharing arrangements with other central banks.

Under its SDP, the BCRM statement of objectives are categorized into "business objectives" and "institutional objectives". The business objectives comprise: (i) price stability through the pursuit of monetary policy, eventually based on indirect instruments, and (ii) legal, administrative and financial independence of the BCRM through the revision of its statutes and the removal of all quasi fiscal obligations. Institutional objectives include: (i) strengthening the budget and internal control functions within BCRM through improved accounting systems and procedures and their harmonization with a new uniform accounting plan for banks; (ii) development of an internal audit function; (iii) development of a fully-fledged research and statistics department; (iv) strengthening of capacities in foreign exchange management, with the BCRM ultimately playing a supervisory rather than a clearing role in the foreign exchange market; (v) strengthening capacity to implement monetary policy through indirect instruments and eventually managed open market operations; (vi) increasing capacities to monitor credit worthiness of banks going hand in hand with the elimination of the review of individuals bank loans as collateral for BCRM refinancing; (vii) enhancing domestic currency management by improving planning and communication capacities; (viii) development of modern information systems for generation, processing storage, transmission, and retrieval of operational and management information in all departments; and (ix) improvement of human resource functions especially in the areas of recruitment, training and promotion.

2. CEM

Background. CEM is a public savings institution with 461 post office outlets distributed throughout the country and approximately 260,000 depositors. CEM is mandated to deposit its funds with the Treasury, for which it receives a below-market interest rate, 11.5%, compared to 17.75% for term deposits in private banks[1]. The CEM has total deposits of approximately $6 million. It does not make loans.

With the largest distribution network in the country of any financial institution, the CEM can play a major role in mobilizing savings, particularly in rural areas. The CEM's ability to mobilize savings, however, is constrained by its minimal marketing resources and delays in posting interest to customer accounts.

Legal Status. The CEM was established in 1919, when Madagascar was a French colony, as a local branch of the French Caisse d'Epargne. The CEM continued to operate much as before when Madagascar gained independence in 1960 in that the CEM continued to maintain its deposits with the French Caisse d'Epargne in France until 1975, when Madagascar left the CFA franc area.

In 1985, a decree signed by the President, the Prime Minister and the two oversight ministers, the Minister of Posts and Telecommunications (PTT) and the Minister of Finance (MOF) established the CEM as a "public establishment of industrial and commercial character" (EPIC). Thus, the decree

[1]About half of CEM's deposits have been deposited by the Treasury at a commercial bank, BNI, at 12.0%

established CEM as a state-owned enterprise intended to function as a quasi-commercial company, no longer strictly as an agency of the PTT.

CEM's EPIC status is viewed as a strength because it has its own Board of Directors to provide guidance and oversight and it must use quasi-commercial accounting principles much the same way a commercially-oriented company would. This facilitates a degree of business-like management and control of the enterprise. Also, Government ownership of CEM and the requirements that all of the CEM's deposits be at the Treasury or the Central Bank imply a strong Government guarantee of customer deposits. This risk-free status of customer deposits facilitates the CEM's efforts to mobilize savings, as customers incur no placement risk. Madagascar has no formal system of deposit insurance.

EPIC status limits CEM autonomy especially in the important areas of management of customer deposits, staff development and financial planning and budgeting. The CEM has no direct access to customer deposits which are deposited by the PTT with the Treasury. Instead, it plays the role of a funds overseer and administrator. The CEM currently has 45 full-time employees based at the headquarters in Antananarivo. All of these employees are civil servants hired by the PTT. In addition, approximately 638 postal employees handle CEM transactions on a full-time or occasional basis. The CEM depends on these employees to collect deposits, issue repayments, open new accounts and provide accurate reporting. On the one hand, this denies the CEM control over the hiring, firing and compensation of employees. On the other hand, it relieves the CEM of the burden of managing a large bureaucracy.

A study on the legal status options available to the CEM found that an EPIC offered the most flexibility and autonomy. The study did recommend that the CEM could increase its autonomy and thus take control over the management of customer deposits, staff development and financial planning and budgeting by changing its legal status to an "improved" EPIC.

Board of Directors. The CEM is governed by a Board of Directors which meets, in principle, at least once each year at a meeting called by the President. In actuality, the Board has met three times in the last eight years. The Board is composed of twenty members. The President and Vice President are the Minister of Finance and the Minister of Post and Telecommunications respectively. The other eighteen members are as follows:

- Minister of Agricultural Production and Agrarian Reform
- Minister of Animal Husbandry, Water and Forests
- Minister of Industry, Energy and Mines
- Minister of Public Works
- Minister of Economy and Planning
- Representative of the National People's Assembly
- Director of the Treasury
- Director of Financial Control

- Director of Postal Services
- Director of Postal Financial Services
- Eight CEM client representatives

The role of the Board of Directors is to approve the CEM's budget, inspect and approve its accounts, settle any questions concerning its organization and functions, and decide on the appropriate use of the CEM's reserve capital and the investment of customer deposits. The infrequent meetings of the Board of Directors has prevented the Board from carrying out its role and has delayed key decision-making. The composition of the Board of Directors does not reflect the needs of the CEM and is viewed as a weakness.

Relationship to the Treasury. According to the 1985 decree, all funds received from depositors are transferred to the Treasury and the Central Bank. The decree has a contradictory clause which allows the CEM to use a portion of its deposits for investments and loans, since 1985 this has never been put into effect. The Treasury sets the interest rates it pays the CEM for deposits. The Treasury also approves the rate the CEM may pay its depositors.

The determination of interest rates by the Treasury is viewed as a weakness because as market conditions change, the CEM is not free to negotiate the best return on its deposits. Historically, the Treasury has preferred to keep this return at relatively low rates. In addition, the Treasury's review of these rates occur infrequently which, in turn, constrains the CEM in adjusting the rates offered to savers.

Relationship to the PTT Ministry. The PTT Ministry is responsible for technical supervision of the CEM and nominates the CEM's director. The Director of the CEM meets with the PTT Ministry on average once a week.

The operations of the CEM depend in many ways on the PTT's personnel and facilities as shown in Figure VI.1. The CEM has no independent sales force or distribution network. All personnel of the CEM are post office employees and all CEM outlets, with the exception of the main office, are inside the post offices.

As of January 1993, several proposals had been made regarding restructuring the PTT. A common theme has been to separate the PTT's telecommunications services from the rest of the post office's operations and to create an independent telecommunications company. On May 27, 1993 the Council of Ministers approved a restructuring of PTT into two entities: Madagascar Telecom and Madagascar Post. USAID convinced the GRM to keep CEM outside the structure of Madagascar Post in recognition of its emerging position as a financial institution independent of the postal system.

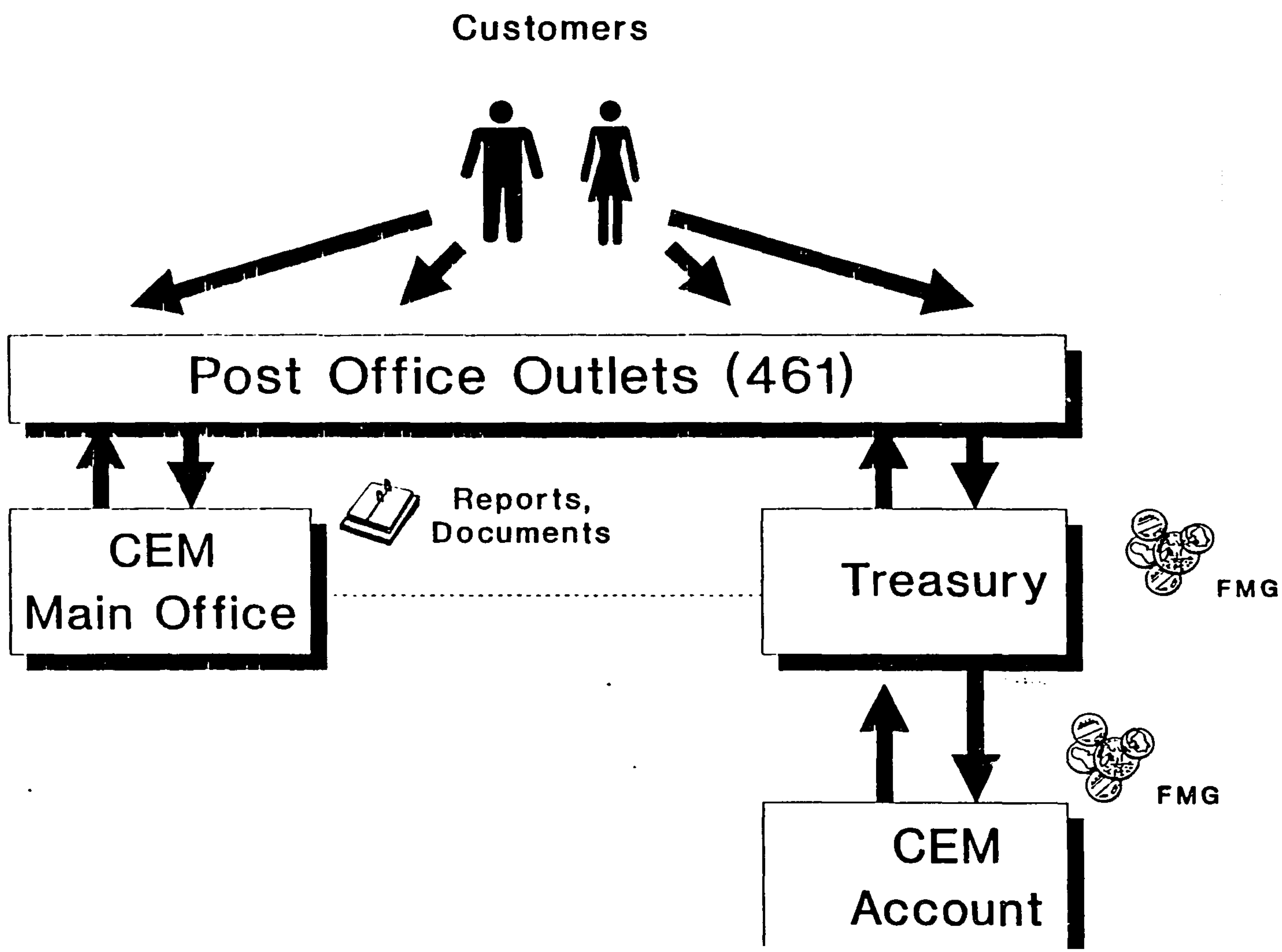
Relationship to the Ministry of Finance. The Ministry of Finance is responsible for financial supervision of the CEM and, along with the PTT Ministry, nominates the CEM's Chief Accountant. The Chief Accountant is the only person within the CEM who reports to the Ministry of Finance. This reporting relationship helps to ensure compliance with EPIC accounting and other regulations, as well as providing more general financial control over the CEM's operations. It does however limit the autonomy of CEM.

Relationship to the Central Bank. Other than being a repository for CEM funds by decree, the Central Bank has no formal relationship with the CEM. The Central Bank does not carry out any supervision of the CEM, even though the CEM performs the bank-like function of accepting customer deposits. According to the CEM, the Central Bank does not have any plans for such an examination. An explanation for the absence of Central Bank's examination as described in the World Bank's March 1992 report is that the Central Bank's examination capabilities are at present, quite rudimentary. One reason to perform a bank examination is to form an independent judgment of the quality of a financial institution's risk assets. Although the CEM's assets are deposited with the Government, the 1985 decree does give it the option to invest depositors' funds and make loans. The lack of supervision by the Central Bank is viewed as a weakness.

Failure to pay interest on CEM deposits invested with the Central Bank from 1975 to 1985 resulted in an overstatement of the CEM's revenues and assets by approximately FMG 2.5 billion, amounting to over 30 percent of reported total assets at the time. The explanation for this overstatement dates back to the period when Madagascar left the CFA franc area in 1975. Until this time, the CEM's deposits were maintained with the Caisse d'Epargne in France. Upon leaving the CFA franc zone, the CEM's deposits, totalling approximately FMG 2.5 billion, were repatriated and deposited in an account at the Central Bank. The CEM recorded interest on this deposit as if it were earning the same rate as it earned on its deposit with the Treasury's Caisse de Dépôts et Consignations (CDC) during this period, or 7 percent per annum. As of December 31, 1985 the amount of this deposit plus accrued interest was shown as FMG 5.0 billion in the CEM's annual reports.

Figure VI.1

Relationship Between CEM, Post Office and Treasury



After the CEM became an EPIC, management had direct access for the first time to statements on its two main deposit accounts at the Central Bank and the CDC. In preparing the CEM's accounts for 1986, the Chief Accountant noted that the statements from the Central Bank showed a total of FMG 2.5 billion instead of FMG 5.0 billion. In fact, the CEM had never earned any interest at all on the deposit at the Central Bank for over 10 years. Investigating the matter further, it was ascertained that the Central Bank's statutes prohibit it from paying interest on such accounts. The deposit was therefore moved to the Treasury in 1987.

Management subsequently decided to revise its accounts for the prior years to have an accurate picture of the CEM's financial condition. The restated accounts show that the CEM had paid more interest to its depositors than it had earned on its deposits throughout the ten year period that the FMG 2.5 billion deposit was at the Central Bank which resulted in significant accumulated losses making the CEM technically insolvent.

The Design Committee has determined that BCRM and CEM have adequate institutional strengths to effectively use the program reforms and project inputs for the benefit of the Malagasy economy. Therefore, the program is institutionally feasible.

D. Social Analysis Summary

This section reports the findings of a survey of CEM clients and non-clients undertaken by Société d'Assistance Technique et de Gestion (SOATEG) in May 1993. The purpose of the survey was to determine the savings behavior of low-income households (the potential client base) and their perceptions of CEM as a savings institution. Low-income households will be the principal beneficiaries of the CEM component of the program.

The CEM's clients tend to be middle-age, about equally divided between men and women, with education beyond the primary level, and with incomes below $50 per month, as seen in the following figures.

<u>Age of Clients Surveyed</u>

less than 20	21-25	26-30	31-40	41-50	51-60	61-
5%	14%	19%	32%	18%	6%	6%

<u>Education</u>

Primary	Lower Secondary	Upper Secondary	University
9%	30%	39%	22%

<u>Monthly Income</u>

less than $12	$12-25	$25-50	$50-75	$75-100	$100-
24%	24%	30%	8%	7%	7%

Twenty-eight percent of clients are employees of companies or of the government. The second most frequent occupation is professional (14%), while twelve percent are artisans and nine percent are merchants. Fourteen percent of clients are students, and seven percent are unemployed.

Each respondent gave multiple reasons for saving. The most common reason given for savings was "health" (42%), followed by saving for old age (34%), purchase of land or housing (19%), other purchases (17%), children's educational expenses (26%), and interest received (18%). Men and women tended to answer the question in the same way.

The source of savings was salary in sixty-five percent of the cases. Other sources of savings were sales (16%) and gifts (8%). The source of men's and women's savings differed, with a higher percentage of women's savings coming from sales and gifts than was the case for men, and a lower percentage coming from salaries.

Source of Savings (percent)			
Source	Men	Women	Total
Salary	71	60	65
Sales	9	22	16
Gifts	5	10	8
Products	3	2	2
Other	12	6	9

Fifty-nine percent of the respondents stated that their income permitted them to save a fixed amount each month, with the amounts saved ranging from fifty cents to one hundreds dollars. The median figure was $8.50. A fixed saving pattern is more frequent among salaried employees than other occupational groups.

The most frequent reason cited for closing a CEM account was lack of money because of economic circumstances (56%), followed by "undertaking projects" (20%), alternative saving opportunities (14%) and dissatisfaction with CEM service (13%).

Eighty percent of the clients surveyed stated that if their income increased, some of the increase would be deposited at CEM. Sixty-two percent of the clients stated that all of their financial savings were deposited at CEM.

The CEM clients were questioned about how CEM could improve its attractiveness to savers. The responses most frequently made were: (1) reduce the waiting time to withdraw funds (currently fifteen days from date of deposit),

(2) increase the interest rate on deposits, and (3) simplify administrative procedures. Surprisingly, given the clientele's desire to receive a higher interest rate, only eight percent of the clients surveyed could correctly state the current CEM interest rate. Twelve percent of clients thought the interest rate on deposits was 4.5%, which was the rate in effect until 1992.

Eighty percent of the clients surveyed expressed satisfaction with the way they were received at CEM. Apparently, CEM customers are patient people. Only ten percent completed their transaction in less than ten minutes. Thirty-four percent reported that more than one hour was required.

Responses to the general question "What do you think of the CEM services?" were:

not satisfactory	12%
barely satisfactory	44%
satisfactory	31%
very satisfactory	13%

In general, women were more satisfied with the quality of CEM service than men.

All the survey results reported above were for CEM clients. SOATEG also interviewed 424 people who do not have accounts at CEM. Their socio-economic profile was similar to the CEM clients. Fifty percent reported that they save on a regular basis. Of these, sixty percent have savings deposits in one of the commercial banks. Security, speed of services and convenience were the reasons cited for preferring commercial banks to CEM.

The results of the survey demonstrate that current and potential clients of CEM are those economic groups who are part of A.I.D.'s mandate. They use and value the services provided by CEM. The FMD program will not attempt to change social behavior, rather it will encourage activity undertaken spontaneously by the population. Therefore, the Design Committee considers the program socially feasible.

E. Initial Environmental Examination Summary

The FMD program activities do not have an effect on the natural or physical environment. The Bureau Environmental Officer has approved a Categorical Exclusion for the Initial Environmental Examination which is Annex 3 of the FMD Program Assistance Identification Paper.

VII. CONDITIONS, COVENANTS AND NEGOTIATING STATUS

A. Conditions Precedent

FMD contains ten conditions precedent to disbursement of the cash transfer for payment of debt service in addition to the standard conditions precedent (specimen signature and designation of authorized representatives). Six conditions precedent must be met for disbursement of the first tranche of $3 million; four conditions precedent must be met for disbursement of the second tranche of $3 million.

- **First Tranche Conditions Precedent**

1. The Government of the Republic of Madagascar adopts a new governing statute for the Central Bank. The statutes will specify: (1) the objectives of the Central Bank; (2) the fixed terms for Governor and Board members and grounds for dismissal; and (3) limitations on advances from the Central Bank to the Treasury.

2. The Board of Directors adopts the Strategic Development Plan drafted by the staff of the Central Bank. The Strategic Development Plan will specify the responsibilities of each Department and will contain a three-year action plan for each Department.

3. The Government of Madagascar deposits into the account of the Caisse d'Epargne de Madagascar held by the Caisse de Dépôts et Consignations the amount of two billion, nine hundred million FMG (FMG 2,900,000,000).

4. The Minister of Finance publishes a decree fixing the rate of interest of the deposits of the Caisse d'Epargne at the Caisse de Dépôts et Consignations equal to the rate applicable on Bon du Trésor par Adjudication (twelve month Treasury Bills). The rate of interest on CEM deposits at CDC will be adjusted every three months. The interest rate for each three month period will be equal to a weighted average of the BTA rate for the previous three months. In the event the BTA market is not functioning, the last published rate will apply unless USAID and the GRM otherwise agree in writing.

5. The Government of Madagascar has established a separate, non-commingled interest-bearing account in a United States bank, and specifying the number of the account in such bank, into which disbursements of U.S. Dollars are to be made.

6. The Government of Madagascar will furnish a schedule of the proposed debts for which the dollars under the first disbursement are to be applied, with reference to both the amounts and timing for payment.

- **Second Tranche Conditions Precedent**

1. The Board of Directors of the Central Bank approves the Research Strategy and a first year research work plan.

2. The Central Bank publishes an annual report, which includes an externally audited balance sheet and income statement.

3. The Government of the Republic of Madagascar adopts new statutes for the CEM in a form acceptable to USAID. The new statutes will (1) reduce the size of the Board of Directors; (2) provide for autonomous Board management of the assets of CEM; (3) establish a personnel system that is managed autonomously; and (4) replace the current accounting system with the commercial accounting system (Plan Comptable Général).

4. The Government of Madagascar furnishes a schedule of the proposed debts for which the dollars under the second disbursement are to be applied, with reference to both the amounts and timing for payment.

B. Covenants

In addition to the above policy reform conditionality, the following special covenants will be included in the Program Grant Agreement.

1. The Government of the Republic of Madagascar will not rescind the decision to transfer responsibility for GRM external debt service from the Central Bank to the Treasury.

2. The Government of the Republic of Madagascar shall not in any way discontinue, reverse or otherwise impede any action it has taken in satisfaction of any condition precedent set forth in the Grant Agreement, except as may be mutually agreed to in writing by the Parties.

C. Negotiating Status

Representatives from the Central Bank, the Ministry of Finance and the Caisse d'Epargne stated in a meeting on June 29, 1993 that their respective institutions agree to six of the seven substantive Conditions Precedent. The Ministry of Finance representatives reserved judgement on the amount of money the Treasury should pay to the Caisse d'Epargne. On June 30, 1993, the Council of Ministers approved all seven substantive Conditions Precedent.

FINANCIAL MARKET DEVELOPMENT
LOGICAL FRAMEWORK

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Goal: Increase investment and employment in the private sector	 - Investment/GDP ratio - Private sector, non-farm employment level	 - National Income Accounts - GRM Employment Surveys	 Investment in Madagascar is constrained by a lack of financing. GRM will take policy measures to improve the investment climate.
Purpose: Increase the level of domestic financial savings and the share going to the private sector	EOPS: - Increase in Commercial Bank credit to the private sector - Ratio of national savings to GDP	 - Central Bank Bulletin d'information et de statistique - National Income Accounts	 GRM pursues a fiscal policy which limits the fiscal deficit to a level that can be financed without recourse to excessive monetary expansion.

Annex A

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
<u>Outputs:</u>			
Central Bank designs and implements non-inflationary market-based monetary policy.	- price stability, i.e. low rates of inflation - ratio of money to GDP (M2/GDP) - Treasury reduces borrowing from commercial banks	- Central Bank Bulletin d'information et de statistique - Annual and Quaterly Economic Reports on Malagasy economy	Central Bank: Staff development and organizational independence are sufficient conditions to conceive and implement non-inflationary monetary policy.
CEM provides low-income households with a safe, reliable, convenient and remunerative entry to the formal financial system through expansion and improvement of its operations.	- Client growth - Growth in deposits	- CEM Annual Report - Central Bank Annual Report - CEM Annual Report - Project Reports	CEM: Low-income rural and urban saving propensities are sensitive to interest rates and/or quality of service Foreign researchers can successfully integrate into C.B. Department of Studies. Personnel and staff development systems, acceptable to all parties, can be designated. CEM senior staff can successfully manage organizational growth.

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
<u>Inputs:</u> Central Bank: - Staff skills to undertake data collection and analysis - New personnel management system established - MA degrees in Econ/Banking CEM: - Daily operations are computerized - Staff development system in place - Accounting system in place	- Technical Assistance - Studies - Training - Equipment	- Contractor reports - Site visits - Audit/Evaluation	Qualified researchers/analysts can be identified and mobilized in a timely manner. Appropriate tailored courses can be designated and run in Madagascar.

Annex B

BANQUE CENTRALE DE MADAGASCAR

B. P. n° 550 - adresse télégraphique (BA CE RE MA) - téléphone 217-51 - 217-52 et 247-03
télex 22-317 22-329 - téléfax 345-32

Antananarivo, le 30 JUIN 1993

éf. : ...287-GV/SG
bjet : Financial market development program - PRODIF

Monsieur le Directeur,

J'ai l'honneur de vous demander d'introduire officiellement auprès des autorités compétentes de votre institution une requête relative au projet cité en objet.

Il convient de rappeler l'objectif de ce projet qui est d'améliorer le système financier afin de faciliter le développement du secteur productif.

Ce dossier, mis au point conjointement par nos services, s'inscrit dans le cadre du Programme de Développement des Institutions Financières qui a été approuvé par l'IDA et qui a fait l'objet d'une Déclaration de politique de réforme par notre Gouvernement.

En réitérant nos vifs remerciements pour la contribution de l'USAID à la réalisation de ce programme,

Je vous prie de croire, Monsieur le Directeur, en l'assurance de ma meilleure considération.

DA 13

Le GOUVERNEUR,

BANQUE CENTRALE DE MADAGASCAR ANTANANARIVO

Blandin RAZAFIMANJATO

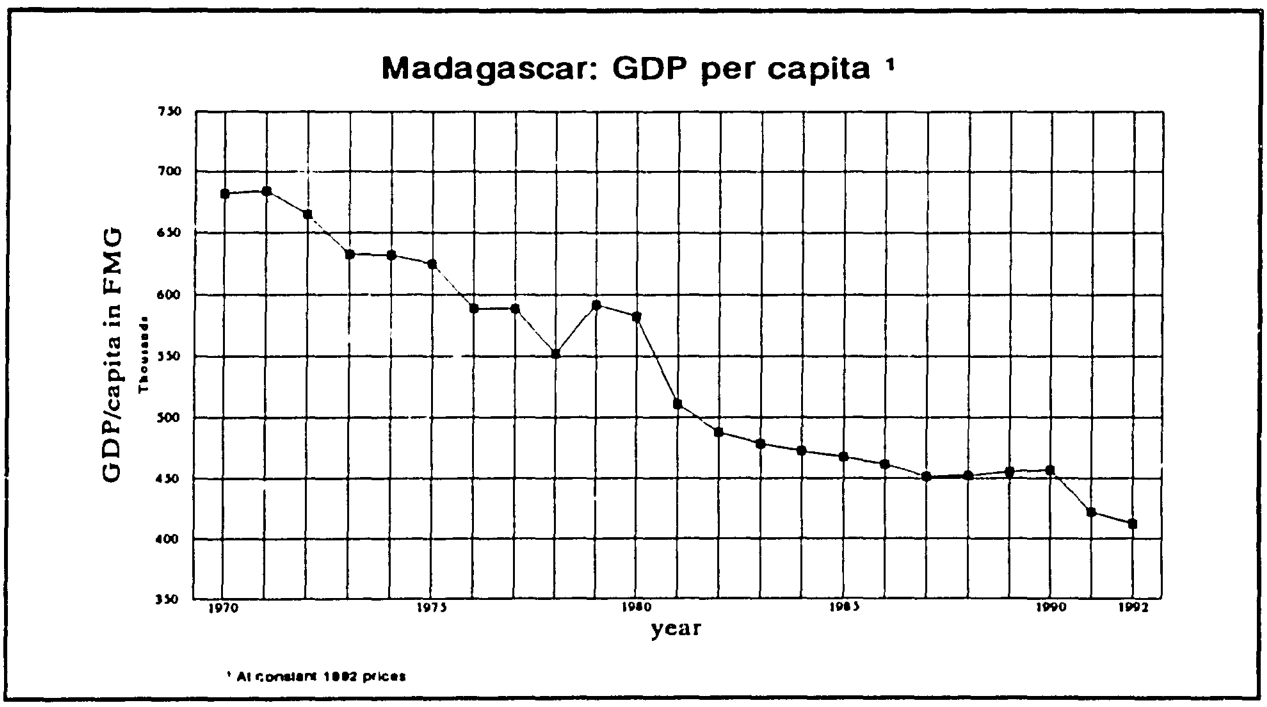
Monsieur le Directeur de
l'United States Agency
or International Development
A N T A N A N A R I V O -

Annex C

FINANCIAL SECTOR ASSESSMENT

▸ Overview

After almost a decade and a half of socialist economic policies characterized by heavy state intervention in both the financial and real sectors, Madagascar began showing the beginning of significant financial liberalization in the latter part of the 1980s *(fig. Madagascar: GDP per capita)*. Among the key aspects of this liberalization was the opening of the banking sector to private capital in 1988, resulting in the entry of two new private banks and subsequent partial privatization of two of three government-owned banks. There has been progressive liberalization of interest rates which, since November 1990, have been fully freed. Selective credit policies have also been progressively dismantled. At the same time, substantial restructuring and clean-up of loan portfolios has moved the banking system from its state of quasi-insolvency in 1986 to one of improved soundness and profitability. Madagascar also been one of the pioneering countries in the Africa and Indian Ocean region to begin moving away from direct to indirect instruments of monetary control. In addition, it does not show any unduly discriminatory taxation of the financial sector found in some other countries where high unremunerated reserve requirements are coupled with explicit forms of taxation.



