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International Science and Technology Institute, Inc.

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MADAGASCAR

ASSESSMENT OF THE CLIMATE

FOR

PRIVATE SECTOR DEVELOPMENT AND INVESTMENT

Prepared for:

Office of Private Enterprise
Bureau for Africa
Agency for International Development
(Contract No. PDC-1406-28-3083-00)

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October 1985

PREFACE

This report describes the findings of a two-man team sent to Madagascar in April 1985 to assess the climate for private sector development and to suggest a program for investment promotion. The team was sent at the request of the AID mission in Antananarivo by the Office for Private Enterprise of the Africa Bureau (AFR/PRE).

Recent economic and political developments in Madagascar made it suitable for this effort. Madagascar has determinedly turned back from extreme statism, and has adhered firmly to agreements made with the IMF and lender consortia to improve its financial situation. On the other hand, it appears stuck politically, unable to make the additional moves towards complete liberalization of the economy.

The team was organized by International Science and Technology Institute Inc. under sub-contract to AID/AFR/PRE. It consisted of Peter Glenshaw and David Harmon, independent businessmen with considerable experience in development and in Africa. The team was supported by Richard Huntington, an anthropologist with 10 years field and other experience in Madagascar and by a private Malagasy consulting firm headed by Madeleine Ramaholimihaso which is a leader in advising businesses in Madagascar. The team interviewed numerous people in Washington who deal currently with Madagascar before traveling there via Paris. Working closely with US Embassy and AID Mission staff, the team made many interviews with public officials and private citizens in Madagascar and made two brief field trips. This work was conducted from March to May 1985. In July 1985 Peter Glenshaw returned to Madagascar mostly for other purposes but made some follow-up calls on the topic of this report. The team is grateful to the many people who cooperated with it and especially the embassy staff who arranged appointments and transportation.

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SUMMARY

Madagascar's economic and political climate is generally bleak for attracting new private investment. Oil exploration, where prospects are good for finding good, profitable deposits and where private US companies plan to spend over $100 million in the near future, and road repair, where the international development agencies have pledged about $200 million, are two bright spots. To a lesser extent, rice cultivation, transportation and distribution holds some promise as the government releases its previous monopolies and relaxes price controls. Textiles could also shine as they are produced in world class mills and compete effectively on world markets. However, the heavy involvement of government in the textile companies is dampening expansion. For the rest, private investment prospects are not encouraging, and investors - both Malagasy and foreign - have adopted a wait-and-see attitude and are doing little more than consider some rehabilitation projects.

These are the chief findings of an assessment team sent to Madagascar in April 1985 by the Office for Private Enterprise of the Africa Bureau of the US Agency for International Development. Peter Glenshaw and David Harmon, independent businessmen with considerable experience in development and Africa, found that despite its enormous potential, Madagascar lies mostly undeveloped, its transportation infrastructure has deteriorated, and the government sits in a quandary with no clear plans for the future.

Madagascar is a huge, under-populated country. Its 10 million people occupy a territory as large as the Eastern seaboard of the USA. It has climate and soils resources that could make it enormously productive. The diligence of its Malay-African people made it a wealthy, independent nation of high culture as little as 100 years ago. Forced colonial domination for over 70 years followed by a decade of neo-colonialist laissez faire left the vast part of the population uncared for and in poverty. A violent overthrow of the government in 1975 attempted to correct the situation by enforcing state-controlled socialism, but left the country in even worse shape as private enterprise stopped and inexperienced officials tried to take its place. In the early 80s the government began a move away from ultra-marxist ideals, accepted the tough prescriptions of the IMF and the "Paris Club" to get its finances in order, and made very acceptable deals with US and Italian companies to drill for oil.

The encouraging moves have now stopped. The government appears reluctant to go further for fear of upsetting vested interests in the bureaucracy and the parastatals which are about its only remaining support. The population at large is in worse poverty than before, and social order is breaking down. There is increasing theft, lawlessness, corruption and public drunkenness - all of which are alien to Malagasy culture. The professional and entrepreneurial class is disaffected and discouraged after many thwarted attempts to deal with the government. Unless there is some positive movement, the political situation could become suddenly unstable and violent, as it has at similar times in the past.

Despite the gloomy atmosphere, the US government has a number of options open to it to ameliorate the situation without the need for much additional financial or personnel resources. Most important would be advancing the agreement with the Malagasy government that it will enhance private sector development by using a significant portion of the nearly $40 million equivalent of local currency counterpart funds that are now accumulating as a result of PL 480 Food-for-Peace programs, under which large quantities of rice are being shipped.

The ideal development would be to use these funds to establish a new privately-owned financial institution, to provide badly needed loans and equity financing for private sector projects. The new institution would also assist Malagasy entrepreneurs with project preparation which is not done well now. If the institution could be run along open, straight-forward, American investment-banking lines possibly with US part-ownership and management assistance, it would go far to counteract current banking practice which is secretive, unclear, and often politically motivated.

As the development of such an ideal institution is likely to take years, it will be necessary to set up interim measures to deal case-by-case with projects that can use the counterpart funds. One way would be for the AID office in Antantanarivo, working with local and US consultants, to assist sponsors to bring their projects to the "bankable" stage and to use the local banks as vehicles for disbursing the funds. These mechanisms could be the basis on which to build a viable, private, investment promotion and financing institution. Consultants are now being recruited to assist in setting up these systems.

With the new investment institution as a centerpiece, fruitful policy dialogue between the US government representatives and Malagasy officials is likely to develop. Future discussions might include offers of technical assistance for managing the road repair program, examining and promoting the underlying demand for consumer goods, and for moth-balling unproductive state-owned enterprises. In the meantime, simple steps like pointing to recent US experience in dealing with political dilemmas similar to those now looming in Madagascar, encouraging private Malagasy businessmen to come forward with ideas and suggestions, and arranging informal social gatherings where they and government officials can meet will do much to dispel the gloom. The injection of a degree of hope is badly needed to help this shattered country regain a sense of itself, and so begin its path back to former greatness.

I GOVERNMENT POLICIES, REGULATIONS, AND PROCEDURES

Government policies, regulations and procedures are described in detail in Annex 1 and summarized below.

Political Stability and Risk

Madagascar has been politically stable for the past decade and is not, nor likely to be, involved in any regional disputes. On the other hand, current political stagnation and growing social deterioration could lead as it has in the past to sudden, violent unrest; but with determination, political change could be orderly.

Based on its abundant natural resources and industriousness of its people, Madagascar had developed a unified, self-supporting, political economy in the last century with high standards of living and cultural achievement, especially for the dominant Merina and Betsileo people of the high plateau. High standards continued under French colonial domination and the initial years of independence in the early 60s, but the formal economy began to turn away from meeting the needs of the growing population and moved to the export of agricultural products, and sophisticated financial dealings among the elite based on real estate.

In 1972, social tensions resulted in a violent change in government, and the economy was forcibly redirected along socialist lines in an attempt to do away with the excesses of the colonial era. New private investment ceased because of heavy and often unwise involvement of the state in the economy. Coming at a time of deteriorating terms of trade for developing countries, this in turn has led to the current sluggish and erratic performance of the economy.

That the failed experiment with radical socialism needs to be terminated and changed to a more liberal approach is widely recognized, but the political problems of doing so are immense and are the basis for the present stagnation.

If political change moved seriously in a direction of a more liberalized economy, small and medium sized enterprises and the professions would gain, and the few larger businesses and the para-public sector would suffer as their privileged positions was eroded. "The government is stuck; it doesn't want to shoot its own golden geese." (Malagasy small businessman)

National Development Plan

The "Charter of the Malagasy Socialist Revolution" outlines a planned economy for Madagascar. In conjunction with this charter, in December 1977, a first development plan, covering the period 1978 - 1980, was published. At the same time, a long term "global" socialist planning strategy was published. This strategy foresaw three stages of development, viz:

- 1978 - 1984: setting the foundations of development
- 1985 - 1992: consolidating the economy
- 1992 - on : economic expansion

The development plans call for 75% of all growth to be by socialist enterprises and cooperatives. All strategic sectors, including banking, insurance, energy, mining, shipbuilding, pharmaceuticals, education and film distribution are reserved for the state. The government has also intervened heavily in other sectors of the economy and now dominates export/import trade, and textiles. Recently there has been some move away from this excessive involvement as the government is relinquishing its monopolies in rice marketing and trucking.

Business Formation and Investment

Business formation and regulation is complex, fraught with a plethora of petty and unclear regulations, and subject to the whims of many minor officials. Thus, even though there are few prohibitions on such things as degree of foreign ownership, access to investment incentives, or location and form of business, the heavy hand of government has all but squashed new business development. Only two or three new applications have been received per year since the previous investment code was promulgated in 1975.

A new investment code (Law No. 85-001) was promulgated by the National Assembly on June 18, 1985. The major changes from the previous code are:

The role of private enterprise in Madagascar is somewhat clarified and more clearly stated.

Equal treatment to all businesses is guaranteed.

Automatic access to Investment Code advantages is guaranteed provided applicants meet the criteria of the Code.

Although the business community is pleased that the new code was eventually passed after going through three drafts since 1982, there continues to be scepticism about the real intentions of the Government. "We must wait to see the regulations (which will describe the detailed working of the code) before we can be sure." (Malagasy businessman)

International Remittances

Private remittances are in arrears or blocked because of severe shortages of foreign exchange brought on by high debt service for unwise industrial facilities purchased recently by the government which are largely idle, falling export receipts, and high imports of necessities like rice, petroleum, spare parts and inputs. Exporters are allowed to retain some part of their foreign earnings to import needed spare parts and inputs, but other importers apply on a case-by-case basis for available foreign exchange. "Parastatals get the lion's share of available foreign currency". (Malagasy entrepreneur)

Madagascar has a single, floating exchange rate based on the daily, average value of a basket of ten hard currencies.[1] There is a small but extremely clandestine black market in foreign exchange where the premium is 100 - 300% above the official rate.

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[1]The exchange rate in June 1985 was US$1 = 650 Fmg.

International Trade Restrictions

Imports are seriously impeded by lack of foreign exchange, by absolute prohibitions, and by high tariffs. Exports are weak because inefficient government monopolies control the major exports and excessive regulation inhibits other exporters. There have been two modest moves to improve exports. Most export taxes were canceled and the export of "pois du cap" (butter beans) was returned to the private sector, with great subsequent success.

International Agreements

Madagascar is a member of GATT, Unctad, Lome III, Preferential Trade Area of East Africa, GSP (Japan and the U.S.) and has trade agreements with various countries, e.g., U.S., West Germany, Japan, France, U.S.S.R. and Norway.

It has programs with OPIC and bilateral investment agreements with France and Germany, and is a member of WIPO.

Taxes

The corporate tax rate on income is 45% (67.5% for companies with a foreign headquarters). There are non-recurrent taxes on initial capitalization, transfer of shares and real property ranging from 2 - 16%. There is a transaction tax on value added of 15%, and a consumption tax ranging from 5 - 20% on 30 broad categories of products. Personal income tax reaches a maximum of 60% at relatively low salaries.

Taxes are applied consistently and at the same rates for companies regardless of sector, but are regarded as high enough to be avoided whereever possible.

"Cash and barter deals are becoming more and more prevalent". (Malagasy exporter)

Investment Incentives

Under the current Investment Code, there are three preference systems for:

Authorized Companies which for five years receive:

(a) Total or partial exemption from import duties

(b) Reduction in corporate income tax (Amount and rate not specified)

(c) Deduction allowed in calculating corporate income tax for capital investments

(d) Priority for foreign exchange allocations and funds transfer.

Small and Medium Sized Companies:

Same advantages as in 1.

Participation Contracts

Negotiated between the government and a foreign company. This system is reserved for activities that the government considers critical, but is unable to carry out itself, such as mining and petroleum exploration.

To be eligible for the Investment Code advantages, companies must meet the following criteria:

(a) Creation of employment, and employment of as many Malagasy as possible, especially in management.

(b) Add value to national resources.

(c) Promotion of economically undeveloped regions.

(d) Meet local needs.

(e) Contribute foreign currency.

Labor Laws

On January 1, 1984, the minimum wage was raised for the first time since 1963 to 17911 FMG/month ($27.50 at current exchange rates.)

Larger private sector employers generally pay up to twice, and certain parastatals 50% more than the government to get and keep qualified senior employees.

Fringe benefits are outlined in general terms in the Labor Code. They cover lodging and meal expenses of employees traveling on business, maternity leave and benefits, paid holidays, paid vacations, educational allowances for employees, and medical benefits.

The setting for labor-management relations is one of severe economic problems, high unemployment, low wages and inflation, coupled with a government policy to brook no protests, and no collective bargaining. Government has therefore held down wages for public sector employees, and has laid off some 2,000 workers in 12 enterprises deemed to be in serious trouble. Work slowdowns have been reported.

Labor-management relations in the private sector are better than in the public sector. High unemployment and higher wages tend to keep employees loyal, and the need to retain capable employees ensures that businesses will keep conditions acceptable.

Salaried foreigners can be employed only with the authorization of the Ministry of Civil Service, Labor, and Social Law. One of the principal requirements to obtain preferential treatment under the Investment Code is that the applicant employ Malagasy to the greatest extent possible, especially in management positions. There are limits on the transfer of expatriate salaries.

Government Controls and Interference

Government controls and interference in business are rife, through its ownership of key sectors, its dominance in access to scarce financial, human and natural resources, and its excessive controls and regulations. Price controls were severely imposed on most goods until recently, but there has been an interesting relaxation since Christmas 1984 of control of the black market for consumer goods. It is too early to judge whether this means that the government intends to move away from the past excessive control or whether by inadvertence - by the government doing nothing - the private sector may be able to reassert itself.

Government interference in business is seen in the formal monopolies it has in utilities, communications and other activities reserved for the State; the monopolies that have arisen through the issuance of import licenses only to one company or individual for a given product, such as tires; the state monopolies which exist for the export of coffee and cloves which is handled by four state companies;.and in the distribution of sugar.

Nationalizations and the threat of nationalization inhibit entrepreneurs following government take-over of the most important import-export houses, all banks, all insurance companies, and the sugar companies. Various areas of business activity are effectively preempted by the State's policy of "vital investments" under which the government negotiated turn-key contracts with foreign firms to build plants for fertilizer, cement, soybean processing, leather tanning, lime production, flour milling and the manufacture of pharamaceuticals. Various consulting and service companies have been established by the State as "socialist enterprises", in the areas of civil engineering, data processing, agriculture, freight forwarding and auditing.

The government has also established an auditing enterprise which competes with private sector firms. The Madagascar Association of Accountants has raised the question of the independence (and objectivity) of the government auditing enterprise - since it audits government and quasi-government organizations.

Government and parastatal tenders legally are supposed to be handled by a market commission with equal opportunity for all qualified bidders. The legalities are rarely respected by government organizations and individual deals are the rule.

The government, if it so wishes, can designate foreign suppliers for firms which wish to import.

There are major parastatal organizations in agriculture (sugar, coffee and cloves processing and marketing, two large rice producers) forestry, energy, mining, manufacturing (textiles, food processing, printing, cement, leather, paper, chemicals, TV and radio production, and production of rum), transportation and public works, telecommunications, banking and insurance, export/import, tourism and business services.

"The government simply dominates our economy - you can't move without meeting it at all times." (Malagasy consultant)

Banking and Credit Policies and Regulations

The banking sector is comprised of three State banks: the Bank for Agriculture (BTM), the National Bank for Industry (BNI) and the National Bank for Trade (BFV). Each bank is supposed to concentrate its efforts on its designated sector and to lend outside its sector only on a co-financing basis with the lead bank. In fact, all three banks compete with one another for loans and deposits.

To date, there is no cohesive banking or credit policy stating priorities as to economic sectors, private vs. public, size of business, or types of business to be encouraged. There is little available information on the interest rate structure. Credit is limited, and State owned enterprises are absorbing more than 50% of what credit there is. "The banks are not there to help us. They are there to write checks for the parastatals." (Malagasy businessman)

Availability of Business Advisory and Promotional Services

There are a variety of organizations in the public sector which offer technical advice to businesses as either a major or minor part of their activities. They include:

Industrial Development Study and Implementation Company (SERDI). Does management and engineering consulting on contract for government and business, and maintains an industrial data base. Carries out feasibility, engineering and marketing studies, as well as technical and diagnostic evaluation for existing companies. Handles approximately twenty contracts per year and is solvent.

National Institute for Training Promotion (INPF). Does training as well as diagnostic, market, financial, internal communications and technical layout studies. Regarded as fairly competent.

Malagasy Institute for Innovation (IMI). Researches appropriate technology for rural activities and regions. Prepares technological models of development adapted to the "socialist environment". Has an information system to locate the most favorable foreign sources of supply, and to find potentially lucrative markets for Malagasy innovations. Not regarded as effective.

National Investment Fund (FNI). Invests in and helps implement certain key public projects and enterprises. Also provides technical advisory services to these enterprises. Recently launched and struggling with a large case load.

National Center for Malagasy Artisans (CENAM). Runs workshops and rural technical centers. Gives technical and management assistance. Helps artisans or artisinal firms negotiate with the banks. Well regarded.

The Ministry of Industry, Energy and Mines. Offers some technical advice while working with existing firms. Competent but limited.The government has also established certain "socialist enterprises" as consulting firms and study bureaus:

DINIKA - civil engineering
MAMOKATRA - agriculture
STIM - data processing
TRANS 7 - freight forwarding
RINDRA - auditing of "socialist enterprises"

The private sector has a limited amount of business advisory services in auditing, accounting, tax, legal, regulatory, and management consulting services. In addition, organizations such as the Council for the Promotion of Small and Medium Sized Enterprises, the Chamber of Commerce, Rotary, Lions, Association of Malagasy Private Enterprises (GEM), and The Association of Malagasy Businessmen (Fiv. Mpa. Ma.) offer member-to-member assistance.

There are three principal sources of public economic information - The National Institute of Statistics and Economic Research (INSRE), the Central Bank (I.P. bulletin) and the annual reports of the three State banks. INSRE's information is often out-of-date and incomplete, the Central Bank bulletin has not been published for a number of years, but the banks' annual reports are concise and useful.

The only activity in the area of investment and trade promotion programs has been the International Trade Center's missions to prospect markets in six major importing countries (1981-82) and to Indian Ocean countries (1983). A project to establish a market information center within the Ministry of Commerce has been formulated. No major successes can be attributed to these efforts.

Government dominance of the business services area is another example of its all pervasive role.

Summary

In summary, of the eleven factors relating to government policies, regulations and procedures, the team found that only four were regarded as favorable for encouraging private sector development, and then only to a very minor extent. The other eight factors were regarded as being unfavorable and of major or moderate importance. As Table 1 indicates, the business community in Madagascar considers the climate of government policies, regulations and procedures to be quite unfavorable to its development.

In addition to these specific factors, Malagasy businesspeople identified a number of other elements that mitigate against private sector development. Briefly put, these are:

1. Lack of political direction, caused by fear of upsetting vested interests, fear of takeover by more powerful groups, pervasive corruption, and lack of trust in the government.

2. The shortage of financial resources, including risk capital, ordinary credit, and foreign exchange.

3. Excessive and incompetent involvement of the government in all sectors, and at all levels of the Malagasy economy.

4. Over-emphasis on the external economy, caused by the excessive attention being paid to meeting debt service requirements. Little is being done to systematically decrease imports, increase exports, or pay attention to developing the internal market.

5. Poor physical and informational infrastructure in which the highway system is badly deteriorated, railroads are overloaded, airline connections are over-booked, and telecommunications are unreliable. Credible official information is not available, and plans and ideas are not discussed openly.

6. Cultural and human resource inadequacies which have led to a production mentality which ignores the need to develop markets, and a lack of entrepreneurial ability, despite clear evidence of considerable entrepreneurial spirit.

These factors are discussed more fully in Annex 2.

Table 1

RELATIVE IMPORTANCE GIVEN BY BUSINESS EXECUTIVES TO GOVERNMENT POLICIES, REGULATIONS AND PROCEDURES IN ENCOURAGING PRIVATE SECTOR DEVELOPMENT IN MADAGASCAR

Factors	Considered as Favorable			Considered as Unfavorable		
	Degree of Importance			Degree of Importance		
	Major	Moderate	Minor	Major	Moderate	Minor
Political Stability & Risk			X			
National Development Priorities				X		
Business Formation Regulations				X		
International Remittances				X		
International Trade Policies					X	
Taxes					X	
Investment Incentives			X			
Labor Laws		X				
Government Controls				X		
Banking and Credit				X		
Business Advisory Services			X			

Source: ISTI Inc., based on results of interviews in Madagascar April and July 1985.

