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MADAGASCAR MAPS
Private Sector Strategy

FINAL REPORT

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EXECUTIVE SUMMARY

The Government of the Republic of Madagascar has been implementing an ambitious economic liberalization program since the mid 1980s. The MAPS private sector strategy design process, which took place over the December 1990-May 1991 period, sought to assess the response of the Madagascar private sector to this program and make recommendations regarding the role of USAID in encouraging and further facilitating the transition to a liberalized economy.

Economic liberalization is a means to create more dynamic, broad-based growth, but only if the preconditions (physical, institutional, infrastructural) exist for efficient market transactions. These pre-conditions are: (a) free entry/exit, (b) access to information on the rules of the game, and to structures for enforcing observance of these rules, (c) means for reducing/minimizing information asymmetries. The MAPS research and dialogue activities carried out at the request of the USAID/Madagascar Mission sought to ascertain the extent to which the pre-conditions for efficient market transactions either existed or were emerging as a result of the economic liberalization process.

The results of research[1] undertaken over the last five months suggest that private sector response to the economic liberalization policies introduced in the mid-1980s has been positive, and seems to have gained significant momentum in the early 1990s. New entrepreneurs have entered the market in increasing numbers to become a source of growth and employment in areas hitherto controlled by the state. But growth has remained uneven and limited to narrow sectors. The research findings summarized below suggest that, while entry and firm growth have occurred as a result of the liberalization process, a series of basic market imperfections continue to hinder the growth and diversification of the local entrepreneurial base.

1. Research Findings

1.1 <u>The number of new entrants is increasing and the indigenous entrepreneurial base is slowly diversifying</u>. Data show that there have been approximately 5,500 new indigenous firms registered each year.

[1]Full reports on the secondary, survey and interview activities are provided under separate cover. See "The Private Sector in Madagascar: Role and Performance, 1984-1991," April 1991 and "The MAPS Private Sector Survey: Madagascar," April 1991. Summaries of these reports and of focus group discussions are provided in the Appendices to this report.

1.2 Barriers to entry have been significantly lowered. Lengthy registration proceedings, permits, high registration fees, have been effectively reduced. According to the recent private sector survey, 80 percent of the firms questioned reported needing less than 5 permits to begin operating, and over 85 percent reported that it required less than 6 months to obtain these permits.

1.3 Capacity utilization has been increasing; firms are reporting high growth and are generally optimistic about the future. Capacity utilization for all firms interviewed increased on average almost 10 percent, from 56 percent three years ago to 65 percent today. Over one quarter of all firms reported sales increases of over 20 percent over the last 12 months. Almost 30 percent believe this growth will continue over the next 12 months.

But:

1.4 Economic concentration remains high. Madagascar remains in most respects a two tiered economy. A small number of very large groups of firms continue to control the majority of commercial and industrial activity in the country, and the practically all distribution channels. Large scale firms, private or parastatals, continue to dominate most productive activity in the country.

1.5. Growth opportunities for SMSEs remain limited. Small firms continue to sell to a very reduced set of buyers, and depend on a limited set of suppliers. Commercial bank credit continues to be channeled exclusively to established large firms; most smaller firms or non traditional operators continue to depend on personal finances for over 90 percent of their capital needs.

1.6 Local markets are highly atomized and fragmented. Results from the private sector survey indicate that only 13 percent of all formal, internal commerce is inter-provincial. There are regularly 12-24 hour communication delays between the cities; the freight train takes on average 12 hours to travel the 180 miles between the largest port and the capital. Underdevelopment of local marketing networks hampers diversification, achievement of economies of scale and efficient specialization in production.

1.7 The economy is highly import intensive, and there is little local sourcing. Present institutional structures and infrastructural deficiencies do not encourage large firms to look inward for their markets and supplies. Large firms continue to look abroad for the provision of their basic machinery and parts, and have not actively sought to develop networks for local sourcing of inputs, even though doing so

would help to minimize their foreign exchange risks, hedge against shortages created by foreign exchange restrictions, and improve the local market for their products.