Madagascar's financial system operates in an economy which has one of the lowest savings rates among developing countries and whose financial depth is among the most shallow. Part of this is simply due to the fact that Madagascar remains among the fifteen poorest countries in the world. However, a number of other countries of similar income levels in Africa and especially in Asia, exhibit markedly higher levels of aggregate and financial savings. While nominal interest rates on both deposits and lending are now freely set by commercial banks, real interest rates for some demand and short-term deposits (including CDs) are still negative, reflecting an inflation rate which has remained above 10 percent in recent years. The majority of the population still suffers from very limited or no access to financial services. Notwithstanding the clearly visible reforms of recent years there persists a problem of confidence in existing financial institutions and instruments, and partly reflecting continued suspicions and fears of the financial system engendered by past policies.

Monetary, regulatory and supervisory policies remain inadequate for the market-oriented vocation that the government has now chosen for the economy. The Central Bank's move toward indirect instruments of monetary control remains hampered by its continued involvement in financing activities that should normally be borne by the government budget. An adequate supervisory and regulatory framework for the financial system has not yet been developed, reflecting the long-standing past neglect of this key policy area. At the same time, the basic infrastructure for financial transactions, notably the texts and practices of relevant laws, accounting, audit and financial disclosure, requires substantial improvements before new financial institutions and instruments could be expected to operate effectively.

Significant imbalances persist between the demand and supply of financial resources. These imbalances are compounded by strong biases in the sectoral allocation and term structure of lending. Between 1987 and 1990, the consolidated balance sheets of banks showed high credit-deposit ratios, generally in excess of 90 percent. Such high ratios have been symptomatic of high rates of non-performing portfolios in the past and continued over-stretching of bank resources. To a significant extent, this situation reflects the inability of banks to place their resources in alternatives other than customer loans because of poorly developed financial markets. As the economy is further liberalized and increased growth stimulates demand for financial resources, this imbalance will grow unless the financial system improves deposit mobilization and the financial system is widened and deepened. At the same time, the maturity structure of both bank deposits and lending remains significantly biased towards the short-term, making term finance less developed in Madagascar than many other Sub-Saharan or low-income countries. Partly as a result, bank lending favors commercial and trading activities much more than activities in primary and industrial sectors which require longer-term funds. To some extent, a previous bias towards allocation of financial resources to the public sector has been mitigated since the latter half of the 1980s. However, continued improvement in public expenditure management and resource mobilization should improve the scope for releasing more financial resources for the private sector. Credit is a key constraint for a majority of firms on the country; none but the larger firms have access to formal credit sources.

The existing financial system in Madagascar is heavily dominated by banking institutions which by themselves cannot be expected to satisfy the full range of needs of an expanding and diversifying economy. In addition to banks, there is usually a need for an intermediate layer of financial institutions and instruments which can also eventually act as bridge between the short-term money market and the longer-term capital markets. Without this continuous array of financial institutions and instruments acting for the diverse maturities of funds on the financial markets, the free market determination of equilibrium interest rates and auctioning of the Treasury bills, for example, cannot be completely effective. At the same time, surveys of users of financial needs and the examination of the financial system confirms that several special financing needs are not being adequately met. These needs mainly pertain to individual sectors (agriculture and housing), term finance (medium- and long-term finance), and certain other types of finance (trade finance, leasing and equity financing). In all these and other areas, adequate financial services to small-scale economic agents are especially lacking.

- **Government Financing by the Central Bank**

Government finance can influence the financial sector through its impact on money supply, credit and interest rates. The main impact comes through the means by which the deficit is financed. In analyzing the impact of deficit financing on the Malagasy financial system, the particular definition of the fiscal deficit must be clarified. The fiscal deficit is conventionally defined as the central government financing gap that is covered by net government borrowing, including borrowing from the central bank. The financing gap results from the excess of total government cash outlays, including interest payments but excluding amortization on public debt, over total cash receipts, including tax and non-tax proceeds but excluding borrowing. At the same time, in Madagascar as in many other developing countries, certain government finance activities that are usually undertaken by the central government have been instead assigned to the central bank. These operations which are not strictly carried out with the purpose of implementing monetary policy, are referred to as quasi-fiscal operations of the central bank. The consolidation of the conventional fiscal deficit and quasi fiscal deficit produces a broader measure of government financing needs.

As is the case for most central banks around the world, BCRM performs a number of banking and agency services for the Treasury which would be generally accepted as proper roles for a central bank. For example, BCRM has a statutory role in maintaining accounts for the Treasury, keeping deposits and making advances to the Treasury. At the same time, BCRM has engaged in a number of "quasi-fiscal" activities which entail explicit or implicit financing of the government. Like BCRM, central banks in many other developing countries have gone beyond their strictly monetary functions by undertaking such quasi-fiscal activities which tend to eventually create central bank losses. These losses either alone or together with other central bank financing of the deficit often end up with monetized. Central bank quasi-fiscal activities have a potential for adverse effects on liquidity and money supply. Moreover, such monetization may quickly get out of hand and undermine the ability of the central bank to control money supply, with threatening consequences for macroeconomic stability and credit availability to the private sector. Such quasi-fiscal activities include negative real returns on financial operations related to the net financing of the Treasury and public enterprises, subsidized credit, rescue of distressed financial institutions, financing of the servicing of the external debt and assuming the accounting and cash losses resulting from foreign exchange operations. It appears that losses of BCRM which have been chronic and substantial since 1980 can be principally, although perhaps not exclusively, traced to the two last type of operations. These principal quasi fiscal activities of BCRM are analyzed in greater detail below.

Under Chapter 3 of its statutes, BCRM can extend advances to the Treasury. These advances are statutory limited to a ceiling equivalent to 15 percent of ordinary budget revenues of the previous fiscal year and should be statutorily reimbursed within six months of the closing of fiscal year in which these advances are made. In practice, as advances to the Treasury has well exceeded the prescribed 15 percent limit. The actual ratio at the end of 1990, for example, was about 291 percent of ordinary budget revenues of the previous year; even net of government deposits, the ratio of advances was 78 percent of previous year's ordinary budgetary receipts.

At the same time, until 1991, BCRM paid virtually no interest on Treasury deposits, while also receiving about one half percent on its advances to the Treasury, an interest rate that was markedly below market rates. In other words, BCRM lending to the Treasury (net of government deposits) has been heavily subsidized over time. In October 1990, the Treasury showed an overdraft position of approximately FMG 275 billion (approximately 5.9 percent of the GDP). To the extent that the cost of funds of the central bank is higher than the rate paid on the Treasury overdraft, provision of banking services to the Treasury and the government could result in a loss. It should be noted that the government and BCRM have decided with effect from 1991 to remunerate both Treasury deposits and borrowing with BCRM at money market rates.

Another quasi-fiscal function of the central bank is the performance of foreign exchange operations and transactions on behalf of the government and the servicing of the external debt without full compensation by the Treasury. This function became very important during the 1980s after BCRM assumed external liabilities from the government and the private sector in the context of Paris and London Club debt rescheduling agreements. The financial repercussions of this quasi-fiscal activity have dramatically reshaped the central bank's balance sheet and income account. The accounting and financial results of these operations are reflected in the "revaluation" account and accumulated losses accounts of the central bank balance sheet. The evolution of these two accounts result from a fundamental mismatch within the balance sheet of BCRM. On the liabilities side are foreign currency denominated liabilities against which there is the domestic currency denominated "revaluation account" on the asset side which is in practice unremunerated by the government. Every time there is a devaluation, there is initially an equal increase in the domestic currency value of both accounts on the liability and asset side. The discussion below however shows that there have subsequently been asymmetric movements in both sides on the balance sheet leading to BCRM operating losses.

The revaluation account originated from the need to account for the changes in value of net foreign assets following devaluations. Since, net foreign assets (including medium- and long-term ones), as shown on the central bank's balance sheet, have been increasingly negative during the 1980s, their increased value in domestic currency consequent to devaluations had to be reflected on the asset side of the central bank's balance sheet by an offsetting entry called the "revaluation account". Over time, this "revaluation account" began to record other foreign exchange operations and transactions. Under normal accounting practices however, only losses on an accrued basis should be included in this account; once these losses are realized, they should be moved to the profit and loss account and be set off yearly against net worth. The revaluation account also records differences in posted values resulting from time value mismatch between outflows of foreign exchange and corresponding domestic currency inflows from the Treasury. This mismatch arises in payments from the Treasury to BCRM in domestic currency equivalent to debt servicing on the original maturity schedule and out payments by BCRM to service external debt according to the maturity profile of rescheduling agreements. Under the 1983 amendment to BCRM statutes which was related to its assumption of new external debt servicing functions, the government was to guarantee any resulting valuation losses that have now been recorded in the revaluation account. In practice, no government compensation on this account has occured. Hence, the revaluation account which now reflects the yearly total value of a number of both accrual and cash foreign exchange operations and transactions, represented in 1990, 40.2 percent of the assets of BCRM in 1990 without generating any income for BCRM.

BCRM has consistently incurred substantial operating losses throughout the 1980s. It appears that the foreign exchange operations and transactions described above are by far the main source of Central Bank losses. The changes in the revaluation account described above can remain unrealized and not have any impact on BCRM income statement. It is only when BCRM has to purchase foreign exchange at a new devalued rate to service old debts acquired at an overvalued rate that an impact occurs in terms of BCRM operating losses. This is because payments from the Treasury do not fully compensate BCRM for valuation losses, leading to operating losses as the valuation charges are realized. Since 1985, these operating losses have averaged 3 percent of GDP a year and have accumulated to the equivalent to 9.6 percent of the GDP in 1990. According to BCRM statutes, the government it to fully compensate BCRM for such losses. Since the Central bank considers that these losses represent a claim on the government, it accounts for them in its balance sheet under "other assets" rather than on liability side as a reduction in net worth.

When including the claims on government represented by the revaluation account with BCRM's operating account and BCRM advances to the Treasury at the end of 1990, the resulting claims on government represented about 607 percent of ordinary budget revenue estimated for 1990. This percentage is about forty times the actual percentage limit of 15 percent prescribed by BCRM statutes for BCRM credit to the Treasury. A more careful study is needed to fully clarify the origins, accounting practices and magnitude of the quasi-fiscal activities of BCRM described here. Although the quasi-fiscal operations of the central bank merit further investigation, the available information suggests that these operations, particularly as reflected in the revaluation and "other assets" accounts, have a major impact on money base creation and the financial stability of the Central Bank. The monetary significance of central bank operating losses is that they lead to reserve money creation. Depending on the size of these losses, they may seriously interfere with monetary policy.

In Madagascar, these losses have become very large, amounting in 1990 to 60.5 percent of the stock of reserve money at the end of 1990. In other words, BCRM in its reserve money management had to compensate for a 60.5 percent autonomous increase of reserve money or accept the inflationary consequences. However, such compensation did not occur by design between 1984 and 1990 but rather inadvertently. During this period the potentially inflationary consequences of BCRM losses were compensated by large net inflows from the Treasury to BCRM arising from the mismatch of debt servicing under the original and rescheduled payment profiles and the substantial accumulation of counterpart fund deposits. This situation underscores the precarious position of monetary management if and when such offsetting factors cease to compensate for the inflationary impact of BCRM operating losses. Continuation of existing external debt servicing arrangements into the 1990s would result in increased inflation or crowding out the private sector if BCRM is to attain its targets for monetary growth. In addition to operating losses, there are the accrued losses found in the revaluation account which, as noted above, will eventually be realized as operating losses. A side issue, but also an important one, is that these quasi-fiscal activities should be of concern from a fiscal standpoint. By obscuring the full magnitude of government financing needs, the importance of these activities cannot be properly weighed against that of other activities competing for limited resources. Accounting for these quasi-fiscal operations significantly changes the picture of fiscal performance and monetary stability and raises a number of key issues with regard to both fiscal and monetary policies.

Restoring BCRM to a sound financial footing will require compensation for BCRM for all existing claims on government and transfer of all debt servicing responsibilities on external liabilities to the Treasury. This would render the financing of a government operations, and specifically those presently related to the quasi-fiscal deficit, more transparent. This transfer of responsibilities from BCRM to the Treasury would however leave external debt servicing burdens for the country as a whole unchanged. The benefits of this arrangement lie in the greater transparency of government financial operations and the ability of BCRM to conduct independent monetary policy. At the same time, this new arrangement obviates the potential of monetizing government financing needs. Transfer of servicing responsibilities on external liabilities from BCRM to the Treasury took place in the first half of 1993.

▸ **Legal Framework**

To enable the financial system to effectively play its two key functions of financial intermediation and provision of payments services, an adequate financial infrastructure is necessary. The key elements of financial infrastructure mainly consist of:

- the legal protection accorded to lenders and borrowers;
- the practices surrounding reporting of financial information; and
- the set of practices and logistic arrangements for discharging financial obligations incurred in economic transactions (payments system).

Financial infrastructure affects two ingredients for financial sector development. The first is the confidence of savers and financial intermediaries in the quality of financial assets they own. The quality of financial assets is reflected in the probability that their owners will get their money back according to terms of the financial contract. Without reliable information about banks and borrowers and adequate legal protection, financial transactions will tend to be limited to short maturities and to borrowers either personally known to the lender or those able to provide easily attachable collateral. The second ingredient is the speed and accuracy of the financial system to settle efficiently obligations that arise from economic transactions. Unless there exists an effective payments mechanism which inspires general confidence, economic agents will prefer to incur the high costs of conducting many transactions in cash and conveying and storing large volumes of currency in insecure conditions. At the same time, an effective external payments system for settling international transactions is necessary for expansion of exports and stimulating capital inflows, including capital repatriation from abroad. Together, these elements of financial infrastructure should help lower the costs and risks of transferring resources from savers to borrowers and of settling financial obligations among economic agents.

The emerging shift towards a market economy in Madagascar requires abrogation of previous legal provisions based on a state-controlled economy. Modernization of the legal framework pertaining to economic activities is an essential pre-condition for economic development. The modernizing process normally involves both updating of existing legislation and creation of new legal instruments as well as repealing inadequate or obsolete ones. In the case of Madagascar this process should also involve a review of the administration of justice itself. Of special relevance to financial sector development are procedures for recovery of claims, enforcement of contractual guarantees, legal procedure and the execution of legal judgements and other enforceable decisions. Specific related areas of law and legal procedure reviewed below are: company law and the law in respect of stocks and bonds; the law governing mortgages which should be applicable to all categories of real property and related rights; protection of consumers and savers; collective procedures to prevent bankruptcy with a view to protecting employment while facilitating the reorganization of enterprises; and procedures for enforcement of official or legal titles. In many areas, the relevant legislation in Madagascar is coherent and satisfactory. However, many of the laws inherited from the French system have become outdated and several reforms have introduced new provisions which are in many case not sufficiently clear. At the same time, successive changes in policy have on occasion resulted in measures inconsistent with the traditional and constitutional hierarchy of the sources of law.

The legal system is perceived as archaic and the machinery of justice as slow, ineffective and unreliable. There is a striking lack of confidence in the administration of justice on the part of company officials. Companies in Madagascar still operate under the 1867 company law. The Commercial Code dates from the colonial era. These laws were frozen at independence because the old colonial texts which used at times to keep pace with developments in the then "metropole" did not evolve after independence in line with new thinking within the legal system from which they were originally derived. Except for the 1987 Plan Comptable National, the basic legal framework for companies has remained unchanged, yet in recent years decrees have been adopted by the authorities introducing new instruments in the financial sector. These decrees based on modern practices and instruments available elsewhere are being grafted on a superstructure which is itself an antiquated one.

Lawyers point out that some decrees or circulares ar not even published or are in contradiction with the enabling legislation. They also complain about the absence of law reports (no report seems to have been published since the mid 70's). Commercial, financial and economic law cannot develop without a proper reporting of case law. It is also observed that the common practice of subjecting ostensibly liberal pieces of legislation to administrative authorization which by definition are discretionary and which also happen to rest on a very bureaucratic system render these legislations, in practice, anything but liberal.

One of the most common complaints against banks is that securities required by banks before loans and other facilities are granted to enterprises are difficult to provide. Whereas mortgage ("hypotheque") is now little used in France for example, this is still the most common form of security required by banks in Madagascar. In addition to the consequent difficulties faced by enterprises because their property has already been mortgaged to a bank, providing the mortgage itself creates difficulties. This is because the titles to property are not always acceptable and the cost of complying with formalities required for mortgages is high. The available title may not be acceptable to banks which are not prepared to accept other forms of security. Banks complain of the difficulties in obtaining repayment even of secured loans because of the present system of administration of justice, the precarious nature of ownership deeds, the cost of recovery in remote areas, and the traditional and cultural factors which impede the execution of judgments.

Banks should be encouraged to adopt the wide range of securities and financing schemes available elsewhere and in particular in countries whose legal systems are derived from French civil law. These include: (a) project financing (agreed proportion of income derived from the investment is contractually assigned to the lender); (b) a combination of "hypotheque" and "cautionnement" (instead of exclusive reliance on hypotheques); (c) "delegation" (to ensure that the number of creditors in relation to a particular project is as wide as possible); (d) greater use of shares and other title deeds as security (this would be facilitated by prior consolidation of the law relating to "valeurs mobilières"); (e) title reservation clauses in contracts of sale financed by loans; (f) insurance cover for loans (this would further develop the local insurance industry); and (g) securitization. Many of these products could probably be developed solely through agreement between the banks and their customer even before there is specific legislation covering them. Banks would thereby contribute to the establishment of a modern system of law. If the overall legal system and procedure for settlement of disputes and recovery of debts (including provisional measures to safeguard the interests of creditors) are improved, bank may be expected to adopt a more liberal approach to loans and securities. The solution therefore does not lie only in new credit arrangements and instruments. Banks in need of immediate liquidity or which face new attractive loan opportunities, but which are constrained by certain supervisory ratios, should be allowed to package and sell some of their loans to banks with excess liquidity. This will allow banks to both meet the legal requirements and reap the benefits associated with new loans. Such provisions will increase banks' leverage on loan creation and may reduce bank failure.

The law in respect of collective procedures for debt owed only admits bankruptcy and court-ordered liquidation in accordance with legislation inherited from the colonial period. The time limits set by this law for the stages of the procedure should not exceed three months from the adjudication of bankruptcy. However, it is not unusual for the proceedings to drag on for more than three or four years. This is party due to the legal system's inability to give decisions and produce the required documents within the time set. The lack of qualifications on the part of managers and trustees is also regrettable; these individuals are not greatly motivated to try to put a troubled enterprise back on its feet nor do they display much efficiency in obtaining the best possible prices for its assets. A situation of this sort calls for modernization of the relevant legislation with institution of procedures which can be initiated by representatives of the personnel, bankers and other creditors concerned, and subcontractors in particular. This procedure would have the effect of suspending proceedings, starting with those initiated by the Treasury and the social security agencies, and of appointment of an adviser to the manager or a qualified temporary administrator to determine and implement restructurings and conversions required, with all available external assistance, to save the enterprise and retain its work force. In the case of liquidation of assets, the debtor and a representative elected by the body of creditors should be able to supervise and facilitate the operations of the trustee to prevent any items from being sold off a bargain-basement prices. The appointment of professionals designated as insolvency practitioners by the relevant authorities by creditors or members themselves will give more confidence to investors and lenders alike.

Improvements in the legal system should aim at preventing disputes or reducing the costs of settlement. Choice of guarantees and special clauses should be made taking into account both the purpose of the contract and the customer's general attitude and reputation. In this way some traditional institutions can find modern applications, such as the "omby sisa mita" clause defining a joint liability, a "fehivava" contract that closely resembles sale with option to repurchase, and the "tsatoka" clause which is close to an arbitration clause. The current bank contract forms include election of domicile and assignment of competence to the court of the place of the contract. There is nothing to prevent the parties choosing instead an arbitration clause specifying an attempt at reconciliation followed, should that prove fruitless, by referral to one or more arbitrators, with or without authority to arrange amicable settlement. A single conciliation or arbitration procedure stipulated from the start seems preferable with regard to legal certainty than interminable legal actions ultimately ending in renunciations or a resignation transaction.

Reforms of the legal system to facilitate financial and other transactions will require time for preparation and implementation. Steps to sensitize and inform economic operators and legal professionals should be undertaken in order to motivate them to ensure sound implementation of the renewed law. Pending this general revision, some preliminary measures could be taken to ensure as of now better certainty as to the law and swifter resolving of disputes. Based on their urgency, costs and complexity, two phases of legal reforms could be envisaged which could be initiated at the same time although with different horizons for implementation. In the first phase, based on the recommendations made above, the following reforms could be envisaged in the near term.: (i) new method for fixing the legal rate of penalty interest; (ii) increasing to FMG 1 million the competence of level without appeal and the procedure for injunctions to pay; (iii) equipping of court offices with an initial batch of word processors and photocopiers; (iv) easing of procedures for enforcement and court seizure of goods in dispute; (v) setting up a center for permanent training and exchanges between bankers and the legal professions; and (vi) developing of arbitration and conciliation. In the medium term, and in the context of studies already undertaken by the Ministry of Justice, the following areas of legal reform could be studied: (i) modernization of collective procedures; (ii) development of legal supports for new financial products; (iii) modernization and revision of company law and the Financial Code to permit generalized use of mortgages; and (iv) preparation of laws and procedures to protect consumers and savers.

Accounting, Auditing and Financial Disclosure. The accounting, auditing and financial disclosure requirements and practices of a country are important for creditors, shareholders and potential investors. The main weakness in this area in Madagascar have historically been the obsolescence of the accounting framework set by law and the poor quality and availability of records and information in general on companies. The first weakness has now been remedied by the introduction of a Plan Comptable national which is largely based on international practices. However, the framework must be coupled with the adoption of standards, general and sectoral, which will be based on international standards with appropriate adaptations. The need for improved and harmonized disclosure requirements and access to information must be given urgent consideration not only because this will give a better overall view of the performance of the economy but also to assist banks and other lending agencies and potential investors. Indeed, if Madagascar is to attract investment in both existing and new enterprises, the record and prospects of the existing enterprises must be made available in a recognized and approved form. This is also an essential pre-condition for the development of a securities market in Madagascar. Trading in securities whether on a listed or unlisted market, can take place only if there is proper disclosure of information.

Much of the prudential oversight of the primary banking sector had, until very recently, been handled exclusively by staff in the Central Bank. The ability to perform this task has been severely hampered by the poor quality of the financial information available, and the lack of timeless. The need to strengthen the accounting practices and financial information presentation for the primary banking sector has been acutely felt.

The 1988 Banking Act provided the legal framework from creating a supervisory body separate form the Central Bank - the Commission de Contrôle des Banques et Etablissements Financiers (CCBEF). The role of the CCBEF is to ensure that banks and financial institutions adhere to the prudential rules and other disciplinary action. The CCBEF is responsible for determining acceptable financial ratios and for establishing a satisfactory chart of accounts for banks. The Commission has the authority to carry out inspection visits and review the reports prepared by the statutory auditor (Commissaire aux Comptes) and/or external auditors.

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Although created in 1988, the CCBEF will only now begin to assume its supervisory role as personnel are transferred from the Central Bank. Nevertheless, much remains to be done to provide it with the requisite structure and resources to carry out its role effectively.

A principle cause of the inadequacy of financial statements prepared by banks in Madagascar has been the inappropriateness of the existing Bank Chart of Accounts. Although in 1983 this chart of accounts was designed specifically for banks, it has failed to impose the application of acceptable accounting standards on banks in certain key areas, particularly the treatment of loans loss provisions (bad debts, doubtful accounts and income on non-performing debts). The situation was particularly unsatisfactory while the commercial, or primary banks, were state-owned. There was a reluctance on the part of bank management to observe normal conservative accounting rules and on the part of external auditors and statutory auditors to take issue on the collectibility of doubtful customer debts. As the private sector takes over control of the primary banking sector, a process which is now well in hand, many of these difficulties will be progressively disappear.

An important initiative to improve bank accounting will be the introduction, later this year, of a new bank chart of accounts (NPCB). The chart of accounts specifies the number, class, composition and nature of the accounts to be used by all financial organizations. It is accompanied by a lengthy series of guidelines prescribing the accounting treatment for various classes of transaction, and the format for presenting financial information. Financial disclosure (explanatory notes to the financial statements) are NOT covered by these guidelines. The new standardized accounts were developed by the CCBEF secretariat in close collaboration with the banks themselves and, to a lesser extent, with members of the accounting profession. Based on a review of the current draft documents, the proposed NPCB should make significant progress in overcoming the inadequacies of the existing chart of accounts of 1983, especially the proper classification of bad or doubtful customer loans and advances and restrictions on accruing income on such loans and advances. Based upon discussions with representatives of the primary banks, there do not appear to be any major problems which would preclude effective introduction of the NPCB by the beginning of the next accounting year (January 1, 1994).

A major concern of users of the financial statements published by banks in Madagascar has been the inconsistency in the reporting by external auditors and statutory auditors. There is clearly a lack of established standards for performing such audits. This is evidenced by the variety in financial statement presentation and reporting contained in the bank reports which were reviewed by Price Waterhouse consultants during FMD design. This concern was discussed with representatives of each of the three major professional firms responsible for these audits and the following points are to be noted.

The imposition of a more appropriate chart of accounts for banks will facilitate financial statement presentation and ensure greater comparability of data. The timely adoption of the NPCB by the CCBEF is an important factor in achieving this objective.

The roles and responsibilities of the statutory auditor (Commissaire aux Comptes) are as enunciated in the Original Companies Act of 1867 (Code Napoléon). As long as this legislation continued to be in force in Madagascar, the efforts of the statutory auditors are unlikely to evolve to meet the needs of today's users of financial statements. Pending a fundamental review of this legislation which may take several years, the CCBEF should use its authority to establish the requirement for an annual full scope external audit. This would improve the quality of the audits carried out and the content of the financial statements presented.

During discussions with the firms directly concerned, all confirmed that they use some form of auditing manual to help them plan and execute their work. In two of the three cases, the audit manual was a published work no more than five years old. However, what is less certain is the degree of understanding amongst the firms' professional staff of the unique nature of bank accounting and the types of risks involved. None of the firms interviewed had developed or applies the more sophisticated risk assessment techniques which are standard practice for the major international accounting firms when performing audits of banks and financial institutions.

Executing a full scope audit in accordance with international standards could impose a cost which certain institutions would be unable to bear. If auditing firms decide to adopt these standards and impose them on their bank clients, they could find themselves being undercut by those firms who are less conservative. It is therefore essential that uniform auditing standards be imposed for all professional firms undertaking bank audits. This should preferably be achieved by the standard-setting body to be established within the profession. However, as an interim measure pending the availability of such standards, the CCBEF could impose minimum acceptable auditing standards and monitor their application in line with its supervisory role. This objective should also be achieved by generalizing the practice of having local firms carry out the audits of banks jointly with international firms, until such time as the professional body has issued its own standards which are deemed acceptable by the CCBEF. It is important, therefore, that the CCBEF gives priority to establishing its expectations for work performed by the external/statutory auditors of banks.