II BASIC ECONOMIC AND MARKET FACTORS

Economic and Market Stability and Growth Prospects

Economic activity has declined markedly in the past decade in Madagascar and is now sluggish and erratic. Excessive involvement of ill-equipped state enterprises, the global downturn in terms of trade for developing countries, and over-investment in unwise industrial plants which are now idle, but which have created large debt obligations are the chief factors behind this decline.

1981 and 1982 saw a 10.4% decline in real domestic product, while 1983 registered only a 0.8% gain. Balance of payments difficulties caused shortages of inputs and a concomitant drop in industrial production, and this decline coupled with a major cut back in capital investment reduced commercial and transportation activities.

The multitude of serious economic and policy problems facing Madagascar today does not portend well for economic growth in the short term. Market growth in the export sector is not particularly promising. The internal market, however, if allowed and encouraged to flourish, could be promising in the longer term.

Four-fifths of its population of 10 million, which is growing at 2.8% per year, lives in the rural areas, and nearly 90% of the workforce of just under 5 million is occupied with agriculture. Life expectancy is below 50 years reflecting the current low standard of living, often eked out of subsistence agriculture. Young people less than 20 years old make up the majority of the population.

The GNP is about $3 billion ($300 per capita), but external debt is $1.5 billion, international reserves are zero, and the trade balance in 1983 showed a deficit of $333 million. The narrow business base where industry accounts for only 16% of GDP, and over-dependence on exports of coffee, cloves and other agricultural products which are over-supplied on world and regional markets (they make up 88% of exports) make it unlikely that Madagascar's economy will improve soon.

Following are each sector's share of gross domestic product (1982) and projected shares for 1985 and 1990:

	1982	1985	1990
Agriculture	41.1%	41.6%	42.0%
Industry	15.0	15.4	16.5
Services	43.9	43.0	41.5

Exports are largely agricultural. The principal exports, ranked by value in 1982, are: coffee, cloves, vanilla, sisal, fish, cotton thread and fabric, sugar and pepper.

The mineral sector - excluding re-exports of refined oil products - represents only 3.4% of export revenue. Moreover, Madagascar suffers from either having those natural resources which many other countries have in abundance (e.g., bauxite, iron, coal), or those for which world demand is stagnant (e.g., chromium, uranium, graphite) or is being met by synthetics (e.g., mica).

Madagascar's neighboring countries in the Indian Ocean account for only about 4% of its exports. The closest countries, the island groups, are small markets by virtue of their relatively small populations.

In world markets for her principal export crops, Madagascar faces slow growth or stagnant demand, as well as increased competition from the major producers of coffee and spices. Madagascar's competitive position is weakened due to counterproductive agricultural policies, deteriorating infrastructure, a lack of adequate market understanding and promotion, and an inadequate mobilization of private sector resources.

At present, Madagascar has two, small cash markets. Internally, approximately 500,000 (5% of her 10,000,000 population) are in the cash economy. Externally, it has small, neighboring Indian Ocean market of nearly 2 million.

The proportion of population in the cash economies of Mauritius, Reunion and the Seychelles is larger than Madagascar due to greater economic development and the growth of tourism.

Madagascar's internal market, given the appropriate policy changes and incentives to the private sector, has potential. First, the rural sector, brought back into the money economy, is the major long term market - principally for consumer goods and agricultural inputs. Shorter term, the current annual 5% growth in urban population means an expanding urban market in the cash economy. By 2000, this market will number slightly over 1,000,000 people. These people will be buying principally consumer goods, housing and services.

Production Resources and Services

These are described in detail in Annex 3. Further indications of the strengths and weaknesses of business potential in Madagascar is found in the following section of the report which summarises that potential and in Annex 4 which describes prospects for the private sector to realise this potential for the 50 main sub-sectors of the economy. Therefore this section will only briefly examine the factors relating to production resources and services. Table 2 summarises the importance of the various favorable and unfavorable factors.

Basic materials and parts are difficult to obtain due to the shortages of foreign exchange needed to import them. Priority in foreign exchange allocation is being given now to importing spare parts and maintenance supplies to rebuild and rehabilitate the deteriorated industrial and infrastructure facilities.

Infrastructure is poor and inadequate in all aspects of transport - road, rail, air and ports, barely able to cope in internal telecommunications, excellent in electricity supply in the area around the capital - but poor and inadequate throughout the rest of the country, and adequate in water supply. Initial steps are being taken to repair the roads.

Local credit and capital is in very short supply due to the restrictions on money growth resulting from the IMF-induced austerity programs. Interest rates and other terms are ill defined, and often exorbitant for private sector borrowers. All banking is tightly controlled by the government and directed primarily at supporting the many weak parastatal organizations. External agencies - including AID - are urging the government to loosen its grip on the banks to let them be more responsive to the private sector, and are offering financial inducements.

Business services are available in the sense that there are willing suppliers, but in practice, as they also suffer from the overall malaise of the economy, they are often unable to supply their services because of lack of resources.

Entrepreneurial and managerial talent is generally lacking especially as the past decade of socialism has not allowed Malagasy businesspeople to obtain the experience of practicing business. On the other hand, there is no lack of entrepreneurial drive and spirit, and with minimum training this could blossom - if the opportunities were available.

Skilled labor is available to some extent as there are many teaching and training institutes, and Malagasy people are naturally diligent, industrious, and quick to learn. They too lack adequate experience due to the lack of operating facilities.

Non-skilled labor is plentiful and there are plenty of eager, capable work-seekers. Labor unrest is infrequent, and turnover and absenteeism are low.

Other facilities are poor and inadequate. Fire and police services have few resources and are slow to respond. Expatriate housing is available but costly. Basic food items are available from the local market in good quality and plentiful supplies. Household goods are mainly imported. Medical services are not of high quality.

Corruption is rife, and the sanctity of contracts is questionable, with inadequate protection from the law.

Table 2 summarises the findings of the team based on interviews with both government and business leaders in Madagascar.

Table 2

RELATIVE IMPORTANCE GIVEN BY BUSINESS EXECUTIVES TO ECONOMIC AND MARKET FACTORS IN ENCOURAGING PRIVATE SECTOR DEVELOPMENT IN MADAGASCAR

Factors	Considered as Favorable Degree of Importance			Considered as Unfavorable Degree of Importance		
	Major	Moderate	Minor	Major	Moderate	Minor
Size of Market and Growth Prospects	X					
Basic Materials and Parts				X		
Infrastructure				X		
Credit and Capital				X		
Business Services					X	
Entrepreneurial Talent					X	
Management and Technical Personnel					X	
Skilled Workers					X	
Unskilled Workers		X				
Other Services					X	
Corruption, Contracts				X		

Source: ISTI Inc., based on results of interviews in Madagascar April and July 1985.

III INVESTMENT PROMOTION PROGRAM RECOMMENDATIONS

A. Economic and Industrial Potential

Madagascar has enormous economic potential, and every possibility of recreating the once thriving and self-supporting nation it was a hundred or more years ago. The potential does not lie in stressing exports, because there is nothing that Madagascar has in the way of natural resources, nor in the way of special skills that would give it advantage over the myriad of other exporters. Only the industrial countries are importers of any significance now, and they are satiated. Only when the developing countries themselves increase their economic activity will the global demand for goods increase. Until then, exports of any one country can increase only at the expense of a decrease in the exports of another.

Madagascar's future economic potential lies in turning inward to meet the needs of its own people. It has the basic land and climate resources to develop agriculture and forestry to feed, clothe, and house its people. It has sufficient mineral wealth to provide its basic building requirements, and the clear potential to become at least self-sufficient in energy supplies. Its people are adept, trainable, and eager to work hard to improve their living standards.

The prospects for the private sector to help realize this potential is described in Annex 4 for the 50 main sub-sectors of the economy. The areas with the greatest immediate potential are summarized below. The areas of least potential are those where the government is likely to remain the chief participant, such as coffee and cloves production and export; those where there are poor economic prospects, like tarsands and heavy oil production; and those which have both excessive government involvement and poor economic prospects, like the operation of the refinery and chrome mine.

The most promising sub-sector is oil exploration, and hopefully oil production if the exploration is successful. Four major oil companies will invest $100 million or more in this sub-sector in the next few years. An oil find will be a major boost but not be a panacea for Madagascar's current ills. It will take at least $300 million to develop and produce an oil field, and with falling oil prices it could be 5 - 10 years before the exploration and development investment is recouped.

Road repair and maintenance ranks second in potential as five or six donors have committed more than $200 million for fixing the roads. Private foreign and local firms are ready to carry out the work and to make the necessary investments in plant, facilities and people. There is some hold-up now as the Ministry of Public Works does not have the capability of managing many large projects, and technical assistance may be necessary.

Rice and textiles also rank high because they are underway, and the government is relaxing its once tight grip on these industries. A free market for rice would be the single greatest boon to the Malagasy economy as the overwhelmingly large proportion of Malagasy workers are engaged in rice production and distribution. An increase in rice prices would put cash into millions of pockets and create demands for consumer goods and services from the now under-utilized industrial facilities.

Other sub-sectors that show promise are transport companies which will grow as the roads are repaired and as the government moves out of the business housing for which enormous demand exists, and for which the basic building materials are available such as from the 80,000 ha of over-mature pine plantations in Morogoro and another 180,000 ha in Matsiatra, and meat production and distribution which has sufficient herds of cattle and pigs but needs modern production and distribution facilities.

In the future, other sub-sectors which show promise for the private sector are small hydro development, food processing and export/import activities.

A number of project briefs are available in AID files for current private sector investment initiatives. None of them is large, the biggest being for an investment of $1 million equivalent.

B. General Strategy

In view of serious state of deterioration of the Malagasy political economy, and the apparent reluctance of the government to take bold and decisive measures to move from the status quo, little can be suggested now to promote new investments apart from policy dialogues aided by the insights of this investigation. Until, and unless, the government signals its intentions, all recommendations are fraught with the danger of being undermined by an unforeseen change in direction.

A vicious circle has developed in which the government appears devoid of new sound ideas, and no one is prepared to come forth with suggestions being put off by the political situation, and the disappointments of previous unheeded advice. Even the recent, rather unexpected promulgation of a new investment code held up for years by the reluctant government has done only a little to restore confidence and some optimism. Scepticism, and further wait-and-see attitudes still prevail.

The key requirement now is to break the vicious circle and two modes of doing so can be seen. On the one hand, there are series of minor steps that can be suggested to break the numerous impasses now facing the government, and on the other a bold, initiative appears viable to establish a new source of investment funds for the private sector. The establishment of new investment institution (discussed below) could form a centerpiece around which the other policy discussions can take place.

The underlying strategies for these policy discussions and 36 talking points and minor actions are detailed in Annex 5. They can be carried out by the five political/economic officers in the embassy with little additional technical or financial assistance in the near future. If these discussions are successful, additional help will be needed.

There is much in recent US history that deals successfully with similar, though quite different, situations, which can be pointed to with pride. Provision of US literature, video-tapes, technical journals, and access to US scholars and businessmen will help the Malagasy to realize they are not alone and that others have dealt successfully with the type of problems they face. Minor actions such as encouraging Malagasy businessmen to come forward with ideas, and arranging informal, social gatherings for them and government officials to meet and discuss issues will play an important role in reestablishing communication. Assisting Malagasy with access to the study and use of English is another significant step that can be taken.

More significant actions in the future would include technical assistance for road repair management, for examination of the underlying potential demand for consumer goods, for preparation of business and investment plans, and for mothballing unproductive state-owned enterprises.

C. Creation of a New Investment Institution

The basic agreement between the US and Malagasy governments regarding shipments of food under PL480 specifies that a significant part of the counterpart funds generated will be used to promote private sector development. The team was explicitly asked for practical suggestions about how this could be done. In turn, the team discussed the idea and asked for suggestions from the many business people it met. One business group responded in writing with the idea of creating a Fund for Industrial and Technology Promotion. The document elaborating this idea is in AID files. A detailed description of how the PL 480 funds could be used to establish a new private investment institution, and an outline of the necessary studies that would precede such a step are given in Annex 6.

The ideal arrangement would be one in which the Malagasy government would approve the establishment of a wholly private investment bank. It would provide three main services - technical assistance and low cost funds for pre-investment planning and studies, long-term loans and equity capital for investments in new or expanding businesses, and a facility to raise other finance by stimulating and tapping local capital resources. In the ideal case, the bank would be co-owned by Malagasy and US private investors, would have access to management and technical assistance from the US partner, and would conduct its business in the open, simple way of US banking practice.

In practice, this idea will be difficult to attain although it should be held out as a goal to reach in the future. It might be more practical to initiate a low key investment fund somewhat like that recently set up in Jamaica which is based on dairy product imports under PL 480, in which the fund also acts as the importer. There will be pressure to associate the new institution with one or other of the government-owned banks, but that would be a mistake, unless there is an impermeable barrier between the new institution and the bank, and agreement that they will be separated in the near future.

As the Malagasy government is the owner of PL 480 counterpart funds, the best mode of transferring these funds to the new institution would be through a medium term loan agreement. The new institution would receive the funds at a low interest rate and would repay on a schedule geared to its own rate of recouping funds from its investments. The government would have rights to ensure equity in the allocation of the funds but not in the management of the new institution. Initially, the new institution would deposit the funds in the existing banks, adding to their deposits, and earning an interest spread which would be the basis of its initial operating funds. As new projects were developed, funds would be transferred from the banks to the projects, thus providing greater yields for the new institution.

Studies that would precede its establishment would look into similar institutions elsewhere, examine the legal and financial situation in Madagascar, and invite and incorporate opinion and ideas from the public and private sectors in Madagascar. A team leader and up to 3 others from the US would probably be needed for a total of about 30 personweeks. The total study cost - including some funds for local participation - would probably be in the order of $150,000 - $200,000.

As the studies for the creation of such a brand-new, and precedent-setting institution are likely to take considerable time, and as there will be considerable opposition to the establishment of a new private sector bank-like entity, there is some urgency to set up interim measures to use the large amounts of counterpart funds now available. About $40 million equivalent of Fmg now resides in a special account in the Central Bank, and a further $15 million equivalent will be deposited in the next 12 months. These are embarrassingly large amounts, especially in a country desperate for new sources of cash capital. About 25% of these funds are ear-marked for private sector development - probably of the order of $2-3 million equivalent per year.

Discussions with embassy and AID staff in July 1985 resulted in practical suggestions being made for an ad hoc case-by-case mechanism to be established in the USAID office in Antantanarivo. Using local and US consultants as technical resource people, the office would consider applications for use of the funds from the Malagasy private sector. It would help applicants turn their proposals into "bankable" projects which could then be funded through one of the banks which could have access to the counterpart funds as part of its Fmg resources. The banks could use existing lines of credit from aid agencies to supply foreign exchange needs for the projects.

The embassy has requested technical assistance from AID/AFR/PRE for consultants to be sent to Madagascar to study these ideas, and to come up with practical recommendations for their implementation. Consultants are now being recruited, and a team should be sent to Madagascar shortly. This would need to be followed in time by the more detailed studies for the implementation of a permanent private sector investment institution.

ANNEX 1

GOVERNMENTAL POLICY FACTORS

This Annex lists in detail the factors of government policies and practices that constrain or promote private sector investment and development. The listing of factors follows that of Attachment I of the Statement of Work.

A. Political Stability and Risk

1. Domestic Stability

The current head of government, Didier Ratsiraka, has served as president since 1975. While at present there is no overt challenge, there recently has been growing opposition to his leadership on the grounds of stagnation and worsening of the economy. If there were future political change, it would probably be orderly with little disruption to the business community. On the other hand, if the current political stagnation and deterioration of social conditions continues, there is the potential for violent unrest. The political situation is discussed in more detail in Annex 2.

If political change moved seriously in a direction of a more liberalized economy, small and medium sized enterprises and the professions would gain, and the few larger businesses and the para-public sector would suffer as their privileged positions were eroded.

2. Regional Stability

It is very unlikely that Madagascar would become involved in serious conflict with its neighboring countries or with its major trading partners. In fact, the President publicly stresses the need for regional cooperation to ensure the political and economic security of the area.

B. National Development Plan

The "Charter of the Malagasy Socialist Revolution" outlines a planned economy for Madagascar. In conjunction with this charter, in December 1977, a first development plan, covering the period 1978 - 1980, was published. At the same time, a long term "global" socialist planning strategy was published. This strategy foresaw three stages of development, viz:

- 1978 - 1984: setting the foundations of development
- 1985 - 1992: consolidating the economy
- 1992 - on : economic expansion

The long term strategy was divided into six medium term plans, the first of which (1978-80) was published in December 1977, and the second (1982-87) which was legally approved in December 1981, but to date has not been published. To date, the accomplishments of the first medium-term plan have not been publicly disseminated, thus it is impossible to know whether its goals were achieved.

1. Role of Private Enterprise and Parastatals

The long term strategy called for the following contribution to economic growth by the year 2000:

• Socialist enterprises and cooperatives	75%
• Private enterprises	25%

2. Sectoral Priorities

The sectors given priority under Madagascar's long term strategy as the basis for development are agriculture and livestock, light industry and mining. Under the National Development Plan the state has responsibility for all "strategic" sectors, namely banking and insurance, foreign trade, utilities, energy including all aspects of petroleum and petroleum products, mining, shipbuilding and repair, pharmaceuticals, education and film distribution.

3. Market Economy or Central Control

Madagascar's economic growth was to have come largely from government control and direction of the country's "economic agents of production". Those sectors which would remain largely private are fisheries, forest products, chemicals, construction and construction materials, some food processing, textiles and commercial and trading activities. In fact, the government through its parastatals and by its acquiring partial ownership of some firms has intruded in the areas of forest products, construction materials, food processing and textiles - thus effectively expanding its measure of control.

C. Business Formation and Investment

1. Application Procedures

(a) Who Must Apply. All individuals, groups of individuals, and organizations wishing to start a business regardless of financial size and nationality must apply.

(b) Clarity and Simplicity of Procedures. The procedures of forming a business are clear for sole proprietorships, partnerships and corporations. The procedures and requirements for those enterprises considered to be of importance to the economy and which can take advantage of preferential treatment accorded by the Investment Code are also clear cut.

The procedure is simple for a sole proprietor. He has only to declare his "existence" as a business to the taxing authorities and be entered in the Register of Companies. For a corporate entity, and especially foreigners, however, the procedures are complex enough to make it important to hire a local competent accounting or legal consulting firm to make certain that all requirements are met. For example, it is difficult for a US company to gather and properly prepare all the necessary documents from the US. Additionally, all documents must be prepared in French or Malagasy, and for the foreign firm, in French or Malagasy, and in English or German.

(c) Government Preferences and Restrictions

(i) Form of Business. The banks, which are owned by the State, prefer the corporate (societe anonyme) form of business for private and public sector enterprises because, under Malagasy law, corporations must be audited by third parties, i.e., by qualified, objective accountants. This is not the case for a limited liability company (Societe a Responsabilite Limitee), the business form that is often adopted by the small enterprise.

(ii) Ownership. Although the proportion of Malagasy ownership in a company is not explicitly stated in official publications, and while there are firms 100% owned by foreigners, the government prefers some Malagasy participation in ownership - the higher the proportion of Malagasy ownership, the better. Complete foreign ownership is possible with the approval of the government. When the State creates a company, it demands 51% ownership.

While the law (78-006) states that all enterprises formed after May 1, 1978, having at least 51% state participation - direct or indirect - must become "Socialist Enterprises", very few companies have done so. In fact, since May 1, 1978, many enterprises with majority state ownership were formed as corporations or even as limited liability companies.

(iii) Business Sector. While there is no stated preference for any sector, the government encourages enterprises which will operate in the agricultural and industrial sectors, which bring in foreign exchange, which employ Malagasy, which add value in production, and which help meet local needs.

Certain activities are reserved for the State, viz:

- Banking
- Insurance
- Energy (electricity, petroleum, water)
- Rail transport
- Imports of products considered to be "tax monopolies", - alcohol, tobacco, matches, flour
- Exports of certain agricultural products - coffee, cloves
- Exploration and production of strategic minerals - petroleum, uranium, chromite (at least 51% government participation with foreign firms is required)
- Shipbuilding and ship repair
- Film distribution

There are other natural resources (mining) for which the State gives concessions, e.g., mica, graphite, and semi-precious stones. Additionally, there are approximately 100 categories of products on which the government imposes a "consumption tax", which allows the government to control firms producing these products if it so wishes.

(iv) Geographic location. The government does not indicate specific geographic locations where it prefers business to locate. Rather it wants industries to be spread out over the country. One of the criteria for small and medium sized enterprises to be eligible for prefer-ential treatment under the Investment Code is that they "promote the undeveloped economic regions". The Code does not state that the firm has to be located in an economically undeveloped region. Since the state has more influence on parastatal companies, it does impose its will on them as to location.