Key constraints to entrepreneurial diversification and growth:

1.8 Weak transport and communications infrastructure. Poor road and communication infrastructures hamper firms' ability to develop local input supply sources. High communication costs mean that none but the larger firms can afford to establish regular ties with traders and producers outside a limited radius. Poor roads increase transportation costs and reduce the margins for all but the higher volume producers. Internal trade and communications barriers lead most new entrants look to export markets as a means to increase demand for their product. But export expansion is only part of the answer: local markets must be integrated in order to encourage efficient operations and rational use of investment resources.

1.9 Weak institutional environment (legal, associations, taxes/regulations). Expanding one's base of business contacts entails new risks and considerable costs: one must be able to build new personal trust relationships with a new set of suppliers and buyers. Businesses are averse to seeking new contacts in part because of a weak, to non-existent, civil/commercial legal/judicial infrastructure for the enforcement of contracts (relationships between entrepreneurs) and protection of intellectual property. The lack of a well developed legal system for protecting intellectual property (or indeed property of any type) also explains why firms express extreme lack of confidence in sharing information with each other, and why there is an aversion to developing close operational and associational ties for accomplishing common collective goals.

1.10 Unclear rules/uneven rule enforcement. Uneven application of regulations has protected companies from additional competition. Limited freight space, particularly maritime and air, is often distributed on the basis of personal contacts, rather than through an open market, at times in violation of contractual agreements.

2. Recommendations: Strategic Framework for Private Sector Support

The Mission can make a major contribution to private sector development over the next five years, even if resources provided directly for private sector support remain limited, by leveraging investments in physical, financial and human resources made by GDRM and donors, and coordinating private sector support with its sectoral programs in the environment and agriculture.

The goal of USAID/Madagascar's private sector program should be to assist the Malagasy private sector to respond efficiently to opportunities offered by economic liberalization. To support this goal, two strategic objectives are proposed:

- Promote the integration of local markets
- Expand the scope of alternative income generating activities

To achieve these objectives, actions along three related dimensions are proposed:

- improving associations'[2] business support services,
- training,
- and policy dialogue.

Priority actions to achieve each of the objectives are outlined below:

2.1 **Promote the integration of markets.** The World Bank, and other donors, are investing heavily in improving Madagascar's communications and transportation infrastructure. Building roads and improving telecommunications, while absolutely necessary pre-conditions for economic integration, will not by themselves result in expanded growth opportunities for indigenous entrepreneurs. Such programs should be accompanied by technical assistance to enable Malagasy entrepreneurs to recognize and use the new marketing opportunities these improvements will provide.

USAID/Madagascar can complement these capacity-building efforts through technical assistance and training activities focused on:

[2] At least 18 business associations, of varying degrees of geographical influence, have been identified. These include the Chamber of Commerce, which has offices in all key cities, but whose effectiveness representing the private sector's interests varies greatly from office to office.

- -- improving association's ability to diagnose member needs and establish a viable and profitable menu of services;
- -- improving access to and provision of marketing information services through associations;
- -- providing training and technical assistance in marketing;
- -- improving knowledge about and access to joint venture investment opportunities through associations.

2.2 **Expand the scope of alternative income generating activities.** Significant for the Mission's focus on the rational use of resources, the internal market's lack of options to generate alternative sources of income increases pressure on the land and natural resources, and limits willingness to abandon traditional but adverse land-use practices. Further, the lack of alternative income generating activities will hinder the international community's efforts to preserve Madagascar's bio-diversity and environment as economic realities will necessitate exploitation of unique natural resources.

A series of donor programs are addressing the needs of new entrants, but their outreach remains limited. Indigenous Malagasy entrepreneurs require direct assistance so that they can recognize and then seize the opportunities created by the liberalization process. USAID/Madagascar can complement programs that encourage the entry of new entrepreneurs, such as ILO's entrepreneur incubator program, by fostering the provision of follow-on ancillary and slightly more sophisticated services, including basic business skills training and training in business English. Non project assistance can be used to encourage the use of fiscal instruments to foster more local sourcing.

Dialogue activities as well as training funds can be used to help develop alternative insurance options to reduce the costs and risks associated with the development of new markets or business relationships, and support the creation and use of financial instruments and institutions which help reduce the risks of lending to small or non traditional producers.