<u>Domestic Payments System</u>. In addition to financial intermediation, one of the essential services that the financial system usually provides to the economy of a country is the facilitation of payments and transfers among various economic agents. Households sell labor and capital services to businesses for money; people spend part of this money on goods produced by businesses; businesses get money for goods sold to the

government and also makes tax payments; and households also receive payments and transfers from the government and also make tax payments. In a market economy it is important that these transactions are carried through as efficiently as possible for the economy and the country to develop. The most suited intermediaries to improve the efficiency of the payment systems are the banks and other financial institutions, by means of using instruments such as checks, money transfers and credit cards in addition to cash.

There are three basic elements within the existing domestic payments and transfer system in Madagascar.

- a system of inter-bank payments among the four commercial banks and the postal checking and savings system operating through a clearinghouse in the capital and fifteen clearinghouses outside the capital;
- inter-branch payments within individual commercial banks and within the postal savings and checking system; and
- government payments and transfers to and from the Treasury.

The performance of the domestic payments system in Madagascar, as elsewhere, can be evaluated according to three criteria that are reviewed below:

- **speed** - the clearing should be done swiftly and not take more than three days, no matter if the checks/transfers are presented in a local clearinghouse area or in another area;
- **availability** - the customer should be able to cash a check without circumstantial procedures in his local bank's branch, as well as when presenting the check in other bank's branches, and it should be possible to cash checks received as payments at the receiver's bank's branch without sending them for collection;
- **acceptance** - possible errors should be reduced to a minimum and easy to detect (eg. bouncing checks, wrong accounts being debited, lost checks in transit); cashed checks should not be in transit for more than a few days before the account is actually debited, so as to receive updated balances;

One of the most obvious problems with the present domestic payment system is the long time for money to be transferred and before the payee is credited, particularly when cashing an inter-branch or out-of-town check. The main reason for this is communication problems among various parts of the vast territory that constitutes Madagascar. This is exemplified both by transportation problems, as during the rainy season large parts of the country can only be reached by airplane or by sea, and by telecommunication problems reflected in the poor quality of telex and telephone services. Poor communications make it difficult to easily verify sufficient funds on the accounts and that the person signing the check is authorized to do so. The most viable sign of the inefficiency (slack) in the present clearing and transfer system is the exceedingly long time it takes for money to be transferred from one place to another. It can be measured in days, but, a more useful illustration to the inefficiency observed would be to quantify how much recipients of funds lose through these delays in monetary terms. An estimate based on empirical examination of the existing clearing and transfer system and a number of conservative assumptions indicates that through these delays recipients of funds collectively incur an opportunity cost equivalent to at least 1.2 percent of GDP. Automatic transfers and automatic deductions from accounts are in use to help speed certain transactions. However, apparently there are no "guidelines" as to how many days in advance a payor has to make the money accessible to the bank, resulting in the bank not having any possibility to benefit from this cash-flow which could help defray the costs of this payments mechanism.

The present payments systems does not allow the check account holder to easily get his money, unless he goes into his local bank's branch where he has his account. Checks can only be cashed at drawee bank, otherwise they have to be sent for collection. The present clearing system, especially between different clearinghouse areas, and clearing between different branch offices of the same bank, result in checks being in transit for sometimes up to a month, thus not enabling either the bank or the customer to get an updated balance on his account. The long time-lags also make it more difficult to possibly detect any errors - for example, when documents in transit clearing disappear, it is difficult to find out what has disappeared and where. While checks are fairly widely used in larger companies and the Treasury, and by individuals as payment of some bills, there is a lack of confidence for checks as a means of payment for cash payments among a majority of tradespeople and others. For them, checks are inconvenient in respect to long clearing, uncertainty of the identity of the customer and sufficient funds. Other reasons are probably a result of the banks not marketing their products properly and lack of financial knowledge amongst the people. Certain measures have already been taken to improve the acceptance for checks as a mean., of payment, they do not solve the problem of confidence in paper instruments since customers have to pay in advance for these types of travellers' checks.

The present system of clearing payments in Madagascar is essentially a document clearing system which is dependent on physical transport of documents and therefore on existing mail and transport systems. Such systems are not likely to be substantially improved in the foreseeable future to an extent which would make it easily to clear documents within three days. An alternative clearing system would be one where the information of the document is exchanged, and not the physical document, and would be based on telecommunication. Although this alternative requires high-quality telecommunications to function efficiently, it is possible to begin to develop such a system even with the relatively lower quality of telecommunications currently available in Madagascar. A clearing system should, in order to minimize errors, be integrated as well as automatically reconciled. Integrations means capturing of data only once at the collecting/cashing branch to be used subsequently throughout the system. Any errors should be easily detected and corrected. Information clearing means that signature verification at drawee branch will not be possible and will, consequently, affect the design of the check system.

- **Banking Institutions**

Commercial banks are likely to continue to represent the preponderant segment of the financial system in Madagascar throughout the 1990s in terms of their share of funds mobilized and resources allocated by the financial system. Recent evolution in the banking system in Madagascar has included the decontrol of interest rates, establishment of inter-bank money markets, private sector participation in previously state-owned banks, and the entry of new, privately-owned banks in the system.

The level of banking activity is shown in Table C.1. The balance sheets are designed to highlight such variables as liquid assets in local currency, net external assets, net claims on government, gross credits to the economy, customer deposits and other domestic liabilities. A review of the balance sheets for the period 1986-1992 brings out a number of salient features. Commercial bank assets grew continuously throughout the period, albeit with sharp interyear variations in credit expansion. The government has traditionally been a net creditor to the commercial banking system with its deposits accounting for 9-12 percent of total commercial bank deposits. Bank financing to the Treasury has essentially been limited to holdings of a small volume of government securities.

The liquidity position of Malagasy banks fluctuated widely during the period under review. Excluding the statutory reserves with the Central Bank, the banks' liquid assets in local currency totalled FMG 49 billion at the end of 1987, while their net external assets stood at FMG 46 billion. During 1988, the banks reduced their excess reserves, with liquid assets in local currency dwindling to a low level of just over FMG 8 billion at the end of October. Despite a recovery during the last two months of 1988, liquid assets in local currency remained at year-end FMG 16 billion below the level of a year earlier. By contrast, the banks' net external assets increased by FMG 13 billion during 1988. In the wake of the significant increase in deposits during 1989, the banks' liquid assets in local currency (excluding statutory reserves) increased substantially reaching a record level of FMG 75 billion at the end of December. Net external assets also peaked at year-end, totalling FMG 90 billion.

Table C.1

Summary Accounts of the Commercial Banks, 1986–92

(in billions of Malagasy Francs: end of period)

	1986	1987	1988	1989	1990	1991	1992 Nov.
Reserves	76.5	88.8	66.3	110.8	80.9	173.3	208.6
Cash	2.7	3.7	3.3	4.0	6.3	10.3	6.5
Deposits with Central Bank	73.9	85.2	63.0	106.8	74.6	163.1	202.1
Net foreign assets	21.7	53.7	64.3	93.3	66.6	130.2	137.0
Foreign assets	40.1	72.3	94.1	121.8	136.3	177.9	180.9
Foreign liabilities	18.4	18.6	29.8	28.5	69.7	47.6	43.9
Claims on Government (net)	–33.8	–51.0	–47.4	–10.4	–51.7	–100.7	–120.4
Credit to Government	10.7	10.7	15.0	78.6	61.1	25.9	19.2
Government deposits	44.5	61.7	62.4	89.1	112.8	126.6	139.6
Claims on private sector and state enterprises	415.9	487.6	512.7	572.5	745.4	845.6	881.5
Assets = Liabilities (net)	480.4	579.1	596.0	766.2	841.2	1048.4	1106.7
Deposits	306.2	353.3	425.3	564.1	587.9	725.3	859.4
Demand deposits	176.3	231.5	283.7	381.7	358.7	465.3	551.4
Time deposits	129.9	121.7	141.6	182.4	229.1	260.1	308.0
Borrowing from Central Bank	0.2	5.4	10.6	11.9	127.5	84.1	42.4
Net worth	131.3	152.1	144.9	149.5	174.1	198.0	221.0
Other liabilities (net)	42.7	68.4	15.2	40.7	–48.2	41.0	–16.1

The situation was again reversed in 1990, which was marked by an acute liquidity crisis experienced by one of the banks, and an over-all reduction in the liquidity position of the banks. The latter appeared to largely result from a surge in credit-financed imports triggered by the liberalization of the trade regime. During 1990, the banks' liquid assets in local currency decreased by FMG 65 billion, while their net external assets decreased by more than FMG 26 billion. In addition, the banks' indebtness to the Central Bank increased dramatically during the interval from FMG 12 to FMG 127 billion.

Banks' liquidity increased in 1991 and 1992 Domestic reserves (including statutory reserves with the Central Bank) increased by FMG 154 billion; while net foreign assets increased by FMG 70 billion. The ratio of loans to the economy to total assets fell from .89 in 1990 to .74 in 1992. The excess liquidity in the banking system in 1992-93 reflects bankers' risk aversion during a time of political and economic uncertainty.

As table C.2 shows, there was not much variation in the shares of the various sectors in total credit, excepting the decline in the share allocated to industry. The industrial sector is the recipient of nearly one-half of the credits extended by the banks, with the agricultural sector accounting for one-fifth and the services sector (mainly commerce) accounting for one-fourth. The entire period has witnessed a significant shift in lending from the public to the private sector. With the banks' tightening of credit to loss making public enterprises, more resources became available for lending to the private sector. Consequently, the share of the private sector in total credits extended by the banks rose steadily from 52 percent at the end of 1987 to 86 percent by end October 1992.

Table C.2

Sectoral Breakdown of Gross Loans
(Percent of total)

Sector	End 1987	End 1988	End 1989	End 1990	End 1991	Oct. 1992
Agriculture	15.4	16.5	16.6	20.7	19.9	21.0
Industry	58.8	56.2	55.8	48.7	46.9	46.0
Services	20.5	21.8	23.6	22.9	25.5	24.7
Not Classified	5.3	5.5	4.0	7.6	7.6	8.3
Private	52.4	63.3	66.2	78.1	84.4	86.7
Public	47.6	36.7	33.8	21.9	15.6	13.3

The immediate challenge facing the Malagasy banking system is the containment of BTM's liquidity crisis. Since BTM accounts for 36% of assets, 35% of deposits, 57% of branches and 39% of the employees of the banking system, internal liquidity and other problems of such a major bank can potentially jeopardize the liquidity and depositor confidence in the banking system as a whole. There is an urgent need to clearly assess the problems of BTM in its accounting, liquidity and portfolio management, and operation of its large branch network. This evaluation is likely to confirm the need for a significant restructuring of this bank. This prospect has led the government to envisage opening up the capital of this institution, a goal which should be pursued once a restructuring plan for BTM is identified.

A key challenge for the 1990s remains making the banking sector more competitive. Lack of competition has resulted in relatively high interest margins that penalize to some extent both depositors and borrowers. This in turn limits the scope of the banking system to increase its deposit mobilization and to reduce the costs of real sector economic activities. The present size of the banking sector coupled with prospects for future economic growth indicates scope for additional commercial banks in the financial system in the near term.

Such a development should lead to a decrease in the interest margin, without unduly affecting the existing banks' profitability. In addition, the move by the BCRM to require all commercial banks to post their base lending rate and terms of their banking operations should favour further competition by enabling clients to more easily choose among banks for their needs for various financial services. This should help mitigate a major problem among users of banks services who had faced great uncertainty in the pricing of both their deposits and borrowing as well as other services from banks. This move should be accompanied by a strengthened framework for prudential regulation and supervision which would require mandatory disclosure of certain basic financial information by banks enabling their clients to better assess the management strengths and soundness of individual banks.

Government ownership in the banking sector has generally not been conducive to financial sector development as experience in Madagascar as well as elsewhere has shown. Madagascar's move towards an increasingly market-oriented economy would be firmly buttresses by a fully private commercial banking system. The government should therefore pursue the process of privatization of the banking system which began in the latter part of the 1980s. Competition would also be favored by further divestiture of government shareholdings in banking, notably in BFV in addition to BTM as discussed previously. Since demand among the general public for share ownership in the banking sector appears to be high, the government could use the occasion of the divestiture of such holdings to further broaden and deepen the shareholding habits of the population. If undertaken through public offerings organized under a simple embryonic framework for capital markets, this further privatization of the banking system could also be used by the government as a vehicle for catalyzing the emergence of full-fledged capital markets.

There is a need to establish a new and independent professional banking association in Madagascar. The existing Association Professionnelle Bancaire (APB) that was created in 1985 supposedly represents the interests of the banking industry. However, it does not appear to fulfill the needs of commercial banks and does not seem to work to the full potential of such an institution, partly because it is managed and reports to the government. The government should therefore take the initiative to dissolve the existing APB and encourage commercial banks to independently create such a new institution which would not have any government participation. The new banking association should be free to set its own rules and should work in areas of common interest to all banks. Among such common issues are banking ethics, education and training issues including the organization of various professional bankers' examinations, promotion of standardization of checks and education campaigns to encourage better financial and savings habits among the general public. This new association should be the primary channel through which the government addresses banks on general banking matters on which mutual consultation and collaboration are useful.

Even as their economies are liberalized and perhaps especially when they are, governments retain a special role in regulation and supervision of banks. In contrast to most transactions in product markets which are carried out on a spot basis, the operations of banks involve the exchange of intertemporal claims (short-term deposits are used to fund long-term loans). Although bankers tend to maintain a reserve of cash on hand to cover net withdrawals that can occur on any given day, they may be wrong in their judgements and may be too optimistic with respect to the success of projects or customers. Consequently, in addition to liquidity management policies of the Central Bank, prudential regulation and supervision are of paramount importance in order to avoid the ensuing problems associated with insufficient liquidity and insolvency. The soundness and solvency of a bank's loan portfolio do not always insulate it from liquidity difficulties. Mismatches in the maturity structure of assets and liabilities could lead to serious liquidity problems if, for example, the duration of assets largely exceeds the duration of liabilities. Safeguards in the form of supervisory ratios which attempt to match the duration of assets and liabilities are important prerequisites of a safe financial system. Banks are also particularly vulnerable to possible opportunistic behavior on the part of managers and employees. Managers and employees of all types of enterprises may occasionally be tempted to take unfair advantage of their positions. Given the relative ease with which money can be misappropriated, compared to the real assets of nonfinancial enterprises, the scope for such behavior in banks and other financial institutions is substantial. Experience shows that bank failures often result not from incompetent management, but from fraud. Consequently, appropriate supervisory measures should be established to protect saver's money from serving the immediate interest of managers or of loan officers.

The confidence of economic agents in the soundness of the financial system depends fundamentally on the existence of an effective regulatory and supervisory framework. Within the financial system, banks in particular hold a special position in most economies as creators of money, principal depositaries of financial savings, the principal allocators of credit and managers of the country's payments system. For this reason, governments establish public policy for banks in the public interest. Central banks play an important role in ensuring effective regulation and supervision of the financial system, particularly banking institutions. In liberalizing economies such as Madagascar's, prudential regulation requires central bank supervisors to move beyond a focus on compliance with monetary policy regulations, foreign exchange controls and credit allocation regulations to reviewing the overall quality of bank assets, accounting procedures and management controls. In order for BCRM to effectively and credibly play its role as an independent monetary institution, it must give top priority to developing an effective regulatory and supervisory capacity over financial institutions. This function will assume greater importance and complexity as the financial system evolves in Madagascar in coming years.

Term Finance

Term finance (i.e. mobilization of resources and development of financial assets for the medium- and long-term) is needed in all countries to ensure that the full productive potential of the economy is realized. In an economy such as Madagascar's which is rapidly restructuring, term finance is becoming increasingly essential to business, household and private sectors. It is needed for expanding the capital stock of the enterprise sector as new machinery replaces old, production and distribution facilities are upgraded and new plants are built; for providing for the development of physical infrastructure such as commercial buildings, schools, and roads; and for creating residential housing which is the major long-term asset of households. To address these needs, the financial system has to meet one of its basic challenges which is to mobilize resources to be transformed into medium- and long-term financial assets with adequate attention to risk, return and liquidity.

Term finance directly and indirectly involves the entire range of financial institutions, instruments and markets within the financial system. Commercial banks have a major role to play in this respect both in resource mobilization and in term credit. Their roles are briefly discussed below. However, their activities must usually be reinforced by other institutions which have an even more specific and direct role in term finance. Perhaps the most important of these are contractual savings institutions (life insurance companies, occupational pensions schemes, national provident funds and funded social security schemes) which are directly involved in mobilizing savings through long-term financial contracts. Contractual savings institutions in Madagascar are the major focus of this discussion.

In the near term in Madagascar, banks will continue to play the major role in term finance within the overall financial system. In comparison to many developing countries including low-income countries in Sub-Saharan Africa, the Malagasy banking system remains relatively biased towards the short-term in its mobilization and allocation of resources. Term deposits in the commercial banking system in Madagascar have tended in recent years to account for only about one-fifth or less of total bank deposits. Although this proportion has been growing in recent years, it is still considerably lower than many other countries. The prevalence of double-digit inflation in Madagascar during most of the 1980s is one of the underlying reasons for this phenomenon. This underscores the importance of a stable macroeconomic outlook to encourage savings through long-term financial contracts.

In addition to commercial banks, most financial systems feature an insurance and social security system which together constitute the contractual savings subsector of the finance system. This sub-sector can play a critical role in Madagascar both in the mobilization of term resources and in the development of financial markets. Madagascar has, like the greater majority of developing countries and more specifically Sub-Saharan Africa, a relatively small contractual savings subsector compared to major component of its financial which are its banking institutions. Insurance companies and the social security institution in Madagascar together accounted for about one-quarter of resources of the financial system in Madagascar with banks providing the rest. Notwithstanding the small size of this sector, contractual savings institutions in Madagascar have a great potential to develop the financial system, given their generally stable cash flows and predictable long-term liabilities. A number of other developing countries in Asia, Africa and Latin America and the Caribbean have already made great progress in developing their contractual savings subsector which in many cases provide term funds not only to government but also to the industrial sector and housing sector. These countries include Barbados, Chile, India, Malaysia, Trinidad and Zimbabwe.

Contractual savings institutions in Madagascar already contribute almost three-quarters of term deposits of commercial banks in Madagascar. The contractual savings institutions of interest here are the insurance industry and social security system.

The Malagasy Insurance Markets. In the developing countries of Sub-Saharan Africa, Madagascar being no exception, the insurance industry is very much in an early stage of development. The ration of gross insurance premiums to GDP in developed countries averages 4.5 percent while developing countries attain less than 2 percent. In developing countries the "supply leading approach" is often apparent when governments establish and control the institutions to try to force financial development. Insurance industry development depends on many factors such as the level and distribution of income and wealth of a country. Social and cultural structures also play a major role since, as the case is in many African countries, rural communities have a lesser need to cover risks as the extended family steps in and covers the shortfalls. The efficiency, solvency and public image of the insurance industry as well as the tax treatment of insurance premiums and benefits and the regulatory framework are important considerations in its development.

Two major companies are presently engaged in the insurance business in Madagascar: ARO, and NY HAVANA. They are stock companies with majority interests held by the government. The organization of the present day insurance sector can be traced back to the period when foreign companies were nationalized, without affecting local Malagasy shareholdings. Marketing and distribution methods have not changed since the times when the agencies were dealing purely with maritime risks.

The oligopolistic quality of the insurance sector has effectively limited participation to two companies of virtually equal size, ARO and NY HAVANA who share more than just government shareholder majority participation. ARO and NY HAVANA also have boards of directors with nearly identical participants, there is also a non-competitive agreement where one company will not take a client that the other company has rejected (as they use the same sources of information to evaluate the clients), they also give a right of first refusal for business they cannot take because of risk limitation, and they also share rate strategy and information. These elements have lowered the operational costs of each of the two companies and have limited the competition in rates allowing the two companies to survive the recent periods of economic decline. However, in an expanding, diversifying and more market-oriented economy, this oligopolistic industry structure is not likely to provide the dynamism necessary to fully exploit the potential of the insurance industry in Madagascar. As a first step to promoting more dynamic management, the government has recently begun a process to augment the autonomy of these companies by electing separate and different board of directors for each company.

The Malagasy Social Security System. The social security system is the second contractual savings institution discussed in this section. In Madagascar, wage earners are covered by two systems -- a small government scheme for public sector employees by way of the Ministry of Finance and the Caisse Nationale de Prévoyance Sociale (CNAPS). For those individuals who are not wage earners, there is no organized social protection. A small number of independent entrepreneurs and farmers are covered by insurance policies issued by the insurance companies. The scussion below focusses on CNAPS which is the main element of the organized social security system. The oversight function of CNAPS is jointly undertaken by the Ministry of Public Works and the Ministry of Finance.

Salaried employees, affiliated to CNAPS during the time frame since inception in 1969 to 1989, amounted to approximately 810,000 individuals. Active employees, affiliated to CNAPS in 1989, amounted to approximately 261,000 individuals equivalent to a coverage of 5 percent of the active workforce. Only 8 percent of the participants in CNAPS have less than one year of affiliation while 44 percent have less than seven years of affiliation and the remaining 48 percent have over seven years with the program. Approximately two to four percent of agricultural workers, which make up the bulk of the Malagasy workforce, have sought social security protection. Only eight percent of local entrepreneurs have sought some sort of social security protection while a total of only five percent of non-salaried workers sought protection through the purchase of insurance policies from the two major carriers in Madagascar.

Social pension systems, being national or at the most regional institutions, have centralized management, although their operations are often decentralized. Their operating cost may be lower than under private and, therefore, completely decentralized systems. By their nature, social pension insurance systems are susceptible to political influence, both with regard to the payment of benefits and with regard to the investment of their reserves. In many countries, such as in Madagascar, social pension insurance institutions lack autonomy from central government and they also suffer from administrative weaknesses that affect their ability to keep records and to enforce compliance with the rules of the schemes, especially the prompt payment of the contributions. The challenge for the government is to identify specific actions that will meet the legitimate needs of the government, as final guarantor, and of employers and workers who have contributed to this scheme, that will simultaneously increase the financial and managerial autonomy of CNAPS and assure the required external monitoring of decisions and the long-term financial soundness of the institution. Such actions should take into account the recent evolution of Malagasy economic policies, and foresee management of the CNAPS as much as possible along the lines of a private enterprise.

Financial resources of CNAPS depend largely on the collection of the quotas payable by affiliated members. Fourteen percent of the worker's salary is payable to CNAPS on a quarterly basis. A yearly ceiling of FMG 1,200,000 was established in 1969, and has not been changed since then. One logical way to increase contractual savings in Madagascar would be to make a one-time adjustment in the ceiling, to compensate for inflation since 1969, and then to make regular changes thereafter. The fourteen percent is comprised of the worker's participation of 1 percent of salary and the employer's participation of 13 percent.

Collection problems are severe with CNAPS, since the declaration of payments by employees must include the corresponding bank checks to be accepted by the regional offices. This creates an internal problem with the contributing members when they are confronted with financial difficulties. Late declarations continue to pile up when difficulties arise with the employers and they no longer consider their obligations to be a priority. Collection is very weak when legal action is undertaken by CNAPS. A major difference between insurance companies and CNAPS is that in the case of insurance companies a requirement of payment of premiums is necessary to activate the issuance of the policy protection. CNAPS on the other hand is required to provide benefits to the individual employee and his family if a claim is made since it is assumed that the payment is deducted by the employer at the source. The fault in the existing system of collection lies with the "ex-post" determination of amounts due and not an "ex-ante" verification of what should be paid. Therefore, there is no effective control of collection or recovery of this social debt. It should be stated that CNAPS functions through the good-will of the employers that participate in the system and not through an effective checks and balances of their social and legal responsibility. The lack of careful control is apparent when, in 1987, more than 8,500 technical default of payments occurred out of a total of 15,000 employers, without any significant verification of these accounts and the subsequent write-off of a signification portion of these obligations. There is a significant lack of perseverance in the collection pattern established of the CNAPS accounts. In all fairness to the organization, there appears to be a legal void, with regard to the collection process, which has created and still fosters a general indifference among employers in the legal payment of the social obligations they undertake.

The final responsibility of fulfilling the social contract in Madagascar lies with the government. Any shortfalls between the amounts received by CNAPS and the amounts paid out to recipients, must be covered by the Government Treasury. Due to the uncertain nature of the benefits to be disbursed annually, a reserve fund was established on April 26, 1969 under Article 127, Decree 69-145, and is strictly required to equal one sixth of the amount spent or disbursed during the year. This is therefore established on the basis of the previous fiscal year.

Two types of reserves were created. This is the result of the vague nature of the legal code, with regard to the constitution and maintenance of statutory reserves. The technical reserve is established under the strict guideline of the law and the surplus is added to the ordinary reserves which has grown to over FMG 19 billion in 1988.

CNAPS has a statutory obligation to deposit its excess liquidity with the Treasury. CNAPS does not derive any financial benefit from these funds. The investment policy of CNAPS is extremely limited. CNAPS holds investments in both local and foreign corporations. The foreign component dates back to the period prior to 1972. The domestic corporate investments have been undertaken in start-up ventures of government controlled companies. The other holdings result from participation in restructured companies that had unsettled accounts with CNAPS. The majority of the equity portfolio lies with domestic companies. According to an ILO study, 23 percent of the receivables amounting to FMG 220 million in the accounts of CNAPS represent losses from participation in liquidated state enterprises. Current accounts are held with local banks as are long-term deposits. Long-term deposits are placed with commercial banks at a set interest rate which is not indexed and therefore carries the inherent risk of inflation and currency devaluation, both of which have been significant since 1986. In real terms, the equity of CNAPS has been eroding at a very dangerous level which could result in the government having to cover shortfalls at a later date as more employees retire. The growth rate of 8 percent of new members in CNAPS is hardly enough to cover the perceived demands on the system when the older affiliates retire. There is an urgent need to ensure a positive rate of return on investments that would at least cover the rate of equity erosion.

While the overall propensity to save in Madagascar is extremely low, closer examination of contractual savings as discussed above reveals that there are many disincentives to contractual savings under present conditions. The first among these is lack of appropriate statutes and a regulatory framework. Another recurring problem to be faced is the nagging inflation and the repeated need by the government to devalue the currency to maintain effective international competitiveness. These elements, along with a lack of domestic financial instruments and the lack of necessary capital market institutions has stifled the growth of contractual savings in Madagascar. This in turn has led to a slowing down of economic activities. All indications suggest that, under the proper conditions, greater financial savings and the economic activity generated through effective contractual savings mechanisms are possible with appropriate incentives.

Financial Services for Small-Scale Economic Agents

A majority of economic agents in Madagascar are "small-scale" both in terms of the volume of their savings and their finance needs. These small-scale economic agents comprise smallhold farmers, owners of microenterprises or small- and medium-scale enterprises (SMEs),artisans, small traders, landless laborers and migrant workers. Of the 30,845 registered and active firms in 1987, only 6% employed more than 10 persons. Over 65% of these firms are in the commercial sector which represents less than one-tenth of employment in the country. Some 1.5 million of the 1.6 million rural families in Madagascar work small, mainly subsistence farms of about one hectare or less and account for 75% of the total population in Madagascar. It is also estimated that there are well over 30,000 microenterprises which are widespread throughout the country including a variety of artisanal and informal sector activities and in addition to some 300 SMEs in the formal sector. Together, these small-scale economic agents represent the largest number of actual and potential users of financial services in Madagascar as well as a potentially significant source of financial savings.