2. Investment Screening and Approval Mechanisms

(a) Complexity/Time Required. For companies wishing to take advantage of preferential treatment under the Investment Code, screening and approval is very complex and time-consuming. The applicant must prepare a proposal along well-defined lines, with many supporting documents showing the economic and social justification of the investment, the internal rate of return over the life of the investment, and the complete business backgrounds of all principals. Anywhere from 20-70 copies of the proposal and all supporting documents must be prepared and submitted according to the regulations in force at the particular time.

Upon receipt by the appropriate ministry, the proposal is transmitted to the Technical Commission for Specific Investments (C.T.I.P.) where it goes through an in-house review process. The investor does not have the right to go before the Commission to explain or justify his proposed investment, nor to consult with it if there are problems or questions. No priorities or deadlines have been established by the Commission to approve or reject proposals. The process can take months or even years. Politics can intervene, and a Ministry can opt to disregard the findings of the Commission. It is interesting and unfortunate to note that since 1975, only two or three private sector proposals per year have been presented to the Commission.

(b) Consistency with Respect to Ownership, Size and Type of Business. In principal, the government is supposed to apply screening and approval criteria consistently. However, it is the screening process which allows the government to control investments. One cannot prove that the government applies the criteria inconsistently, however, because of reports that proposals sit for months or years unacted upon, that proposals get "lost", and that good ideas from the private sector are rejected only to appear later under parastatal auspices, one is led to believe that the operations of the Commission are less than equitable. In addition, the government is balking at the "automaticity" provisions being called for by the private sector in the new Investment Code because the provision effectively takes control away from the State and limits its discretionary powers. Under the new code there would be automatic access to its benefits according to the eligibility criteria, and equal treatment would automatically be given to all who qualify.

3. Major Changes Anticipated

(a) New Investment Code. In January 1982, the idea to revise the existing Investment Code was broached to the government by the private sector. Since then three major drafts have been written. The major changes proposed are:

(i) That the current three preferential categories (approved businesses, participation contracts, and small/medium sized enterprises) be maintained, but the sectors in which private business can operate be expanded to include minerals, petroleum, energy, water resources, and public works.

(ii) That the role of private enterprise in Madagascar is somewhat clarified and more clearly stated.

(iii) That equal treatment to all businesses is guaranteed.

(iv) That automatic access to Investment Code advantages is guaranteed provided applicants meet the criteria of the Code, and that case-by-case treatment of applications be discontinued.

(v) That the review and approval process be streamlined.

(b) New Priorities. No new priorities, sectoral or otherwise, are expected in the proposed new Code. The private sector will be more than satisfied if it can get the government to state, once and for all, the role of private enterprise in Madagascar's economy, to guarantee equitable treatment of business, to be open and transparent in its dealings with business, and to inject fairness and speed in Investment Code decisions.

(c) Likely Impact. Even if the new Investment Code is adopted, the impact on business growth will initially be minimal. In the longer term, if the Investment Code is applied fairly by the government, it will have a confidence building effect. More important, however, than the existence of a well-written, even-handed Investment Code is a long term track record of business success in an economic environment that is conducive to success. Recent actions by the State, such as turning over rice marketing to the private sector, cancellation of export taxes, and allowing export companies to reserve part of their foreign exchange to purchase necessary inputs and parts, have more immediate impact than would a new Investment Code.

D. International Remittances

1. Constraints on Capital Repatriation

Capital repatriation over 2 - 20 years is permitted only in the cases of cessation of operations and dissolution of the business, because foreign exchange is not available. If it were, requests for capital repatriation would be respected.

(a) Repayment of Debt. Foreign debt can be repaid in installments, and interest on debt can be paid, once loan agreements have been certified by the Exterior Finance Service. Here too, the constraint is the lack of availability of foreign exchange.

(b) Remittance of Profits. Dividends, directors fees, and directors shares in profits (tantiemes) are 100% transferable by industrial firms and 75% transferable by other types of enterprises. Once again, the constraint is the availability of foreign exchange. Currently, 1979 - 80 dividends are being paid or transferred. Even if sufficient foreign exchange were available and dividend transfers were up-to-date, the procedure to get approval would take eight months on average.

2. Foreign Exchange

(a) Availability. In general, foreign exchange is not available, except for exporting companies which can hold a fraction of earned foreign exchange in a special account called E.P.I. (Exploration - Pieces Detachees - Intrants or Exports - spare parts - inputs) with which they can purchase needed inputs and spare parts. A Central Bank Commission decides the percentage each company has the right to reserve on a case-by-case basis.

(b) How Obtained. An import quota and license are required. The more influence a business has, the more foreign exchange it can get when foreign exchange is available. Individuals can obtain 10,000 FMG (approximately $15) per day for business trips abroad, and 100,000 FMG (approximately $150) per year for pleasure trips abroad.

(c) Exchange Rate. Madagascar has a single, floating exchange rate based on the daily, average value of a basket of ten hard currencies.

3. Other Remittances

(a) Payment of Royalties. Royalties do not exist yet in Madagascar.

(b) Licensing Fees and Fees for Technical Assistance. These fees are 100% transferable provided the contract was certified by the Ministry of Finance, and provided that profit making companies, which don't pay taxes in Madagascar, pay a 15% transfer tax on the transfer. These fees are transferred on a timely basis once the request for transfer is effected.

E. International Trade Restrictions

1. Imports

(a) Tariff Levels. Tariffs are imposed on 1020 different merchandise items. An abbreviated import duty schedule, by broad category of merchandise, follows:

Agricultural implements	10-18%
Construction material	20-31%
Fabrics	40-95%
Food products	30-100%
Trucks, vans, busses	31-40%
Personal vehicles (depending on engine type)	60-180%

At present, it is impossible to find an up-to-date, complete import duty schedule.

(b) Quotas. There is no formal import quota system, rather all imports enter under license.

(c) Restrictions on Payments and Credits. A firm wishing to import anything follows a lengthy procedure to get an import license. It receives an import license only if there is sufficient foreign exchange available. The principal restriction is the general lack of foreign exchange with the government (Central Bank) deciding who gets what little foreign exchange there is.

In the case where an overseas parent company or headquarters can supply and pay for the needed spare parts and/or inputs, import licenses are granted. Currently, this is an important way in which commodities are imported.

(d) Non-Tariff Barriers. There are numerous barriers ranging from absolute prohibitions on the import of certain products (e.g., candles, condensed milk, certain alcoholic beverages) to government control of foreign exchange, and infrequently, government decision as to which supplier will furnish goods.

In principal, import priorities are granted to so-called PNN products (products of primary necessity) and to inputs necessary for their production. The definition of PPN is subjective and is subject to change.

All imported shipments in excess of four million FMG (approximately $6200) are subject to quality, quantity and price evaluation by the General Surveillance Company of Switzerland.

There is one monopoly for private imports (apart from imports for activities legally reserved for the State). It is accorded to the French firm SYMAG for the importation of its own brand of micro-computers. This brand is apparently two to three times more expensive than other brands of comparable quality, and it is felt that SYMAG micro-computers will be technically outmoded in the near future. Thus, many organizations rely on manual information systems or use ADP services.

(e) Restrictions on Imports of Spare Parts. The principal restriction is the lack of foreign exchange. The large parastatals are favored over members of the private sector in the granting of import licenses and in the allocation of foreign exchange. Smaller firms are forced to smuggle spares from Reunion, attempt to manufacture their own or do without.

2. Exports

(a) Quotas. There are no export quotas imposed by the government. Madagascar faces EEC quotas on meat and sugar, but has not reached the limits of these quotas.

(b) Price Controls. There are no price controls on exports, but should the price of a particular product be quoted at well below world level prices, customs can stop the export.

(c) Licenses. Only those holding export licenses can export, and only for the range of those products for which they are licensed. Exports of coffee and cloves are reserved for State companies. Administrative formalities are overwhelming. Agricultural products must pass sanitation controls and quality controls, which are often unevenly applied. One exporter of mushrooms to Europe reported that each shipment requires approximately 100 pages of documentation. Artisinal products must pass specific controls of the Ministry of Revolutionary Art and Culture. Even wood carvings for tourists, such as salad forks, require a certificate of origin, usually obtainable by the tourist at the point of sale. An example is attached to this Annex.

(d) Special Incentives. The only export incentives have been the cancellation of the export tax on most goods, and the EPI provision that allows exporters to retain a certain percentage of foreign exchange earned in order to import necessary inputs and spare parts. Madagascar is considering a policy of not taxing imported, semi-finished goods destined for re-export as finished goods, but little has been done on that so far.

F. International Agreements

1. Trade Agreements

Madagascar is a member of GATT, Unctad, Lome III, Preferential Trade Area of East Africa, GSP (Japan and the U.S.) and has trade agreements with various countries, e.g., U.S., West Germany, Japan, France, U.S.S.R. and Norway.

2. Investment Guarantees and Insurance Programs

It has programs with OPIC and bilateral investment agreements with France and Germany.

3. Patent and Trademark Protection

Madagascar is a member of WIPO.

G. Taxes (see key below)

1. Corporate

(a) Initial capitalization of a company or increase in capitalization (NR)
   (i) cash contribution — 2%
   (ii) in-kind contribution — 6%

(b) Transfer of shares, automobiles (NR) — 8%

(c) Transfer of real property (NR) — 16%

(d) Distribution at liquidation (NR) — 1%

(e) Tax on Profits (corporate income tax) (P) — 45%
   (i) for companies with a foreign headquarters — 67.5%

(f) Transfer tax on companies repatriating licensing fees or technical assistance fees, but not paying other Malagasy taxes (P) — 15%

(g) Professional tax - paid y professionals and merchants (A)
   (i) a fixed amount depending on the nature of the business activity, the size of the local population, and the number of employees — 600-120,000 FMG
   (ii) a proportional amount arrived at by the application of rates, specific to each activity, to the rental value of premises occupied and equipment utilized — 1/30 - 1/5 of the rental value
   (iii) of the fixed amount plus proportional amount — 30%

(h) Transaction tax - a tax on value added (every two months) — 15%

(i) Tax on dividends, directors' fees and directors' shares in profits (SA) — 25%

(j) Consumption tax* applies to various industries which manufacture approximately 30 broad product categories, e.g. furniture, jewelry, textiles, clothing, plastics, soap, perfumes, petroleum products, tobacco, construction materials, food products. (M) — 5-20%

*It is very difficult to determine what is taxable and what is not, and if taxable, at what rate, due to the mass of detail in the laws, constant changes in cited products, and what qualities and quantities are to be taxed at what rates.

One can say that corporate taxation is significant, if not onerous. Taxation is often avoided through cash and barter deals.

2. Sales
   There are no explicit sales taxes paid by the consumer.

3. Personal

(a) Income tax for salaried persons (M)	60% max.
(b) Income tax for non-salaried persons (A)	60% max.
(c) Professional tax - see preceding "corporate" section	

Due to a difference in formulas between salaried and non-salaried persons, the non-salaried person pays taxes at a higher rate until the ceiling rate is reached. He also reaches the ceiling rate faster due to the difference in formulas.

KEY: NR = non recurrent; P = periodic; A = annual; SA = semi-annual; M = monthly

4. Consistency in Application

Taxes are applied consistently, and at the same rates, for companies, regardless of sector.

5. Tax Incentives, Concessions, Deferrals

Madagascar has no policy to use tax concessions as incentives for certain key sectors. Effectively, the country just has a budget policy to raise income for the State. The only tax incentives, concessions or deferrals are those stated in the Investment Code. (See following Section H)

H. Investment Incentives

Under the current Investment Code, there are three preference systems:

1. Authorized Companies

   For five years:

   (a) Total or partial exemption from import duties

   (b) Reduction in corporate income tax (Amount and rate not specified)

   (c) Deduction allowed in calculating corporate income tax for capital investments

   (d) Priority for foreign exchange allocations and funds transfer.

2. Small and Medium Sized Companies:

Same advantages as in 1.

3. Participation Contracts

Negotiated between the government and a foreign company. This system is reserved for activities that the government considers critical, but is unable to carry out itself, such as mining and petroleum exploration.

To be eligible for the Investment Code advantages, companies must meet the following criteria:

(a) Creation of employment, and employment of as many Malagasy as possible, especially in management.

(b) Add value to national resources.

(c) Promotion of economically undeveloped regions.

(d) Meet local needs.

(e) Contribute foreign currency.

I. Labor Laws

1. Wage Levels and Fringe Benefits.

For all employees, the government fixes only the minimum hiring wages by professional qualifications, and various fringe benefits. The minimum hiring wage in 1963 was 15,911 FMG/month or 29 FMG/hour. On January 1, 1984, it was raised for the first time to 17911 FMG/month ($27.50 at current exchange rates.) Average wages in manufacturing in 1983 were approximately 24,000 FMG/month. ($37)

Larger private sector employers generally pay up to twice what the government pays for similar work. Certain parastatals, e.g., FNI, pay approximately 50% more than the government to get and keep qualified senior employees.

Fringe benefits are outlined in general terms in the Labor Code. They cover lodging and meal expenses of employees traveling on business, maternity leave and benefits, paid holidays, paid vacations, educational allowances for employees, and medical benefits.

2. Labor Management Relations.

The setting for labor-management relations is one of severe economic problems, high unemployment, low wages and inflation, coupled with a government policy to brook no protests, and no collective bargaining. Government has held down wages for public sector employees, and has encouraged parastatals and the private sector to reduce wages rather than lay-off employees. Even so, the government has laid off some 2,000 workers in 12 enterprises deemed to be in serious trouble. Work slowdowns have been reported.

Labor-management relations in the private sector are better than in the public sector. Businesses generally pay better and are more generous with raises and bonuses. High unemployment and higher wages tend to keep employees loyal, and the need to retain capable employees ensures that businesses will keep conditions acceptable.

3. Training Programs.

See Appendix 3, Sections B6 and B7 for details.

4. Limitations on the Employment of Foreigners.

Salaried foreigners can be employed only with the authorization of the Ministry of Civil Service, Labor, and Social Law. In general, the use of foreign executives is not encouraged. In fact, one of the principal requirements to obtain preferential treatment under the Investment Code is that the applicant employ Malagasy to the greatest extent possible, especially in management positions. In addition, there are limits on the transfer of expatriate salaries, brought on in part by the severe shortage of government revenues and in part by the lack of foreign exchange.

J. Government Controls and Interference

1. Barriers to Entry by Local Entrepreneurs

(a) Legal. The only legal barriers are prohibition for anyone other than the government to undertake those activities reserved for the State.

(b) Ethnic. There are no overt ethnic barriers confronting local entrepreneurs, although friction between the Merina/Betsileo and the Cotier people seem to block Cotier from establishing businesses in the plateau, which is a Merina/Betsileo area. This is unclear and uncertain.

(c) Monopolistic. There are formal monopolies in utilities and communications and other activities reserved for the State. In effect, however, monopolies have arisen through the issuance of import licenses only to one company or individual for a given product, such as tires. State monopolies exist for the export of coffee and cloves which is handled by four state companies. Internally, the distribution of sugar is a monopoly of the State, in that the sugar mills can only sell to State companies. A wholesaler or merchant cannot buy sugar at the mill. One private monopoly does exist - that of micro-computers sold by the French firm, SYMAG.

Oligopolies exist by virtue of the fact that a very few large companies (public, parapublic and/or private) operate in various business activities such as vegetable oil, soap, and textiles.

(d) Resources. Lack of financial resources (capital, credit, foreign exchange) and human resources (trained technical personnel, skilled labor and management) restrict local entrepreneurs. Lack of raw materials, inputs, machinery, spare parts, adequate transportation and internal communications are other resource barriers to local business.

(e) Other.

(i) Nationalizations and the threat of nationalization inhibit entrepreneurs following government take-over of the most important import-export houses, all banks, all insurance companies, and the sugar companies.

(ii) New Investments. Various areas of business activity were effectively preempted by the State's policy of "vital investments" under which the government negotiated turn-key contracts with foreign firms to build plants for fertilizer, cement, soybean processing, leather tanning, lime production, flour milling and the manufacture of pharamaceuticals. These plants are by and large majority State owned.

(iii) Socialist Enterprises. Various consulting and service companies have been established by the State as "socialist enterprises", e.g., in the areas of civil engineering, data processing, agriculture, freight forwarding and auditing.

(iv) National Investment Fund (FNI). The fund is a public institution whose aim is to promote productive investment projects within the framework of a "national socialist economy". The fund will take equity participation in the investment project it helps to fund.

2. Controls

(a) Price. All but 78 products have to submit to price homologation (the buildup of the maximum price authorized taking into account various production and distribution costs and permitted profit margins). Where the market operates, price homologation means little to companies, other than a bureaucratic chore, since competition drives prices below the maximum sales price allowed. Profit margins allowed are fairly generous which give companies, especially merchants, latitude to be price competitive. The government indicates that it has related price control enforcement on all but "products of primary necessity" and of commodities manufactured by "monopolies". Since December 1984, the government appears to have adopted a hands off approach to much of the black market for goods.

(b) Wages. Wages are controlled insofar as the State sets minimums by degree of skill, by speciality and sometimes by sector. Seniority, i.e., more than five years, raises the minimum wage. Salaries in the government are set by the university degree one has. There are no regulations on salary increases, however the government gives yearly raises of three to five percent. Some parastatal organizations such as the National Investment Fund pay higher salaries in order to attract competent personnel. The private sector sets its own salaries, which in general are higher than government and parastatal salaries. The private sector only has to respect the minimum wages set by the government. A company in good financial condition would give yearly raises on the order of 10% and bonuses at year end. The practice is to give a "13th month".

(c) Production Controls. There are no explicit government imposed production controls. Production, however, can be adversely affected by price controls as, for example, is the case with coffee whereby producer prices are set by the government irrespective of actual production costs.

(d) Profit Limits. Profit margins are surprisingly generous when compared with those in developing countries which control prices. For most manufacturing, the allowable profit margin is between 15 and 20%. Merchants are allowed up to 40%. Only on "products of primary necessity" are margins kept below 10%.

3. Government Role in Purchasing and Marketing Materials and Services

The government controls the most important import/export firms, all banks and insurance companies. It has also established consulting and study firms as well as an auditing enterprise. These organizations compete with private sector firms. The Madagascar Association of Accountants has raised the question of the independence (and objectivity) of the government auditing enterprise - since it audits government and quasi-government organizations.

Insofar as purchasing is concerned, tenders legally are supposed to be handled by a market commission with equal opportunity for all qualified bidders. The legalities are rarely respected by government organizations and individual deals are the rule.

The government has imposed the services of the Societe Generale de Surveillance on all imported shipments in excess of $6200 with respect to quality, quantity and prices. The government, if it so wishes, can designate foreign suppliers for firms which wish to import.

4. Parastatals Role by Major Sector

(a) Agriculture. Sugar production, processing and marketing, of coffee and cloves, and two large rice perimeters (areas) are under government control. For the rest, agriculture is largely in the hands of the private sector.

(b) Forestry. Timber, lumber, fuelwood and charcoal are essentially private sector activities. There are state plantations run by the parastatals Famalamanga and SIB.

(c) Energy. This sector is principally run by parastatals. Only in the exploration of petroleum is there private sector (foreign) participation. Some micro-hydroelectric operations are run by peasants or private interests.

(d) Mining. Mica, graphite, clays and building materials are produced by the private sector. Chromite production, processing and export is handled by the parastatal, Kroama (COMNIS). The government, however, does reserve the right to operate in natural resource areas it considers strategic, e.g., uranium.

(e) Manufacturing. The manufacturing sector is largely private, the main exception being textiles where there are five companies processing cotton and marketing fabric. One is a "socialist enterprise", two are 51% State owned, and the other two have minority State ownership. The two 51% State owned companies also produce cotton, as do many small farmers. A State purchasing monopoly, HASYMA, purchases all cotton produced. Other areas of manufacturing where there is limited State activity are:

Food Processing:	beverages (STAR-minority State ownership) condensed milk - State owned biscuits/candies - approximately 50% of companies are parastatals
Printing:	The National Printing Company
Cement:	A State-owned plant being built
Leather:	Two State plants which barely operate
Paper:	Minority government ownership in the country's one paper mill
Chemicals:	One parastatal operating
Pharamaceuticals:	Currently all private; State company not yet in operation
Mechanical/ Electrical:	One State company which builds TVs and radios
Spirits:	Rum production belongs to sugar industry and hence the State.

(f) <u>Transportation/Public Works</u>. This sector is largely public, the exceptions being road construction which is private, some coastal shipping and some freight forwarding.