3. Implementation Mechanisms

In the absence of a private sector project in the short term, there are a number of existing structures available to capitalize on the high degree of Malagasy interest in USAID interventions. Some immediate avenues for strengthening private sector structures, and responding to the private sector priorities highlighted above are:

3.1 HRDA. The Mission should consider expanding the role of the HRDA committee to one of coordinating and evaluating additional private sector support activities. The HRDA committee could serve as a sanctioning and evaluation body for general private sector support strategy actions. This committee has had experience working with the Mission, and has the mechanisms and contacts in place. By working with a local body, interest in private sector support continues to be institutionalized locally, and the possibility for ongoing interest in these activities is enhanced.

Initially, the HRDA Committee can serve as a vehicle for organizing seminars and workshops to define association strengthening priorities. The HRDA Committee can also help identify association leadership exchange opportunities in the region (e.g. visits to builder associations in Swaziland, or transporter associations in South Africa, agro-exporter associations in the US and Caribbean). It can help identify and establish ties between private sector support institutions and other resources, helping for example to define and identify groups with which Peace Corps can work to provide basic business skills and business English training.

3.2 MAELSP. The project can be used to strengthen exporter and agroprocessing association services in marketing, and other basic business skills for agroexporters, and support services including transport.

3.3 RHUDO IQC (RECAP). The Mission can access technical assistance and training funds for small builders and contractors through this IQC. IQC resources can be channeled primarily to strengthen builder association services in the areas of tendering, contracting, and other basic business services. Success with builder associations can serve as an example and pave the way for other associations to become increasingly service oriented. Specific attention should be paid to small builder associations outside the capital. The IQC resources can serve as a means for strengthening and enhancing the self-sustainability of regional infrastructure building and maintenance initiatives. By strengthening the capacity of

small builders to tender and respond to contracting opportunities in road and other infrastructure maintenance emerging as a direct result of donor capital infusions for infrastructure development and eco-tourism, small businesses are assisted and regional development capabilities enhanced.

3.4 Peace Corps. Volunters are now scheduled to begin teaching English. The Mission could explore ways of expanding their scope into teaching business English. PCVs would also be an ideal mechanism for expanding basic business skills training.

In the longer-term however, as the economy continues to open and indigenous business activity grows, the HRDA and other existing mechanism may lack the funding or the flexibility to respond effectively to new opportunities for private sector strengthening. Hence, it is recommended that the Mission consider establishing a separate Technical Assistance Fund (TAF) for supporting activities under the objectives described above.

The TAF would specialize in non agriculture/agro-processing sectors highlighted in this report: transport, construction, manufacturing and finance. TAF resources would be primarily focused on the provision of technical assistance to improve information and marketing services provided through local associations. Associations wishing to receive funds from USAID would be expected to compete for access to the TAF. It would also be the distribution point between agents of competence and requesting associations and organizations.

1. BACKGROUND

The logic of the economic liberalization program begun by the Government of the Democratic Republic of Madagascar (GDRM) is that decentralized economic decision-making can be a tool for mobilizing and allocating development resources efficiently. But economic liberalization will not necessarily lead to increased resource mobilization nor more efficient economic decision-making unless certain preconditions exist. In particular:

- An efficient decentralized economy requires free entry and exit of economic actors. High barriers for either entry or exit will perpetuate economic concentration, decrease the efficiency of market based allocation mechanisms, and perpetuate price rigidities.

- An efficient decentralized decision-making system requires that all actors have access to information on the rules of the game, and to structures for enforcing observance of these rules. Unclear rules or uneven rule enforcement will also raise entry barriers, and artificially limit the expansion of markets.

- An efficient decentralized decision-making system based on markets requires structures which guarantee economic actors at least equal opportunity to relevant market information -- on prices, suppliers, sellers, and risks. Asymmetries in information will create structural rigidities in prices and create non competitive behavior, thereby limiting entry and growth of new players in the economic arena.