Sustainable and equitable long-term growth in Madagascar cannot be envisaged without the active participation of this overwhelming majority. Yet, many of them have little or no access to the existing financial system and are therefore unable to effectively contribute to resource mobilization nor to fully avail themselves of payment services, working capital, term loans or equity finance from existing financial institutions. One of the biggest challenges for the future will be to improve financial services to this category of the population and better integrate them within the overall financial system.

There is much evidence to suggest that substantial savings exists in Madagascar among small-scale economic agents, particularly in rural areas which tend to generate net surplus resources. However, for various reasons, the financial system in Madagascar has not captured the bulk of savings among small-scale economic agents who tend to prefer real assets to financial assets. At the same time, their demand for financial services (both debt and equity finance as well as depositary and payment services) is high but is known to be largely unmet by formal financial institutions and believed to be inadequately provided by informal institutions. The fundamental problem remains one of access of small-scale economic agents both to financial services and information. In addition, improvements in infrastructure as well as in regulatory policies and in the legal framework, which would be conducive to improving the profitability of small-scale economic activities, would in turn improve their access to finance. Much therefore remains to be done to realize the considerable productive potential of this preponderant segment of the population. A coherent approach by the government is therefore needed to ensure that public policies support rather than impede the activities of this important segment of the economy and population.

Government policies toward small-scale finance have not shown a distinct pattern. In the past, such policies have varied from neglect to outright interventionism but more recently there has been renewed consciousness of the importance of such policies but with an approach which is still not yet fully defined. Government policies have been compounded by a multiplicity of initiatives from donor agencies and from non-governmental organizations (NGOs) which have not been fully coordinated. A variety of support programs have been tried which have not either individually or collectively attained national coverage of small-scale economic agents. Notwithstanding these results, Madagascar has a history of relatively active cooperatives and groups which indicates significant potential for developing alternative professionally or community-based grassroots institutions for helping improve access to financial services. At the same time, existing financial institutions can either be revitalized or stimulated to improve their provision of services to this important segment of the market for financial services. Together with the economic reforms initiated during the 1980s, this background augurs well for the development of a set of viable, responsive, and sustainable institutions, instruments and markets for servicing the financial needs of small-scale economic agents during the 1990s.

Although a top-down or "blueprint" government approach to small-scale finance has not succeeded in any country, there remains considerable scope for supportive public policies which rely primarily on market forces to direct financial services towards small-scale finance should aim at appropriate actions in four areas: (i) efficiency and competition among banking institutions; (ii) sustainable and demand-driven small-scale finance policies encouraging both savings and credit; (iii) linkages and integration of small-scale finance within the overall financial system; and (iv) improvements in the regulatory framework and

in financial infrastructure which would lower transactions costs and risks. Such policies should be guided by past experience which provide many lessons on which approaches or initiatives might be replicated and which should be abandoned.

Efforts to create specialized banking institutions solely catering to the needs of small-scale finance (notably for either SMEs or rural credit) have not generally been successful in any developing country. In Madagascar, the post-nationalization restructuring of the banking system led to the creation of a new bank (BTM) which was intended to have primarily an agricultural vocation. In fact, however, such specialization did not occur largely because agricultural activities, especially on a small-scale, were not an attractive source of business for banks who continue to prefer to finance large-scale manufacturing or trade activities. There is therefore, first of all, a need to make such small-scale activities profitable enough to attract bank financing for which banks tend to face significantly higher transactions costs than lending to large enterprises, for example. At the same time, there should be sufficient competition within the banking sector to ensure that banks have an incentive to look beyond their traditional sources of business. Although banks in Madagascar appear to face somewhat increased competition since the introduction of private banking in Madagascar in the late 1980s, they still enjoy a significant interest margin and exhibit relatively high costs of intermediation. Pursuing greater competition within the banking sector should therefore be adopted for improving the overall financial system. This would also favor the development of small-scale finance. Increasing such competition among banks is not likely in the short term to generate a significant increase in their activities towards small-scale economic activities. However, such competition is essential for sustaining small-scale finance activities over the medium term and ensuring that they become increasingly integrated within the overall financial system.

Almost all small-scale finance programs targeted at rural areas in Madagascar, whether undertaken by the Government, BTM, NGOs or other donors, have to date individually reached less than one percent of rural households. The collective impact of these programs in terms of number of households or enterprises served is also extremely small. This results from a number of factors which suggests important lessons. Given the sheer size and variety of the country, it is not only feasible but also undesirable to attempt to create a centralized national-level small-scale finance program. No single approach of programs is likely to be suited to all the different agro-climatic regions in Madagascar not to the heterogeneous activities found among small-scale economic agents. In order to succeed, any new program should be established in areas where economic activity is already profitable; in other areas, additional inputs such as infrastructure and other services are likely to be necessary before small-scale finance programs can succeed on their own. At the same time, appropriate legal and regulatory mechanisms need to be put in place (and certain other regulatory restrictions removed) to catalyze small-scale finance activities.

One institution does have a wide network of offices for the collection of savings: the Caisse d'Epargne de Madagascar (CEM). CEM already attracts the business of every fourth inhabitant in Antananarivo and hence, has a good foundation form which to grow further. Apart from its one outlet in the capital, CEM operates 220 windows in post offices in 208 towns throughout Madagascar, giving it the widest financial network in the country. The vast majority of its accounts are held by individuals; the rest are held by a handful of enterprises, local governments, educational institutions, and religious as well as other associations. Individual accounts however average only about FMG 40,000 (much lower than the minimum deposit required by commercial banks for a checking account). Thanks to its widespread network, the CEM could form an excellent base for establishing the necessary link between informal and formal financial activities. With an access rate to the market of one account for every four person in Antananarivo it makes it a formidable platform to be the link to the formal banking system. At the same time, a large portion of the small-scale finance initiatives could be both initiated and operated through the CEM. Notwithstanding this potential however, the CEM remains hampered by organizational and other problems.

The present CEM provides only very limited service to its customers. Its financial management is hampered by its dependence on the Treasury with which it is required to place all its funds and which pays a below market interest rate on its accounts. Delays in making funds available to customers reduce the attractiveness of the CEM as a major agent for mobilization of resources. There is no clear-cut marketing strategy through which the CEM could better adapt and design financial products so as to broaden its clientele and enlarge its deposit base. The revenue generating capability of the CEM is constrained in its present form, making it difficult to make the necessary investments for CEM to play a more active role as a financial institution.

CEM has a diversified clientele. Individual depositors who number about one quarter of a million are drawn from artisans, traders and farmers, mainly in urban areas. Despite a relatively passive promotion effort, CEM manages to open 700 new accounts on average every month. This underscores the substantial scope for developing CEM as a savings bank. However, its attractiveness to depositors will remain limited by relatively cumbersome service, among other factors. For example, interest on passbook savings must be updated at the CEM center in Antananarivo and personally certified by a public accounting agent, creating delays for customers.

One of the major problems faced by small-scale economic agents (particularly SMEs which need capital equipment) is a lack of equity financing. One potential vehicle for such financing which is yet to fully develop in Madagascar is venture capital. Venture capital is equity financing based on the principle that a partnership can be forged between the entrepreneur and the investors. This is still a relatively new financial instrument in both industrial and developing countries. It is significantly different from bank financing and financing by passive "portfolio investors" in that venture capitalists generally add value to their investments through the provision of management assistance. Venture capital companies can make a significant contribution to the development of the real sector, especially through promotion of SMEs, by: (i) providing capital to small business with substantial growth prospects but inadequate security to tap bank loans; (ii) supporting new ventures in the form of "seed capital"; (iii) increasing the capital base of SMEs to enhance their potential to mobilize resources from existing financial institutions; (iv) being an active partner in the business (as opposed to the "sleeping partner" status of many other shareholders), thereby allowing the SME to benefit form the experience of the VC company in management and marketing and its access to global information network. More generally the contribution of venture capital companies to the growth of enterprises can be more meaningful than banks and other lending institutions because: (i) by providing capital or loans which are convertible into equity after some time, they do not impose on new or restructuring business the burden of high debt servicing which are unbearable in the initial years; and (ii) the remuneration of the venture capital company being through a combination of dividends and capital appreciation, it has an incentive to make every effort to ensure the success of the enterprise.

The impact of venture capital companies in Madagascar on the growth of private enterprise has been so far very limited, both generally and particularly for SMEs, for several reasons. First, the volume of finance made available (less than USD 1 million) is insignificant with regard to the enormous investment needs (both debt and equity finance) of enterprises generally and SMEs in particular. Second, the bulk of the resources (83%) have gone to large established companies. Third, only part of the activities of existing companies are devoted to purely venture capital activities. The prospects for a more significant contribution from the two existing venture capital companies in the future are remote as they have themselves fixed their combined annual equity participation to about 1000 million FMG. Under their most optimistic scenario, only some 25 - 30 SMEs would obtain an average of 15 - 20 million FMG (about USD 1,000) annually. More such companies should therefore be encouraged if venture capital is to claim a significant role in equity financing in Madagascar.

The development of venture capital faces a double handicap in a developing country like Madagascar: (i) limited real investment opportunities (few businesses offer a minimum security and entrepreneurship that would attract venture capital); and (ii) absence of a readily available market to realize the capital appreciation of their investment. Venture capital companies can only grow at the pace at which private enterprise thrives and matures, and a capital market develops. If venture capital companies are artificially promoted, the result will be (i) companies investing in "blue chips" rather than high risk/high return ventures with limited developmental impact (to some extent, this is already being done by the existing companies); and (ii) loss making companies which invest in development oriented but very risky business (SMEs) and have to be supported by public grants; and (iii) companies which only nominally engage in venture capital in order to benefit from any special incentives. The main incentives for venture capital companies will come from policies that improve the profitability of real sector activities and which facilitate entry of SMEs into new spheres of activity.

- **Trade Expansion and Investment Promotion**

To ensure that Madagascar's economy becomes increasingly diversified and export-oriented, the financial system will need to be better placed to facilitate the expansion of domestic and foreign trade and both domestic and foreign investment. While it is unrealistic to expect Madagascar to develop within the 1990s the sophisticated trade finance systems which exist in industrial countries, Madagascar can follow the example of a number of developing countries which have succeeded in developing a strong export base in recent years, notably those in East Asia and neighboring Mauritius. This section considers in particular what financial policies the experience of these developing countries might suggest to malagasy policy makers for development of a more diversified economy with a strong export base.

Both the medium- and long-term horizons -- which could extend beyond the 1990s -- are considered in this section in examining which financial instruments, markets and institutions could be developed to expand trade and investment and stimulate trading of financial assets. It should therefore be stresses that several of the financial innovations discussed here involve instruments, markets and institutions which cannot be realistically expected to emerge in the near term. They especially include relatively sophisticated trade finance instruments such as bankers' acceptances or capital market securities and institutions such as an export credit guarantee scheme or an offshore banking center. These and other relatively sophisticated innovations will notably require: (i) prior improvements in the financial infrastructure, many of which are discussed above, (ii) greater diversification of real sector activities and especially exports; and (iii) effective operation of more basic instruments and markets including a secondary market in trade and Treasury bills and an active inter-bank market. Since it is not unrealistic to expect these basic prerequisites to be in place within the medium-term given the appropriate policies, the more sophisticated innovations could also be envisaged in the longer term once the Malagasy economy begins to realize its substantial scope for broad diversification and export orientation. As discussed below, public policy will have an important role in the 1990s for helping lay the ground for a number of financial innovations in Madagascar.

A strategy of sustainable growth in Madagascar based on expanding and broadening the export base requires effective international trade finance. Without this, Malagasy exporters cannot respond effectively to foreign demand. They will have to continue to substantially rely on self-financing which severely constraints the scope for expanding trade and particularly exports. A survey of Malagasy enterprises conducted by the World Bank showed that much remains to be done to improve international trade finance in Madagascar. For most Malagasy enterprises, payment of imports is made generally at sight while a good proportion of exports is settled after shipment or delivery (normally 60 days). The need to finance international trade from domestic sources could be reduced if the payments terms could be altered in favor of Madagascar. A combination of increased supplier credit, foreign bank trade finance and preshipment finance will be required as discussed below.

The discussion below points to at least three policy areas which are crucial to improving financial system for trade expansion and investment. First, it is crucial that the government rapidly exploit the full potential of the business investment and free trade zone policies it has already adopted. While the basic free zone legislation already exists and appears adequate, many outstanding problems remain in the application of this legislation which is unnecessarily cumbersome. The one-stop window ("guichet unique") to facilitate new enterprises should also be made operational as soon as possible. Second, improvements in the legal and accounting framework, broadly discussed above, are needed to encourage the development of a bill market in Madagascar. A third area of attention are foreign exchange controls which could be made more flexible to adapt to the needs of exporters and importers.

Supplier credit is generally one of the most important sources of credit for importers. Foreign suppliers' credit depends on suppliers' assessment of the credit worthiness of the Malagasy importers and their general confidence in the Malagasy economy. The severe external payments situation which the country had experienced during most of the 1980s led to an erosion of confidence among foreign suppliers. With the emerging liberalization of the economy and the improvement in the financial situation in the country, Madagascar should normally be eligible for more suppliers' credit. The business community and the government have a joint responsibility to promote the credit worthiness of the country. Yet, confidence building is likely to be a gradual process. The recent built-up of external arrears will compromise this confidence-building process.

To accelerate the availability of trade finance, joint ventures with foreign firms can open the way for suppliers' credit on favorable terms. Almost all respondents to an enterprise survey who indicated they had access to suppliers' credit were either partly or wholly foreign-owned. Many newly industrializing developing countries including Malaysia, Mexico and Singapore have been able to dramatically expand exports and employment by developing trade finance through affiliations with foreign or multinational companies. Madagascar should therefore continue to favor joint ventures to enhance the catalytic role that well-established foreign companies can play in fostering stronger trade links; strategic alliances between Malagasy firms and multinational firms could also be pursued to facilitate Madagascar's access to foreign export markets. Strategic alliance, more specifically, refers to the association between two or more companies at a particular stage of the production/distribution process which, in general, results in synergistic benefits for all the parties involved. For instance, a Malagasy firm with a highly marketable product, but without any prior experience in foreign markets, could associate itself with a reputable foreign firm which would be primarily involved in the marketing of the product abroad, in return for a share in profits. In this particular case, an association with a firm of established reputation will tell the market that the Malagasy firm's product is of good quality. Strategic alliances can also be considered at other stages of the production/distribution process such as manufacturing, financing, and research and development.

Foreign banks, including offshore banks, can provide trade finance both on imports and exports. On the export side, an offshore entity can discount export documents and provide the exporter with the expected foreign earnings which would be settled on payment of the foreign exchange by the foreign importer. This would be a self-liquidating operation on foreign currency which accelerates the receipt of foreign exchange and it would, therefore, be in line with the Central Bank's policy of early transfer of exchange earnings. The recourse to offshore banks might be less appropriate (because of global foreign exchange limitation) and more risky (the importer has to bear the exchange risk) for imports. However, it could be very helpful for export enterprises operating under the free zone regime in Madagascar. The example of Mauritius is instructive where offshore banks are already financing the imports of the

Mauritius EPZ companies. There is also the possibility for offshore banks to discount the documents of a foreign exporter enhancing thereby his capacity to grant suppliers' credit to his Malagasy importers.

Bank finance is more readily available for finished products which are marketable than for products in earlier stages of production. In Madagascar, as elsewhere, producers who are at the initial stage of the production cycle are often denied financing simply because the product has not yet reached a marketable stage. Yet it is essential that producers at this level are duly supported by means of adequate financing. Producers of intermediate inputs are often forced to rely on their own equity or working capital which constrains their production considerably -- in Madagascar, this problem particularly affects small and medium-scale enterprises whose access to equity and working capital finance is already limited. In some case, the absence of such financing may act as a severe constraint on the volume of final products which emerges from real sector activity among "indirect exporters." The reluctance of financial institutions in their intervention at this "preshipment" stage of production is mainly due to the fact that there is a significant element of risk that final production, and hence payment, may not materialize especially where there is a long time lag between the "preshipment" stage of production and the final product. Banks are worried that their funds may become tied up for too long and without much guarantee of repayment as in the case of marketed finished products. There is therefore a distinct preference for financing the finished product due to the self-liquidating character of such financing.

Preshipment finance, especially for indirect exporters, will become important as Madagascar seeks to increase its exports. Enlarging preshipment finance will require increased synergy between direct and indirect exporters and small and large manufacturers and adequate backward linkages between exporting enterprises operating under the free zone regime and the rest of the economy. The free movement of bills of exchange should assist in overcoming this financial constraint. The need for specifically supporting producers at the "preshipment" level was identified in the early stages of industrialization in Mauritius. The fear was that many potential exports would not eventually materialize due to lack of adequate financing in the raw material transformation stages. Banks in Mauritius were and still are unwilling to take the associated risks in this part of the market. Over time, the speed and turnover of real sector activity provided a solution to this problem in so far as the exporting sector in Mauritius progressed at unexpectedly high growth rates. Banks became willing in these circumstances to enlarge the overdraft limits of thriving businesses in the fast growing phase of the exporting sector. Consequently, both the pre-and post-shipment financing requirements of producers were fulfilled by the larger access to overdrafts.

In addition to the above-mentioned means of facilitating international trade, notably for exports, Madagascar should also strive to develop a system of trade financing using bills of exchange which could be discounted. The survey of Malagasy enterprises reveals the acute lack of a real bill market in Madagascar. This is generally attributable to the lack of credit worthiness of the issuers of the bills which may fail to be honored on the due date. In a financial market where tight credit limits are applied and where smaller enterprises in particular have problems in obtaining bank credit, it is quite likely that individual issuers of bills may fail to honor their obligations on the due date. Better access to credit by the smaller enterprises would be a part of the solution to this problem. As transportation and other problems hindering domestic trade in goods and services are gradually overcome, Malagasy enterprises should be encouraged to adopt bill financing as a convenient mode of extending credit to each other which would also ease pressure on domestic commercial banks to provide trade finance. Careful attention should be paid, therefore, to the development of a sound and dependable bill market. Wider circulation of internal bills would depend on the time taken to introduce the necessary safeguards regarding the determination of liabilities on bills in the context of an overall improvement of legal provisions relating to bills. Bills should be a legal obligation to pay debt that is binding on the acceptor, the drawee, and the endorser. An adequate legal framework for bills should promote general acceptability of these credit instruments as quickly as possible in order that the present dependence on cash for trade transactions is minimized.

Once bills become a common financing instrument, other financial products may be introduced. For example, the same bills may be accepted by banks so as to enable a holder to obtain funds prior to the maturity of the bill. While it may not be appropriate for the Central Bank to go directly to the market in the first instance to support such a facility, one or several discount houses specialized in the key sectors may be established in accordance with the stance of monetary policy. Similarly, the barter trade which now characterizes part of agricultural trade within Madagascar may come to be financed by means of these instruments which would become negotiable and, hence, put the farmers and peasants in close contact with financial institutions. At a more advanced stage of development of trade finance in Madagascar, bills can be accepted by banks which are then traded as bankers' acceptances (BAs).

To encourage Malagasy exporters to expand foreign trade, they should be given wider options for taking and managing exchange rate risks associated with import and export transactions. This has been the case in Mauritius where foreign exchange receipts continue to be closely managed by the Central Bank, as in Madagascar, but with greater flexibility. Mautitius offers yet another advantage of the export sector which, unlike exporters based in Madagascar, import most of their raw materials or semi-finished inputs. The typical Mauritian exporter generates a demand for foreign exchange in the first phase of its production cycle due to these imports which is followed by the generation of foreign exchange when export receipts are realized. Normally, an enterprise buys the foreign currency for its imports by utilizing the local currency and then selling the foreign exchange earned subsequently to the banks in exchange for local currency. A special proviso in Mauritian Exchange Control regulations permits exporting enterprises, however, to retain export earnings in the foreign currencies if the latter have to be utilized towards payment of anticipated imports. It is only the net residual export earnings which are eventually repatriated into local currency. Exporting enterprises are thus covered against exchange rate fluctuations and do not always feel the need to obtain exchange risk cover against short or long-term positions held in particular currencies.

Madagascar is uniquely situated in close proximity to the highest income countries in the Africa and Indian region (with the exception of oil producing countries), notably Mauritius, Seychelles, and South Africa. In addition, neighboring Reunion, a department of France, affords a potential gateway to the European market. There is particular scope to further develop Madagascar's commercial and financial relations with these neighboring countries in the region to expand trade and investment flows including trade in financial services. Madagascar's rich physical and human resource base is a special attraction with its labor costs being one-fourth or less of those from these neighboring countries. In addition, international companies (notably from Hong Kong and Taiwan) operating in Mauritius are very keen to extend or transfer part of their labor-intensive activities to Madagascar. Further development of regional commercial and financial relations could help the existing financial system and the productive sectors of the economy in several ways: (i) through encouraging private direct foreign investment which can help meet the capital needs of local entrepreneurs; (ii) through further provision of onshore financial services by foreign financial institutions through partial or complete ownership of a financial institution domiciled in Madagascar which could help improve financial skills and develop international banking relationships. The scope and constraints of further trade between Madagascar and individual countries which are two of the key neighbors in the region -- Mauritius and South Africa -- including prospects for trade in financial services, are discussed below. This discussion illustrates how, during the 1990s, Malagasy policy makers will increasingly face choices on whether and how to exploit the considerable potential for increasing trade and investment flows from these countries.

<u>Mauritius</u>: In the near-term, the greatest potential for Madagascar to enhance trade and investment flows within the region appears to lie with Mauritius. The low cost and relative abundance of qualified labor as well as the abundance of land are major attractions to Mauritian investors. The government of Mauritius has waived the 15% tax on transfer of capital for approved investment projects in Madagascar within its strategy to encourage labor intensive industries faced with severe labor shortages to transfer part of their business there. Already, some dozen Mauritian companies have invested in Madagascar. Continued investment from Mauritian and Mauritius-based companies in Madagascar will create a need for more regional financial services. One leading Mauritian bank in partnership with a South African bank already opened in Madagascar. Although Mauritian offshore banking is still in its infancy, at least one offshore bank in Mauritius has intervened both in favor of a

Malagasy financial institution by providing a foreign loan and Malagasy enterprises by financing their imports and exports.

<u>South Africa</u>: South African interest in direct investment in Madagascar is still an exploratory level. The most promising sector to South African investors seems to be the mining industry which has a big potential and in which South Africa has considerable experience; tourism, construction and agro-industry could be of interest to various large groups. However, to be able to proceed further, potential investors need to be assured of the legal status and security of their investments and ability to obtain necessary work permits and remit profits. Also, they need to be convinced on the real advantages of investing in Madagascar as they are now having a wider choice of investment opportunities as almost every country in Sub-Saharan Africa is opening its frontiers to the South African business community. As they tend to be risk-averse, they will prefer countries which already have a high international rating as an investment center. South Africa also has the most developed financial system of the region with a broad range of services offered by commercial banks, merchant banks, discount houses, factors, confirming houses, a stock exchange (the largest in Sub-Saharan Africa), insurance companies and the Credit Guarantee Insurance Corporation. There could be considerable scope for further regional trade in financial services including technical assistance to Malagasy financial institutions.

<u>Improving regional payments</u>: Madagascar's trade in the Indian Ocean was traditionally limited because of historical trade links with other regions, similarities with the export product mix of neighboring countries and political differences. The inward-looking development strategy of the late 1970s and early 1980s hindered further the development of regional trade and related financial services. However, the recent significant liberalization of trade and the opening up of the financial sector to foreign participants have generated new interest and initiatives in several countries. In addition, Madagascar is a member of the Indian Ocean Commission. To the extent increased trade and investment flows results in a shift in direction of trade in Madagascar more towards the countries in the region, there might be benefit to Madagascar for expanding its participation in regional trading arrangements. Madagascar has applied for member status in the eighteen-nation Preferential Trading Arrangement (PTA) which operates a clearing house arrangement which enables the amount of hard currency supporting regional trade transactions to be minimized.

ECONOMIC ANALYSIS

COST/BENEFIT ANALYSIS OF SAVINGS MOBILIZATION AND INVESTMENT COMPONENT OF FMD

SUMMARY

As required by Non-Project Sector Assistance (NPA) Guidance a cost/benefit analysis has been undertaken to determine whether the FMD investment of $10 million is economically feasible.

The analysis is based on the costs and benefits expected to accrue to the CEM component of the program. The design team was unable to develop a methodology to quantify the benefits of the Central Bank component. Estimates of the cost/benefit ratio were calculated based on attributing one-half of the cash transfer ($3 million) to the CEM, and on the notion that one-half of the cash transfer is attributable to the Central Bank. Estimates of the cost/benefit ratio were also calculated based on attributing the full amount of the cash transfer to CEM. The analysis showed that the program is economically feasible even if the full cash transfer is attributed to CEM. Thus, only those results are presented as the one-half attribution has higher benefit/cost ratios.

The key element of the analysis is the essential growth of new deposits resulting from the AID investment in improving efficiency of CEM financial intermediation. Improved efficiency will be achieved both through technical assistance ($1 million) and policy reform ($6 million of NPA).

Economic benefits will result principally from increasing household preferences for formal sector savings and placement of those savings by CEM in high rate of return private sector investments.

The results of the analysis showed the CEM component of the FMD project to be economically feasible at 15% average annual growth of new CEM deposits. Based on the record of the past several years, annual average growth of new CEM deposits would be about 5% without the project.

At 10% average annual growth of new deposits at CEM component would be feasible if the AID NPA investment was cut back by $1 million or if assumptions were made that income redistribution impacts of the CEM investment favor the poor and the cost benefit analysis then weighted the stream of benefits to take this impact

into account. At present, most CEM investors are poor and receive negative real interest rates on their deposits.

At rates of growth of new CEM deposits of less than 10% the project is infeasible.

While the rate growth of new CEM deposits is an unknown, the scope for improvement of CEM services, including the interest rate offered, is so large that an average annual growth rate of new CEM deposits of between 15% and 20% with the CEM component of the FMD project appears reasonable.

I. Introduction

This economic analysis covers the investment of $7.0 million to improve efficiency of financial intermediation by the Caisse d'Epargne of Madagascar (CEM). The Caisse d'Epargne is a postal savings bank. It is the only formal sector financial institution with outreach throughout the country.

As required under Bureau for Africa's Non Project Sector Assistance (NPA) Guidance of October 1992 a "cost/benefit calculus" has been executed "to determine whether the project is worthwhile."

As with all such analyses understanding of underlying assumptions is critical to drawing sound conclusions from benefit/cost ratios and economic rates of return which are the end-product of the analyses. Accordingly, a discussion of underlying assumptions follows.

II. Summary of Key Elements of the Analysis

A. Benefit Stream

The benefit stream will derive principally from two changes brought about by the FMD project.

-- Increased savings with CEM that would otherwise have been (a) consumed or (b) invested in low return traditional sector activities.

-- More economically efficient allocation of CEM savings to investment opportunities.

B. AID Investment in the CEM

The AID investment through the FMD project for the CEM of $7.0 million is split between technical assistance (TA) of $1.0 million that will be disbursed over four years and NPA of $6.0 million that will be disbursed in two tranches.

- -- The TA will assist CEM in virtually every facet of its operations including developing a marketing strategy, improving data processing, staff training, better systems management, and designing and implementing a new organizational structure. The TA will improve customer service and CEM's management of internal operations. It should enable CEM to attract and manage a much larger volume of business than it does at present.

- -- The policy reform (NPA component) will provide CEM with the legal status and flexibility to introduce new products and invest funds where CEM will receive the highest returns consistent with requirements of prudent banking.