(g) <u>Construction</u>. The building industry is private. Urban development insofar as planning, services and utilities are concerned is public.

(h) <u>Telecommunications</u>. Completely public.

(i) <u>Banking and Insurance</u>. The preserve of the State

(j) <u>Retailing</u>. Totally private

(k) <u>Wholesaling</u>. A mixture of private and parastatals.

(l) Import/Export. The four largest Import/Export firms are nationalized, formerly private firms. The private sector does compete in this area.

(m) Tourism. This sector is principally private, the exception being Tananarive's Hilton Hotel which is 50% owned by the State and 50% by Israeli interests.

(n) Business Services. Both private and parastatal companies operate.

5. Extent of Foreign Competition

(a) From Imports. There is little competition for Madagascar's products from imports because of the general lack of foreign exchange, import substitution policies and fairly high tariff protection on those products that Madagascar does produce.

(b) From Expatriate Investment Presence. After the overturn of the Tsiranana regime in 1972, and following the development of a progressively hostile political and economic environment, many French and Asians left Madagascar. With the exception recently of a few French farmers, they have not returned. The current business climate is such that expatriate investment simply is not interested in Madagascar.

K. Banking and Credit Policies and Regulations

The banking sector is comprised of three State banks: the Bank for Agriculture (BTM), the National Bank for Industry (BNI) and the National Bank for Trade (BFV). Each bank is supposed to concentrate its efforts on its designated sector and to lend outside its sector only on a co-financing basis with the lead bank. In fact, all three banks compete with one another for loans and deposits.

To date, there is no cohesive banking or credit policy stating priorities as to economic sectors, private vs. public, size of business, or types of business to be encouraged. There is little available information on the interest rate structure. Credit is limited, and State owned enterprises are absorbing more than 50% of what credit there is. For greater detail on bank credit policies, see Appendix 3, Section B3, Local Credit and Capital.

L. Availability of Business Advisory and Promotional Services

1. Technical Advisory Services

There are a variety of organizations in the public sector which offer technical advice to businesses as either a major or minor part of their activities. They include:

(a) Industrial Development Study and Implementation Company (SERDI). SERDI is a "socialist enterprise" charged with doing management and engineering consulting on contract for government and business, as well as maintaining an industrial data base. It carries out feasibility, engineering and marketing studies, as well as technical and diagnostic evaluation for existing companies. It handles approximately twenty contracts per year and is solvent.

(b) National Institute for Training Promotion (INPF). A perastatal operating under the aegis of the Ministry of Civil Service, Labor and Social Law, INPF is charged with training and advising businesses in management and technical areas. In the advisory field, it does diagnostic, market, financial, internal communications and technical layout studies.

(c) Malagasy Institute for Innovation (IMI). A parastatal charged with the following objectives:

(i) Research into appropriate technology for rural activities and regions.

(ii) Technological models of development adapted to the "socialist environment".

(iii) An information system to locate the most favorable foreign sources of supply, and to find potentially lucrative markets for Malagasy innovations.

To date, the only known activity of the organization (formed in August 1979) is the development of several appropriate technology prototypes. There is no report of these having gone into production.

(d) National Investment Fund (FNI). A parastatal charged with investing in and helping implement certain key projects and enterprises, FNI will also provide technical advisory services to these enter-prises.

(e) National Center for Malagasy Artisans (CENAM). In addition to running workshops and rural technical centers, CENAM gives technical and management assistance as a condition of the loans it helps the artisan or artisinal firm negotiate with the bank.

(f) The Ministry of Industry, Energy and Mines. Through its support to the Industry Department, offers some technical advice while working with existing firms.

(g) In addition to the foregoing, the government has established certain "socialist enterprises" as consulting firms and study bureaus:

(i) DINIKA - civil engineering
(ii) MAMOKATRA - agriculture
(iii) STIM - data processing
(iv) TRANS 7 - freight forwarding
(v) RINDRA - auditing of "socialist enterprises"

(h) The private sector has a limited amount of technical advisory services generally through firms which offer auditing, accounting, tax, legal regulatory, and management consulting services. In addition, organizations such as the Council for the Promotion of Small and Medium Sized Enterprises offers such services informally through its members - but not on a planned basis. The same sort of member-to-member assistance occurs in the other business and service organizations, such as the Chamber of Commerce, Rotary, Lions, Association of Malagasy Private Enterprises (GEM), and The Association of Malagasy Businessmen (Fiv. Mpa. Ma.)

2. Economic, Market and Other Information Services.

There are three principal sources of public economic information - The National Institute of Statistics and Economic Research (INSRE), the Central Bank (I.P. bulletin) and the annual reports of the three State banks. INSRE's information is often out-of-date and incomplete, the Central Bank bulletin has not been published for a number of years, but the banks' annual reports are concise and useful.

Although the government requires a great deal of information and data from Malagasy enterprises, not only legally, but also via a multiplicity of questionnaires, the results of the data gathering and processing rarely reach the public.

The business and service organizations informally trade information within their memberships. There appears to be no formal, private sector economic or market information service.

3. Investment and Trade Promotion Programs.

The only activity in this area of investment and trade promotion programs has been the International Trade Center's missions to prospect markets in six major importing countries (1981-82) and to Indian Ocean countries (1983). A project to establish a market information center within the Ministry of Commerce has been formulated.

One of the principal constraints mentioned by the World Bank in its December 1984 Export Crops Sub-sector Review was the "neglect of export services and promotion." Also mentioned is the inadequate market research and promotion services of the country, there is little reason now to promote either local or foreign investment. Local investment is highly suspicious of the government, and foreign investment simply is not interested and has better places to put its money.

ANNEX 2

PRIORITIZATION AND EXPLANATION OF NEGATIVE FACTORS THAT INHIBIT PRIVATE SECTOR DEVELOPMENT

This Annex elaborates on the 6 main factors now limiting new private sector investment in Madagascar. It identifies and explains a number of sub factors.

1. Lack of Political Direction

Having swung violently to the extreme left when it came into power, the government has had to turn back to the center as it saw its policies lead to one failure after the other. In a step of major importance, the "strong medicine" of the IMF & Paris Club was taken in the early 80s. The austerity moves this required are now causing their own sets of problems, and as a result, the government has stopped its moves away from marxist-socialism and now sits bewildered and directionless somewhere near the political center. As one government insider put it succinctly: "We don't have any ideas for the second half of the speech of June 26th (the 25th anniversary of independence and the 10th anniversary of the 'revolution')".

The political problems are at once ideological and practical. Among the latter aspects, the following are important:

a) Fear of upsetting vested interests

Many people benefit from the status quo either legally by being job holders in the civil service or in the many parastatal organizations, or illegally through bribe taking and other corrupt practices (see below). These people and those they in turn support make up a growing part of the government's political support especially as the vast majority of the population becomes more and more disaffected because of the economic deterioration. The government appears reluctant to take steps to upset this part of its support, even though in the medium term such steps could gain it more support from others as the economy improves.

These vested interests block economic advances directly as well. The parastatals crowd out the private sector, absorbing vast amounts of national financial, infrastructure, and human resources, and performing very poorly, if at all. Corruption adds considerably to the costs and complexities of doing business. All parts of the economy are affected as government activity extends to every sector.

b) Fear of takeover by more powerful groups

Prior to the change in political direction in 1972/75, the economy was largely in hands of French ex-colonials, other non-ethnic Malagasy (especially Indians & Chinese) and the Merina people who live on the plateau on the Antananarivo/Fianarantsoa axis. The Cotier people from the north and eastern coastal areas have gained some ascendancy since 1975. They fear - with justification - that in a more liberal environment, the other groups will take over the best parts of the economy again.

Much of recent political activity has been to balance the Merina/Cotier rivalry and to supress the outsiders. This has led to the present standstill, inactivity by non-ethnic Malagasy, and lack of interest by outsiders.

In a recent ameliorating move, the government invited back some 300 French ex-colonials whose farms had been nationalized. About 30 have returned so far to their properties which were declared never to have been nationalized in the first place. The others are waiting for developments before they move.

c) Pervasive corruption

Corruption, per se, is not inherent in Malagasy culture. It is on the rise, however, to the point where the churches are making public pleas to their parishioners and to the community at large. It arises largely out of the economic difficulties of the country, and is pernicious because it aggravates the economic deterioration.

There are two types of corruption: that of the small wage earner using everything at his disposal to make ends meet, and that of a few well-placed people using their positions to increase their personal fortunes. Payoffs are said to add anywhere from 50-150% to the cost of getting a new activity started.

Malagasy businessmen are reluctant even to apply to the government for the necessary authorization to proceed with a new undertaking as there have been many cases of applications set aside only to be adopted later by other individuals with government connections.

Government restrictions on repatriation of capital and profits and restrictions on business in general have led to petty capital flight by private and public sector entities and individuals via over-billing by foreign suppliers for imported goods. To curtail over-billing, the government imposes quality, quantity, and price criteria on all imports which are established and monitored by the Société Général de Surveillance (SGS) - a private concern based in Geneva. The response to SGS closing this avenue of capital flight is the current practice of having foreign carriers overbill on freight.

d. Lack of trust in the government

Lack of trust in the government shows itself in many ways beyond the corrupt practices just described. One of the chief areas of mistrust is lack of movement for nearly two years on a new investment code in whose drafting private professional groups played a large part.

The business community has requested three principal guarantees in the new code:

- a guarantee of existence, i.e., that there will be no expropriations.

- a guarantee of transparency, i.e., that investment code will be implemented openly with no secret dealings.

- a guarantee of automatic equality, i.e., that incentives will be automatic, based on well-defined criteria, and will be applied equally to all approved applicant enterprises.

The proposed investment code is a necessary, but not a sufficient, step. Many Malagasy businessmen set the code as a panacea for all their ills, but more than that, they see its acceptance by the government as a necessary signal of the government's seriousness.

Other expressions of distrust are over the tendency of the government owned banks to channel donor funds into the hands of small affiliates of state enterprises which have the appearance of being in the private sector, rather than to true private sector firms. In addition, the Fonds National d'Investissement, a recently created government development fund, is perceived as wanting to have a monopoly on small and medium enterprises.

Little is done by the government to allay these areas of mistrust as there is little communications between it and the private sector. Lack of formal and informal links between government and private sector is one of the most serious current problems.

2. Shortage of Financial Resources

Largely as a result of firm adherence to IMF guidelines, there is a shortage of all forms of finance in Madagascar today. There is little hope of any near term relief as Madagascar is still far in arrears on its overseas payments. Lack of risk capital, credit and foreign exchange are probably the most severe of the more tangible constraints inhibiting private sector development.

a) Risk Capital

There is little, if any, risk capital nowadays in Madagascar. There is complete unwillingness by foreign private sources to put up any risk capital. Any expansion of existing operations is largely done through retained earnings. In addition, there is no true development bank, nor investment bank in the country.

b) Credit

The three existing banks, which are fully government owned, are looked upon by the private sector as government agencies, serving primarily the parastatal organizations.

In general, state enterprises are favored over private enterprises in the allocation of credit, and larger enterprises over small ones. There is no explicit financing system, or mechanism, for small and medium sized enterprises, and there are no publicly stated credit policies.

Interest rates run at 20-25% for smaller private enterprise and are felt to be prohibitively high - especially in the case of industrial production, where turnover is low in the start up phases relative to commercial (trading) activities.

c) Foreign Exchange

The Central Bank controls the allocation of foreign exchange on a case-by-case basis. State enterprises and large private firms (with clout and usually with significant government participation) are favored.

As one Malagasy businessman put it: "If you are not a member of the government inner clique, you do not get foreign exchange".

Capital repatriation, loan repayments, interest payments, and pay-outs in the case of dissolution of business are severely delayed. Capital repatriation, in the form of dividends, is now taking place for the years 1979-1980. It is virtually impossible for the small businessman to get a foreign exchange allocation to import spare parts.

One ameliorating factor is a rather reasonable exchange rate policy where the value of the Franc Malagasy (FMG) is set daily on the basis of a managed float against the basket of currencies of the trading partners. There is a very small black market in foreign currency where the FMG is put at about half its official rate.

3. Excessive and Incompetent Involvement of the Government

In its swing to the left, the government became the main participant in all aspects of the Malagasy economy from agricultural and industrial production, to transportation, distribution, banking, export and import services. Prices were fixed at all levels by government fiat, and most large and medium private sector operations were nationalized and taken under state control. There was some justification in such radical statism as the private sector had largely neglected the growing and increasingly impoverished rural population, was mostly engaged in land and real estate speculation, and was not expanding production of basic goods. Moreover there was little participation in the private business by ethnic Malagasy.

As is usually the case with such radical changes, the cure has proven worse than the disease. State-owned enterprises are now generally in bad physical repair, their staff and management are ill-equipped for their jobs, and their performance is poor as a result. There is little room for private sector involvement in the economy which is dominated by the State.

To make matters worse, a number of large and expensive plants were built recently under State sponsorship which makes little economic sense and which can survive financially only with subsidies and interventions from the government. These include two flour mills and two soybean processing plants in a country which has never produced wheat or soybeans, an ammonia-urea fertilizer plant with high unit costs because of its small size and its need for naphtha, fuel oil and diesel based on imported crude oil as feedstock and fuel, and two poorly located leather plants which must import leather because there is insufficient tanning capacity. There are also a number of state-owned enterprises being kept in operation when their economic viability is marginal at best. These include the oil refinery, the chrome mine and the Boeing 747 operated by Air Madagascar.

Besides the excessive involvement of the government in operating enterprises, it inhibits the economy by excessive regulation. The written rules and regulations go into crashing detail controlling the minutae of every business activity. It is almost impossible to understand what is required as many old regulations are not cancelled, but only superceded. Compounding the problem is a breakdown in the administrative capacity of the government especially away from the cities. As the regulations have increased, the number of regulators has decreased.

There is some evidence that the government is aware of these problems and may be trying to solve them. There have been recent studies of the fertilizer plants, the refinery and the Boeing 747. Export of "pois du cap" (a type of lima bean) has been successfully turned back to the private sector. The government monopoly on the transport and marketing of rice is being removed and the private sector is active there again, although unreasonable price controls are inhibiting this progress. There is even some evidence that black market activity in rice, other foodstuffs and consumer goods is being tolerated. As black market price levels are more acceptable to producers and marketers, gradual acceptance of these prices could lead to increased production, which in turn could decrease the prices. By inadvertence, free market forces may thus begin to operate again. Controlled and black market prices are listed at the end of this Annex.

4. Over Emphasis on the External Economy

Part of the reason for Madagascar's economic ills is that its external economy has been over-emphasized at the expense of the internal economy. This is not surprising as the colonial economy was based almost entirely on exports of low cost agricultural products and some tourism, and the import of manufactured goods. The formal economy after independence and even after the 1975 revolution followed and exagerated this pattern, culminating as it did in the acquisition of the "white elephant" projects just described.

At present, the country has severe financial problems that have resulted largely from the high cost and low - if not zero - return of these projects. At the same time, prices for its exports have dropped and prices for its imports, especially oil, have increased. In this financial crisis, almost all attention is necessarily directed to the external economy as the government grapples to maintain some degree of credit worthiness by meeting at least some of its external payment obligations.

Given the recent economic history and current financial crisis, it is not surprising that private sector initiatives are damped completely by this over-emphasis on the external economy. It is necessary that this not continue and that changes be introduced which include the following:

(a) Decrease imports

By careful and serious management, Madagascar could reduce its imports considerably. For instance, the import bill for petroleum products would be cut if Madagascar imported only the necessary refined products it needs. These are becoming increasingly less costly as new refining capacity opens up in the Persian Gulf countries. The critical need for imported spare parts could be cut in half according to UN estimates by substitution of locally made parts and even more by accepting less elaborate components. Rice imports would be cut to zero if good prices were offered to producers and if marketing and distribution channels functioned properly.

b) <u>Increase exports</u>

Madagascar will always need to export as it will require a basic minimum of imports. As has recently been demonstrated in the case of pois du cap, private sector companies do a much better job of exporting than do state-owned companies. The same could be true if Madagascar's main exports, coffee, cloves and vanilla, which are exported under strict state control, were also turned back completely to the private sector. Madagascar has no outstanding comparative advantage (except for vanilla where it has 80% of global production) in any of its exports and needs sharp and efficient expert marketing skills to keep and improve its place in the highly competitive markets.

At the same time excessive government regulations for exports need to be reduced. It takes over an inch of papers and visits to five or six ministries to airfreight a container - load of mushrooms to Europe. A signed and stamped certificate of origin (see Annex ___) is even needed for the export of a $2.00 set of carved salad forks by a visitor. Elimination, or at least drastic reduction of such petty over-regulation is a necessary step to allow the private sector to seek and develop additional markets for Madagascar's exports.

c) <u>Increase the internal economy</u>

Important though these changes in the management of the external economy may be, it is Madagascar's internal economy where the real future potential lies. Most of the working population (88%) are engaged in agriculture. A simple step like an increase in the price of rice would immediately increase the purchasing power of the rural population thereby creating a demand for all types of consumer goods which could easily be produced in the many industrial plants in the country, most of which now operate at 10-30% of their capacity.

To meet the basic needs of the more than 10 million Malagasy people will be an immense undertaking, but the inherent capacity is available. For instance, only 1.5% of the working population is employed in industry now, and there is growing unemployment. With some redirection of training and education systems adequate numbers of personnel can be made available to increase industrial output. The country has the basic natural resources to meet its needs of food, clothing and shelter, and can generate the exports needed to import what it does not have or cannot produce.

Even beyond meeting its basic needs, Madagascar has a vast land-mass, and adequate soil and climate resources to support a population much larger than it presently has at a much higher standard of living. Population density is only 16 persons per square kilometer, compared for instance to 54 in Malawi (101 in France). There is therefore no practical limit in the foreseeable future to the development of the internal economy which should be given the emphasis it deserves so that private sector development is not restricted.

5. Poor Physical and Information Infrastructure

The vastness of the country creates immense requirements for adequate transportation and communications infrastructure. The basic structures are in place, but they have been badly neglected and today are rundown and quite inadequate to serve the nation. Roads are in such bad condition that the city/rural links are all but severed and few goods move. The railroads are the main arteries for the flow of imports and exports, but they too can operate at only a fraction of their underlying capacity. Air transport links are over-booked, infrequent and unreliable.

There has been a massive allocation of funds from donor agencies to correct these basic problems, but it is not clear that the government has the management ability to handle the large increase in construction activity that will be required.

Adding to the inadequacies of physical infrastructure is the lack of both adequate and timely business and economic information and the means to make it available. There is almost a complete absence in basic rural data especially on agricultural production. This is a serious constraint for government planning, and also for any business which deals in the agricultural sector or in agriculturally-related activities. For example, without knowing agricultural production data and potential, it is impossible for a small seller of agricultural imports to know if a market in a given locale exists.

Other informational gaps cited by businessmen include:

- The government's intentions and requirements for the private sector and especially for small and medium sized enterprises.
- Bank credit policy for the private sector.
- Bank credit availability, terms and interest rates.
- Market information.
- Simplification and clarification of the fiscal system, especially regarding price homologation criteria, import duty schedules, and tax duty schedules.

6. Cultural and Human Resource Inadequacies

Malagasy government and business people - like those in many developing countries - tend to emphasize production capability and their current and future capacities, and do not recognize that the basic economic driving force is market demand. They speak glowingly of the many raw materials Madagascar has, and comment that anything and everything will grow there. Very few ask what markets exist or can be created for Madagascar's raw materials and agricultural production.

The Malagasy private sector (with the exception of a few individuals) demonstrates a lack of a "market mentality" and a general absence of marketing expertise - from basic marketing research to customer service and follow-up. Lack of "market mentality" is hindering the effective operation of businesses across the range of activities from planning to point-of-sale. Without a market oriented philosophy, companies are having difficulty in responding rapidly to opportunities that arise.

The lack of understanding of the role of markets, and the export market and an unwarranted expectation that foreign joint venture partners are waiting to come to Madagascar, are part of a more general human resource constraint.

Although more entrepreneurial spirit exists than the Malagasy are generally given credit for, it is not clear how much true entrepreneurial ability exists on any large scale. This was shown by the fact that not one businessman had a written, well conceived, completely costed proposal at his disposition. Some had well-conceived ideas and some had notions of accurate costs as well as ways to circumvent constraints, but few showed experience with the various important factors and complexities of running a business. Managerial talent is missing, but with training and opportunities it can be acquired. There are some competent entrepreneurs among the Malagasy, but a lot more must be found. There is a lack of inherent leadership qualities, and one of the hardest tasks will be to find the entrepreneurs (or cause them to surface) and to instill missing leadership qualities of the sort that business demands.