The private sector strategy assessment implemented over the December 1990-May 1991 period at the request of the USAID Mission sought to develop:

(a) deeper and broader knowledge of the changing economic and regulatory environment brought about through the economic liberalization process;

(b) understanding of the effect of that environment upon different segments of the Malagasy formal and informal private sector and upon its evolving linkages with the public/parastatal and foreign private sector; and

(c) an understanding of the types of interventions and entrepreneurial support mechanisms necessary and available to enable the Malagasy entrepreneurs to respond effectively to the economic liberalization

process. The Mission wished to emphasize growth and diversification into non-traditional and environmentally neutral areas of activity.

The results of the research activities[3] undertaken over the last five months suggest that private sector response to the economic liberalization policies introduced in the mid 1980s has been positive, and most importantly seems to have gained significant momentum in the early 1990s. New entrepreneurs have entered the market in increasing numbers to become a source of growth and employment in areas hitherto controlled by the state. But growth has remained uneven and limited to narrow sectors. Research suggests that a series of basic market imperfections continue to hinder the growth and diversification of the local entrepreneurial base. The section which follows will highlight basic findings from the research and dialogue and outline the rationale for the recommended private sector support strategy.

[3] Full reports on the secondary, survey and interview activities are provided under separate cover. See "The Private Sector in Madagascar: Role and Performance, 1984-1991," April 1991 and "The MAPS Private Sector Survey: Madagascar," April 1991, as well as the summary these reports and of focus group discussions provided in the Appendices to this report.

2. FINDINGS

This section summarizes key findings regarding the pattern of private sector development in Madagascar over the last five years, and in particular, key issues affecting the expansion and diversification of the entrepreneurial base. Findings are divided into three major issue areas:

a) entrepreneurial response to the liberalization;

b) economic integration and growth;

c) institutional environment.

2.1 Entrepreneurial response to emerging opportunities for entry and growth: is the structure of the economy changing? The answer to this question is a qualified "yes." Over 5,000 new firms are registering per year, according to the central statistical service. Data show that private firms have moved into areas previously controlled/dominated by parastatals, including agro-processing. Given that the domestic market comprises less than 12 million people, and that the export market for traditional agro-exports is mature, there may at first glance appear to be little opportunity for new private sector, entrepreneurial entrants. This would be the case should one pit inexperienced entrants against the established agro-merchants and trading houses in a stagnant/mature market. However, the experience over the last 5 years suggests there is ample room for new entrants willing to enter non traditional areas of activities, especially as the liberalization program frees up more disposable income for purchases on the domestic market, and infrastructure development improves access to a broader base of consumers.

One example of a successful entrant who expanded traditional agricultural strengths of the local economy to satisfy export demand is the Ste Bongou, of Ambohidratrimo. This SARL directed by Mme Josette Razafiarosoa is a vertically integrated producer of EEC-standard *pate de foie gras*. It was founded as a sole proprietorship in 1980, converted to an SARL in September 1988, did a little more than FMG100 million[4] (US$55,000) in business in 1989, and received its EEC certificate in July 1990. Its product, a duck *foie gras*, received the International Food Award this year at the Madrid International Food Salon. The company produces vinegars, condiments from piment, cornichon and lemon, and a

[4] FMG = Madagascar Francs. The rate of exchange as of May 1991 was approximately FMG 1,800 = US$1.00

duck pate produced from its own farm. It has expanded its product line and exports to France and Reunion and soon to Germany.

Madagascar reveals other such new entrants, as well. However, not all new entrepreneurs, in any economy, move this quickly, and no one can predict whether the Bongou's will continue to grow. But, as the above example amply illustrates, basic conditions for successful entrepreneurial entrance into the private sector exist in Madagascar. The better equipped and least risk adverse entrepreneurs are already responding to the liberalization of the economy and will be poised to fill expanding domestic demand as it develops. Despite the past blocking role of the established first level players in the market, recent policy changes made during the economic liberalization period and effectively reduced or eliminated structural barriers to entry. Basic interventions (e.g., training, access to market studies, some form of financial support), can have a major impact in this environment by encouraging new entrepreneurs to enter the market.