C. Economic Feasibility

The combination of TA and policy reform for CEM should result in an increase in savings available for high return private sector investment over and above what would have been available without the AID investment. The increase in savings at the CEM and the placement of the savings plus deposits already with the CEM in high return private sector investments instead of government and traditional sector investments and household consumption will be the source of the stream of economic benefits that will determine economic feasibility of the AID investment in improving CEM capability as a financial intermediary.

III. Assumptions

The important assumptions for the analysis follow:

A. Changes in Savings Behavior

The greater efficiency and flexibility of CEM will make the financial services provided by CEM so attractive that households will have

- -- a higher propensity to save with a formal financial institution like CEM rather than in traditional ways;

- -- and a higher propensity to save.

In other words, CEM services will become so attractive that (a) existing savings will be shifted from traditional forms of saving and investment such as cattle or precious metals or gems into deposits with CEM and (b) some consumption will be sacrificed in favor of deposits with CEM.

1. Savings at CEM without the FMD Project

Without the FMD project, projected growth of deposits at CEM is 5%.

The projected growth is based on financial analysis carried out for PAAD preparation by the local consultant group, Cabinet Rindra. The average annual growth of deposits (new deposits less withdrawals) over the past six years as a percentage of year-end deposits was 4.9%.

2. Savings at CEM with the FMD Project

The minimum projected annual rate of growth of new CEM deposits with the FMD project is 10% over the 15 year life of the investment; the maximum rate, 20%.

The difference between the maximum and minimum scenario reflects uncertainty with respect to (a) the market response to the improvements brought about by the FMD project and (b) the speed and effectiveness of CEM in implementing change.

The base on which the above projections rest is a set of studies sponsored by the Mission which show that

-- scope for improvement in CEM service (e.g. reducing waiting time for customer withdrawals and diversification of product line) is of a major order of magnitude.

-- scope for raising the interest payments to customers is also of a major order of magnitude. For example, while private banks paid 17.75% on deposits in January 1993, CEM received 11.5% on its deposits with Treasury.

-- CEM will be aggressively tapping into a market, small savers,that has hardly been tapped (approximately 2.5% of the countries population has CEM passbooks) and in which CEM has no serious competition at present.

Despite very poor service and low interest rates the CEM deposits have grown at an annual average rate of about 5% since its change in legal status in 1985. The expectation is that with only moderate improvements in service and interest rates, deposits will bound upwards.

3. Political/Economic Shocks

The possible adverse impact of political/economic shocks needs to be given serious consideration because savings behavior is very sensitive to such shocks. For example, the general strike of 1991 and the hardships associated with it caused CEM deposits to decline for the first time in six years.

In the medium term Madagascar will be facing extremely difficult circumstances in the management of domestic and external accounts. The Government's determination to control inflation will be severely tested. If that determination is not strong, and rapid inflation takes hold, the projected growth of savings could be undermined.

B. Impact of Source of New CEM Deposits on Benefit Stream

An important assumption for the analysis is the proportion of new CEM deposits that will be shifted from

-- traditional forms of savings and investment to CEM deposits

-- consumption to CEM deposits.

In this analysis new CEM deposits that originated in shifts from consumption will provide nearly twice as much economic benefit as new CEM deposits that originated in shifts from traditional savings.

A cautious approach would suggest that no more than 10% of total new CEM deposits would be attributable to the shift from consumption to savings, i.e. the degrees of freedom in a poor household (the majority of CEM's customers) for shifting from consumption to savings may be very limited.

An optimistic approach would suggest that as much as 50% of new CEM deposits could originate in a shift from consumption to savings, i.e. the capacity of the poor to save in the face of high incentives is inevitably greater than researchers estimate.

In executing the cost/benefit analysis, cautious and optimistic as well as a moderate scenario (25% of new CEM deposits originating from a shift in household consumption) will be run.

C. Placement of Savings by CEM

As already noted the economic benefit stream for the CEM component of the FMD project will come about from shifting savings from low return traditional sector investments and consumption to high return private sector investments. The major contribution of the NPA component of the FMD will be to break down the barriers that prevent CEM from placing funds where CEM and its depositors can receive the highest rate of return.

The values assigned to rates of return to modern private, government, and traditional sector investments are as follows:

-- rate of return to formal or modern private sector investment is at least 22%, i.e. the current rate of borrowers at major banks is between 20% and 22%;

-- rate of return to investment by the government is at least 14%, i.e. an assumption that the recent rise from 7% to 11.5% paid by the Treasury for CEM funds reflects the expected rate of return from investments by the Government.

-- rate of return to investments by households from household savings is in the range of 10-12%, i.e. the return to investments in traditional sector economic activity is assumed to be the same as the social discount rate of 10% used in this analysis.

D. CEM Intermediation Costs

The CEM at present receives 11.55% interest from Treasury on its funds

-- average rate paid to customers is 7.55%

-- costs of operations including .15% staff incentive is 2.65%

-- payment to the Post Office is 0.80%

-- payment to the reserve fund is 0.50%

The source of the above numbers is a Price Waterhouse report on the CEM prepared for the Mission. The report noted that in "financial parlance the "net interest margin" is 3.95%.

The net interest margin of 3.95% does not cover the salaries of the 638 postal employees who work on a full or part time basis for CEM. An estimate by the local consultant, Cabinet Rindra, indicated that CEM used the equivalent of 249 full time postal employees. The estimate by Price Waterhouse was that the equivalent of 350 full time postal employees handle transactions in the Main Office in Antananarivo, local account offices and satellite offices.

Labor costs at the CEM are assumed to reflect market prices.

The .80% transfer payment to the Post Office according to Price Waterhouse covers "social charges" for postal employees, not salaries. If Price Waterhouse report is accurate then CEM is also not charged fees for space at post offices, mail, utility and other costs.

Based on the limited evidence available at this time the CEM would require a "net interest margin" at the very least on the order of 5% and possibly much higher to cover the actual costs of its financial intermediation.

The intermediation costs in both the without and with FMD project case can be expected to decline over time especially as the backroom productivity of the CEM rises.

In the without FMD project case intermediation costs are assumed to be 5% of deposits from years 1-7 and 4% in years 8-15.

In the with FMD project case, intermediation costs are assumed to be 5% of deposits in years 1-5, 4% in years 6-10 and 3% in years 11-15.

E. Expenditure Pattern of AID Investment

The planned expenditure pattern for the AID investment in CEM is as follows:

t	TA ($000)	NPA ($000)
0		
1	250	3,000
2	400	3,000
3	300	
4	50	

IV. Cost/Benefit Analysis

A. Terms and Values

-- Life of the FMD project investment is 15 years.

-- Social discount rate used is 10%.

-- t is one year.

-- Ip was a one time placement of funds at a commercial bank allowed by Treasury in lieu of debt repayment by GRM to CEM. Ip=$2,600,000

-- D is the total deposits of CEM. Dt0=$5,400,000

-- Ig is the CEM deposits which are placed with Treasury. Ig=Dt-Ip

-- ^ is the annual average rate of growth of deposits.

-- r1 is the rate of return to investment in modern private sector channeled through CEM. r1=0.22

-- rg is the rate of return to investment in government sector channeled through CEM. rg=0.14

-- r0 is the rate of return to investment in the traditional sector channeled through household savings. r0=0.10

-- Ds is the new CEM deposits originating from shift of household savings to CEM savings.

-- Dc is new CEM deposits originating from shift of household consumption to CEM savings.

-- Bp is economic benefit from one time placement of CEM funds with commercial bank for lending to private sector.
Bp=(r1-r0)Ip

-- Bg is economic benefit from placement of funds with Treasury for investment by Government.
Bg=(rg-r0)Ig

-- Bwo is benefits without the CEM component of the FMD project.
Bwo=Bp+Bg-Cwo

-- Bt0 is economic benefit from placement of existing deposits at t0 with commercial bank for lending to private sector.
Bt0=(r1-r0)Dt0

-- Bs is economic benefit from shift out of traditional savings to CEM savings. s is proportion of new CEM deposits shifted from traditional savings to CEM savings.
Bs=s(^Dt)

-- Bc is economic benefit from shift from consumption to CEM savings. c is proportion of new CEM deposits shifted from consumption to CEM savings.
Bc=c(^Dt)

-- Bgwp is gross economic benefit with the FMD project.
Bgwp = Bt0+Bs+Bc

-- Bwp=Bgwp-Bwo

-- Cwo is the cost of CEM intermediation without the FMD project. Cwo=(Dt)0.05 for t1..t7, (Dt)0.04 for t8..t15

-- Ci is the AID investment in the CEM.

-- Cs is the cost of CEM intermediation services.
Cs=(Dt)0.05 for t1..t5, (Dt)0.04 for t6..10, (Dt)0.03 for t11..t15

-- C is the cost of CEM intermediation services and the AID investment in the CEM.
C=Ci+Cs

-- Bnwp=Bwp-C

B. Scenarios

The cost/benefit analysis was run for nine scenarios. The analysis was run using annual average growth rates of new CEM deposits of 10%, 15% and 20%. Also, three scenarios were run for each of the three average annual growth rates varying the proportions of new CEM deposits originating from traditional savings and from consumption. The proportions for the three scenarios were 90% originating from traditional savings, 10% form consumption; 75% traditional savings, 25% consumption; 50% traditional savings, 50% consumption.

Alternative Cost/Benefit Analysis Scenarios

Scenarios	Average Annual Growth New CEM Deposits	New CEM Deposits Originating from Traditional Savings	Consumption
1	.10	.90	.10
2	.10	.75	.25
3	.10	.50	.50
4	.15	.90	.10
5	.15	.75	.25
6	.15	.50	.50
7	.20	.90	.10
8	.20	.75	.25
9	.20	.50	.50

C. Results

The summary results of the analysis are shown below. Table 1-19 provide the details for each scenario.

Scenarios	Benefit/Cost	Net Present Value
1	0.88	-$745,000
2		
3	0.95	-$285,000
4	1.13	$771,000
5		
6	1.28	$1,698,000
7	1.54	$3,231,000
8		
9	1.82	$4,916,000

IV. Conclusions

The results of the analysis indicate that if new CEM deposits grow at an average annual rate of 15% or more, the project will be economically viable.

At growth rates of new CEM deposits of 10%, the economic feasibility of the AID investment becomes questionable.

Below annual average growth rate of new CEM deposits of 10%, the CEM component of the FMD project is economically infeasible.

The work done by foreign and Malagasy consultants all suggest that the prospect of a growth rate of CEM deposits in excess of 15 percent is reasonable provided the improvements in service and interest rates anticipated via the Program are realized. Therefore, a positive benefit/cost ratio seems reasonable.

Table 1

Benefit Calculation without the CEM Project Component

($000)

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period	Invest Priv	Benefit Priv	Invest Govt	Total Deposits	Deposits Growth	Benefit Govt	Cost	Ben with-out Proj
t	Ip	Bp	Ig	Dt0+^D	^D	Bg	Cwo	Bwo
0	2,600		2,800	5,400				
1	2,600	312	3,070	5,670	270	123	270	165
2	2,600	312	3,354	5,954	284	134	284	163
3	2,600	312	3,651	6,251	298	146	298	160
4	2,600	312	3,964	6,564	313	159	313	158
5	2,600	312	4,292	6,892	328	172	328	155
6	2,600	312	4,637	7,237	345	185	345	153
7	2,600	312	4,998	7,598	362	200	362	150
8	2,600	312	5,378	7,978	380	215	304	223
9	2,600	312	5,777	8,377	399	231	319	224
10	2,600	312	6,196	8,796	419	248	335	225
11	2,600	312	6,636	9,236	440	265	352	226
12	2,600	312	7,098	9,698	462	284	369	226
13	2,600	312	7,583	10,183	485	303	388	227
14	2,600	312	8,092	10,692	509	324	407	228
15	2,600	312	8,626	11,226	535	345	428	229

t= 1year	^=0.05
Ip=$2,600,000	Ig=(D+^D)-Ip
Bp=(r1-rO)Ip	Bg=(rg-r0)Ig
r1=0.22	rg=0.14
r)=0.10	Cwo=0.05t1..t7(Dt1.t7); 0.04(t8..t15)(Dt8..t15)
Dt0=$5,400,000	Bwo=Bp+Bg-Cwo

Table 2

Benefit Calculation with CEM Project Component

($000)

SCENARIO 1

Average Annual Growth of Deposits: 10%
New Deposits: 90% Shift from Traditional Savings; 10% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period 't	Total Deposits Dt0+^Dt	Ben on Dep t0 Bt0	Deposits Growth ^Dt	Cum Dep Growth ^Dt1..tn	Ben from Sav Shift Bs	Benefit Con Shift Bc	Gross Ben with proj	Cost Service
0	5,400							
1	5,940	648	540				648	270
2	6,534	648	594	540	58	12	718	297
3	7,187	648	653	1,134	122	25	795	327
4	7,906	648	719	1,787	193	39	880	359
5	8,697	648	791	2,506	271	55	974	395
6	9,566	648	870	3,297	356	73	1,077	383
7	10,523	648	957	4,166	450	92	1,190	421
8	11,575	648	1,052	5,123	553	113	1,314	463
9	12,733	648	1,158	6,175	667	136	1,451	509
10	14,006	648	1,273	7,333	792	161	1,601	560
11	15,407	648	1,401	8,606	929	189	1,767	462
12	16,948	648	1,541	10,007	1,081	220	1,949	508
13	18,642	648	1,695	11,548	1,247	254	2,149	559
14	20,506	648	1,864	13,242	1,430	291	2,369	615
15	22,557	648	2,051	15,106	1,632	332	2,612	677

t= 1year
Dt0=$5,400,000
Bt0=(r1-r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period 't	Gross Ben with Proj Bgwp	Ben without Proj Bwo	Ben with Proj Bwp	AID Investment: Ci Expenditure Project	NPA	Cost Service Cs	Total Cost	Ben -Exp B-E	(1+r)^t {ii}	Discounted 'Benefits	Costs	Incremental Net Benefits
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761
2	718	163	555	400	3000	297	3,697	(3,142)	1.21	459	3,055	(2,597
3	795	160	635	300		327	627	9	1.33	477	471	7
4	880	158	722	50		359	409	313	1.46	493	280	214
5	974	155	819			395	395	423	1.61	508	245	263
6	1,077	153	924			383	383	541	1.77	521	216	305
7	1,190	150	1,040			421	421	619	1.95	533	216	317
8	1,314	223	1,091			463	463	628	2.14	509	216	293
9	1,451	224	1,227			509	509	717	2.36	520	216	304
10	1,601	225	1,376			560	560	816	2.59	531	216	315
11	1,767	226	1,541			462	462	1,079	2.85	540	162	378
12	1,949	226	1,723			508	508	1,214	3.14	549	162	387
13	2,149	227	1,922			559	559	1,363	3.45	557	162	395
14	2,369	228	2,141			615	615	1,526	3.80	564	162	402
15	2,612	229	2,383			677	677	1,706	4.18	570	162	408
										7,772	9,141	(1,369

i=social discount rate 0.1

PRESENT NET VALUE: (1,369)

BENEFIT-COST RATIO: 0.85

Table 3

Benefit Calculation with CEM Project Component

($000)

SCENARIO 2

Average Annual Growth of Deposits: 10%
New Deposits: 75% Shift from Traditional Savings; 25% from Consumption

(1) Period 't	(2) Total Deposits Dt0+^Dt	(3) Ben on Dep t0 Bt0	(4) Deposits Growth ^Dt	(5) Cum Dep Growth ^Dt1..tn	(6) Ben from Sav Shift Bs	(7) Benefit Con Shift Bc	(8) Gross Ben with proj	(9) Cost Service
0	5,400							
1	5,940	648	540				648	270
2	6,534	648	594	540	49	30	726	297
3	7,187	648	653	1,134	102	62	812	327
4	7,906	648	719	1,787	161	98	907	359
5	8,697	648	791	2,506	226	138	1,011	395
6	9,566	648	870	3,297	297	181	1,126	383
7	10,523	648	957	4,166	375	229	1,252	421
8	11,575	648	1,052	5,123	461	282	1,391	463
9	12,733	648	1,158	6,175	556	340	1,543	509
10	14,006	648	1,273	7,333	660	403	1,711	560
11	15,407	648	1,401	8,606	775	473	1,896	462
12	16,948	648	1,541	10,007	901	550	2,099	508
13	18,642	648	1,695	11,548	1,039	635	2,322	559
14	20,506	648	1,864	13,242	1,192	728	2,568	615
15	22,557	648	2,051	15,106	1,360	831	2,838	677

t= 1year
Dt0=$5,400,000
Bt0=(r1−r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1) Period 't	(2) Gross Ben with Proj Bgwp	(3) Ben without Proj Bwo	(4) Ben with Proj Bwp	(5) AID Investment: Ci Expenditure Project	NPA	(6) Cost Service Cs	(7) Total Cost	(8) Ben −Exp B−E	(9) (1+r)^t {ii}	(10) Discounted 'Benefits	Costs	(11) Incremental Net Benefits
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	726	163	563	400	3000	297	3,697	(3,134)	1.21	466	3,055	(2,590)
3	812	160	652	300		327	627	26	1.33	490	471	19
4	907	158	749	50		359	409	340	1.46	512	280	232
5	1,011	155	856			395	395	461	1.61	532	245	286
6	1,126	153	973			383	383	590	1.77	549	216	333
7	1,252	150	1,102			421	421	681	1.95	566	216	350
8	1,391	223	1,168			463	463	705	2.14	545	216	329
9	1,543	224	1,319			509	509	810	2.36	560	216	344
10	1,711	225	1,486			560	560	926	2.59	573	216	357
11	1,896	226	1,670			462	462	1,208	2.85	585	162	423
12	2,099	226	1,873			508	508	1,365	3.14	597	162	435
13	2,322	227	2,095			559	559	1,536	3.45	607	162	445
14	2,568	228	2,340			615	615	1,725	3.80	616	162	454
15	2,838	229	2,609			677	677	1,933	4.18	625	162	463
										8,260	9,141	(881)

i=social discount rate 0.1

PRESENT NET VALUE: **(881)**

BENEFIT−COST RATIO: **0.90**

Table 4

Benefit Calculation with CEM Project Component

($000)

SCENARIO 3

Average Annual Growth of Deposits: 10%
New Deposits: 50% Shift from Traditional Savings; 50% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period 't	Total Deposits Dt0+^Dt	Ben on Dep t0 Bt0	Deposits Growth ^Dt	Cum Dep Growth ^Dt1..tn	Ben from Sav Shift Bs	Benefit Con Shift Bc	Gross Ben with proj	Cost Service
0	5,400							
1	5,940	648	540				648	270
2	6,534	648	594	540	32	59	740	297
3	7,187	648	653	1,134	68	125	841	327
4	7,906	648	719	1,787	107	197	952	359
5	8,697	648	791	2,506	150	276	1,074	395
6	9,566	648	870	3,297	198	363	1,208	383
7	10,523	648	957	4,166	250	458	1,356	421
8	11,575	648	1,052	5,123	307	564	1,519	463
9	12,733	648	1,158	6,175	371	679	1,698	509
10	14,006	648	1,273	7,333	440	807	1,895	560
11	15,407	648	1,401	8,606	516	947	2,111	462
12	16,948	648	1,541	10,007	600	1,101	2,349	508
13	18,642	648	1,695	11,548	693	1,270	2,611	559
14	20,506	648	1,864	13,242	795	1,457	2,899	615
15	22,557	648	2,051	15,106	906	1,662	3,216	677

t= 1year
Dt0=$5,400,000
Bt0=(r1−r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period 't	Gross Ben with Proj Bgwp	Ben without Proj Bwo	Ben with Proj Bwp	AID Investment: Ci Expenditure Project	NPA	Cost Service Cs	Total Cost	Ben −Exp B−E	(1+r)^t (ii)	Discounted 'Benefits	Costs	Incremental Net Benefits
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	740	163	577	400	3000	297	3,697	(3,120)	1.21	477	3,055	(2,579)
3	841	160	681	300		327	627	54	1.33	511	471	41
4	952	158	794	50		359	409	384	1.46	542	280	263
5	1,074	155	919			395	395	524	1.61	571	245	325
6	1,208	153	1,055			383	383	673	1.77	596	216	380
7	1,356	150	1,206			421	421	785	1.95	619	216	403
8	1,519	223	1,296			463	463	833	2.14	605	216	389
9	1,698	224	1,474			509	509	964	2.36	625	216	409
10	1,895	225	1,670			560	560	1,109	2.59	644	216	428
11	2,111	226	1,885			462	462	1,423	2.85	661	162	499
12	2,349	226	2,123			508	508	1,615	3.14	677	162	515
13	2,611	227	2,384			559	559	1,825	3.45	691	162	529
14	2,899	228	2,671			615	615	2,056	3.80	703	162	541
15	3,216	229	2,987			677	677	2,310	4.18	715	162	553
										9,075	9,141	(67)

i=social discount rate 0.1

PRESENT NET VALUE: **(67)**

BENEFIT−COST RATIO: **0.99**

Table 5

Benefit Calculation with CEM Project Component

($000)

SCENARIO 4

Average Annual Growth of Deposits: 15%
New Deposits: 90% Shift from Traditional Savings; 10% from Consumption

(1) Period 't	(2) Total Deposits Dt0+^Dt	(3) Ben on Dep t0 Bt0	(4) Deposits Growth ^Dt	(5) Cum Dep Growth ^Dt1..tn	(6) Ben from Sav Shift Bs	(7) Benefit Con Shift Bc	(8) Gross Ben with proj	(9) Cost Service
0	5,400							
1	6,210	648	810				648	270
2	7,142	648	932	810	87	18	753	311
3	8,213	648	1,071	1,742	188	38	874	357
4	9,445	648	1,232	2,813	304	62	1,014	411
5	10,861	648	1,417	4,045	437	89	1,174	472
6	12,491	648	1,629	5,461	590	120	1,358	500
7	14,364	648	1,874	7,091	766	156	1,570	575
8	16,519	648	2,155	8,964	968	197	1,813	661
9	18,997	648	2,478	11,119	1,201	245	2,093	760
10	21,846	648	2,849	13,597	1,468	299	2,416	874
11	25,123	648	3,277	16,446	1,776	362	2,786	754
12	28,891	648	3,768	19,723	2,130	434	3,212	867
13	33,225	648	4,334	23,491	2,537	517	3,702	997
14	38,209	648	4,984	27,825	3,005	612	4,265	1,146
15	43,940	648	5,731	32,809	3,543	722	4,913	1,318

t= 1year	r0=0.10	Bgwp=Bt0+Bs+Bc
Dt0=$5,400,000	^Dt=0.15	Cs=0.05t1..t5(Dt1..5);
Bt0=(r1−r0)Dt0	Bs=0.90(^Dt)	0.04t6..t10(Dt6..t10);
r1=0.22	Bc=0.10(^Dt)	0.03t11..t15(Dt11..t15)

Present net value calculation

(1) Period 't	(2) Gross Ben with Proj Bgwp	(3) Ben without Proj Bwo	(4) Ben witt Proj Bwp	(5) AID Investment: Ci Expenditure Project	NPA	(6) Cost Service Cs	(7) Total Cost	(8) Ben −Exp B−E	(9) (1+r)^t {ii}	(10) Discounted 'Benefits	Costs	(11) Incremental Net Benefits
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	753	163	590	400	3000	311	3,711	(3,120)	1.21	488	3,067	(2,579)
3	874	160	714	300		357	657	57	1.33	537	494	43
4	1,014	158	856	50		411	461	395	1.46	584	315	270
5	1,174	155	1,019			472	472	547	1.61	633	293	339
6	1,358	153	1,205			500	500	705	1.77	680	282	398
7	1,570	150	1,420			575	575	845	1.95	729	295	434
8	1,813	223	1,590			661	661	930	2.14	742	308	434
9	2,093	224	1,869			760	760	1,110	2.36	793	322	471
10	2,416	225	2,191			874	874	1,317	2.59	845	337	508
11	2,786	226	2,560			754	754	1,806	2.85	897	264	633
12	3,212	226	2,986			867	867	2,119	3.14	951	276	675
13	3,702	227	3,475			997	997	2,478	3.45	1,007	289	718
14	4,265	228	4,037			1146	1,146	2,891	3.80	1,063	302	761
15	4,913	229	4,684			1318	1,318	3,366	4.18	1,121	316	806
										11,508	10,359	1,150

i=social discount rate 0.1

PRESENT NET VALUE: 1,150

BENEFIT−COST RATIO: 1.11

Table 6

Benefit Calculation with CEM Project Component

($000)

SCENARIO 5

Average Annual Growth of Deposits: 15%
New Deposits: 75% Shift from Traditional Savings; 25% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period 't	Total Deposits Dt0+^Dt	Ben on Dep t0 Bt0	Deposits Growth ^Dt	Cum Dep Growth ^Dt1..tn	Ben from Sav Shift Bs	Benefit Con Shift Bc	Gross Ben with proj	Cost Service
0	5,400							
1	6,210	648	810				648	270
2	7,142	648	932	810	73	45	765	311
3	8,213	648	1,071	1,742	157	96	901	357
4	9,445	648	1,232	2,813	253	155	1,056	411
5	10,861	648	1,417	4,045	364	222	1,234	472
6	12,491	648	1,629	5,461	492	300	1,440	500
7	14,364	648	1,874	7,091	638	390	1,676	575
8	16,519	648	2,155	8,964	807	493	1,948	661
9	18,997	648	2,478	11,119	1,001	612	2,260	760
10	21,846	648	2,849	13,597	1,224	748	2,619	874
11	25,123	648	3,277	16,446	1 480	905	3,033	754
12	28,891	648	3,768	19,723	1,775	1,085	3,508	867
13	33,225	648	4,334	23,491	2,114	1,292	4,054	997
14	38,209	648	4,984	27,825	2,504	1,530	4,683	1,146
15	43,940	648	5,731	32,809	2,953	1,804	5,405	1,318

t= 1year
Dt0=$5,400,000
Bt0=(r1−r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period 't	Gross Ben with Proj Bgwp	Ben with-out Proj Bwo	Ben with Proj Bwp	AID Investment: Ci Expenditure Project	NPA	Cost Service Cs	Total Cost	Ben −Exp B−E	(1+r)^t (ii)	Discounted 'Benefits	Costs	Incremental Net Benefits
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	765	163	602	400	3000	311	3,711	(3,108)	1.21	498	3,067	(2,569)
3	901	160	741	300		357	657	83	1.33	556	494	63
4	1,056	158	898	50		411	461	437	1.46	613	315	299
5	1,234	155	1,079			472	472	607	1.61	670	293	377
6	1,440	153	1,287			500	500	787	1.77	726	282	444
7	1,676	150	1,526			575	575	952	1.95	783	295	488
8	1,948	223	1,725			661	661	1,064	2.14	805	308	496
9	2,260	224	2,036			760	760	1,276	2.36	864	322	541
10	2,619	225	2,394			874	874	1,521	2.59	923	337	586
11	3,033	226	2,807			754	754	2,053	2.85	984	264	720
12	3,508	226	3,282			867	867	2,415	3.14	1,046	276	770
13	4,054	227	3,827			997	997	2,830	3.45	1,109	289	820
14	4,683	228	4,455			1146	1,146	3,308	3.80	1,173	302	871
15	5,405	229	5,176			1318	1,318	3,858	4.18	1,239	316	924
										12,428	10,359	2,069

i=social discount rate 0.1

PRESENT NET VALUE: 2,069

BENEFIT−COST RATIO: 1.20

Table 7

Benefit Calculation with CEM Project Component

($000)