Black Market Operations

	Controlled Price (FMG)	Black Market Price (FMG)	Ratio: Black Market over Controlled Price
Rice	300/kg	200/kapok = (700/kg) 800/kapok in Toamasina	2.3 9.3
Sugar	300/kg	500/kg	1.6
Oil	800/litre	2500/litre	3.1
Flour	400/kg	600/kg	1.5
Meat	1200/kg Pork 800/kg Beef	2000/kg Pork 1200/kg Beef	1.6 1.5
Blue Jeans	20000 each	32000 each	1.6
Adidas Sport Shoes	15000/pair	40000/pair	2.7
Shirt	6000/each	18000 each	3.0
Soup Base	600 for 4 blocks	2000 for 4 blocks	3.3
Deodorant Spray	6000/can	18000/can	3.3
Tires	30000 each	60000 and poor quality	2.0
Leather Jacket	50000 each	150000 at Christmas; 120000 by March and 110000 by May	3.0 2.4 2.2

Price levels as of April 1985

At that time 1$ = 680 FMG

ANNEX 3

BASIC ECONOMIC AND MARKET FACTORS

Economic and Market Stability and Growth Prospects

Economic activity has declined markedly in the past decade in Madagascar and is now sluggish and erratic. Excessive involvement of ill-equipped state enterprises, the global downturn in terms of trade for developing countries, and over-investment in unwise industrial plants which are now idle, but which have created large debt obligations are the chief factors behind this decline.

1981 and 1982 saw a 10.4% decline in real domestic product, while 1983 registered only a 0.8% gain. Balance of payments difficulties caused shortages of inputs and a concomitant drop in industrial production, and this decline coupled with a major cut back in capital investment reduced commercial and transportation activities.

The multitude of serious economic and policy problems facing Madagascar today does not portend well for economic growth in the short term. Market growth in the export sector is not particularly promising. The internal market, however, if allowed and encouraged to flourish, could be promising in the longer term.

1. Economic Data[a,b]

a. Gross Domestic Product (1983)	$3.0 billion
b. GDP Growth Rate (1983)	0.8%
c. Per Capita Income (1983)	$330.0
d. Inflation (1984)	30%
e. External Accounts:	
(i) Current account balance (est. 1984)	$333 million
(ii) External debt (1/1/85)	$1.5 billion
(iii) Annual debt service (projected 1985)	$53.7 million
(iv) International reserves	0

2. Population/Labor Force Data

a. Total Population (est 1985)	10 million
b. Growth Rate (annual)	2.8%
c. Distribution/Characteristics	
(i) persons per square kilometer	16
(ii) urban	19.5%
rural	80.5%
(iii) age structure (1981)	
0-14	45.4%
15-19	10.1%
20-29	16.2%
30-39	9.4%
40-49	7.7%
50-59	5.7%
60 and over	5.5%
(iv) life expectancy	47.9 years

(v) 18 Malagasy tribes, small numbers of Comorans, Indians, Pakistanis, Chinese and French

d. Labor Force (est 1980-82)

(i) Total	4.6 million
(ii) Male	55.5%
(iii) Female	44.5%
(iv) Participation Rate:	
Total	50.4%
Male	56.0%
Female	44.7%

e. Labor Force Distribution Among Broad Sectors

(i) Agriculture	88.4%
(ii) Industry	2.7%
(iii) Commerce, Banking	2.5%
(iv) Government	1.8%
(v) Services*	3.5%
(vi) Not Reported	1.1%

*transportation, education, health, other.

f. <u>Population in Cash Economy</u> 3 - 4%

g. <u>Trends</u>

	1960	1970	1980/82	1984
Population Growth Rate				
Total (%)	1.8	2.1	2.5	2.8
Urban (%)	4.9	5.0	5.2	n/a
Crude Birth Rate (per 1,000)	46.7	45.2	46.7	n/a
Crude Death Rate (per 1,000)	26.6	21.9	17.8	n/a
Available Labor Force (% of growth)	n/a	2.1	3.0	n/a

From now until the end of the century, Madagascar will have 120,000 - 200,000 new workers annually for whom to provide employment.

h. <u>Adequacy of Educational Level</u>

(i) Enrollment (%)	
o Primary (1978)	100
o Secondary (1977)	14
o Vocational (% of secondary 1970)	8.7
o Post Secondary (1980)	2.4
(ii) Literacy (%)	53

3. <u>Breadth of Business Base</u>[c,e]

Madagascar's industrial sector, like that of many other developing countries, contributes a relatively small amount to the economy when compared with the agricultural and service* sectors. Moreover, agriculture employs some 88% of the active work force. Following are each sector's share of gross domes-tic product (1982) and projected shares for 1985 and 1990:

	1982	1985	1990
Agriculture	41.1%	41.6%	42.0%
Industry	15.0	15.4	16.5
Services	43.9	43.0	41.5

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*It should be noted that services includes commerce, banking, government, education, health, and all other activities which are not industrial or agricultural.

he business base appears to be relatively narrow, concentrated in the food, beverage, textile, clothing, leather, forest products, and construction industries, as well as in commercial and transport activities. As of 1982, there were some 360 manufacturing firms and approximately 2,000 artisinal manufacturing enterprises.* Of the 360 manufacturers, about 100 firms reportedly account for 80% of manufacturing output.

Exports are largely agricultural. The principal exports, ranked by value in 1982, are: coffee, cloves, vanilla, sisal, fish, cotton thread and fabric, sugar and pepper. The following table shows the percentage composition of Madagascar's export value in 1982:

	%
Agricultural products	84.4
Manufactures	4.6
Mineral products	8.6
Of which: petroleum products	(5.2)**
Other	2.4

Madagascar has the agricultural potential to produce and export more than it does. The country's experience over the last 10 years, however, has seen the disappearance of rice and bananas as export crops, and a decline in exports of livestock products, sisal, raffia and oilseed cake. The World Bank recently proposed a strategy calling for diversifying markets and expanding exports for Madagascar's major export crops in the short and medium term, and to prepare to diversify crops, products and markets in the long term. The crops under consideration for the longer term are sisal, cocoa, butter beans, maize, cashew, cassava (for tapioca), coconut products, other spices (cinnamon, nutmeg, and ginger), and tropical fruits.

The mineral sector - excluding re-exports of oil products - represents only 3.4% of export revenue. Moreover, Madagascar suffers from either having those natural resources which many other countries have in abundance (e.g., bauxite, iron, coal), or those for which world demand is stagnant (e.g., chromium, uranium, graphite) or is being met by synthetics (e.g., mica).

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* The National Center for Malagasy Artisans reports some 100,000 artisinal enterprises employing 120,000 people in all. The bulk of these could not be considered manufacturing enterprises, however, they are important to the extent that they commercialize the products of the more formal manufacturing sector.

**Madagascar is unable to use all the products of its refinery and has to export a considerable portion of the refinery's output which is based entirely on imported oil.

4. Market Potential in Neighboring Countries.

Madagascar's neighboring countries in the Indian Ocean account for only about 4% of its exports. The closest countries, the island groups, are small markets by virtue of their relatively small populations. The nearby countries of East Africa do not represent good markets for Madagascar's major export crops, because they are competitors*, because of poor economic conditions (Tanzania, Mozambique), or, as in the case of South Africa, because of political reasons (although some fungible products do reach South Africa). Other Indian Ocean neighbors produce the same major crops that Madagascar does.**

Some neighboring market potential exists for two of Madagascar's "lesser" crops such as butter beans (pois du cap) and maize which are in strong demand in Reunion and Mauritius.

In world markets for her principal export crops, Madagascar faces slow growth or stagnant demand, as well as increased competition from the major producers of coffee and spices. Madagascar's competitive position is weakened due to counterproductive agricultural policies, deteriorating infrastructure, a lack of adequate market understanding and promotion, and an inadequate mobilization of private sector resources.

5. Population and Effective Cash Markets

At present, Madagascar has two, small cash markets. Internally, approximately 500,000 (5% of her 10,000,000 population) are in the cash économy. Externally, it has a small, neighboring Indian Ocean market:

Country	Total Population
Mauritius	approximately 1,000,000.
Reunion	approximately 550,000.
Comoros	approximately 350,000.
Seychelles	approximately 70,000.

The proportion of population in the cash economies of Mauritius, Reunion and the Seychelles is larger than Madagascar due to greater economic development and the growth of tourism. The principal Malagasy products currently imported by these countries are:

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* Kenya, Tanzania (coffee); Tanzania (cloves). Also the Comoros Islands produce cloves and vanilla. Reunion produces vanilla.

**Indonesia, India, Sri Lanka (cloves); Indonesia (vanilla).

Mauritius	fish, butter beans, coffee
Reunion	pepper, butter beans, corn, canned beef

Corn, fish, butter beans, meat and meat products are reported to have export potential for Madagascar. The Comoros apparently have very small livestock holdings, and a small fish catch, and may represent a modest outlet for thse products. Growing European tourist trade on Reunion, Mauritius and the Seychelles should be an expanding market for high quality food products.

Madagascar's internal market, given the appropriate policy changes and incentives to the private sector, has two main potentials. First, the rural sector, brought back into the money economy, is the major long term market - principally for consumer goods and agricultural inputs. Shorter term, the current annual 5% growth in urban population means an expanding urban market in the cash economy. By 2000, this market will number slightly over 1,000,000 people. These people will be buying principally consumer goods, housing and services.

B. Production Resources and Services

1. General Description

Madagascar is a vast country well endowed with good soils and rainfall. It is about 1,300 km long and over 400 km wide in the widest part. If Madagascar were laid out on the East coast of the USA it would stretch from Boston to Jacksonville, and as far west as Cleveland. With the eastward drift of the tectonic plate it occupies, mountains are piled up on its eastern side, which flatten out into plains in the west.

The narrow eastern coastal strip is extremely fertile, and well watered, and hence is the location of the greatest economic activity and population density. The interior highland plateau behind the eastern mountains has a fair, temperate climate with adequate rainfall and good soils. This is the location for intensive rice growing which is the basis for the strong economy and culture of the Merina and Betsileo people who live there. The western plains are mostly open savannah, quite dry in parts, and are used for cattle ranching.

Madagascar's most serious climate problems are frequent severe cyclones which cause extensive damage yearly, especially on the west coast. Heavy rainfall in the eastern mountains and soft soils make road construction there very difficult. These are manageable problems and do not seriously detract from the fact that Madagascar has enormous potential agricultural wealth available from its excellent land and climate resources.

Despite these assets, the economy is very weak now. Because of the need to reduce its balance of payments deficit and curtail the growth of foreign debt service, Madagascar is unable to finance the imports of needed raw materials, spare parts, machinery and other required imports. The lack of inputs is playing a major role in the reduction of industrial output and in the stagnation of agricultural output. In addition, although local capacity to produce basic materials and parts exists, it is unable to perform because of the deterioration of the economy.

a. Natural Resource Availability

Madagascar is relatively well endowed with productive farmland, has a large amount of rangeland, and a fair amount of productive forestland. Most of the forestland is being overexploited, with resultant erosion problems. While Madagascar has many rivers and streams, hydro power is largely an underexploited resource. The mineral resources Madagascar has are, unfortunately, those which many other countries have, or for which world demand is stagnant or falling, or for which cheaper substitutes exist. Thus, export possibilities are limited.

Agricultural land*	
Total cultivable	approx. 8.5 million ha
Total cultivated	approx. 3.0 million ha.
Total irrigated	approx. 1.0 million ha.
Pastureland	approx. 34 million ha.
Livestock	
Cattle	approx. 10,400,000
Swine	" 1,100,000
Sheep and goats	" 1,900,000
Poultry	" 22,000,000
Forest Land	
Total	" 12,500,000 ha.
Productive	" 7,000,000 ha.
Man made	" 260,000 ha.
Fisheries	
Ocean (largely shrimp, prawns)	" 10,000 MT yearly catch
Fresh water	" 58,000 MT yearly catch
Estimated ocean potential	" 150,000 MT catch

* Madagascar's total land area = 592,000 square kilometers, or 59,200 ha.

Mineral Resources*	Reserves (R)/Production (P)
Petroleum	unknown; exploration phase underway (R)
Heavy Oil	4.8 billion barrels (R)
Tar sands	80 million MT (R)
Coal	80 million MT steam coal (R)
Chromite	41,600 MT concentrate (P 1983)
Barite	approx 840,000 MT (R)
Phosphates	n/a
Iron Ore	400 million MT (R)
Lateritic Nickel	n/a
Zinc, lead	Traces
Uranium	2000 MT/year production of yellow cake possible
Gold	110 tray ounces (P-1983)
Graphite	13,550 MT (P-1983)
Clays (Kaolin)	2500 MT (P-1983)
Marble	15 MT (P-1983)
Ilmenite Zircon, monozite	n/a
Semi-precious stones (all P-1983)	gem garnets 60 kg industrial garnets 5000 kg gem amethysts 15 kg beryl 6500 kg
Hydropower	est. 3600 MW possible; currently 260 MW installed.

n/a - not available

*Latest comprehensive reference, Gites Minerau de Madagascar by H. Besiane, a documentary on Madagascar's geology and mineral resources, dates from 1966.

2. Infrastructure

(a) Road, Rail and Air. Both rail and road networks are physically run down from years of neglect. The average road speed from Antanarivo to Antsirabe is about 20 mph in a Peugeut 504. The average rail speed from Antanananarivo to Toamasina (down grade) is 10 mph. The inability to finance the imports of vehicles and spare parts for cars, trucks, or the railroad has aggravated the situation. The road vehicle fleet is shrinking.

The result of the deteriorated transportation infrastructure is increasingly slow movement of production inputs to the agricultural and industrial sectors, agricultural and manufacturing outputs to internal markets, export commodities to ports, and consumer goods to rural people. Various donors are financing the reconstruction of all the principal paved roads in the country. The key to their future adequacy will be sufficient, timely maintenance. Rural and feeder roads, which represent 3/4 of the total road network need upgrading so that agricultural inputs and outputs and consumer goods can move efficiently. The rail link from Antananarivo to Toamasina is antiquated and the road bed has deteriorated in part from age, in part from lack of maintenance, and in part from the use of too heavy locomotives. Currently, the system, while operating at its maximum, is having difficulty maintaining an economic flow of goods to and from the port. Rehabilitation of the entire rail system would be very expensive and impossible now given Madagascar's funding constraints. The question of road maintenance on this route is doubly important. The road from Tananarivo to Toamasina (which parallels the railroad) is being rebuilt and must be adequately maintained, or the freight burden will once again fall on the railroad - which will be five or more years older and less able to shoulder this burden.

The port of Toamasina is adequate for the current low level of imports and exports. The current bottlenecks to efficient operation are the lack of forklift trucks, spare parts, cranes, a new tug boat, and Ro-ro equipment to handle containers efficiently. Timely maintenance of equipment is also reported to be a problem - in part aggravated by the lack of spare parts. At present the port can only handle 20 foot containers. These bottlenecks result in costly demurrage charges for ships tied up in port or in the roads, and delays in moving goods internally, which in turn adversely affect manufacturing and agriculture.

Port operations are further limited by the fact that the government has not allowed port fees to rise since 1982. The port is currently running at a slight loss.

While there are plans for potential World Bank financing to expand the port's general cargo capacity from 1.0 to 1.5 million tons per year, the key to the port's success is a viable railroad and road to Antananarivo. Secondary ports which handle coastal shipping suffer from old and deteriorating handling equipment.

Air travel is an effective means of moving people and certain goods rapidly in Madagascar, as all of the major and intermediate cities are serviced. However, the system is strained because of the decreasing viability of the road and rail systems. Air Madagascar's international service is potentially in jeopardy because of its inability to keep up on payments for its one 747 aircraft.

(b) Electricity and Water Supply. Generally, the supply of electricity and water in the country's main industrial centers (Antananarivo and Antsirabe) are reliable. With the decrease in industrial production, demand for electricity has softened. Power generation is largely from fuel oil, although hydropower is growing and represents the best opportunities for the future, as Madagascar is blessed with water resources.

There is considerable scope for small hydro developments which could serve isolated communities, and others which could be connected to the main electrical grid. The country's main hydro power plant at Andelekalea can easily be doubled in capacity (to 116 MW) as the basic infrastructure was built into the first phase of the development.

3. Local Credit and Capital

(a) Availability of Credit. The government is keeping a tight rein on the availability of credit following its agreements with the IMF and the "Paris Club" of lenders. In addition, there has been a continuing decline in savings (6.6% of GDP in 1983 vs. 11.3% in 1976), and in September 1983 a currency recall demonetized the economy (especially the rural sector) by somewhere between 40-80 billion FMG ($93-186 million at the average 1983 exchange rate).

The BNI (National Industrial Bank) reports that it recently offered a ten year bond issue with interest rates ranging from 15 - 18%, but apparently, in their words, "we didn't get what we wanted". Only "institutional" clients - the other two state banks and the insurance companies purchased the bonds.

Since 1984, the banking sector has kept credit especially tight, while the Central Bank, the Bankers Professional Association and the Ministry of Finance works out a comprehensive credit policy.

In the allocation of credit, state enterprises are generally favored over private enterprises, and larger enterprises are favored over smaller ones. Influence, connections, vested interests, and state-perceived importance of the particular enterprise all play important roles in the decision to allocate credit. Also, according to BNI, the usual criteria are applied to loan applicants, such as soundness of the business, collateral, capacity to repay, character of the borrower, and the liquidity of the business. Specifics on these criteria were not obtainable from bank officials.

(b) Cost/Term. To date, the banking industry has no published interest rate structure. Interest rate information was given reluctantly by BNI officials, but businessmen were more forthcoming. The following is a composite of this information:

Customer	Term*	Interest Rate	Source
Best (parastatal in good financial condition)	1-2 yrs	12-14%	BNI
Small, Riskiest (private)	1-2 yrs	22% maximum	BNI
Medium Sized Enterprise	1-2 yrs	13 - 18%	BNI
Small Sized Enterprise	1-2 yrs	18 - 22%	BNI
Medium Sized Enterprise	medium term	20 - 25%	Malagasy Businessmen
Small Sized Enterprise	medium term	nearer 25%, if he can qualify	Malagasy Businessmen
Best	unsecured line of credit	20% approx.	Local CPA

*BNI reports that its longest term loan is for 7 - 8 years. It also states that it does not make long term loans.

(c) Source and Availability of Local Equity Capital. Given the deterioration of the economy, the adverse political situation, and the overall poor business climate, there is little risk capital available in Madagascar or for Madagascar from without. Very occasionally, small and medium sized business owners will collaborate in putting up small amounts of capital to help finance a new business operation. The owner of a printing business in Antananarivo and several other businessmen are helping finance (via equity partici-pation) another businessman who is starting a printing business in Fort Dauphin.

In general, new operations and businesses are very rare today. Expansions of existing operations are financed from retained earnings. There have been a few instances of purchases of small operations and factories with capital believed to have been generated by commercial and trading businesses. Foreign private sources are unwilling to put capital into Madagascar now, but rumors persist Malagasy and foreign capital is waiting in Reunion, Mauritius and Paris for the time when Madagascar once again becomes viable for business.

(d) Constraints by Type, Size and Ownership of Business. See Appendix 4, page 4-5.

(e) Leveraging Levels Permitted. This information was not available to the team.

4. Business Services

(a) Distribution and Marketing Channels. In principal, parastatal companies have responsibility for distribution of those products considered to be of "primary necessity", following a program established by the Ministry of Transportation, Supply and Tourism. In a policy shift late last year, the government allowed the private sector to take over marketing of rice, the main crop. SOLIMA, the national petroleum company, would like to divest itself of its service stations and tanker truck operations.

For products not considered vital, marketing channels are largely private and are becoming increasingly fragmented with the growth in number of intermediaries, retailers and shopkeepers. With the assumption of much of the country's industrial activity by the government, the establishment of capital intensive industries by the government, and the general economic decline of the past five years, commerce, trading, transportation, and artisinal manufacturing have become the most viable activities for many.

(b) Subcontracting for Maintenance, Repairs and Parts. There are no firms which specialize in maintenance and repairs, and each company has its own repair shop. Distributors of office equipment, vehicles and agricultural equipment do have after-sale services, providing spare parts and repairs.

5. Availability of Local Entrepreneurs.

There is a general lack of experienced, financially sound Malagasy entrepreneurs. Entrepreneurial ability is found more often among people of ethnic Indian, Pakistani and Chinese background who constitute a small but significant part of the population. The Malagasy tend to be averse to long term risk-taking and appear to lack entrepreneurial skills and ability. On the other hand, there is more entrepreneurial spirit among the Malagasy than they are commonly given credit for. Among the Malagasy the Merina and Betsileo people from the high plateau on the Antananarivo-Fianarantsoa axis are more business minded than others.