SCENARIO 6

Average Annual Growth of Deposits: 15%
New Deposits: 50% Shift from Traditional Savings; 50% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period 't	Total Deposits Dt0+^Dt	Ben on Dep t0 Bt0	Deposits Growth ^Dt	Cum Dep Growth ^Dt1..tn	Ben from Sav Shift Bs	Benefit Con Shift Bc	Gross Ben with proj	Cost Service
0	5,400							
1	6,210	648	810				648	270
2	7,142	648	932	810	49	89	786	311
3	8,213	648	1,071	1,742	104	192	944	357
4	9,445	648	1,232	2,813	169	309	1,126	411
5	10,861	648	1,417	4,045	243	445	1,336	472
6	12,491	648	1,629	5,461	328	601	1,576	500
7	14,364	648	1,874	7,091	425	780	1,853	575
8	16,519	648	2,155	8,964	538	986	2,172	661
9	18,997	648	2,478	11,119	667	1,223	2,538	760
10	21,846	648	2,849	13,597	816	1,496	2,959	874
11	25,123	648	3,277	16,446	987	1,809	3,444	754
12	28,891	648	3,768	19,723	1,183	2,170	4,001	867
13	33,225	648	4,334	23,491	1,409	2,584	4,642	997
14	38,209	648	4,984	27,825	1,670	3,061	5,378	1,146
15	43,940	648	5,731	32,809	1,969	3,609	6,225	1,318

t= 1year	r0=0.10	Bgwp=Bt0+Bs+Bc
Dt0=$5,400,000	^Dt=0.15	Cs=0.05t1..t5(Dt1..5);
Bt0=(r1−r0)Dt0	Bs=0.90(^Dt)	0.04t6..t10(Dt6..t10);
r1=0.22	Bc=0.10(^Dt)	0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period	Gross Ben	Ben with-	Ben witt	AID Investment: Ci		Cost	Total	Ben −Exp	(1+r)^t	Discounted		Incremental
	with Proj	out Proj	Proj	Expenditure	NPA	Service	Cost	B−E	{ii}	'Benefits	Costs	Net Benefits
't	Bgwp	Bwo	Bwp	Project		Cs						
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	786	163	623	400	3000	311	3,711	(3,088)	1.21	515	3,067	(2,552)
3	944	160	784	300		357	657	127	1.33	589	494	95
4	1,126	158	968	50		411	461	508	1.46	661	315	347
5	1,336	155	1,181			472	472	708	1.61	733	293	440
6	1,576	153	1,423			500	500	924	1.77	803	282	521
7	1,853	150	1,703			575	575	1,129	1.95	874	295	579
8	2,172	223	1,949			661	661	1,288	2.14	909	308	601
9	2,538	224	2,314			760	760	1,554	2.36	981	322	659
10	2,959	225	2,734			874	874	1,861	2.59	1,054	337	717
11	3,444	226	3,218			754	754	2,464	2.85	1,128	264	864
12	4,001	226	3,775			867	867	2,908	3.14	1,203	276	927
13	4,642	227	4,415			997	997	3,418	3.45	1,279	289	990
14	5,378	228	5,150			1146	1,146	4,004	3.80	1,356	302	1,054
15	6,225	229	5,996			1318	1,318	4,678	4.18	1,436	316	1,120
										13,961	10,359	3,602

i=social discount rate 0.1

PRESENT NET VALUE: 3,602

BENEFIT−COST RATIO: 1.35

Table 8

Benefit Calculation with CEM Project Component

($000)

SCENARIO 7

Average Annual Growth of Deposits: 20%
New Deposits: 90% Shift from Traditional Savings; 10% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period 't	Total Deposits Dt0+^Dt	Ben on Dep t0 Bt0	Deposits Growth ^Dt	Cum Dep Growth ^Dt1..tn	Ben from Sav Shift Bs	Benefit Con Shift Bc	Gross Ben with proj	Cost Service
0	5,400							
1	6,480	648	1,080				648	270
2	7,776	648	1,296	1,080	117	24	788	324
3	9,331	648	1,555	2,376	257	52	957	389
4	11,197	648	1,866	3,931	425	86	1,159	467
5	13,437	648	2,239	5,797	626	128	1,402	560
6	16,124	648	2,687	8,037	868	177	1,693	645
7	19,349	648	3,225	10,724	1,158	236	2,042	774
8	23,219	648	3,870	13,949	1,507	307	2,461	929
9	27,863	648	4,644	17,819	1,924	392	2,964	1,115
10	33,435	648	5,573	22,463	2,426	494	3,568	1,337
11	40,122	648	6,687	28,035	3,028	617	4,293	1,204
12	48,147	648	8,024	34,722	3,750	764	5,162	1,444
13	57,776	648	9,629	42,747	4,617	940	6,205	1,733
14	69,332	648	11,555	52,376	5,657	1,152	7,457	2,080
15	83,198	648	13,866	63,932	6,905	1,406	8,959	2,496

t= 1year
Dt0=$5,400,000
Bt0=(r1−r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period	Gross Ben	Ben with-	Ben with	AID Investment: Ci		Cost	Total	Ben −Exp	(1+r)^t	Discounted		Incremental
	with Proj	out Proj	Proj	Expenditure	NPA	Service	Cost	B−E	(ii)	'Benefits	Costs	Net Benefits
't	Bgwp	Bwo	Bwp	Project		Cs						
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	788	163	625	400	3000	324	3,724	(3,099)	1.21	517	3,078	(2,561)
3	957	160	797	300		389	689	108	1.33	599	518	81
4	1,159	158	1,001	50		467	517	484	1.46	684	353	331
5	1,402	155	1,247			560	560	687	1.61	774	348	426
6	1,693	153	1,540			645	645	895	1.77	869	364	505
7	2,042	150	1,892			774	774	1,118	1.95	971	397	574
8	2,461	223	2,238			929	929	1,310	2.14	1,044	433	611
9	2,964	224	2,740			1115	1,115	1,626	2.36	1,162	473	690
10	3,568	225	3,343			1337	1,337	2,006	2.59	1,289	516	773
11	4,293	226	4,067			1204	1,204	2,863	2.85	1,425	422	1,003
12	5,162	226	4,936			1444	1,444	3,492	3.14	1,573	460	1,113
13	6,205	227	5,978			1733	1,733	4,245	3.45	1,732	502	1,230
14	7,457	228	7,229			2080	2,080	5,149	3.80	1,904	548	1,356
15	8,959	229	8,730			2496	2,496	6,234	4.18	2,090	598	1,492
										17,071	12,208	4,863

i=social discount rate 0.1

PRESENT NET VALUE: 4,863

BENEFIT−COST RATIO: 1.40

Table 9

Benefit Calculation with CEM Project Component

($000)

SCENARIO 8

Average Annual Growth of Deposits: 20%
New Deposits: 75% Shift from Traditional Savings; 25% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period 't	Total Deposits Dt0+^Dt	Ben on Dep t0 Bt0	Deposits Growth ^Dt	Cum Dep Growth ^Dt1..tn	Ben from Sav Shift Bs	Benefit Con Shift Bc	Gross Ben with proj	Cost Service
0	5,400							
1	6,480	648	1,080				648	270
2	7,776	648	1,296	1,080	97	59	805	324
3	9,331	648	1,555	2,376	214	131	993	389
4	11,197	648	1,866	3,931	354	216	1,218	467
5	13,437	648	2,239	5,797	522	319	1,489	560
6	16,124	648	2,687	8,037	723	442	1,813	645
7	19,349	648	3,225	10,724	965	590	2,203	774
8	23,219	648	3,870	13,949	1,255	767	2,671	929
9	27,863	648	4,644	17,819	1,604	980	3,232	1,115
10	33,435	648	5,573	22,463	2,022	1,235	3,905	1,337
11	40,122	648	6,687	28,035	2,523	1,542	4,713	1,204
12	48,147	648	8,024	34,722	3,125	1,910	5,683	1,444
13	57,776	648	9,629	42,747	3,847	2,351	6,846	1,733
14	69,332	648	11,555	52,376	4,714	2,881	8,243	2,080
15	83,198	648	13,866	63,932	5,754	3,516	9,918	2,496

t= 1year
Dt0=$5,400,000
Bt0=(r1−r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period 't	Gross Ben with Proj Bgwp	Ben without Proj Bwo	Ben with Proj Bwp	AID Investment: Ci Expenditure Project	NPA	Cost Service Cs	Total Cost	Ben −Exp B−E	(1+r)^t {ii}	Discounted 'Benefits	Costs	Incremental Net Benefits
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	805	163	642	400	3000	324	3,724	(3,082)	1.21	530	3,078	(2,547)
3	993	160	833	300		389	689	144	1.33	625	518	108
4	1,218	158	1,060	50		467	517	543	1.46	724	353	371
5	1,489	155	1,334			560	560	774	1.61	828	348	480
6	1,813	153	1,660			645	645	1,015	1.77	937	364	573
7	2,203	150	2,053			774	774	1,279	1.95	1,054	397	656
8	2,671	223	2,448			929	929	1,519	2.14	1,142	433	709
9	3,232	224	3,008			1115	1,115	1,893	2.36	1,276	473	803
10	3,905	225	3,680			1337	1,337	2,343	2.59	1,419	516	903
11	4,713	226	4,487			1204	1,204	3,283	2.85	1,573	422	1,151
12	5,683	226	5,457			1444	1,444	4,012	3.14	1,739	460	1,278
13	6,846	227	6,619			1733	1,733	4,886	3.45	1,917	502	1,415
14	8,243	228	8,015			2080	2,080	5,935	3.80	2,110	548	1,563
15	9,918	229	9,689			2496	2,496	7,193	4.18	2,319	598	1,722
										18,633	12,208	6,425

i=social discount rate 0.1

PRESENT NET VALUE: 6,425

BENEFIT−COST RATIO: 1.53

Table 10

Benefit Calculation with CEM Project Component

($000)

SCENARIO 9

Average Annual Growth of Deposits: 20%
New Deposits: 50% Shift from Traditional Savings; 50% from Consumption

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period	Total Deposits	Ben on Dep t0	Deposits Growth	Cum Dep Growth	Ben from Sav Shift	Benefit Con Shift	Gross Ben with proj	Cost Service
't	Dt0+^Dt	Bt0	^Dt	^Dt1..tn	Bs	Bc		
0	5,400							
1	6,480	648	1,080				643	270
2	7,776	648	1,296	1,080	65	119	832	324
3	9,331	648	1,555	2,376	143	261	1,052	389
4	11,197	648	1,866	3,931	236	432	1,316	467
5	13,437	648	2,239	5,797	348	638	1,634	560
6	16,124	648	2,687	8,037	482	884	2,014	645
7	19,349	648	3,225	10,724	643	1,180	2,471	774
8	23,219	648	3,870	13,949	837	1,534	3,019	929
9	27,863	648	4,644	17,819	1,069	1,960	3,677	1,115
10	33,435	648	5,573	22,463	1,348	2,471	4,467	1,337
11	40,122	648	6,687	28,035	1,682	3,084	5,414	1,204
12	48,147	648	8,024	34,722	2,083	3,819	6,551	1,444
13	57,776	648	9,629	42,747	2,565	4,702	7,915	1,733
14	69,332	648	11,555	52,376	3,143	5,761	9,552	2,080
15	83,198	648	13,866	63,932	3,836	7,032	11,516	2,496

t= 1year
Dt0=$5,400,000
Bt0=(r1−r0)Dt0
r1=0.22

r0=0.10
^Dt=0.15
Bs=0.90(^Dt)
Bc=0.10(^Dt)

Bgwp=Bt0+Bs+Bc
Cs=0.05t1..t5(Dt1..5);
0.04t6..t10(Dt6..t10);
0.03t11..t15(Dt11..t15)

Present net value calculation

(1)	(2)	(3)	(4)	(5)		(6)	(7)	(8)	(9)	(10)		(11)
Period	Gross Ben with Proj	Ben without Proj	Ben with Proj	AID Investment: Ci Expenditure Project	NPA	Cost Service	Total Cost	Ben −Exp B−E	(1+r)^t (ii)	Discounted 'Benefits	Costs	Incremental Net Benefits
't	Bgwp	Bwo	Bwp			Cs						
0												
1	648	165	483	250	3000	270	3,520	(3,037)	1.10	439	3,200	(2,761)
2	832	163	669	400	3000	324	3,724	(3,055)	1.21	553	3,078	(2,525)
3	1,052	160	892	300		389	689	203	1.33	670	518	153
4	1,316	158	1,158	50		467	517	642	1.46	791	353	438
5	1,634	155	1,479			560	560	919	1.61	918	348	570
6	2,014	153	1,861			645	645	1,216	1.77	1,051	364	687
7	2,471	150	2,321			774	774	1,547	1.95	1,191	397	794
8	3,019	223	2,796			929	929	1,868	2.14	1,305	433	871
9	3,677	224	3,453			1115	1,115	2,339	2.36	1,465	473	992
10	4,467	225	4,242			1337	1,337	2,904	2.59	1,635	516	1,120
11	5,414	226	5,188			1204	1,204	3,[illegible]84	2.85	1,818	422	1,396
12	6,551	226	6,325			1444	1,444	4,880	3.14	2,015	460	1,555
13	7,915	227	7,688			1733	1,733	5,955	3.45	2,227	502	1,725
14	9,552	228	9,324			2080	2,080	7,244	3.80	2,455	548	1,908
15	11,516	229	11,287			2496	2,496	8,791	4.18	2,702	598	2,105
										21,235	12,208	9,027

i=social discount rate 0.1

PRESENT NET VALUE: 9,027

BENEFIT−COST RATIO: 1.74

Social Analysis

Available upon request

UNITED STATES

AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID / ANTANANARIVO
DEPARTMENT OF STATE
WASHINGTON D.C. 20521-2040

USAID

INTERNATIONAL POSTAL ADDRESS
c/o AMERICAN EMBASSY
B.P. 5253 — ANTANANARIVO
MADAGASCAR
TEL. 254.89 FAX 261 2.346.89

ANALYSE DU MARCHE DE LA CAISSE D'EPARGNE DE MADAGASCAR (CEM)

RAPPORT FINAL

SOA.TEG.
SOCIETE D'ASSISTANCE TECHNIQUE ET DE GESTION
09 RUE BENYOWSKI - TSARALALANA - B.P. 361
TEL. 321.85 - FAX. 254.26
101 ANTANANARIVO - MADAGASCAR

JUIN 1993

ASSISTANCE AU DEVELOPPEMENT DU MARCHE FINANCIER A MADAGASCAR

ANALYSE DU MARCHE DE LA CAISSE D'EPARGNE

SOMMAIRE

147

148

149

& &
&

150

Institutional Analysis

Available upon request

151

USAID/MADAGASCAR

CAISSE D'EPARGNE DE
MADAGASCAR

FINAL REPORT

APRIL 15, 1993

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

April 15, 1993

Mr. Frank Martin
USAID/Madagascar
Villa Vonisoa III - Anosy
B.P. 5253
Antananarivo, Madagascar

Dear Mr. Martin:

RE: *AID/PRE Financial Sector Development Project*
Contract No. PDC-2206-Z-00-8191-00
USAID/Madagascar - CEM Assessment
PIO/T No. 687-0510.03-3-20008

We are pleased to present you with ten copies of our Final Report for the CEM Assessment (English version) prepared by the Price Waterhouse team and reviewed by Price Waterhouse, Prime Contractor under FSDP. Additional copies have been forwarded to Ms. Rebecca Maestri, AID/PRE/PD.

It has been a pleasure working with USAID/Madagascar. We look forward to further collaboration with the Mission.

Sincerely,

J. Richard Breen
Director, Director

Attachments

CAISSE D'EPARGNE DE MADAGASCAR
FACT SHEET

Year Founded	1918
Number of Outlets	461
Number of Employees	45
Number of Depositors at December 31, 1992 (est.)	260,000
Value at December 31, 1991	
• Customer Deposits	FMG 10,567,532,047 (approx. U.S. $5.9 million)
• Total Assets	FMG 10,335,953,271 (approx. U.S. $5.7 million)
• Net Worth	-FMG 727,946,668 (approx.-U.S. $400,000)
• FMG Per U.S. Dollar	FMG 1,800
Standard Deposit Rate	6.65%
Premium Deposit Rate	8.45%
Interest Received on Deposits with the Treasury (CDC)	11.5%
Interest received on Deposits at BNI (via Treasury)	12.0%

CAISSE D'EPARGNE DE MADAGASCAR

TABLE OF CONTENTS

CAISSE D'EPARGNE DE MADAGASCAR

TABLE OF CONTENTS

(Continuation)

USAID

S. AGENCY FOR INTERNATIONAL DEVELOPMENT

ACTION MEMORANDUM FOR THE ACTING ASSISTANT ADMINISTRATOR FOR AFRICA

FROM: J. Paul Guedet, AFR/EA

SUBJECT: Madagascar Financial Market Development Program (687-0121), Waiver Request for full 25 percent Host Country Contribution Requirement

Action Requested: Your approval is requested to waive the requirement that the Government of Madagascar (GOM) contribute at least 25 percent of costs as specified in section 110 of the Foreign Assistance Act of 1961, as amended, for the subject program.

Country:	Madagascar
Program Name:	Financial Market Development
Program Number:	687-0121
Life of Program Funding:	$10,000,000
Source of Funding:	Development Fund for Africa

Discussion:

A. Section 110 of the Foreign Assistance Act of 1961, as amended (FAA), provides that: "No assistance shall be furnished by the United States Government to a country under Section 103 through 106 of this act until the country provides assurances to the President, and the President is satisfied, that such country will provide at least 25 percentum of the costs of the entire program, project, or activity with respect to which such costs borne by such country may be provided on an 'in-kind' basis."

B. FAA Section 124(d) permits a waiver, on a case-by-case basis, of the requirements of FAA Section 110 for projects in Relatively Least Developed Countries (RLDCS). Handbook 3, Appendix 2G, Section E2B states that this includes countries on the United Nations General Assembly list of RLDCS and the Development Assistance Committee (DAC) list of "Low Income Countries". Madagascar is on both of these lists.

c. Appendix 2G also states that the fact that a country appears on the list is not a sufficient justification alone, but the granting of a waiver is permissable whenever the initiation and execution of an otherwise desirable project is handicapped primarily by the 25 percent requirement. The appendix provides that the relevant considerations which should be taken into account in determining when a waiver of FAA Section 110 is appropriate are financial constraints, country commitment, and nature of the project. These constraints are addressed below.

Financial Constraints: Madagascar has been on the list of Least Developed Countries since January 1992. According to the World Bank Development Report 1992, Madagascar's per capita GNP for 1992 was $230 and Madagascar is thus the fourteenth poorest country in the World.

The economy in 1993 continues to feel the repercussions of the political disturbances that took place in 1991 and of the democratic transition in 1992/93. GDP growth in 1992 was one percent; growth was positive, but slight in agriculture and services, but negative in the industrial sector. Inflation in 1992 was twelve percent. GOM estimates for 1993 project a continuation of the economic stagnation; GDP growth is projected at 1.4 percent, inflation at 15 percent. The inability of the GOM to formulate a credible IMF Program for 1992 and 1993 has denied Madagascar access to the Paris or London clubs' rescheduling process. Debt relief fell from $180 million in 1990 to $65 million in 1991 to $3 million in 1992. Foreign Exchange Reserves were used up by mid-1991. Consequently, beginning in 1991 arrears in meeting foreign obligations began to accumulate and will continue to accumulate in 1992.

Country Commitment: The GOM has demonstrated its intent to tackle the financial constraints restricting economic growth in the development of a financial strategy in collaboration with the World Bank. This strategy will work towards increasing the level of financial savings, increasing the efficiency of investment and lowering the costs and risks of financial transactions. To this end the council of ministers approved a "letter of development policy for the financial sector". This policy document commits the GOM to continued liberalization in the financial sector. It is anticipated that the World Bank project entitled "Financial Institutions Development Technical Assistance Project" will begin in June

As part of this strategy development, the GOM asked the World Bank to coordinate donor programs in the financial sector. The FMD Program has been designed in coordination with the World Bank, and along with the World Bank Project, is being negotiated with the Central Bank as joint projects.

The host country financial contribution is estimated at $2 million, or 16 percent of total Life-of-Program Funds of $12 million. The host country financial contribution will comprise $1 million paid by the Central Bank to the National Savings Bank as compensation for interest not paid during 1975-1985 and $1 million in increased interest paid by the Central Bank to the National Savings Bank.

The host country in-kind contribution will include seven hundred person-months of salaries for Central Bank Trainees, operating costs of the Research Department and the Administration Department of the Central Bank and the operating costs of the National Savings Bank. As a result of the financial situation described above, salary levels and other operating cost budgetary allocations are very low. For example, the monthly salary of a middle-grade civil servant is seventy-five dollars. Because of extremely low wage rates the in-kind contribution will not increase the total contribution of the GOM to the level necessary to reach twenty-five percent of total project cost.

Nature of Program: The purpose of the Financial Market Development Program (FMD) is to increase the level of domestic financial resources going to the private sector. This will be accomplished by augmenting the capacity of the Central Bank and the National Savings Bank. FMD will support the Central Bank in research and analysis and staff development and the National Savings Bank through expansion and improvement of operations. It is anticipated that implementation of FMD in concert with the World Bank project will result in alleviating some of the economic constraints that Madagascar has faced over the past few years.

Justification: The Financial Market Development Program fits the criteria as outlined in Appendix 2G of Handbook 3 for Waiver of the full 25 percent host country Contribution Requirement. First, as noted above, Madagascar is a "Relatively Least Developed Country" whose fiscal position has deteriorated to the extent that funds may not be available for essential development programs. Second, Madagascar has demonstrated strong support for the objectives of FMD through its development of a financial strategy with the World Bank.

Third, the nature of the program is to work toward alleviation of the financial constraints that have limited economic growth so that the country's fiscal position will improve.

Authority: Under Section 4. of Delegation of Authority 403, dated December 13, 1976, the authority of the Administrator to waive the cost-sharing requirements of FAA Section 110(a) was delegated to the Assistant Administrator for Africa for projects or activities in countries on the UNGA and UNCTAD lists of "Relatively Least Developed Countries".

That section provides that while the authority may not be re-delegated, it may be exercised by a Deputy Assistant Administrator having "alter ego" authority or by a person performing the functions in an "Acting" capacity.

Under DOA 551, revised March 19,1989, principal officers are delegated Project Implementation authorities, including amendments, but any required waiver, which must be executed by the Assistant Administrator (or as alternatively provided), must be approved prior to authorization of a project or an amendment.

Recommendation: That you waive the FAA Section 110 requirement that Madagascar contribute 25 percent or more of the program costs for the Financial Market Development Program.

Approved: [signature]

Disapproved: ____________

Date: 6/21/93

Clearances:

GLewis, AFR/EA _______ Date: 6/1

MBonner, AFR/DP _______ Date: _______

JScales, GC/AFR _______ Date: 6/1/93

DCobb, DAA/AFR _______ Date: 6/16/93

AFR/EA:GCarner:GCashion:dd:5/17/93:Madagascar\Waiver.FMD

Annex H

USAID

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

August 6, 1993

ACTION MEMORANDUM FOR THE ACTING ASSISTANT ADMINISTRATOR FOR AFRICA

FROM: AFR/EA, J. Paul Guedet

SUBJECT: Madagascar Financial Market Development Program (687-0121) - Proposed Non-Project Assistance (NPA)/Cash Transfer.

Problem: Your approval is requested (1) to disburse dollar resources as cash, and (2) to make service of debt owing to the IMF and multilateral development banks eligible, to the extent there is not unrescheduled non-military debt service owing to the USG, for the proposed Madagascar Financial Market Development Program (687-0121).

Discussion: USAID/Madagascar plans to initiate a Non-Project Assistance (NPA) Program composed of a $6 million NPA component and $4 million Project Assistance (PA) component which will increase investment and employment in the private sector by increasing the level of domestic financial savings and the share of savings going to the private sector.

A. INDIVIDUAL RESPONSIBLE FOR THE DECISION TO USE CASH: Mission Director, USAID/Madagascar

B. AMOUNT:

Fiscal year 93: $6 million NPA obligation,
$4 million PA

Life-of-Project: $6 million NPA,
$4 million PA

C. DETERMINATION OF AMOUNT: The Mission's assessment is that a $6 million NPA is appropriate under the Africa Bureau NPA guidance, Section IV, A, 3 Page 11. This $6 million NPA component is, to quote from the NPA guidance, large enough to make it worthwhile for the Host Country to incur all of the costs attendant to the proposed policy reform agenda. The program will be large enough to compensate for the increased fiscal outlays associated with the reforms during the life of the program.

However, as the GRM will be eliminating its privileged position for access to the financial savings of low-income households via the National Savings Bank, the Caisse D'Epargne De Madagascar (CEM), the higher fiscal outlays will eventually exceed the amount of the program. A smaller program would compromise the GRM's ability to pay CEM savers competitive market interest rates on their deposits.

D. USE OF DOLLARS (HOW THE DOLLARS WILL BE SPENT): The Government of the Republic of Madagascar (GRM) will use NPA funds for Debt Servicing Payment. Eligible debt consists of first, any unscheduled service of non-military debt owing to the USG (Export-Import Bank), and secondly, to the extent there is not first priority debt service, service of debt to the IMF and multilateral development banks.

E. ACCOUNTABILITY (WHAT CONTROLS WILL OPERATE TO ACCOUNT FOR THE FUNDS): A separate bank account will be established in a U.S. bank or financial institution where funds will be disbursed by the U.S. Treasury once program conditionality has been met. The GRM will be required to submit a schedule of eligible debt to be serviced with the release of the NPA disbursement. Only one disbursement totalling $6 million is anticipated at this time.

Release of funds for the FMD Program will operate similar to that used for the Knowledge for Effective Policies in Environmental Management (KEPEM) Program in that once USAID/Madagascar has determined that program conditionality has been met and has approved the list of eligible debt to be serviced, the U.S. Treasury will be notified to release the funds to the separate account established for the FMD Program. The GRM will then be required to submit proof within a specified time period to USAID that the specified debt has been paid directly from that account.

F. PURPOSE OF PROGRAM (WHAT DOLLARS WILL BUY): The NPA component will support a program to transform the National Savings Bank or Caisse D'Epargne De Madagascar (CEM). Preliminary analysis indicates three policy changes will need to be part of a revitalization plan for CEM. The first policy change is the legal status of CEM. Currently CEM is a public establishment of Industrial and Commercial Character or Enterprise Publique D'Interet Commerciale (EPIC). A revised status of the CEM which permits more autonomy and private capital participation will be a performance criteria. The second policy change relates to the interest rate paid on CEM assets deposited at the Treasury. Currently the interest rate is set annually by the Ministry of Finance and is well below market-determined rates. The FMD Program will negotiate a policy determination that will result in pegging the CEM interest rate to an observable market rate.

The third policy change will require a payment by the GRM to the CEM in the approximate amount of $1 million to compensate CEM for interest not received on its deposits at the Central Bank during the period 1975-1985. This payment will eliminate the CEM's current negative net worth position.

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G. HOW SUCCESS WILL BE MEASURED: The FMD Program consists of two components:

(1) Support to the Central Bank in design and implementation of a non-inflationary market-based monetary policy; and

(2) Support to CEM through expansions and improvement of its operations so that it can provide low-income households with a safe, reliable, convenient and remunerative form of financial savings.

At the EOPS level, impact of the program will be measured by the increase in commercial bank credit to the private sector and the ratio of national savings to GDP. At the output level, impact will be measured for the Central Bank component by price stability, ratio of money to GDP, and reduced Treasury borrowing from commercial banks. Impact for the CEM component will be measured by the growth in deposits and client growth base.

H. JUSTIFICATION FOR SERVICE OF DEBT TO MULTILATERAL DEVELOPMENT BANKS. CONSIDERATION OF ALTERNATIVE MEANS (E.G. CIP, CAPITAL PROJECTS, TECHNICAL ADVICE) TO ACHIEVE PROGRAM OBJECTIVES: The most recent DFA Procurement Procedures [February 1, 1993] provide that disbursement of NPA as cash is appropriate where dollars can be used appropriately for repayment of eligible debts. As discussed below, this is the case here.

The current DFA NPA guidance [October 1992] states that the general Agency guidance on the use of cash transfer proceeds [87 State 325792, October 20, 1987] applies to the use of DFA cash disbursements, with the caveat that authorization of debt service should be based on host government and economic priorities [p. 32-33]. 87 State 325792 provides that "where recipient country debt service is a significant barrier to growth and development,...cash transfer assistance may be used to effect debt service payments." This is the case in Madagascar. In 1992, Madagascar's debt service ratio was equal to 90% of GDP and total outstanding debt equals approximately 124% of GDP. The debt service burden has become this high recently because the GRM has been unable to formulate a credible IMF program for 1992 and 1993 which has denied Madagascar access to the Paris or London clubs rescheduling process. Debt relief fell from $180 million in 1990 to $65 million in 1991 to $3 million in 1992. With such high debt service payments, there are not sufficient funds for investment in development activities. This payment is key to enabling the GRM to pay the IMF and reach accord with it.

The President of Madagascar has recently appointed an eight person committee to oversee the elaboration of a macroeconomic framework and to prepare for negotiations with the World Bank and the IMF. The committee is currently reviewing the government's fiscal policy and they are expected to recommend mid-year adjustments in the 1993 GRM budget. The IMF is on record that the first economic priority of the new government will be the fiscal deficit and it is expected that the GRM and IMF to agree on a macroeconomic framework before the end of 1993. In addition, the President of Madagascar has outlined the GRM's priorities to the World Bank and IMF and assurances that the GRM is ready to negotiate. Foreign exchange is needed now to fill the financing gap for 1993, as a bridge before IMF Standby funds become available.

This guidance also states that the first priority debt service for use of cash transfer proceeds is non-military debt owing to the USG, and the second priority debt service is that owing to the IMF and multilateral development banks. Regional AA approval is required for use of cash proceeds for service of this second priority debt. While Madagascar currently has a $5.6 million debt to the U.S.G. Export-Import bank, that loan has been recently rescheduled, and the service of it is de minimus and in any case not sufficient to absorb the entire amount of the $6 million cash disbursement. Thus, use of the cash proceeds for service of second priority debt is appropriate, to the extent that unrescheduled non-military debt service payments to the U.S.G. are not due.

Project assistance is inappropriate because the PAAD's sector analysis shows that the critical constraints are policies which the GRM can revise itself, rather than the lack of foreign technical assistance, and the financial sector is not in need of commodities. Additionally, the Central Bank is responsible for servicing foreign debt and the FMD Program will directly support the Central Bank.

I. STATUS OF MISSION NEGOTIATIONS WITH THE HOST GOVERNMENT: The GRM has agreed with the general policy environment necessary to develop a program for the CEM. The GRM adopted a financial sector reform and development policy in March, 1993, which contains a two-stage strategy for strengthening the financial system.

This policy statement commits the GRM to restructuring the CEM to make it more responsive to small and medium scale savers. Since the PAIP was approved in April, negotiations at the technical level have continued with the Ministry of Finance and will be concluded by mid-July.

J. HOW THE PROGRAM FITS WITH THE MISSION PROGRAM STRATEGY: This Program directly complements the Mission's CPSP which was approved in September, 1992. The goal of the FMD Program is the same as one CPSP sub-goal which is to increase investment and employment in the private sector. The Program was developed to address Strategic Objective No.1 of the CPSP--to establish a competitive pro-business climate--by working towards Target 1.2--

increased domestic resources for private sector investment resulting from financial market reforms.

Recommendation: That you approve (1) disbursing dollar resources as cash, and (2) making service of debt owing to the IMF and multilateral development banks eligible, to the extent there is not unrescheduled debt service owing to the USG, for the proposed Madagascar Financial Market Development Program (687-0121).

Approved: [signature]

Disapproved: ____________

Date: 8/19/93

Clearances:

GLewis, AFR/EA	(draft)	Date:	7/13/93
MBonner, AFR/DP	(draft)	Date:	7/10/93
DRhoad, FA/B/PB/C	(draft)	Date:	7/16/93
ESpriggs, GC/AFR	MAK	Date:	8/5/93
DCobb, DAA/AFR		Date:	8/9/93

AFR/EA:GCarner:GCashion:dd:5/17/93:7/12/93
Madagascar\FMDP0121.MEM

Annex I

UNOFFICIAL TRANSLATION

Government of the Republic of Madagascar

STATEMENT OF FINANCIAL SECTOR REFORM AND DEVELOPMENT POLICY

1. Recognizing the vital importance of the effective allocation and mobilization of capital through the use of efficient financial systems, the Government wishes to pursue a two-phase comprehensive program for the reform and development of the financial system in Madagascar. This program is related to the pursuit of macroeconomic stability and economic growth based on a reduction and non-inflationary financing of the budget deficit, including the elimination of the quasi-fiscal deficit of the Central Bank of Madagascar (BCRM), the program related to the Government's divestiture from the productive sectors of the economy, and a higher degree of factor mobility. The importance which the Government attaches to this program is primarily a reflection of the concern for sound development in the private sector, so that restored private investment and savings can serve as a driving force for economic growth in the coming years.

2. The comprehensive program for the reform and the development of the financial sector is designed to reach the following objectives:

(i) To improve the regulatory, legal, and accounting environment with a view to ensuring the security of contracts and financial instruments, and the sound management of financial institutions in accordance with the internationally-accepted rules of prudence and transparency;

(ii) To shift to a monetary policy based on indirect instruments, to enable BCRM in the long term to eliminate the credit ceilings allocated to individual banks;

(iii) To reinforce the market mechanisms with increased competition resulting from the entry of new private institutions operating within an appropriate regulatory framework;

(iv) To encourage the creation of money and capital markets, aiming initially, inter alia, at implementing a more effective structure for the issuance and trading of treasury securities (concurrently with a strict ceiling on claims on Government and Government paper held by BCRM), and the gradual issue of financial securities by financial institutions and/or private nonfinancial enterprises; and

(v) To promote interest rates determined by the market as competition intensifies and as a more market-oriented regulatory framework develops;

3. In the context of this comprehensive program, reinforcement of the institutional capacities of the financial system, primarily those of BCRM, the Financial Supervisory Commission (CCBEF), and the strengthening of the accounting and audit framework, constitute an absolute priority for phase one of the financial system reforms, aiming to lay the foundations for other fundamental reforms which include, among others, the shift to the use of indirect monetary policy instruments. The reform and development of the financial system in Madagascar will begin with an initial phase of reforms. This first phase primarily involves the institutional reinforcement of the financial system as stated below:

(i) to strengthen the independence of BCRM and its institutional capacity to formulate and execute monetary policy, eventually through indirect instruments (see paragraphs 6 to 10);

(ii) to restructure financial institutions and remove the Government from the ownership and management of financial institutions, and specifically commercial banks (see paragraph 11 and 12); and

(iii) to reinforce the supervision of banks and financial institutions and to adapt the regulatory framework (see paragraphs 16 to 18).

4. Phase one pertains to specific priority measures already identified and under way, and measures to be defined by June 1993. The Government believes that the specific strategy for phase two of the program will be developed before end-1993.

5. All activities and measures stipulated in the comprehensive program for reform and development of the financial sector cover all financial institutions, infrastructure, and financial markets. The strategic orientation of this program and the activities under way and to be undertaken are indicated below.

I. Financial Institutions

Central Bank of Madagascar

6. In light of the critical role which an efficient, independent, and responsible central bank pays in any program to develop the financial system, the restructuring and strengthening of the capacities of BCRM constitute one of the priorities of the program which is being pursued by the Malagasy authorities. This objective involves three areas of focus: (i) strengthening BCRM institutional and financial independence; (ii) making BCRM more accountable and its operations more transparent; (iii) strengthening the human and logistic resources of BCRM to prepare it more effectively to formulate and execute monetary policy, primarily with a view to the shift to indirect control of monetary aggregates.

7. The independence of BCRM involves both institutional and financial factors. As regards the institutional aspect, revised statutes for BCRM will be developed by the end of April 1993. This revision aims primarily at limiting its excessive dependence vis-à-vis the Government in matters concerning the development and execution of monetary and credit policy. These new statutes will be adopted by the Government before the middle of May 1993. The financial aspect of BCRM independence consists primarily of ensuring that its activities do not include those responsibilities which must clearly be incumbent on the Treasury. To that end, there are two types of actions. The first, which was completed at the end to 1992, consists of isolating credit to the Government resulting from previous losses and placing it in a separate account, while stipulating the conditions and modalities for settling these claims. This makes the quasi-fiscal activities of BCRM which to date have encumbered its balance sheet with non-interest earning assets and liabilities more transparent. Stage two consists of taking steps before the end of 1993 to prevent the recurrence of past problems and the accrual of new losses. These steps would be accompanied by a reduction in the budget deficit.

8. The accountability of BCRM and its more transparent operations will be accompanied by strengthening of its independence, as described above. Accordingly, an external audit of BCRM and an analysis of its internal audit function will be assigned to an independent firm, to be undertaken during the first half of 1993. In addition to a conventional financial audit, this audit will include a study of the present internal audit function in BCRM and will make recommendations to strengthen this function. The Government has specified that FINDEP should provide assistance for the structuring and development of a new internal audit function for BCRM, which would be separate from other functions of BCRM and would report directly to the Governor and the Board of BCRM.

9. This initial external audit will then lead to systematic external audits of BCRM for each fiscal year, to be conducted by an independent and qualified firm, and which would lead to an annual report published by BCRM accompanied by audited financial statements. The first report is scheduled to be published in 1994.

10. The independence of BCRM and its increased accountability will be facilitated by strengthening of its human and logistic resources, with a view to pursuing its main objective, i.e. to ensure price stability through monetary policy. To that end, BCRM has prepared a strategic development plan which it will adopt in March 1993 and which provides for a strengthening of the departments which are directly responsible for the core functions of central banking (Credit, Foreign Services, and Research) and all support functions (primarily accounting, data processing, and administration). The assistance of FINDEP should contribute to the implementation of this plan over a three-year period.

Commercial Banks

11. In keeping with its concern to ensure that the above mentioned objective is attained, i.e the creation of a real financial market with freely determined interest rates, the Government recognizes the importance of a competitive banking system which meets the needs of economic agents. This goal is consistent with the orientation which the government adopted in 1988, which consists of replacing the former roles of the government as the owner of the financial institutions, and the decision maker for selective policies for credit and direct control, with a strategy which limits the role of the government essentially to providing the appropriate regulation and the supervision necessary for market mechanism to function properly.

12. With the final objective of Government divestiture of remaining ownership and bank management, the Government intends to pursue and accelerate the policy which it began in 1988. Accordingly, the process of privatizing the BTM was undertaken in 1992, and the Government has followed up on the recommendations of the consulting firms recruited to that end. Similarly, the Government will pursue the privatization of the BFV by increasing the share of private stockholders to at least a majority level, if not one hundred percent of the capital, by end-1993.

Insurance

13. In the insurance sector, the Government will pursue the objective of introducing private capital into the two existing state-owned corporations and to open this sector up to competition. Concurrently, the regulatory system governing this sector will be reviewed. These activities will be carried out during phase two of the program for reform and development of the financial system.

CNaPS and Social Security

14. Considering the weight which it carries in mobilizing financial resources, the Caisse National de Prévoyance Sociale (CNaPS) is, in addition to its fundamental role as a social institution, a considerable institutional investor and, therefore, is one element which must be taken into account in the reform and development of financial markets and institutions in Madagascar. The Government's goal is to make the management of CNaPS more efficient by providing it with the required transparency and increasing its level of accountability. In this connection, the Government during the last quarter of 1992 initiated a series of three studies on CNaPS with the assistance of the World Bank and the International Labor Office, i.e. and organizational and financial analysis of CNaPS, an actuarial study, and a study on the investment of funds. After these studies are completed, prior to June 1993, and in the context of phase two of the program for reform and development of the financial system, a plan of action will be developed to reorganize CNaPS, which will primarily involve the following elements: (i) more transparent operations, achieved, inter alia, by preparing

financial statements according to international accounting procedures and auditing them in accordance with the relevant international standards; (ii) strengthened management of this institution, which included establishing actuarial forecasting and analysis capabilities; and (iii) regulations concerning investments of funds more suitable to ensure the security of funds while participating in the development of financial markets.

<u>Postal financial services</u>

15. The postal financial services, i.e. the Caisse d'Epargne de Madagascar (CEM), a postal savings institution, and the Centre de Chèques Postaux, a postal checking institution, will be restructured with a view to making them better suited to meet the needs of small- and medium-scale savers and the payments system, respectively. In the context of its sectoral policy on post and telecommunications adopted on June 30, 1992, the Government already provided for these services to be more autonomous and to be managed according to commercial principles. This policy is intended to result in a separation of the activities of the postal financial services from the Treasury's overall operations, and their privatization, to the greatest extent possible. The practical ways and means for the implementation of this strategy are being studied, including the development of the relationships between these services and private businesses and financial institutions. Phase two of the reforms will include the implementation of this strategy to be adopted before end-1993.

II. The Financial Infrastructure

16. The Government attaches particular importance to the financial infrastructure, primarily the regulatory framework governing banking operations, including prudential supervision, the accounting and audit framework, and the legal environment for financial transactions. The reinforcement of the process of the supervision of banks and financial institutions and the improvement of accounting and audit standards will, inter alia, facilitate the elimination of direct controls applicable to banks and the shift to indirect monetary policy instruments. The first phase of the reforms stipulated in this connection will accordingly give priority to the strengthening of the Financial Supervisory Commission (CCBEF), the implementation of a regulatory framework governing the accounting profession, and the adoption of texts governing financial institutions before end-1993.

17. As regards the operation of CCBEF, the present situation which is characterized by shared responsibilities between BCRM and CCBEF for the functions and staff involved in supervising the banking system, will be modified in the context of the implementation of the strategic development plan for BCRM. The main responsibility for the supervision of banks and financial institutions, as regards on- and off-site supervision, will fall to CCBEF. The transfer of the banking supervision functions of BCRM to CCBEF, the strengthening of the human resources of CCBEF by the assignment of a minimum number of permanent staff, and the development of a plan of action for CCBEF,

under the supervision of a technical assistant -- a seasoned inspector recruited from the outside before June 1993 for a three-year period -- will be completed by the end of 1993. The technical assistance will serve as an advisor to the Governor of BCRM, as Chairman of CCBEF, and will be responsible for implementing a systematic training program for CCBEF staff, including on-the-job training, and for reinforcing all aspects of on- and on-site supervision. CCBEF will conduct a general on-site inspection of each commercial bank at least annually. The first series of these on-site inspections will be completed by June 1994.

18. Financial management will be reinforced by the establishment of audit and accounting standards compatible with international standards. To ensure that these standards are applied and observed the accounting profession will be subjected to a regulatory framework developed by the profession itself and submitted for the approval of the authorities before end-1993. This regulatory framework will ensure that accounting experts uphold high professional ethics and standards in their endeavors, so that the requirements of sound financial management can be met more effectively, primarily thorough the use of the following measures:

- Authorization of the title of accountant and the right to practice this profession;

- Professional ethics to be observed, and disciplinary measures for failure to observe them;

- Organization and operation of the Association of Accounts, including its goals, initiation fees, financial conditions, etc.; and

- The statutory component, including the production and auditing of annual financial statements and the filing of such statements with the competent authorities, and the deadlines to be met.

19. In the general context of improving the legal framework governing business, more particular attention will be focused on filling the gaps both in the basic legal texts and in the application texts related to financial transactions. These gaps involve the following fields of business law: law applicable to stocks and bonds; general law and procedures pertaining to guarantees, mortgages, and collection of claims, as well as bankruptcy and liquidation. The actions to be taken to that end will be coordinated with the other components of the legal framework to be improved (commercial code, law on competition, and mining code), as discussed earlier with IDA. A program of specific activities will be developed before end-1993, to be incorporated into phase two of the reforms stipulated in this program.

20. The Government, BCRM, and the banking industry will examine the different options for making the existing payments system more effective. The Government and IDA will examine the recommendations of a consultants' study on this subject, with a view to identifying a strategy before the end of 1993.

III. Financial Markets

21. The Government's goal is to promote the development of financial markets which can determine interest rates through the interplay of supply and demand for financial resources. The immediate priority for the Government in the development of such financial markets is to restore the proper operation of the interbank market, which has for all intents and purposes been dormant since the two Government banks began to experience problems. The privatization of these banks and the opening of the sector should improve the operation of the interbank market.

22. The Government intends to restore the regular issue of Treasury bills and concurrently reduce its direct recourse to BCRM. This action to reinforce the operation of the money market will be accompanied by a considerable effort to manage Government cash flow and to implement stricter coordination between the Treasury and BCRM. This will result in improved liquidity forecasts made by BCRM in the context of monetary policy program management.

23. The Government also believes that initiating the development of a nascent capital market in Madagascar would be a decisive step in fostering the economy's market orientation. The private sector should play a vital role in the design and organization of such a market. With a view to helping stimulate the start-up of such a market with high grade marketable securities, the Government will accelerate as much as possible its program to privatize financially viable public enterprises (for example, in the insurance sector, banks, telecommunications, and transportation) and for which a portion of the designated capital could be privatized through a public offering for sale, aimed, inter-alia, at small-scale owners and institutional investors. The Government will examine the ways and means to reach this goal as quickly as possible in the context of phase two of the reforms under the comprehensive development program for the financial sector.

Adopted by the Government

Antananarivo, March 3, 1993.

5C(2) - ASSISTANCE CHECKLIST

Listed below are statutory criteria applicable to the assistance resources themselves, rather than to the eligibility of a country to receive assistance. This section is divided into three parts. Part A includes criteria applicable to both Development Assistance and Economic Support Fund resources. Part B includes criteria applicable only to Development Assistance resources. Part C includes criteria applicable only to Economic Support Funds.

CROSS REFERENCE: IS COUNTRY CHECKLIST UP TO DATE?	Yes

A. CRITERIA APPLICABLE TO BOTH DEVELOPMENT ASSISTANCE AND ECONOMIC SUPPORT FUNDS

1. **Host Country Development Efforts** (FAA Sec. 601(a)): Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	(b), (c) Project will encourage efforts of the country to increase the level of domestic financial resources going to the private sector.
2. **U.S. Private Trade and Investment** (FAA Sec. 601(b)): Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	N/A

3. **Congressional Notification**

a. **General requirement** (FY 1993 Appropriations Act Sec. 522; FAA Sec. 634A): If money is to be obligated for an activity not previously justified to Congress, or for an amount in excess of amount previously justified to Congress, has Congress been properly notified (unless the Appropriations Act notification requirement has been waived because of substantial risk to human health or welfare)?

A Congressional Notification was submitted to the Hill on and will expire on

b. **Notice of new account obligation** (FY 1993 Appropriations Act Sec. 514): If funds are being obligated under an appropriation account to which they were not appropriated, has the President consulted with and provided a written justification to the House and Senate Appropriations Committees and has such obligation been subject to regular notification procedures?

N/A

c. **Cash transfers and nonproject sector assistance** (FY 1993 Appropriations Act Sec. 571(b)(3)): If funds are to be made available in the form of cash transfer or nonproject sector assistance, has the Congressional notice included a detailed description of how the funds will be used, with a discussion of U.S. interests to be served and a description of any economic policy reforms to be promoted?

Yes

4. **Engineering and Financial Plans** (FAA Sec. 611(a)): Prior to an obligation in excess of $500,000, will there be: (a) engineering, financial or other plans necessary to carry out the assistance; and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?

(a) Yes

(b) Yes

5. **Legislative Action** (FAA Sec. 611(a)(2)): If legislative action is required within recipient country with respect to an obligation in excess of $500,000, what is the basis for a reasonable expectation that such action

Legislative Action must be completed prior to release of first disbursement of cash transfer.

Annex J

DETAILED PROCUREMENT PLAN

1. Procurement of Technical Assistance

The Mission Contracting Officer will assist in the procurement of technical services. It is envisioned that AID/W centrally funded projects will be accessed through buy-ins for the necessary expatriate short-term technical assistance. This includes approximately 28 months of short-term TA to BCRM and approximately 30 months to the CEM. Potential central AID/W projects for buy-ins include:

- Consulting Assistance for Economic Reform (CAER)
- Financial Resources and Management (FIRM)
- Financial Sector Development II.

Existing IQCs will be used for evaluations and audits. The contracting entity will assure compliance with the mandatory ten percent subcontracting requirements of the Gray Amendment.

If buy-ins are not feasible for the acquisition of short-term TA, first consideration will be given to a limited competition to be conducted among Gray Amendment/Section 8(a) firms. USAID's Office of Small and Disadvantaged Business Utilization (OSDBU) will be contacted and asked to provide capability statements for firms registered with OSBDU and firms which OSDBU believes possess the required expertise and experience to successfully implement the Financial Market Development Project.

If neither buy-ins nor limited Gray/8(a) competition are feasible for the required short-term TA, a full and open negotiated competition will be conducted to obtain the necessary services.

2. Personal Services Contracts

i. A Personal Services Contractor will be hired as the Research Advisor at the Central Bank for three years. This person will work under the supervision of the MBD Private Sector Officer, the USAID FMD Project Officer. The Mission will advertise broadly for this position.

ii. A local hire Personal Services Contractor will be hired as a Program Assistant for two years. This person will work under the supervision of the Private Sector Officer and will handle all administrative and secretarial matters to support the program.

3. Procurement of Commodities

a. Development Fund for Africa Certification

This Program will be funded by resources provided under the Development Fund for Africa (DFA). The legislation establishing the DFA authorized procurement of goods and services from A.I.D. Geographic Code 935. Notwithstanding, A.I.D. has been directed to maximize U.S. procurement whenever practicable to the extent consistent with the program objectives. In addition A.I.D. requires under the revised DFA guidance of 13 February 1993, that AFR/Washington concurrence be obtained for any procurement transaction for which the non-U.S portion exceeds $5 million. Moreover, annual procurement plans must be submitted to AID/W.

b. Source of Commodities

Under this Project, it is not anticipated that Africa Bureau concurrence will be required for any non-U.S. procurement. U.S. manufactured goods for which parts and service are available locally are being procured. Further, all practical efforts are being made to purchase non-U.S. manufactured items from U.S. suppliers.

c. Procurement Agent

Procurement of commodities for the activity will be the responsibility of USAID. As shown on the following equipment list, the total amount of the commodities to be purchased is estimated to be less than $400,000. USAID will procure the commodities directly, either locally or from the U.S., since the size of the procurements are relatively small.

d. Equipment List

The following is a list of equipment for the different components of the FMD project.

CENTRAL BANK

ITEM	QTY	PROB. S/O	PROCURING ENTITY	ESTIMATED AMOUNT
Computer PSC	1	000	USAID	$5,000
Residential furniture PSC	1 ST	000	USAID	$50,000
Audiovisual Equipment		899	USAID	$20,000
Library material		000	USAID	$40,000
Shipping costs				$27,500
SUBTOTAL COMMODITIES CENTRAL BANK				**$142,500**

CAISSE D'EPARGNE DE MADAGASCAR

ITEM	QTY	PRO. S/O	PROCURING ENTITY	ESTIMATED AMOUNT
Computers Hardware		000	USAID	$114,000
Computers Software		000	USAID	$97,000
Office equipment		000/935	USAID	$15,000
Shipping costs				$24,000
SUBTOTAL COMMODITIES CEM				$250,000

e. Commodity Marking

Commodities purchased with Project Funds will be appropriately marked with the A.I.D. emblem. It is the responsibility of the USAID mission or implementing contractor to assure compliance with the A.I.D. marking requirements contained in HB 1B, Chapter 22. The Mission Project Officer is responsible for assuring compliance with A.I.D. marking requirements.

Annex K

FINANCIAL MARKET DEVELOPMENT
PROJECT ASSISTANCE ILLUSTRATIVE BUDGET

	UNIT COST	NUMBER	YEAR 1 1994	YEAR 2 1995	YEAR 3 1996	YEAR 4 1997	TOTAL
BCRM BUDGET:							
A. TECHNICAL ASSISTANCE							
1. LONG TERM TA – PSC							
RESEARCH ADVISOR	$5,000.00	36 MONTHS	60,000	63,000	66,150	0	189,150
SUBTOTAL LT TA			60,000	63,000	66,150	0	189,150
B. FRINGE BENEFITS–25% SALARY			15,000	15,750	16,538	0	47,288
C. POST ALLOWANCES							
POST DIFFERENTIAL – 25%			15,000	15,750	16,538	0	47,288
HHE/TVL/CONS/UAB/STR			48,005	3,780	45,666	0	97,451
EDUC ALLOWANCE	$6,000.00	YEAR	12,000	12,600	13,230	0	37,830
R&R TVL/EMERG TVL			5,000	22,181	5,513	0	32,694
LOCAL HOUSING COST	$19,800.00	YEAR	19,800	20,790	21,830	0	62,420
SUBTOTAL POST ALLOWANCES			99,805	75,101	102,775	0	277,682
D. LOCAL TRAVEL	$1,500.00	YEAR	1,500	1,575	1,654	0	4,729
E. COMMODITIES							
COMPUTER	$5,000.00	SET	5,000	0	0	0	5,000
FURNITURE	$50,000.00	LT TA	50,000	0	0	0	50,000
TRANSPORTATION	50 %	COST	27,500	0	0	0	27,500
SUBTOTAL COMMODITIES – PSC			82,500	0	0	0	82,500
TOTAL PSC COSTS			258,805	155,426	187,117	0	601,348
F. SHORT–TERM TA							
1. ST TA – RESEARCH							
MONETARY POLICY ADVISOR	$5,000.00	3 MONTHS	5,000	5,250	5,513	0	15,763
INFO SYSTEMS ADVISOR	$5,000.00	2 MONTHS	10,000	0	0	0	10,000
NAT'L INCOME ACCT ADVISOR	$5,000.00	4 MONTHS	10,000	10,500	0	0	20,500
FINANCIAL ADVISORS	$5,000.00	5 MONTHS	10,000	10,500	5,513	0	26,013
2. ST TA – PERSONNEL POLICIES	$5,000.00	6 MONTHS	20,000	10,500	0	0	30,500
3. ST TA – H.R. ACTION PLAN	$5,000.00	8 MONTHS	20,000	10,500	11,025	0	41,525
SUBTOTAL ST TA			75,000	47,250	22,050	0	144,300
G. OVERHEAD – 100%			75,000	47,250	22,050	0	144,300
H. TRAVEL AND PER DIEM							
TRAVEL – ST TA	$6,300.00	TRIP	94,500	59,535	27,783	0	181,818
PER DIEM – ST TA	$182.00	TANA	81,900	51,597	24,079	0	157,576
SUBTOTAL TRAVEL AND PER DIEM			176,400	111,132	51,862	0	339,394
TOTAL ST TA COSTS			326,400	205,632	95,962	0	627,994

(Continued)	UNIT COST	NUMBER	YEAR 1 1994	YEAR 2 1995	YEAR 3 1996	YEAR 4 1997	TOTAL
I. TRAINING							
SEMINARS/LOCAL – RESEARCH	$20,000.00	EACH	60,000	63,000	66,150	0	189,150
STUDY TOURS	$7,000.00	PERSON	35,000	73,500	38,588	0	147,088
SEMINARS/INT'L	$15,000.00	MONTH	195,000	204,750	214,987	0	614,738
SEMINARS/LOCAL – H.R.	$20,000.00	EACH	160,000	168,000	176,400	0	504,400
ENGLISH TRNG	$50.00	HOUR	25,000	26,250	27,562	0	78,813
SUBTOTAL TRAINING			475,000	535,500	523,687	0	1,534,188
J. COMMODITIES			40,000	20,000	0	0	60,000
K. TOTAL ASSISTANCE – BCRM			1,100,205	916,558	806,766	0	2,823,529
CEM BUDGET:							
L. STUDIES AND ANALYSIS – INT'L			50,000	50,000	50,000	0	150,000
M. LOCAL STUDYS/EXPENDITURES			105,000	50,000	25,000	0	180,000
N. TRAINING							
SEMINARS – INT'L	$12,000.00	MONTH	36,000	37,800	39,690	0	113,490
LOCAL COURSES	$300.00	EMPLOYEE	21,000	24,150	27,773	0	72,923
STUDY TOURS	$7,000.00	PERSON	42,000	0	44,100	0	86,100
SUBTOTAL TRAINING			99,000	61,950	111,563	0	272,513
O. COMMODITIES							
COMPUTERS			235,000	0	0	0	235,000
OFFICE EQUIPMENT			15,000	0	0	0	15,000
SUBTOTAL COMMODITIES			250,000	0	0	0	250,000
TOTAL CEM BUDGET			504,000	161,950	186,563	0	852,513
P. PROGRAM ASSISTANT – LOCAL	$30,000.00	2 YEARS	30,000	34,500	0	0	64,500
Q. AUDIT			0	25,000	0	25,000	50,000
R. EVALUATION			0	40,000	0	40,000	80,000
TOTAL			1,634,205	1,178,008	993,326	65,000	3,870,541
S. CONTINGENCY	3 PERCENT	YEAR	65,368	35,490	28,600	0	129,458
GRAND TOTAL			1,699,573	1,213,498	1,021,928	65,000	4,000,000

Annex L

STATUTORY CHECKLIST

will be completed in time to permit orderly accomplishment of the purpose of the assistance?