Malagasy with an interest in business are mostly attracted to business in agricultural, livestock or food processing, or a combination of these. This may be partly due to the rural background of many Malagasy, and partly because many Malagasy families who are well-off have agricultural and livestock operations as a side line to their principal income earning activities in government or real estate. There is also the prevailing production mentality often expressed by the statement, "Anything will grow in Madagascar". A certain amount of self-convincing exists that agriculture is a low risk, high return activity.

6. Management and Technical Resources.

(a) Adequacy and Availability. Although some Malagasy have received management education both in Madagascar and abroad, wide-spread, hands-on management skills and experience are largely absent. Management, in the sense of calling for timely, hard-nosed decisions, is not culturally innate to the Malagasy. In traditional society, decisions are always a result of consensus. This may explain, in part, a tendency of Malagasy to seek administrative jobs not calling for a great deal of initiative. Modern management capability to deal effectively with business activities is an area which will have to be developed over the longterm, given the Malagasy predilection to shun individual responsibility.

While the university and its branches offer management courses, the churches and employers criticize the educational system as being too ideological, and question the relevance of instruction which gives the student little preparation to enter the work world upon graduation.

Skills in the social sciences are present in higher cadres. Over one half of university students study economics, sociology, arts, law and management. Less than 30% study the physical sciences and other technical areas. Only 1% study agronomy. Approximately 80% of the student body received government scholarships in 1981-82. An important constraint for the private sector is that the receipt of a government scholarship implies that the recipient will work for the government for ten years after graduation. Further aggravating the situation is the decrease in educational quality caused by rapidly increasing enrollment in the last ten years. Many degrees are not completed and the dropout rate is high.* The higher education system has created an entitlement mentality in that everyone thinks that he or she is qualified for and owed a high position in government. At the same time, the need for well trained middle and lower level technicians has been largely ignored.

(b) Adequacy of Local Training Facilities. Those few technical high schools which turn out middle and lower level technicians are suffering from lack of finances. In general, in-house government training operations lack funds and skilled trainees. Only the training facilities which operate under the aegis of religious missions are reported to be viable.

Three donors, the World Bank, UNIDO and the FED are somewhat active in the management area. The World Bank finances the Center for Accounting Training. The Center provides in-depth training in accountancy, and envisages offering management training in the future. UNIDO, under its Small and Medium Sized Industry Project plans to give intensive technical and management training to the best five small or medium sized firms in the country. The FED (European Development Fund) finances the Antsirabe Center for Training Leadership Cadres. The Center uses a seminar format to upgrade high level administrators. Unless renewed, the FED finances will end in 1985.

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*FY 1986 CDSS - Madagascar, Annexes, p. 147.

7. Skilled Workforce

(a) Availability. The current skilled labor pool which is neither large nor mobile is largely composed of people who acquired expertise on their own, such as auto mechanics, or who gained hands-on expertise in the private and para-public sectors. The lack of skilled labor is felt especially in manufacturing and transportation where the dearth of sufficiently trained technical and managerial personnel in operations and maintenance leads to inefficiencies. On the other hand, the Malagasy are intelligent and very trainable. There is no shortage of people willing to be trained in whatever work is available.

(b) Training. Training is therefore required to increase the size of the skilled labor pool. Businessmen are unanimous in their opinion that the Malagasy are eminently trainable, make good employees, and are extremely ingenious in working with very little means, whether tools, machinery or raw materials. It will be difficult to get training programs going because of insufficient numbers of trained employees, training facilities, equipment, and qualified personnel to do the training.

(c) Training Centers. The government's plans for vocational training centers to meet local needs for technical skills have not yet come to full fruition. Shortage of funds, poor transportation and communication, lack of equipment and materials, and low level of teaching expertise has hampered this program. More skills training on the level of artisinal and small/medium sized enterprises is needed.

The bright side of the picture is that the National Institute for Promotion Training has established retraining and job upgrading programs for technical workers and managers. This organization specializes in general mechanics, auto mechanics, electronics and industrial refrigeration. To date, it has trained more than 1,500 technical personnel and 2,000 managers.

In the artisinal area, the National Center of Malagasy Artisans has urban workshops and rural technical centers. The urban workshops are in Antananarivo and specialize in manufacture of tools, equipment, bricks, ceramics as well as in weaving and leather working. Two rural centers concentrate on the manufacture of agricultural tools and a third specializes in fish preservation. The National Center trains approximately 500 artisans per year.

In addition, church missions have apprenticeship centers for artisinal activities, for both adults and youth, as well as farm training schools.

8. Labor Characteristics and Quality.

Madagascar has more potential skilled labor than most African developing nations of comparable population size. Conventional wisdom, which appears to be correct, holds the Malagasy to be intelligent and therefore very trainable. All businessmen, foreign and Malagasy, support this view. On the negative side, the Malagasy are not a "take charge" people. While the labor force is characterized as "good", and at times ingenious as it has little with which to work, it is also characterized as one which works slowly, and one in which the concept of maintenance is largely absent.

On the professional level, experienced Malagasy reportedly do well in staff positions, and for example, turn out good project designs, and studies of potential and on-going economic and business activities. They tend to have a good theoretical base, but few have hands-on experience. A cited example of the lack of experience is that professionals do not know how to strike a hard bargain when purchasing goods or services.

Somewhat over 10,000 university graduates enter the economy each year. Until recently, the government's policy was to hire them all, but now with the abysmal economic situation, this is no longer possible. The result is a large number of young people, eager to work, but over-trained for the available jobs, and rather desperate and frightened for their futures.

(a) Union Strength and Control.
Madagascar's labor union movement is weak, disorganized and splintered. The government policy is to keep organized labor in the background as the country's socio-economic problems have grown. Only two organizations (FMM and FISEMA) currently function as traditional trade unions, and have refused affiliation with any political party. A third union has direct political ties with the pro-Soviet AKFM party. Five splinter unions were formed by the various political parties in the mid 1970's, but exist more as workers' branches of the parties than as labor unions. A traditional role of Madagascar's trade unions has been to organize and to help rural workers via the formation of cooperatives. The activity has been neglected over the past ten years since many existing cooperatives were nationalized in the mid 1970's.

Madagascar's trade union members number approximately 100,000 (down 16,000 from 1965) with FMM and MISEMA accounting for approximately 40-50% of that number. The current economic situation, which includes high unemployment, low wages and inflation, does not encourage the growth of trade unions. Minimum wages have risen 17% over the last 20 years, while prices went up 145% in the 1970's alone. There is no national level collective agreement, nor has there been any collective bargaining since 1972. Further, no legislation has been promulgated to determine the application of the 1975 labor code. FMM members are reportedly critical of the government's socialist policies and are openly pro-Western. FMM, however, is neither strong nor effective by reason of lack of finances and member education.

(b) Labor Unrest. Malagasy labor is in no position to organize a collective protest. Anything that smacks of protest is crushed by the government. Labor's freedom of action in protesting government policy was further constrained by a 1979 accord with the government by the major labor unions agreeing that they would "collaborate to support the triumph of the Malagasy socialist revolution."

(c) Turnover and absenteeism. With the decline in the economy, labor turnover and absenteeism are not serious issues. Rather, layoffs, increasing unemployment, the general slowing of work and business activities, and gross under-employment are the problems now facing the labor force.

9. Adequacy of Fire and Police Services.

Both the fire and police services of Antananarivo have inadequate equipment and manpower. There are too few fire engines, and they are old. Thus, response time is long. In fact, in the case of fire, it is preferable to call the airport fire team as they have better, newer equipment. Inadequacy of the police force is seen in the rise of petty crimes, car theft and burglaries. Public drunkenness is on the rise in Antananarivo, especially in the early evening hours when police are not in evidence.

Security in the countryside in certain parts of Madagascar is reported to be breaking down. There are increasing incidents of livestock and crop theft, as well as personal assault. Reportedly, neither the police force nor the army is able to guarantee the security of these parts of Madagascar. The inability to respond is in large part due to the widescale breakdown of Madagascar's transportation infrastructure.

10. Facilities for Expatriates.

Good quality, but expensive, housing is available for expatriates. Basic foodstuffs are available, and there is an abundance of fresh fruits and vegetables. Fish and meats are of good to excellent quality, but dairy products are only fair in quality and all in short supply. Except for a few good quality canned goods produced locally, convenience foods are not available. Some American and European household equipment can be obtained, but is expensive.

C. Principal Sectors/Industries

The sectors and industries chosen are based on various critical needs of Madagascar (food, employment, state of the economy, balance of payments) and on the opportunities which exist and could exist for the private sector to grow. Annex 7 is a detailed description of the investment bank proposed, and as such examines the banking industry as a subset of the financial sector. It also includes more detail on the housing industry as a proposed activity for the investment bank to undertake. Following are the other principal sectors/industries selected for examination.

1. Agricultural Sector and Markets.

The key sector in Madagascar is agriculture. It employs 88% of the work-force, contributes over 40% to GDP and over 80% to export earnings, feeds 2/3 of the country's manufacturing capacity, and has good short term potential to increase output and farm family incomes. Currently, it is stagnant and as such contributes to increased food imports and a concomitant deteriorating balance of payments.

Markets are the principal key to unlocking the short term potential of the agricultural sector. Markets are also important from the standpoint of credibility, (i.e., hard data can be generated fairly quickly) for the proposition that a climate conducive to success of the private sector must be forthcoming. Discussion of markets, internal and external, can help prove to the GDRM that the private sector is the engine of growth we say it is. It can also set the stage for the more sensitive areas of discussion. The starting point in a policy discussion should be that of the markets this sector serves and could serve, and the agro/food processing industry as the "motor" to help rejuvenate the agricultural sector.

(a) The Food Chain. The Agro/Food Processing Industry. The agro/food processing industry is chosen as a key industry, and as a "motor", because a well-developed processing industry helps assure both markets (supply) and a successful agricultural sector (supplying its inputs and taking its outputs). The Malagache agro/food processing industry has large amounts of excess manufacturing capacity, due in large part to a lack of sufficient quantities of agricultural raw materials. Thus, increased agricultural production feeding and receiving from a well-running processing industry represents increased national income at very little cost.

(i) Strengths/Weaknesses. First, food processing and textile manufacture account for 60% of value added in Madagascar. Second, rice alone accounts for one-third of the value of agricultural outputs, livestock, 20%, fruits and vegetables, 17% and industrial/export crops, 15%. Furthermore, the cotton industry, through its by-product, cotton seed oil, supplies 15-20% of domestic demand (which is growing) for cooking oil. Cotton seed cake is used for feeding livestock. The foregoing shows the basic strength and breadth of this industry in Madagascar's economy.

Agricultural production is largely in the hands of the private sector, with some public sector involvement, direct and indirect (ownership, in sugar, large rice perimeters, cotton and coffee and other commodities. Agro/food processing is partly private and partly public. Certain large parastatals, and mixed ownership companies, operate with varying degrees of success across the gamut of post farm-gate activities. The government is also involved in marketing, input supply, and other activities normally the province of the private sector.

The food chain is a useful construct because food entails more than just the agricultural sector. It involves the entire gamut of activities from terms of food quantity and quality, than in the case of agricultural production alone. This chain includes all of the activities from the farmer to the consumer - on and off farm storage, transportation, processing, packaging, market communications, wholesaling, retailing, other market arrangements (e.g., agents, franchising, etc.) and ultimate consumption - including changing consumer preferences.

From the farm perspective of the food chain, the essential elements are the networks which supply farmers with production inputs, financial resources and consumer goods which make increased agricultural production for sale possible and worthwhile for the farm family. Consumer goods are necessary for the family to have things to buy - which availability in turn will cause them to produce more.

The use of this construct increases the chances to place scarce resources where they will have the greatest possibility of success and helps discover infrastructural gaps which can be filled - in order to capitalize on the business and physical infrastructure already in place. Examples abound of where high-potential opportunities exist - and these all represent on-the-shelf technologies and state-of-the-art practices. Post harvest food losses can be reduced via better marketing arrangements, timely transport from farm storage or field to processing point, establishment of cold-chains (refrigerated storage, transport and holding for sale), and better packaging (ranging from canning to aseptic packaging). It also permits greater use of technology to "side-step" seemingly intractable situations caused by institutional and/or physical bottlenecks.* Finally, the food chain focuses on the developing country's need to keep as much of the value stream of products in-country as possible.

The principal negative factors in this "industry" are the presence of state marketing monopolies, counterproductive economic policies (which discourage production and stall market opportunities), and the existence of badly run state processing enterprises, both large and small. The bright side of the picture is the government's willingness to see its past mistakes, and to start liberalizing the marketing activity as it did with rice, and to consider alternatives for its many agro/food processing "white elephants.

It should be noted that the fact that there is excess manufacturing capacity in a given processing activity may or may not be a strength. For example, the new soybean processing activity, Mamison, may never open (and perhaps never should) because of the lack of domestically grown soybeans and the more economic

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*It is often the case that certain macro- and micro-nutrients are absent in the diets of much of a country's population. The classical remedy could call for increasing agricultural production of certain crops two or threefold - often a physical impossibility. Technology offers a solution in the means to side-step the impossibility. The centralization of milling operations permits the fortification of flour, a low-cost, administratively simple, effective means of correcting some nutritional deficiencies. It is an entry point that is feasible, economic and helpful.

alternatives to soybean oil production which exist in Madagascar. Some of the factories, e.g. SOJUFA, are so rundown that it would be an act of mercy to simply stop operating.

(ii) Opportunities/Risks.
Strengthening the agro/food processing industry would take advantage of the business infrastructure and linkage to the agricultural sector and to the marketplace that already exist. It would help meet certain objectives the state has set, i.e., food self sufficiency, adequate supply of inputs to agriculture and increased value added in domestic manufacture.

Opportunities exist for AID. For example, the supply of steel under the CIP for the private manufacture of agricultural implements on animal traction equipment would strengthen an already productive artisinal industry. AID can draw on its Latin American experience in development of small scale agribusiness and market linkage. The foodchain construct will allow AID and GDRM to place resources so that local inter-industry links are built. Finally, concentrating on downstream activities - milling, storage, distribution, transportation and marketing - in the rice subsector, would take advantage of AID's current involvement in rice research, feeder roads and irrigation infrastructure.

A capsule description of how part of this industry can be a "motor" follows: Madagascar has 10 million cattle, over 20 million poultry, over a million swine and close to two million small ruminants. The cattle and small ruminants and most of the poultry are raised in the traditional extensive manner. The urban population, 2,000,000 people currently, is growing at a rate of 5% per year. Foreign markets exist, and in fact, Madagascar beef is preferred by some on a basis of taste.

Rationalizing of the production and collection system of animals for slaughter and meat distribution/ marketing process would not only directly affect Madagascar's internal and external markets (In 1972, Madagascar exported over 14,000 tons of meat and meat products. Exports slipped steadily over the next ten years to a low of 1300 tons in 1982.), but also as a ripple effect would cause more livestock to be forthcoming (there is already clear evidence of the desire of businessmen and potential businessmen to become increasingly engaged in livestock operations) thus lowering meat prices domestically and thereby affording more meat in the domestic diet. Also, there would be positive secondary effects on agriculture, agri-business and livestock-related activities - such as the increased need for feedgrains, feed supplements (including minerals and salt), veterinarian products and services, farm equipment, credit, trucks (and associated spare parts/maintenance/repair facilities), and a gamut of other products for more formalized livestock feeding programs, i.e., fencing, buildings, equipment, feedstuffs, and, of course, labor.

(iii) Government Attitudes/Priorities
Key government priorities are food self-sufficiency and rehabilitation of the agricultural sector. The state feels that industry's primary role is to insure an adequate supply of inputs for agriculture. Also, the state gives high priority to developing a greater capacity to process its many goods produced domestically, i.e., increase value added. Fortunately, the former government attitude that it would control most of the country's food activities through various "interventions", is changing. Indications of the change are the liberalization of rice marketing, the invitation to former French farmers to return, the complete prioritization of the production processing and sale (domestic and foreign) of butter beans, the benign neglect paid to the black market since December 1984, and the wide scale, public recognition that the government can not effectively operate many of its parastatals.

Given the current uncertain political situation, and the fact that the government must be absolutely certain of the importance of the private sector for development in order to take the necessary, difficult policy actions and to offer the necessary incentives for comprehensive development of the private sector, the approach to the GDRM must be one of proving to it that the best interests of Madagascar's economic development will be served by support of the private sector. Assistance to the industrial side of the private sector assists the indigenous side because it is this side which largely transports, sells, trades, builds, fabricates and services. In the end it is the GDRM that must convince itself that the private sector deserves support and that that support will entail necessary policy changes.

A useful vehicle to draw attention to the potential of the agro/food processing industry would be well conceived and prepared presentations to groups of leading businessmen and government officials.

Fora exist, and in fact the Ministry of Commerce asked for such gatherings. The presentations would deal with the key effects of the current economic/business stagnation (hard data) on this industry, the present and potential areas of endeavor not being realized because of various impediments and counterproductive policies, what it would take to release the potential and, once released, what that potential would mean to the industry and to the country.

2. Construction Sector.

(a) Housing Industry. Madagascar, as its urban population grows, and as its very young population enters the family formation stage, will need increasing amounts of low cost housing.

(i) Strengths/Weaknesses. The housing industry is selected because it is a "motor" industry, in the sense that demand for housing pulls forth economic activity all along the "housing chain" back to the forests, which produce much of the basic raw material of construction. It also encompasses different business activities which lend themselves to small and medium sized businesses, from home builders to wood cutters.

(ii) Opportunities/Risks. Growth in the housing sector provides various opportunities. First, it generates business activities from the sources of raw materials (wood, cement, brick) to the finished product (house construction, roofing, plumbing and electrical supplies, other construction hardware). The housing chain is also labor intensive, and its growth is an opportunity to alleviate, in part, Madagascar's growing unemployment. An additional opportunity would be the use of wood from the Matsiatra plantations which are becoming increasingly crowded, with attendant rise of fire and disease.

From USAID's standpoint, assistance to this industry would meet goals of employment and increased GNP, as well as capitalize on the goodwill already generated by USAID's recent disaster relief (anti-cyclonic housing) in Madagascar.

(iii) Government Attitudes/Priorities. While the government has not specifically designated housing as a key industry, it does consider housing to be important. It views housing as an integral part of the orderly development of urban centers, which in turn, it believes are key links to rural areas both as markets for rural products and as sources of products for rural areas. It recognizes that over the past 10 years, this linkage has been broken and must be reestablished.

3. Export Sector

(a) Principal Export Crops. Although we state earlier in this report that too much attention is being given to exports as the saviour of Madagascar's adverse balance of payments and foreign exchange situation - especially in the short term. The country's principal export crops, coffee, cloves, vanilla, fish and shellfish, make up approximately 75% of total export value:

Crop	1982	1983
Coffee	29%	40%
Cloves	25%	5*
Vanilla	18%	20%
Fish/Shellfish	6%	8%
	78%	74%

(i) Strengths/Weaknesses. Export crops, in the short term, are one of Madagascar's principal means of stopping the deterioration of an perhaps improving its balance of payments and foreign exchange positions. Of the major export crops, coffee is the most important, accounting for over $110 million in receipts in 1983. Cloves and clove oil exports have been as high as $80 million in 1982. Exports of natural vanilla, the world demand for which Madagascar supplies 80%, accounted for $58 million in receipts in 1983. Fish and shellfish in 1983 generated $23 million.

For the land crops, the private sector plays a significant role in production, processing and trading. Production of coffee, cloves and vanilla is predominantly in the hands of independent small holders. Collection of crops and primary marketing are largely private. Further, there are about 20-30 private enterprises (European, Chinese, Malagasy) engaged in crop processing, especially vanilla and the "lesser" export crops (pepper, other spices, sisal products, maize, tapioca, tropical fruits). Many

*Sharp decline due to Madagascar's failure to negotiate a contract with Indonesia, Madagascar's principal customer.

of these firms have been in business over 30 years. Given more favorable production conditions and a more conducive business environment, these companies could expand exports and markets.

On the negative side, many of the same factors which plague Madagascar's internal economy, are a detriment to export activities. The principal bottlenecks are deteriorating transportation, storage and marketing facilities, pricing systems which serve as a disincentive for greater production, decrease in product quality, absence of a coherent market strategy and lack of resources and skills to promote export crops and open new markets. Externally, Madagascar faces a generalized slow growth in demand in what she produces, coupled with growing competition from other countries for coffee and spices.

(ii) Opportunities/Risks. Various modes opportunities are present. First Madagascar has the potential to produce Arabica coffee which commands a 5-15% price premium on world markets. Madagascar also grows an indigenousindigenous, caffeine-free coffee, "mascaro coffea". She also grows (predominantly) robusta coffees, which are preferred in France and Italy. While Madagascar's coffee exports have not kept pace with the slow growth of world demand, the Ivory Coast and Cameroon, for example, have outperformed Madagascar in both ICO (International Coffee Organization) quota markets and in non-quota markets.

For cloves, the only major constraints currently are labor availability (production) and the availability/ generation of export markets. From 1970-1980, Madagascar became the principal supplier of cloves to the world, at the expense of Tanzania. Today, however, Madagascar is beginning to face completion from Brazil, Indonesia, Malaysia and Sri Lanka. Madagascar needs to exercise flexible pricing to retain its regular markets and to get into new ones.

Natural vanilla's two largest markets are the U.S. and France, and Madagascar is the main supplier. Market promotion in the U.S. and France so far has blunted the use of synthetic vanilla. Madagascar has a near monopoly position in the supply of vanilla, and produces the premiere variety of vanilla. Unfortunately, Madagascar's exports of the dried product barely conforms to minimum standards (content, consistency, aroma, color, cleanliness) set by importing countries/users. The risks Madagascar faces, if she does not improve the reliability of supply of quality product at reasonable prices, is loss of markets to new or expanding producer countries, and to synthetic vanilla (synthetic vanilla is available at approximately 1/100 the cost of natural vanilla extract equivalent).

Madagascar must consolidate her current markets and discourage new producing countries by maintaining reasonable prices, by active trade promotion, and by raising product quality.

Fish/shellfish exports are principally comprised of frozen shrimp sold to Japan, Hong Kong and France. "Lesser" crops offer some opportunity, e.g., maize in Indian Ocean markets, cocoa for high quality chocolate manufacture (Malagasy cocoa, the little that is grown, is the Criolla type - and is in high demand in Europe), butter beans (U.K., Indian Ocean and Japan), green pepper (world trade), sisal (world trade).

USAID could consider assisting Madagascar in the organization of private sector capacity to do detailed export market surveys/assessments of current and potential markets, or new uses for existing products and promotion of those products, current and new, which have potential. Most of Madagascar's exportables are foods and food products. There is a natural U.S.-Madagascar "partnership" here - no country has more food product marketing expertise than does the U.S.

(iii) Government Attitudes/Priorities. The government has effectively established a monopoly over trade in coffee, cloves and pepper. It also has a high degree of financial and administrative control over vanilla and other agricultural exports. On the other hand, there is no clear policy to develop export crop resources. The government places high priority on balance of payments correction and the need to obtain foreign exchange. Recently, the state turned over marketing/export of butter beans to the private sector, and it may be increasingly receptive to more decontrol.

4. Transportation Sector

(a) Road Repair and Maintenance. This area is selected as a potential "industry" because for Madagascar to have a viable economy, its road infrastructure must be well maintained. Lack of maintenance is what led to the current deplorable state of the country's roads.

(i) Strengths/Weaknesses. The repair and reconstruction of Madagascar's paved road system is planned, funded and, in part, currently being carried out. Thus the "market" for repair and maintenance is growing. The basic weakness is the Malgache unfamiliarity with the concept of timely, adequate maintenance. Coupled with this weakness is the government's limited management ability to carry out extensive road maintenance, and the lack of equipment to do the maintenance.

(ii) Opportunities/Risks. This "industry" has to be developed from the ground up, since there are virtually no firms which specialize in road maintenance and repair, paved or unpaved. Only the very few large firms which build roads have the capability, but perhaps not the incentive/willingness, to do road maintenance. There is a limited pool of skilled labor, engineers, and management familiar with road construction/maintenance in the Ministry of Public Works. Conceivably, this group holds potential entrepreneurs, who with incentives, could be encouraged to start maintenance operations and become the nucleus of a new "industry." The key needs will be equipment, skilled labor, government willingness to spin off maintenance operations, and willingness to offer incentives/assistance to start up businesses.

(iii) Government Attitudes/Priorities. The government has designated the rehabilitation of the transportation sector second only to that of the agricultural sector. Since the village level/ cooperative type arrangements and central government activities for road maintenance have largely failed, the government could be receptive to encouraging the private sector in this area.

D. Other Considerations

1. Corruption.

Corruption is not inherent in the Malagasy. In fact, Malagasy proverbs and certain customs indirectly inveigh against greed.

Corruption is relatively new to the Malagasy and is in large part due to the economic deterioration of the country. It also, in turn, aggravates the economic situation. Corruption takes two forms: first, petty corruption (graft) at lower levels of employment by employees using all means to make ends meet; second, larger scale corruption by well-placed officials using their positions to increase their own wealth.

Corruption, has reached the scale where the churches feel it necessary to speak out to their parishioners. Corruption, however, is contrary to the Malagasy nature. It is not inherent in them. Anthropologists and foreigners, born, raised and working in Madagascar bear this out. Furthermore, many Malagasy recognize corruption as a severe problem and are visibly hurt when speaking of it.

2. Sanctity of Contracts.

Traditionally, the Malagasy respect harmonious relationships between individuals and between families and larger groups. Rare infractions of relationships are punished by the group. Until the recent economic crisis, deals and contracts were generally concluded verbally, and were respected.

Increasingly, written contracts are in use today. The deterioration of the economy and the growing pressure to use every means at one's disposal to make ends meet, has led to the growing use of written contracts. Even so, in those cases where contracts (written or verbal) are not respected, it is usually due to lack of funds or means rather than bad faith.

References

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[c]World Bank, "Madagascar: Current Economic Situation and Prospects", October 25, 1984.

[d]U.S. Department of State, "Background Notes - Madagascar", September 1984.

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ANNEX 4

ECONOMIC AND INDUSTRIAL POTENTIAL

For the convenience of examining the potential for private sector development, the Malagasy economy can be divided into 12 major sectors and about 50 sub sectors. These are listed below with a brief notation as to whether private sector investment - local and/or foreign - can reasonably be expected to increase in the near future (next 2-3 years). These notations are based on the assumption that there will be no deterioration in the political climate, no further overt government involvement in the economy, but continued government withdrawal whether by explicit policy or by inadvertence. This part of the report concludes with detailed descriptions of the 10 most promising sub-sectors, for new private sector investment which in order or potential are:

1. Oil exploration
2. Road repair
3. Rice production and distribution
4. Textiles
5. Transport companies
6. Housing
7. Meat production and distribution
8. Small hydro development
9. Processing of agricultural products
10. Export/import.

Potential for New, Near-Term Private Investment by Economic Sub-Sector

1. Agriculture

Rice production and distribution	-	Very Good
Meat production and distribution	-	Good
Coffee production and export	-	Poor
Cloves production and export	-	Poor
Vanilla production and export	-	Poor
Other agricultural production and export (e.g. pois du cap)	-	Fair

2. Forestry

Chipboard Mill	-	Fair
Sawmills	-	Fair
Fuelwood plantations	-	Fair
Charcoal production and marketing	-	Fair

3. Energy

Oil Exploration	-	Very good
Heavy oil/tarsands development	-	Poor
Refinery operations	-	Very poor
Petroleum distribution	-	Fair
Small hydro development	-	Good

4. Minerals

Chromite operations	-	Very poor
Gold mining	-	Poor
Other export minerals	-	Fair
Construction minerals	-	Fair

5. Transportation

Transport companies	-	Good
Railroad operations	-	Poor
Port operations	-	Fair
Air Transport	-	Poor

6. Construction

Road repair and maintenance	-	Very good
Housing	-	Good
Infrastructure development	-	Poor
Building construction	-	Fair

7. Manufacturing

Textiles	-	Very good
Processing of agricultural products	-	Good
Metal working	-	Fair
Other manufacturing	-	Fair

8. Commerce

Export/Import	-	Good
Wholesale	-	Fair
Retail	-	Fair

9. Finance

Commercial banking	-	Very poor
Development banking	-	Poor
Investment banking	-	Fair

10. Tourism

Hotels	-	Fair
Restaurants	-	Fair
Tour operators	-	Poor

11. Business services

Accounting	-	Fair
Consulting	-	Fair
Engineering and design	-	Poor
Maintenance and repair	-	Fair

12. Social Services

NGOs/PVOs	-	Fair
Health	-	Poor
Education and training	-	Fair

Summary:			
	Very good	-	4
	Good	-	6
	Fair	-	23
	Poor	-	11
	Very poor	-	3
	Total		47

Most Promising Sectors

The most promising sectors for an increase in private sector investment in the near term are described briefly below in order of priority:

1. Oil Exploration

This activity must lead the way given the fact that Amoco has already announced that it will spend an additional $60 million in drilling on-shore, Mobil is about to begin to drill off-shore, and announcements of the intentions of Occidental/Unocal are expected soon. Unfortunately, in the nature of this business, not all of this investment stays in the country. In fact, most will move abroad to pay for imported goods and services. Nevertheless, what remains will be considerable, and will be the biggest single private input into the Malagasy economy in the near term.

There is a good chance of an oil and/or gas strike, but it will have to be evaluated before any development plans are made, especially in light of the falling global oil markets.

Even if a field is found and developed, it could be 8 - 10 years before positive cash flow will accrue to Madagascar, as the cost of development will be high. Amoco estimated it will cost at least $300 million for drilling and developing an oil field.

2. Road Repair and Maintenance

This activity ranks second because it too is funded. Five or six donors have allocated more than $110 million for fixing the roads, and private foreign and local firms are ready to make the necessary investments that will be required to do the work. One firm - Colas - already has considerable investment in Madagascar in plant, machinery, and facilities.

It is not clear how this work will be done, and there is considerable doubt as to the management ability of the Ministry of Public World which is charged with the task. It is also not clear how the roads will be kept in repair once they have been rebuilt, but there is scope for private firms to do much of this work under contract.

3. Rice Production and Distribution

This activity is ranked third on the expectation that the current tolerated black market, in which the price is 2 - 5 times the controlled price, will eventually become a "grey" market, and then the only market. Experience in other countries with similar market developments shows that the price will swing wildly as higher prices attract new producers to the market. In turn, this will dampen the market as it is flooded with new products. Eventually though, the price is likely to settle down at a higher level than at present which will be attractive enough to keep a permanent number of newcomers in production, transport, distribution and marketing. There will be a corresponding increase in rice milling and processing.

It is likely that only local investors will participate in these developments, although there are some possibilities for foreigners, as is the case of the returning French farmers, and as would be the case if the government sells off its rice parastatals at attractive prices.

4. Textiles

This sector ranks high because it is now well developed, stands in world class for quality and cost, and can be easily expanded, especially if new markets are opened abroad or locally. Foreign markets will be difficult as the competition is strong, but Madagascar has done well in the past in the face of this competition. The local market has great potential, especially if there were an increase in agricultural activity - as described above. This would bring a corresponding increase in demand for all consumer goods and particularly clothing which is now in poor condition among the rural people. New investments in textiles would be mostly local although there is scope for foreign participation in the local plants.

5. Transport Companies

With the slow movement of state-owned companies out of the transport business, the lifting of transport tariffs, and the eventual improvement in the roads, it can be expected that more private sector transport companies will come into business, and that the existing ones will expand. Simple calculations show that the existing tariffs offer good returns to well run trucking companies despite the poor road conditions and consequent low speeds and high operating costs. If tariffs are allowed to increase, or even go free, an increase in activity is bound to occur. One inhibiting factor is the poor state of repair of the truck fleet, and the high costs of importing spare parts and new trucks. New transport investment is likely to be strictly local.

6. Housing

There is a high demand for housing, especially in the Antananarivo area, and in places devastated by cyclones. There is also a vast unused forest resource of 80,000 ha of maturing pine plantations. Other building materials are available locally, or soon will be, as there are projects to build plants to produce builder's hardware. Housing construction will also reduce unemployment. There are thus many complementary reasons why housing could become an important activity, especially if economic activity in general builds up, and if suitable financing means can be found for home owners. There is great scope for the local private sector to catalyse this potential, and there are indications that it is willing and able to do so, if it receives the proper political and financial signals.

7. Meat Production and Distribution

Madagascar has adequate herds on which beef and pork production can be expanded, and it has a tradition of high meat consumption. Facilities for modern meat production and distribution are inadequate, and the sub-sector had a severe set-back recently when botulism in bad meat led to scores of deaths. Many schemes are being discussed to improve the situation and to fill these gaps in the market, some based on sound current operations. There is also the possibility of meat exports to the EEC where Madagascar does not fill its allotted quota. On the other hand, the nearby export market of Mauritius and Reunion is slowly being invaded by meat from Botswana and South Africa. It will take considerable efforts to realize this potential, but the basic building blocks are in place. The development of the meat industry is likely to be entirely by local investors.

8. Small Hydro Development

Considerable potential is available for the development of small hydro-electric schemes either connected to or isolated from the electrical grids. There is sufficient industrial and construction capacity in the country to allow most of the schemes to be built locally from local materials. Only a minimum of imports will be necessary. USAID is supporting this development, and will soon dispatch a detailed survey mission to do pre-feasibility studies. Development of small hydro and housing development - can be core activities around which many other activities can develop. The potential is greatest in the east coast area which has the greatest population density, the highest concentration of agricultural activity, and many suitable hydro sites because of the high rainfall and steep mountains.

There is ample scope for the local private sector to be involved in small hydro development, both in supplying goods and services to build the plants and in owning them. This is especially so in unconnected schemes which could be developed by local communities which can establish - with technical assistance - their own local power authorities.

9. Processing of Agricultural Products

This sub-category would include such activities as rice milling, meat processing, soap making (processing of tallow), and cooking oil production, in the near term based on the rehabilitation of existing facilities and taking advantage of the great demand for the final products. In the longer term, other activities can be envisaged, especially those which would put the current "white elephant" projects onto a sound footing once the economy improves and raw materials become available. Among the latter are flour milling, soybean processing and leather production.

Many local private businessmen speak of projects in rice, soap, meat and cooking oil and wait only for the right circumstances to launch them. The longer term projects are not yet discussed, but clearly something will need to be done to put the expensive plants to use.

10. Export/Import

This sub-sector has recently been dominated by state-owned enterprises in an effort to do away with the perceived excesses prior to the revolution when the sector was wholly in private - and often, foreign - hands. There is tacit admission that the state-owned enterprises have failed in maintaining export markets, let alone in securing new ones. The dramatic shift of Indonesian cloves purchases to Tanzania after a long tradition of buying from Madagascar is the most clear example of such failures. The government is slowly moving out of the business, as it has demonstrated in the case of poids du cap exports, and could - and should - be persuaded to shift all of exporting to the private sector once more.

On the import side, state-owned enterprises again dominate, not so much as trading companies, but as producing enterprises that require foreign inputs. As many of these are of questionable worth - under present circumstances - there is a strong case to be made to curtail their activities in the near term, and to free up the import capacity for other activities which would be mostly in the local private sector.

ANNEX 5

STRATEGY AND POINTS FOR POLICY DIALOGUE

This annex examines the underlying strategy for establishing an indepth policy dialogue between the US and Malagasy governments to improve the prospects for private sector development in Madagascar. It then details a number of talking points and minor actions that the Ambassador, his 3 political/economic officers and the AID mission officer in Antananarivo may wish to use in their disucssions with counterparts in the Malagasy government. It finishes with some views on executing policy dialogue pointing out that there is a degree of urgency to remove present frustrations, and offering a clear chance for positive success.

Strategy

The plan is based on six underlying strategic considerations that are derived from the identification of the constraints now inhibiting private sector development.

1. Political Reinforcement Is Needed

The Malagasy government is in dire need of practical political measures it can take to continue its moves away from extreme marxist-socialism. It needs to deal with justifiable fears that non-ethnic Malagasy and the Merina people will take the best parts of a more liberalized economy, and to handle the vested interests who want to maintain the status quo. There is much in recent American political development that can be called on to supply this reinforcement.

2. Need to Increase Financial Resources

The severe limits on credit brought about by the following IMF/Paris Club guidelines need to be relieved in a non-inflationary way if the private sector is to grow. This can be done by reducing government demand for credit, which will occur as and when the government withdraws from its now excessive involvement in the economy, and by the creation of a new financial institution to fund private investment but not consumption. PL 480 funds could be used to help create such a new investment fund for the private sector, and move away from the current practice of adding these funds to government revenue, an inflationary process.

3. Reduction of Government Involvement

In order for the private sector to grow it will be necessary for the Malagasy government to reduce its involvement in and its mis-direction of the economy. In fact, the best government involvement would be the least involvement. There is no need to create new institutions or to elaborate new sets of laws and regulations, but rather a need to deliberately dismantle the plethora of existing controls that now inhibit production income and thus private sector activity. There are indications that the government recognizes this, especially in the way it is allowing the operation of a grey market in consumer goods. It is necessary to formalize such non-actions, and to initiate others. The less the government is involved, the fewer policies need to be elaborated and debated, the less the bureaucracy needs to be reinforced and the faster the Malagasy people will take care of themselves. The past 6-8 years of deregulation in the USA and its positive effect on economic growth can be an example for the Malagasy to follow.

4. Re-orientation In Economic Management

At present the management of the economy is completely dominated by the external payments crisis. The crisis is still not over, but its resolution can be accelerated if the government will take more serious steps to reduce imports (especially those induced by its own activities) and improve exports. Shutting down state-owned enterprises of dubious economic worth would help reduce imports, and turning more of the export activities over the private sector would increase exports. As the payments crisis recedes, attention will need to be paid to the internal economy where the real growth possibilities lie for the future. The current restructuring of the American economy can provide some ideas and indications of direction even though it is not directly comparable to what needs to be done in Madagascar.

5. Improve Physical and Information Infrastructure

It is vital that the road repair and maintenance program be completed as soon as possible if the private sector in particular, and the economy in general, is to grow. Madagascar is a vast country and must have adequate transportation of which road transportation is the most important. At the same time, information resources must be revived and expanded. The USG could help the road program by offering technical assistance for the management of the repair program. Internal information resources will be improved by current USG assistance with agricultural statistics, and external information can be increased by small additions to the USIS programs.

6. <u>Improvement of Attitudes to Business</u>

The past decade of marxist-socialist denigration of private initiative, has all but destroyed the confidence Malagasy business people have in themselves, and created a poisoned atmosphere where profit motives and private endeavor are demeaned. This will have to change, externally in the sense that public approval of the private sector will have to be recreated, and internally in the sense that individuals will need to once again believe in themselves. The basic cultural milieu exists, as the current revolution has been a small part of a long and rich history which extolled individual efforts, but much will need to be done to get the Malagasy to reassert themselves. The American ethic is clearly appropriate, and ways could be found to make it applicable to the situation in Madagascar.

<u>Specific Opportunities and Suggestions</u>

Based on this strategy, a number of practical recommendations can be made, for USG intervention to improve private sector development. These suggestions consist mostly of policy dialogue measures that can be taken immediately by the US embassy staff. One of the recommendations will require more substantial inputs, as it calls for the establishment of a new private investment funding institution, but it will not require major new funding as it is based mostly on counterpart PL 480 funds. Only the investigations that will need to precede the establishment of the investment institution will need new study funding of probably less than $200,000. The proposal for the investment fund is dealt with in detail in Annex 7.

Suggestions are also made for possible future technical assistance to the government. They deal with help in managing the road repair program, developing data on the national demand for consumer goods, preparation of business and investment plans, and the temporary shutting down of unproductive state-owned enterprise.

The recommendations are presented in abbreviated form under the six headings used in the above strategic analysis:

1. <u>Political reinforcement</u>

   a. Encourage more open political discussion and debate to expose the issues - particularly those of fear of dominance by stronger groups, and methods dealing with vested interests.

   b. Create informal and formal fora where this can take place.

c. Bring in speakers to address how these issues were handled and are being handled in the USA.

d. Provide video-tapes, pamphlets and other literature on US debates on these issues.

e. Publicize recent US attempts to deal with official and unofficial corruption.

f. Expose US systems of affirmative action programs, set-asides for particular groups, definition and enforcement of minority rights, aid for displaced workers, and other relevant social and political steps to deal with a society in transition.

g. Arrange study tours of the USA for leading Malagasy to see such systems in action for themselves.

2. Increase Financial Resources

a. Develop agreement with the Malagasy government for the establishment of a new private investment institution based initially on PL 480 counterpart funds. Details of a number of different scenarios for such a fund, and the steps needed for a feasibility study are contained in Annex 7.

b. Ask for ideas, suggestions and proposals for such an institution from the Malagasy private sector, particularly from business associations, professional groups, and leading individuals. One such proposal has already been received as a result of the mission. It is attached to Annex 7.

c. Seek cooperation with other donor nations and institutions in the establishment of the new investment institution, but avoid excessive complications by not having too many people have too great a voice in its formulation, at least initially.

d. Integrate current and anticipated activities in housing and small hydro development into the formulation of the investment institution, both as a means of funding these activities, and as a means of providing suitable customers to it.

e. To improve the foreign exchange situation, encourage greater relaxation in foreign exchange controls, including allowing the FMG to float completely freely once some stability is reached, and abolishing foreign exchange control regulations, particularly at the border.