6. **Water Resources** (FAA Sec. 611(b); FY 1993 Appropriations Act Sec. 501): If project is for water or water-related land resource construction, have benefits and costs been computed to the extent practicable in accordance with the principles, standards, and procedures established pursuant to the Water Resources Planning Act (42 U.S.C. 1962, et seq.)? (See A.I.D. Handbook 3 for guidelines.) — N/A

7. **Cash Transfer and Sector Assistance** (FY 1993 Appropriations Act Sec. 571(b)): Will cash transfer or nonproject sector assistance be maintained in a separate account and not commingled with other funds (unless such requirements are waived by Congressional notice for nonproject sector assistance)? — Yes

8. **Capital Assistance** (FAA Sec. 611(e)): If project is capital assistance (e.g., construction), and total U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistant Administrator taken into consideration the country's capability to maintain and utilize the project effectively? — N/A

9. **Multiple Country Objectives** (FAA Sec. 601(a)): Information and conclusions on whether projects will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions. — See No. 1

10. **U.S. Private Trade** (FAA Sec. 601(b)): Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

Program will include study tours to the U.S. where contacts with U.S. businessmen will take place.

11. **Local Currencies**

a. **Recipient Contributions** (FAA Secs. 612(b), 636(h)): Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

A host country contribution waiver was approved on June 21, 1993 by the Acting Assistant Administrator for Africa

b. **U.S.-Owned Currency** (FAA Sec. 612(d)): Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?

No

c. **Separate Account** (FY 1993 Appropriations Act Sec. 571). If assistance is furnished to a foreign government under arrangements which result in the generation of local currencies:

(1) Has A.I.D. (a) required that local currencies be deposited in a separate account established by the recipient government, (b) entered into an agreement with that government providing the amount of local currencies to be generated and the terms and conditions under which the currencies so deposited may be utilized, and (c) established by agreement the responsibilities of A.I.D. and that government to monitor and account for deposits into and disbursements from the separate account?

(a-c) No local currency will be generated as the funds will be disbursed from the U.S. Treasury to a separate account established by the GRM in a U.S. bank

(2) Will such local currencies, or an equivalent amount of local currencies, be used only to carry out the purposes of the DA or ESF chapters of the FAA (depending on which chapter is the source of the assistance) or for the administrative requirements of the United States Government? N/A

(3) Has A.I.D. taken all appropriate steps to ensure that the equivalent of local currencies disbursed from the separate account are used for the agreed purposes? N/A

(4) If assistance is terminated to a country, will any unencumbered balances of funds remaining in a separate account be disposed of for purposes agreed to by the recipient government and the United States Government? N/A

12. **Trade Restrictions**

a. **Surplus Commodities** (FY 1993 Appropriations Act Sec. 520(a)): If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity? N/A

b. **Textiles (Lautenberg Amendment)** (FY 1993 Appropriations Act Sec. 520(c)): Will the assistance (except for programs in Caribbean Basin Initiative countries under U.S. Tariff Schedule "Section 807," which allows reduced tariffs on articles assembled abroad from U.S.-made components) be used directly to procure feasibility studies, prefeasibility studies, or project profiles of potential investment in, or to assist the establishment of facilities specifically designed for, the manufacture for export to the United States or to third country markets in direct competition with U.S. exports, of N/A textiles, apparel, footwear, handbags, flat goods (such as wallets or coin purses worn on the person), work gloves or leather wearing apparel?

13. **Tropical Forests** (FY 1991 Appropriations Act Sec. 533(c)(3)(as referenced in section 532(d) of the FY 1993 Appropriations Act): Will funds be used for any program, project or activity which would (a) result in any significant loss of tropical forests, or (b) involve industrial timber extraction in primary tropical forest areas?

NO

14. **PVO Assistance**

a. **Auditing and registration** (FY 1993 Appropriations Act Sec. 536): If assistance is being made available to a PVO, has that organization provided upon timely request any document, file, or record necessary to the auditing requirements of A.I.D., and is the PVO registered with A.I.D.?

N/A

b. **Funding sources** (FY 1993 Appropriations Act, Title II, under heading "Private and Voluntary Organizations"): If assistance is to be made to a United States PVO (other than a cooperative development organization), does it obtain at least 20 percent of its total annual funding for international activities from sources other than the United States Government?

N/A

15. **Project Agreement Documentation** (State Authorization Sec. 139 (as interpreted by conference report)): Has confirmation of the date of signing of the project agreement, including the amount involved, been cabled to State L/T and A.I.D. LEG within 60 days of the agreement's entry into force with respect to the United States, and has the full text of the agreement been pouched to those same offices? (See Handbook 3, Appendix 6G for agreements covered by this provision).

Agreement date not yet set

16. **Metric System** (Omnibus Trade and Competitiveness Act of 1988 Sec. 5164, as interpreted by conference report, amending Metric Conversion Act of 1975 Sec. 2, and as implemented through A.I.D. policy): Does the assistance activity use the metric system of measurement in its procurements, grants, and other business-related activities, except to the extent that such use is impractical or is likely to cause significant inefficiencies or loss of markets to United States firms? Are bulk purchases usually to be made in metric, and are components, subassemblies, and semi-fabricated materials to be specified in metric units when economically available and technically adequate? Will A.I.D. specifications use metric units of measure from the earliest programmatic stages, and from the earliest documentation of the assistance processes (for example, project papers) involving quantifiable measurements (length, area, volume, capacity, mass and weight), through the implementation stage?

YES

17. **Women in Development** (FY 1993 Appropriations Act, Title II, under heading "Women in Development"): Will assistance be designed so that the percentage of women participants will be demonstrably increased?

YES

18. **Regional and Multilateral Assistance** (FAA Sec. 209): Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

Yes. Program is a major part of World Bank Financial sector Project.

19. **Abortions** (FY 1993 Appropriations Act, Title II, under heading "Population, DA," and Sec. 524):

a. Will assistance be made available to any organization or program which, as determined by the President, supports or participates in the management of a program of coercive abortion or involuntary sterilization? NO

b. Will any funds be used to lobby for abortion? NO

20. **Cooperatives** (FAA Sec. 111): Will assistance help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward a better life? YES

21. **U.S.-Owned Foreign Currencies**

a. **Use of currencies** (FAA Secs. 612(b), 636(h); FY 1993 Appropriations Act Secs. 507, 509): Are steps being taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services. YES

b. **Release of currencies** (FAA Sec. 612(d)): Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release? N/A

22. **Procurement**

a. **Small business** (FAA Sec. 602(a)): Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed? YES

b. **U.S. procurement** (FAA Sec. 604(a) as amended by section 597 of the FY 1993 Appropriations Act): Will all procurement be from the U.S., the recipient country, or developing countries except as otherwise determined in accordance with the criteria of this section? YES

c. **Marine insurance** (FAA Sec. 604(d)): If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company? YES

d. **Non-U.S. agricultural procurement** (FAA Sec. 604(e)): If non-U.S. procurement of agricultural commodity or product thereof is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.) N/A

e. **Construction or engineering services** (FAA Sec. 604(g)): Will construction or engineering services be procured from firms of advanced developing countries which are otherwise eligible under Code 941 and which have attained a competitive capability in international markets in one of these areas? (Exception for those countries which receive direct economic assistance under the FAA and permit United States firms to compete for construction or engineering services financed from assistance programs of these countries.) N/A

f. **Cargo preference shipping** (FAA Sec. 603)): Is the shipping excluded from compliance with the requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 percent of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates? NO

g. **Technical assistance** (FAA Sec. 621(a)): If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? Will the YES facilities and resources of other Federal agencies be utilized, when they are particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs? YES

h. **U.S. air carriers** (International Air Transportation Fair Competitive Practices Act, 1974): If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available? YES

i. **Termination for convenience of U.S. Government** (FY 1993 Appropriations Act Sec. 504): If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States? YES

j. **Consulting services** (FY 1993 Appropriations Act Sec. 523): If assistance is for consulting service through procurement contract pursuant to 5 U.S.C. 3109, are contract expenditures a matter of public record and available for public inspection (unless otherwise provided by law or Executive order)? YES

k. **Metric conversion** (Omnibus Trade and Competitiveness Act of 1988, as interpreted by conference report, amending Metric Conversion Act of 1975 Sec. 2, and as implemented through A.I.D. policy): Does the assistance program use the metric system of measurement in its procurements, grants, and other business-related activities, except to the extent that such use is impractical or is likely to cause significant inefficiencies or loss of markets to United States firms? Are bulk purchases usually to be made in metric, and are components, subassemblies, and semi-fabricated materials to be specified in metric units when economically available and technically adequate? Will A.I.D. specifications use metric units of measure from the earliest programmatic stages, and from the earliest YES documentation of the assistance processes (for example, project papers) involving quantifiable measurements (length, area, volume, capacity, mass and weight), through the implementation stage?

l. **Competitive Selection Procedures** (FAA Sec. 601(e)): Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise? YES

23. **Construction**

a. **Capital project** (FAA Sec. 601(d)): If capital (e.g., construction) project, will U.S. engineering and professional services be used? N/A

b. **Construction contract** (FAA Sec. 611(c)): If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable? N/A

c. **Large projects, Congressional approval** (FAA Sec. 620(k)): If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the Congressional Presentation), or does assistance have the express approval of Congress? N/A

24. **U.S. Audit Rights** (FAA Sec. 301(d)): If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights? YES

25. **Communist Assistance** (FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries? YES

26. **Narcotics**

a. **Cash reimbursements** (FAA Sec. 483): Will arrangements preclude use of financing to make reimbursements, in the form of cash payments, to persons whose illicit drug crops are eradicated? N/A

b. **Assistance to narcotics traffickers** (FAA Sec. 487): Will arrangements take "all reasonable steps" to preclude use of financing to or through individuals or entities which we know or have reason to believe have either: (1) been convicted of a violation of any law or regulation of the United States or a foreign country relating to narcotics (or other controlled substances); or (2) been an illicit trafficker in, or otherwise involved in the illicit trafficking of, any such controlled substance? N/A

27. **Expropriation and Land Reform** (FAA Sec. 620(g)): Will assistance preclude use of financing to compensate owners for expropriated or nationalized property, except to compensate foreign nationals in accordance with a land reform program certified by the President? N/A

28. **Police and Prisons** (FAA Sec. 660): Will assistance preclude use of financing to provide training, advice, or any financial support for police, prisons, or other law enforcement forces, except for narcotics programs? N/A

29. **CIA Activities** (FAA Sec. 662): Will assistance preclude use of financing for CIA activities? N/A

30. **Motor Vehicles** (FAA Sec. 636(i)): Will assistance preclude use of financing for purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained? N/A

31. **Military Personnel** (FY 1993 Appropriations Act Sec. 503): Will assistance preclude use of financing to pay pensions, annuities, retirement pay, or adjusted service compensation for prior or current military personnel?

N/A

32. **Payment of U.N. Assessments** (FY 1993 Appropriations Act Sec. 505): Will assistance preclude use of financing to pay U.N. assessments, arrearages or dues?

N/A

33. **Multilateral Organization Lending** (FY 1993 Appropriations Act Sec. 506): Will assistance preclude use of financing to carry out provisions of FAA section 209(d) (transfer of FAA funds to multilateral organizations for lending)?

YES

34. **Export of Nuclear Resources** (FY 1993 Appropriations Act Sec. 510): Will assistance preclude use of financing to finance the export of nuclear equipment, fuel, or technology?

N/A

35. **Repression of Population** (FY 1993 Appropriations Act Sec. 511): Will assistance preclude use of financing for the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?

N/A

36. **Publicity or Propaganda** (FY 1993 Appropriations Act Sec. 516): Will assistance be used for publicity or propaganda purposes designed to support or defeat legislation pending before Congress, to influence in any way the outcome of a political election in the United States, or for any publicity or propaganda purposes not authorized by Congress?

NO

37. **Marine Insurance** (FY 1993 Appropriations Act Sec. 560): Will any A.I.D. contract and solicitation, and subcontract entered into under such contract, include a clause requiring that U.S. marine insurance companies have a fair opportunity to bid for marine insurance when such insurance is necessary or appropriate?

YES

38. **Exchange for Prohibited Act** (FY 1993 Appropriations Act Sec. 565): Will any assistance be provided to any foreign government (including any instrumentality or agency thereof), foreign person, or United States person in exchange for that foreign government or person undertaking any action which is, if carried out by the United States Government, a United States official or employee, expressly prohibited by a provision of United States law?

NO

39. **Commitment of Funds** (FAA Sec. 635(h)): Does a contract or agreement entail a commitment for the expenditure of funds during a period in excess of 5 years from the date of the contract or agreement?

NO

40. **Impact on U.S. Jobs** (FY 1993 Appropriations Act, Sec. 599):

(a) Will any financial incentive be provided to a business located in the U.S. for the purpose of inducing that business to relocate outside the U.S. in a manner that would likely reduce the number of U.S. employees of that business?

NO

(b) Will assistance be provided for the purpose of establishing or developing an export processing zone or designated area in which the country's tax, tariff, labor, environment, and safety laws do not apply? If so, has the President determined and certified that such assistance is not likely to cause a loss of jobs within the U.S.?

NO

(c) Will assistance be provided for a project or activity that contributes to the violation of internationally recognized workers rights, as defined in section 502(a)(4) of the Trade Act of 1974, of workers in the recipient country? NO

B. CRITERIA APPLICABLE TO DEVELOPMENT ASSISTANCE ONLY

1. **Agricultural Exports (Bumpers Amendment)** (FY 1993 Appropriations Act Sec. 521(b), as interpreted by conference report for original enactment): If assistance is for agricultural development activities (specifically, any testing or breeding feasibility study, variety improvement or introduction, consultancy, publication, conference, or training), are such activities: (1) specifically and principally designed to increase agricultural exports by the host country to a country other than the United States, where the export would lead to direct competition in that third country with exports of a similar commodity grown or produced in the United States, and can the activities reasonably be expected to cause substantial injury to U.S. exporters of a similar agricultural commodity; or (2) in support of research that is intended primarily to benefit U.S. producers? N/A

2. **Tied Aid Credits** (FY 1993 Appropriations Act, Title II, under heading "Economic Support Fund"): Will DA funds be used for tied aid credits? NO

3. **Appropriate Technology** (FAA Sec. 107): Is special emphasis placed on use of appropriate technology (defined as relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)? N/A

4. **Indigenous Needs and Resources** (FAA Sec. 281(b)): Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

FMD will augment the capacity of two financial institutions. (the Central Bank and the Caisse d'Epargne de Madagascar) to fulfill their objectives.

5. **Economic Development** (FAA Sec. 101(a)): Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth?

YES

6. **Special Development Emphases** (FAA Secs. 102(b), 113, 281(a)): Describe extent to which activity will: (a) effectively involve the poor in development by extending access to economy at local level, increasing labor-intensive production and the use of appropriate technology, dispersing investment from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using appropriate U.S. institutions; (b) encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries.

FMD through it's two components (CEM and Central Bank) will protect the real value of low-income household's financial savings and offer a position rate of interest on those savings.

7. **Recipient Country Contribution** (FAA Secs. 110, 124(d)): Will the recipient country provide at least 25 percent of the costs of the program, project, or activity with respect to which the assistance is to be furnished (or is the latter cost-sharing requirement being waived for a "relatively least developed" country)?

Same as 11(a) p. 4. A waiver of this requirement has been obtained.

8. **Benefit to Poor Majority** (FAA Sec. 128(b)): If the activity attempts to increase the institutional capabilities of private organizations or the government of the country, or if it attempts to stimulate scientific and technological research, has it been designed and will it be monitored to ensure that the ultimate beneficiaries are the poor majority? YES

9. **Abortions** (FAA Sec. 104(f); FY 1993 Appropriations Act, Title II, under heading "Population, DA," and Sec. 534):

a. Are any of the funds to be used for the performance of abortions as a method of family planning or to motivate or coerce any person to practice abortions? NO

b. Are any of the funds to be used to pay for the performance of involuntary sterilization as a method of family planning or to coerce or provide any financial incentive to any person to undergo sterilizations? NO

c. Are any of the funds to be made available to any organization or program which, as determined by the President, supports or participates in the management of a program of coercive abortion or involuntary sterilization? NO

d. Will funds be made available only to voluntary family planning projects which offer, either directly or through referral to, or information about access to, a broad range of family planning methods and services? N/A

e. In awarding grants for natural family planning, will any applicant be discriminated against because of such applicant's religious or conscientious commitment to offer only natural family planning? N/A

f. Are any of the funds to be used to pay for any biomedical research which relates, in whole or in part, to NO methods of, or the performance of, abortions or involuntary sterilization as a means of family planning?

g. Are any of the funds to be made available to any organization if the President certifies that the use of these funds by such organization would violate any of the above provisions related to abortions and involuntary sterilization?

NO

10. **Contract Awards** (FAA Sec. 601(e)): Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?

YES

11. **Disadvantaged Enterprises** (FY 1993 Appropriations Act Sec. 563): What portion of the funds will be available only for activities of economically and socially disadvantaged enterprises, historically black colleges and universities, colleges and universities having a student body in which more than 40 percent of the students are Hispanic Americans, and private and voluntary organizations which are controlled by individuals who are black Americans, Hispanic Americans, or Native Americans, or who are economically or socially disadvantaged (including women)?

At least 10 percent of the technical assistance will be set-aside for monitories of Gray Amendment entities

12. **Biological Diversity** (FAA Sec. 119(g): Will the assistance: (a) support training and education efforts which improve the capacity of recipient countries to prevent loss of biological diversity; (b) be provided under a long-term agreement in which the recipient country agrees to protect ecosystems or other wildlife habitats; (c) support efforts to identify and survey ecosystems in recipient countries worthy of protection; or (d) by any direct or indirect means significantly degrade national parks or similar protected areas

(a) N/A

(b) N/A

(c) N/A

(d) N/A

13. **Tropical Forests** (FAA Sec. 118; FY 1991 Appropriations Act Sec. 533(c) as referenced in section 532(d) of the FY 1993 Appropriations Act):

a. **A.I.D. Regulation 16:** Does the assistance comply with the environmental procedures set forth in A.I.D. Regulation 16?

N/A

b. **Conservation:** Does the assistance place a high priority on conservation and sustainable management of tropical forests? Specifically, does the assistance, to the fullest extent feasible: (1) stress the importance of conserving and sustainably managing forest resources; (2) support activities which offer employment and income alternatives to those who otherwise would cause destruction and loss of forests, and help countries identify and implement alternatives to colonizing forested areas; (3) support training programs, educational efforts, and the establishment or strengthening of institutions to improve forest management; (4) help end destructive slash-and-burn agriculture by supporting stable and productive farming practices; (5) help conserve forests which have not yet been degraded by helping to increase production on lands already cleared or degraded; (6) conserve forested watersheds and rehabilitate those which have been deforested; (7) support training, research, and other actions which lead to sustainable and more environmentally sound practices for timber harvesting, removal, and processing; (8) support research to expand knowledge of tropical forests and identify alternatives which will prevent forest destruction, loss, or degradation; (9) conserve biological diversity in forest areas by supporting efforts to identify, establish, and maintain a representative network of protected tropical forest ecosystems on a worldwide basis, by making the establishment of protected areas a condition of support for activities involving forest clearance or degradation,

(1 - 13) N/A

and by helping to identify tropical forest ecosystems and species in need of protection and establish and maintain appropriate protected areas; (10) seek to increase the awareness of U.S. Government agencies and other donors of the immediate and long-term value of tropical forests; (11) utilize the resources and abilities of all relevant U.S. government agencies; (12) be based upon careful analysis of the alternatives available to achieve the best sustainable use of the land; and (13) take full account of the environmental impacts of the proposed activities on biological diversity?

c. **Forest degradation:** Will assistance be used for: (1) the procurement or use of logging equipment, unless an environmental assessment indicates that all timber harvesting operations involved will be conducted in an environmentally sound manner and that the proposed activity will produce positive economic benefits and sustainable forest management systems; (2) actions which will significantly degrade national parks or similar protected areas which contain tropical forests, or introduce exotic plants or animals into such areas; (3) activities which would result in the conversion of forest lands to the rearing of livestock; (4) the construction, upgrading, or maintenance of roads (including temporary haul roads for logging or other extractive industries) which pass through relatively undergraded forest lands; (5) the colonization of forest lands; or (6) the construction of dams or other water control structures which flood relatively undergraded forest lands, unless with respect to each such activity an environmental assessment indicates that the activity will contribute significantly and directly to improving the livelihood of the rural poor and will be conducted in an environmentally sound manner which supports sustainable development?

(1 - 6) NO

d. **Sustainable forestry:** If assistance relates to tropical forests, will project assist countries in developing a systematic analysis of the appropriate use of their total tropical forest resources, with the goal of developing a national program for sustainable forestry?

N/A

e. **Environmental impact statements:** Will funds be made available in accordance with provisions of FAA Section 117(c) and applicable A.I.D. regulations requiring an environmental impact statement for activities significantly affecting the environment?

N/A

14. **Energy** (FY 1991 Appropriations Act Sec. 533(c) as referenced in section 532(d) of the FY 1993 Appropriations Act): If assistance relates to energy, will such assistance focus on: (a) end-use energy efficiency, least-cost energy planning, and renewable energy resources, and (b) the key countries where assistance would have the greatest impact on reducing emissions from greenhouse gases?

N/A

15. **Debt-for-Nature Exchange** (FAA Sec. 463): If project will finance a debt-for-nature exchange, describe how the exchange will support protection of: (a) the world's oceans and atmosphere, (b) animal and plant species, and (c) parks and reserves; or describe how the exchange will promote: (d) natural resource management, (e) local conservation programs, (f) conservation training programs, (g) public commitment to conservation, (h) land and ecosystem management, and (i) regenerative approaches in farming, forestry, fishing, and watershed management.

(a - i) N/A

16. **Deobligation/Reobligation** (FY 1993 Appropriations Act Sec. 515): If deob/reob authority is sought to be exercised in the provision of DA assistance, are the funds being obligated for the same general purpose, and for countries within the same region as

N/A

originally obligated, and have the House and Senate Appropriations Committees been properly notified?

17. **Loans**

a. **Repayment capacity** (FAA Sec. 122(b)): Information and conclusion on capacity of the country to repay the loan at a reasonable rate of interest.

N/A

b. **Long-range plans** (FAA Sec. 122(b)): Does the activity give reasonable promise of assisting long-range plans and programs designed to develop economic resources and increase productive capacities?

N/A

c. **Interest rate** (FAA Sec. 122(b)): If development loan is repayable in dollars, is interest rate at least 2 percent per annum during a grace period which is not to exceed ten years, and at least 3 percent per annum thereafter?

N/A

d. **Exports to United States** (FAA Sec. 620(d)): If assistance is for any productive enterprise which will compete with U.S. enterprises, is there an agreement by the recipient country to prevent export to the U.S. of more than 20 percent of the enterprise's annual production during the life of the loan, or has the requirement to enter into such an agreement been waived by the President because of a national security interest?

N/A

18. **Development Objectives** (FAA Secs. 102(a), 111, 113, 281(a)): Extent to which activity will: (1) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (2) help develop cooperatives, especially by technical

(1 - 5) same as B6 (p. 16)

assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (3) support the self-help efforts of developing countries; (4) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (5) utilize and encourage regional cooperation by developing countries?

19. **Agriculture, Rural Development and Nutrition,** and **Agricultural Research** (FAA Secs. 103 and 103A):

a. **Rural poor and small farmers:** If assistance is being made available for agriculture, rural development or nutrition, describe extent to which activity is specifically designed to increase productivity and income of rural poor; or if assistance is being made available for agricultural research, has account been taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made. N/A

b. **Nutrition:** Describe extent to which assistance is used in coordination with efforts carried out under FAA Section 104 (Population and Health) to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people. N/A

c. **Food security:** Describe extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the N/A poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

20. **Population and Health** (FAA Secs. 104(b) and (c)): If assistance is being made available for population or health activities, describe extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

N/A

21. **Education and Human Resources Development** (FAA Sec. 105): If assistance is being made available for education, public administration, or human resource development, describe (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

FMD will provide assistance for human resource development for Central Bank staff and Caisse d'Epargne staff. The program will provide limited commodities such as audio-visual equipment, short-term technical assistance to develop personnel policies and implementation strategies and short-term training in the form of English training, study-tours, and seminars both abroad and in-country

22. **Energy, Private Voluntary Organizations, and Selected Development Activities** (FAA Sec. 106): If assistance is being made available for energy, private voluntary organizations, and selected development problems, describe extent to which activity is:

a. concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and facilitative of

N/A

research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

b. concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations; N/A

c. research into, and evaluation of, economic development processes and techniques; N/A

d. reconstruction after natural or manmade disaster and programs of disaster preparedness; N/A

e. for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance; N/A

f. for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development. N/A

23. **Capital Projects** (Jobs Through Export Act of 1992, Secs. 303 and 306(d)): If assistance is being provided for a capital project, is the project developmentally sound and will the project measurably alleviate the worst manifestations of poverty or directly promote environmental safety and sustainability at the community level? N/A

CRITERIA APPLICABLE TO ECONOMIC SUPPORT FUNDS ONLY

1. **Economic and Political Stability** (FAA Sec. 531(a)): Will this assistance promote economic and political stability?