3. <u>Reduction of Government Involvement</u>

a. Draw on examples of recent US deregulation to demonstrate to the Malagasy government the value of doing away with regulations, and decreasing controls.

b. Point to the steps the Chinese have been taking in doing away with price control, privatization of state enterprise including state farms, and devolvement of responsibility from the center to the regions - steps the Malagasy could emulate while retaining some of the better aspects of socialism.

c. Discuss these political aspects with the Chinese embassy in Antananarivo.

d. Avoid any call for elaborate studies, investigations, or the establishment of new government institutions.

e. Promote pragmatic actions such as the recent visit of the US Navy repair ship which helped with repairing cyclone damage. Such actions speak more clearly and promote more real development than any number of studies can do.

f. Expose current US discussion and action on the disposal of state-owned assets like Conrail, Amtrak, the weather service, and satellite communication systems.

g. Urge the government to consider closing down of state-owned enterprises of dubious economic worth like the flour mills, soybean plants, leather plants, refinery, fertilizer plant, chromite mine, and Boeing 747, at least on a temporary basis until the economy improves enough to support these facilities. Offer assistance - if necessary - to take those steps. Urge the government to dispose of its participation in these enterprises and other parastatals.

4. <u>Re-orientation of Economic Management</u>

a. Encourage the government to move towards greater private sector participation in the traditional exports of coffee, cloves and vanilla, emulating the recent successful moves in this direction with poids du cap.

b. Suggest deregulation of other exports to eliminate the excessive red tape now involved.

c. Promote exports of Malagasy specialities to the US, especially embroidered clothes, gourmet food, and polished stones.

d. Assist in the promotion of the regional market for Malagasy goods, especially in East and Southern Africa, and the nearby islands.

e. Obtain UN and other studies on opportunities to reduce imports such as by producing spare parts locally, and encourage the implementation of the recommendations of these studies.

f. Stress the development of the internal economy as the only reliable place for continued growth in the future.

g. Suggest technical assistance to develop data on national demand levels for all types of consumer goods at different income levels to demonstrate the potential for their production in the future.

5. Improve Physical and Information Infrastructure

a. Offer technical assistance to the Ministry of Public Works in the management of the road repair program and coordination of the donors' activities. World Bank funding exists for paying for at least two full-time project management personnel. Offer to assist in their recruitment and/or to bring in a US project management firm.

b. Encourage the gradual dropping of road tariff schedules and promote other deregulation steps to allow greater involvement of private transport companies.

c. Investigate what can be done to assist in improving railroad operations, especially in speeding up the movement of the trains to increase capacity, and reduce unit costs.

d. Urge greater autonomy for the railroads and the ports - especially in setting tariffs.

e. Investigate ways to improve the availability of business and technical information, both internal and external, by working with Chambers of Commerce and other business organizations.

f. Bring in as many technical and business journals as possible via the USIS, and make them freely available.

6. Improve Attitudes Towards Business

a. Encourage greater self-confidence in Malagasy business people by such devices as meeting with them and their organizations to hear their complaints, arranging formal and informal meetings between them and government officials at which problems can be aired, explaining the workings of USG assistance - especially PL 480 and how the funds it generates can be made available, asking for written suggestions and proposals on how to speed up the liberalization of the economy and the establishment of a new private investment institution.

b. Follow up the project ideas listed in Annex ___ which were presented to the mission. Attempt to get the ideas more formalized as quantified business plans, showing proper cost/benefit analysis.

c. Investigate getting technical assistance to the business organizations to help with project preparation and formalization of business ideas.

d. Expand opportunities for Malagasy business people to use and learn English as the global lingua-franca of business.

e. Develop deeper understandings and encourage study and debate of the origins and nature of Malagasy culture, how it views business, why it has reacted so strongly against private enterprise recently, and how it is being shaped now by the economic collapse.

Policy Dialogue

These 36 points can form the basis of the continuing policy dialogues between USG and Malagasy government representatives and can add substance to the dialogue. The impasse which the Malagasy government now encounters is a serious one. Expectations have been raised by the swing back from extreme marxist-socialism and the current stagnation is leading to growing discontent. If no perceptible movement occurs, the situation might even become dangerous. Madagascar has a history of great tolerance and acceptance of poor or oppressive conditions followed by violent reaction to rid itself of the difficulties if no change occurs. Such a situation is building now, as is evidenced by a growing breakdown of law and order, more visible poverty on the streets, and a high amount of public drunkenness.

There is therefore some urgency to deal with the situation, and concrete actions like those discussed above would do much to alleviate frustrations. Most of the ideas have come directly from the Malagasy with whom the mission dealt. These recommendations are therefore wholly endorsed by the Malagasy private sector. The notions have also been discussed at various levels in the government, and no objections were voiced. The stage is therefore set for a continuation of the efforts initiated by the mission, which was enthusiastically received wherever it went.

Policy dialogue will probably center around the idea of establishing the new private investment institution. Possible objections to this idea will be based on the loss of new PL 480 funds for more directly suitable political purposes. That can be countered by pointing out the greater political support likely to result from the establishment of a truly new source of capital for the private sector. As there will be a need for some access to foreign exchange - in addition to the PL 480 funds which are wholly in FMG - it will be necessary to add other resources. Such sources as Commodity Import Programs, and funds from the Foreign Economic Policy Reform program, could be considered. Such offers of possible additional assistance should help to gain acceptance of the idea of establishing the new funding institution.

With the new investment institution as the centerpiece, policy dialogue on more directly political issues such as the need to change political direction, the withdrawal of the government from the economy, and deregulation will be made easier. The keys in discussion on these more sensitive issues would seem to be complete openness and frankness on the one hand, and drawing on the positive examples of recent American life on the other. Practical help can also be offered in the areas of infrastructure improvement which should temper difficult dialogue on the more sensitive issues.

Thus, the toughness of having to point out the serious shortcomings of the present political situation, and the need for rather drastic actions to correct them, can be assuaged by offers of very serious and immediately applicable help which will be bound to increase the government's stature. What the government might lose in taking the tough steps will be more than made up in the support it will receive if it moves on such things as the new investment institution.

ANNEX 6

CREATION OF A NEW INVESTMENT INSTITUTION

Purpose

This annex describes in some detail the concepts, modes of operation, and initial studies required to establish a mechanism to use PL 480 counterpart funds now building up in Madagascar to promote and accelerate the development of the private sector there. The annex responds to a request from the US Ambassador in Antananarivo for details to add to his on-going discussion with the Malagasy government for such an arrangement. There is some degree of agreement that the funds should be used for this purpose, and discussions now are concerned with the method by which this can be done.

The annex describes firstly an ideal arrangement whereby the funds would be used to establish a wholly private investment bank, then deals with compromises from this ideal that will probably be necessary given the political realities in Madagascar. It argues for as private an operation as possible, and cites a proposal from the Malagasy private sector prepared as a result of the mission. One use of these funds - for private housing development - is described. The annex finishes by describing some of the mechanics by which the funds could be transferred, and gives a broad outline of the initial studies that will be required.

The Ideal Case

In the ideal case the PL 480 funds would be used to establish a completely private investment bank. The new bank would be owned and operated by private Malagasy and American business people, and it would make its services available to all comers. It would favor development of enterprises

- that had a good track record or a good chance of success;
- that needed the least amount of foreign exchange; and
- that would produce the goods and services most needed by the economy.

It would probably emphasize projects to produce intermediate goods and services like spare parts, maintenance, and the first stages of agricultural production rather than too many consumer goods and services. The bank would probably favor small and medium sized enterprises, that needed capital infusions in the range of $50,000 - $200,000, but would keep a balanced portfolio, by also dealing with some larger customers. It would initially emphasize rehabilitation projects over new investments, and projects which could be implemented quickly.

The ideal bank would provide three main services - technical assistance and reimbursable* grants for project preparation; medium and long-term loans for specific projects; and minority equity investments in new and on-going enterprises. The terms of its financing would be set by the financial market conditions that prevailed in Madagascar at the time. The bank would also try to stimulate development of the capital market by offering its shares, issuing notes, selling parts of its loans and investments, wholesaling loans and investments in the enterprises it finances, and - eventually - underwriting new equity and loan issues.

Ideally, the bank would be characterized by simplicity of operation, openness in its dealings, and a high degree of transparency and even publicity about its business. It would be able to respond quickly to requests for financing in a straight-forward, clear and business-like way. It would have the technical expertise and business savvy to quickly assess proposals and to deal with them promptly.

It would take no financial risks in its loan operations, as all loans would be fully collateralized; but it would take risks with its equity investments and its reimbursable grants for project preparation.

It would probably operate a small subsidiary which would offer project preparation services at the lowest possible cost. Initially, much of this effort would be of the nature of project promotion as there is a need now to restore the confidence of Malagasy entrepreneurs and to help them to come forward with good, well-prepared projects. There may even be a need to go out and identify projects. On the other hand, as is usual with such operations, a good part of the bank's work will be to scale down overly ambitious projects, to redefine poorly prepared ones, and to reject clearly impossible ones while at the same time not deterring the entrepreneurial drive.

The bank would take its modus operandi and management systems from American rather than French banking experience stressing the concepts of openness, and quick business-like response. An ideal top manager would be a Malagasy with considerable American investment banking experience and good contacts among the Malagasy business sector. If possible, an American

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*Project preparation grants would be reimbursed if the project went ahead.

investment bank would participate in the ownership of the bank and assist it with technical and managerial services. The American partner would help the plan, start-up, and run the bank in its initial stages. It will be necessary for the bank to have access to foreign exchange. Ways might be found to use portions of AID CIPs to provide a source of foreign exchange. If Madagascar were made a Policy Initiative Country by USAID, it would be eligible for Foreign Economic Policy Reform funding which could be used to provide foreign exchange for the bank. It may also be possible to bring IFC into the ownership, or to get a line of credit from the World Bank (although that would require a government guarantee which should be avoided). If there were to be an American partner, it should provide part of its investment in foreign exchange and it may also be able to arrange lines of foreign credit once things settle down in Madagascar's balance of payments. As a last option, the government might be asked to provide a foreign exchange line of credit through the Central Bank.

Alternative Schemes

These are some of the characteristics an ideal investment bank would have. In the political realities of Madagascar today, it is very unlikely that such an ideal institution could be brought into existence. Stranger things have happened in times of political flux such as are occurring now in Madagascar, and so it is worthwhile to hold out for such an ideal, only reluctantly dropping away from it, and then with the understanding that the ideal will be reverted to when the situation improves.

It is likely, for instance, that the government will prefer the funds to be handled by one of three existing banks or by the FNI. It would be a mistake to let this happen as the banks and FNI are deeply involved in government sponsored operations, like the parastatals, and are subject to considerable political pressure.

As a last resort, it may be necessary to attach the new bank to one of the existing banks, but that should be done only if there is a water-tight barrier at the interface of the two institutions. Not only should the funds of the new organizations be kept firmly separate from those of the existing bank, but there should be no involvement in each other's management. Only at the board of directors level should there be any organizational joining. The new bank should not have to share premises with any existing bank.

It may be necessary to compromise at first by establishing not a new bank, but a type of investment promotion fund which would be less formally structured than a bank. Experience is being gained in such a use of PL 480 funds in Jamaica, although the chief activities of the new fund are in agriculture and agribusiness. In the Jamaica case, much of the fund's initial activity is thought to be in project identification and preparation.

It may also be necessary, for the sake of assuaging political concerns, to establish some "set-asides" by which particular target groups would either be guaranteed or denied access to the funds. The set-asides could be done by economic sector, by geographic region, by size of operation or even by tribal or ethnic group. It would be unfortunate if this became too formalized as it is likely that the funds would be spread around anyway by a prudent management wanting to have a balanced portfolio.

Need for a Fully Private Organization

It is the concept of a "prudent management" that argues most strongly for the new institution to be kept as wholly private as possible. The goals of such a management would be simple and straight forward, like making prudent investments, keeping a balanced portfolio, disbursing funds quickly so as to build up cash flow by recouping the repayments of loans and the growth of equity, and dealing with anyone in any sector who comes with a sound proposition. As soon as overt political goals are allowed to interfere, confusion creeps in as the fear of stepping on political toes causes reluctance to act boldly and decisively. In other words, an ideal private "prudent management" is likely to be a better guarantee of fairness and equity than would any amount of regulation imposed from without.

It would also seem anomalous to initiate activities to accelerate private sector development with the PL 480 counterpart funds through an institution that was not wholly in the private sector itself. Suspicions would be raised as to the sincerity of the intentions of the Malagasy and US governments if the PL 480 funds were used through the existing parastatal banks and FNI, or if they were used with too many political strings attached. There would be little likelihood that entrepreneurs would come forward with proposals in such a case.

There is clear and considerable support among all sectors of the Malagasy private sector for a truly private investment institution. Such a thing has not existed in Madagascar for a long time, if ever. Eyes light up, plans bubble out, courage and determination are restored and eagerness and vigor to participate in organizing the institution are expressed. It will be a pity to disappoint that enthusiasm.

An example of this enthusiasm is contained in the attached proposal from the Conseil pour la Promotion des Petites et

Moyennes Enterprises, a Madagascar (Council for the promotion of small and medium sized firms in Madagascar), prepared just after the mission left the country. The CPPME suggests the formation of a Fund for Industrial Promotion and Technology whose ownership would include the state, US financial and economic aid organizations, and the Malagasy private sector. It would have both financial and technical functions and provide some management consulting. Under the financial functions, the fund would provide funds for studies, equity and loans. In its technical functions, it would investigate, identify and promote projects including joint ventures with foreigners.

Financial Assistance for the Private Housing Sector

One use to which a part of the PL 480 counterpart funds could be put is to help the private housing construction industry develop. This has appeal for a number of reasons:

(a) Antananarivo reportedly needs 20,000 low cost housing units per year.

(b) The "housing chain" is wide and long - encompassing many potential small and medium sized business activities
including wood products (lumber, finished wood products, particle board, etc.), brick manufacture, manufacture of construction hardware and roofing, metal working, carpentry, plumbing and electrical supplies, associated distribution and service networks, builders and buyers/renters.

(c) The "housing chain" is largely labor-intensive and if expanded would help address one of Madagascar's concerns - growing urban unemployment.

(d) USAID has already been involved in housing activities as a result of its disaster relief in Mahajanga - an action which was visible to the Malagasy, and one which engendered goodwill. It would seem logical, politically, to capitalize on the goodwill.

Working under the aegis of the proposed investment bank, a strategy could be developed to assist the entire housing chain. Financial and technical assistance could be given, via the bank, to small and medium sized enterprises. Financial assistance would be in the form of loans for start-up activities, expansions and for operating capital requirements. Technical assistance could take the form of:

(a) assistance in proposal preparation, feasibility studies and start-up.

(b) assistance in production and operational areas, including logistics.

(c) management and financial training.

(d) legal assistance, in the sense of meeting regulatory and legal requirements.

Financial Operations

It is envisaged that PL 480 counterpart funds will accumulate at the rate of $11 million for FY85, and about $8 million for each fiscal year thereafter for at least 4 or 5 years. Thus, a total of $40 - 50 million could become available. This is a considerable sum by the current standards of the needs of the Malagasy private sector and would fuel a considerable expansion, if all the funds could be absorbed in sound, productive investment projects. Thus, the level of the proposed operation is significant, and would result in major changes in the Malagasy economic structure.

It is understood that the PL 480 counterpart funds belong - in legal terms - the host government, but that by agreement with the USG they can be used only for development purposes with which the USG approves. It is important to recognize that the legal owner of the funds is the Malagasy government, even though the USG has absolute control on the initial generation of the funds in its decision to ship PL 480 products, and the USG has absolute veto power on the use of the funds. This understanding is key to establishing the mechanics for the transfer of the funds.

Whatever type of institution is to be set up, it is strongly recommended that the Malagasy government not be required to place the funds in the institution in the form of an equity investment. This would give the government ownership rights, whereas the intention is to keep the government at arm's length as much as possible.

It would be better for the government to lend the funds to the new institution under a carefully negotiated loan agreement, which would have two main terms:

1. The funds would be lent at a concessionary rate of interest which would enable the institution to redeposit the funds in interest-earning instruments with Malagasy banks and so enjoy an interest spread which would provide it with its initial operating funds.

2. The government would have considerable rights in the use the institution made of these funds, but these rights would exclude involvement in the operation of the bank. The rights would be mainly to ensure that the use of the funds was spread throughout the Malagasy economy and among all parts of Malagasy society.

The new institution would then set about business, using the interest spread to pay for its operations, and for the initial study and promotion projects it would initiate. As soon as a viable project was available, the institution would withdraw funds from its bank deposits and place them in the project - hopefully earning as much as, if not more than, it did on its bank deposits. As the projects repaid their loans, the institution, in turn, could begin to retire its own loans from the government. By this time it would have acquired something of a track record, and should be in a position to raise its own funds in the market to replace those it repays to the government.

Under such a scheme, government participation, and the use of the PL 480 funds would only a temporary initial step to get things started. It would provide a transitional period where the government would be initially quite heavily involved - as the main source of funds - but would work at arm's length, and would be deliberately withdrawn from its involvement step-by-step as the loans were repaid. It would be in the interest of the institution's management to retire the government loans as soon as possible, so as to gain greater freedom of operation.

The scheme would also have the advantage of initially transferring the PL 480 funds to the existing banks even though in the form of somewhat short-term deposits. Thus the existing, government-owned banks would enjoy the use of the PL 480 funds, which would partly assuage their desire to be actively involved in the new scheme.

An alternative system - the one now being organized in Jamaica - would be to transfer some of the PL 480 operations from the government to a privately run institution. This institution would have two functions - one to receive and sell the PL 480 products, and the other to use the proceeds from those sales to set up and run a development finance operation. This would be particularly appropriate if some new PL 480 products were to be shipped. There is talk, for instance, of shipping tallow for soap making. These shipments could be handled through the device of a Jamaica-like institution.

Outline of Feasibility Studies

In order to properly plan a new institution to use the PL 480 funds to promote private sector development, it will be necessary to study the matter in more detail than was possible during the mission. The studies would have two main aspects - examination of similar operations in other parts of the world, and examination of the requirements - political and technical - in Madagascar.

A two-step approach could be envisaged, in which the experience in other parts of the world is studied in Washington through interviews at USAID, the World Bank Group and the Inter-American Development Bank. The results of this desk-type study could then be sent to Madagascar for review by the Embassy, the government, and private sector groups. Once they had had a chance to examine the other examples and consider how these might be applied to Madagascar, a study mission - which would include those who did the first step work would be sent to Madagascar to gather and then synthesize the views being generated there. It would also investigate objectively the financial and legal situation in the country and likely size and initial operations of the new institution, and the steps needed to get it implemented.

It is important that the Malagasy at all levels of government and the private sector be involved as much as possible in the formation of the new institution, if it is to be successful. Malagasy culture puts great stress on consensus-making, and it would be a mistake to simply impose ideas from outside.

This work would result in two main products - one being a description of examples of similar institutions throughout the world, and the other, a description of Malagasy ideas for the institution they would like to have. The study team would then make its recommendations as to the form of institution it sees as most appropriate, and the steps needed to be taken for its formation.

It is difficult to estimate the likely cost of such work, as it is not clear how many examples would need to be examined in Washington, whether some of them might need to be examined in-situ, and how long the gathering and synthesizing of Malagasy views would take. As a rough guess, the first step - the Washington data gathering stage might require two people for 4 weeks each; the second stage - the Madagascar investigations and consensus gathering - would require a larger team, probably four people for 4 weeks; and, the final step - report writing - would probably require these 4 people for another 2 weeks. Altogether this amounts to 28 personweeks. At a cost of approximately $3,000 per person week for the calibre of person required, the personnel cost would be $96,000. To this study management, travel, communications, and other costs would need to be added - amounting to a total of about $150,000.

It would also be good to make some study funds available for private Malagasy groups to give them an incentive to participate seriously. There was apparently a fund of 60 million FMG available in FY 84 called Fiche Technique which could be used for 40 - 50% of study work by local groups.

The funding of the American part of the study is probably best done by the Private Enterprise Department of the Africa Bureau as a follow-on project to the Assessment Mission. This would expedite the work as there is likely to be some urgency to mount this study effort, especially if the discussions between the Embassy and the government which will follow the mission are positive.