But in many ways the Madagascar economy continues to exist at two levels. The first level, representing the majority of business revenues, consists of the agricultural producer/merchant firms and parastatals. The second level, comprising the bulk of the population, but a relatively small share of business revenues, consists of the small traditional agricultural producers and small enterprises producing primarily for subsistence. The sections below illustrate some of the reasons why this is so.

2.2 Economic Integration and the Growth of Markets. The concept of a national economy is misleading in Madagascar. Not only is there a two-tier economy on a national scale, but there are also numerous small domestic markets all of which are, by and large, independent of each other. Evidence from the MAPS Research indicate that markets are fragmented in a variety of ways --by location, by size of economic actor, by nationality of economic actor and by sector of activity.

2.2.1 Severely underdeveloped communication and physical infrastructure has limited geographic integration of markets. Poor road and communication infrastructures have exacerbated the dependence on very localized markets; high communication costs mean that none but the larger firms can afford to establish regular ties with traders and producers outside a limited radius. Poor roads increase transportation costs and reduce the margins for all but the higher volume producers. Results from the private sector survey indicate that only 13 percent of all formal internal commerce is

inter-provincial. That any significant volume of internal commerce exists between Antananarivo and Toamasina is actually astounding, considering that there are regularly 12-24 hour communication delays between the cities and that it takes 12 hours for the freight train to cover the 180 miles. These limited markets hamper diversification, achievement of economies of scale and efficient specialization in production.

There are some satellite uplink facilities in the capital and main naval port. But the commercial ports of Toamasina and Mahajanga have no, or extremely difficult, direct connection with the overseas customers.[5]

The flawed national transport and communications network, and concentration around the capital, Antananarivo, mean that most firms located outside this area must also bear inflated overheads to stay in business. Most firms located outside the capital also have an agent or office in Antananarivo in order to gather business information on a personal, face-to-face, basis, whether they actually conduct their main business in Antananarivo or not.

Finally, communication/transport costs are inflated by the oligopolistic structure of the freight industry, and weak insurance markets. Though most larger firms have integrated forward into the transportation of their products from the point of production to the point of market, most firms must rely on the few transporters which provide inter-provincial carriage. Interview data suggest fees may be artificially high due to lack of competition; transport fees are also inflated by the need to operate fleets exceeding actual capacity requirements to compensate for the cost to use the roads.

2.2.2 Local sourcing remains very limited. A small number of very large groups of firms continue to control the majority of commercial and industrial activity in the country, and the overwhelming majority of distribution channels. These firms continue to look abroad for the provision of their basic machinery and parts and have

[5] A South African entrepreneur with European broadcast experience is presently negotiating use of Russian satellite transponder space to distribute a weekly, English language television service to the southern Africa - Indian Ocean basin region from a Madagascar operating site.

not actively sought to develop networks for local sourcing of inputs. Though doing so would help to minimize their foreign exchange risks, hedge against shortages created by foreign exchange restrictions, and improve the local market for their products, the types of institutional and infrastructural deficiencies, highlighted above, do not encourage large firms to look inward for their markets and supplies. For example, large firms cannot establish long-term contracts with smaller transporters to carry their goods to markets because of the large uncertainties created by poor road conditions. Small transporters cannot guarantee regular on time delivery of goods because of constant break downs in equipment, roads and bridges.

2.2.3 Local entrepreneurs lack access to market information and knowledge of basic marketing techniques. This exacerbates marketing problems caused by poor physical infrastructure. Madagascar now has a number of potentially rich domestic sources of business information, some of them commercially published. They include the several competing Malagasy and French language daily newspapers, weekly and monthly magazines including DMD, Jureco, PME, and others planned. But these publications are limited in impact, with print runs of between 2,000 and 10,000. From focus group discussions, and survey responses, it appears that even employees of the major trading houses are not able to organize their sources of business and market information beyond their traditional, personal trading relationships.

2.2.4 There has been little integration between indigenous and non-indigenous Malagasy firms. Non-Malagasy operators, first the French, then the Chinese, and now the Indo-Pakistani, have traditionally controlled first tier businesses. The present prevalence and dominance of the Indo-Pakistani community has bred resentment. This is potentially Madagascar's most dangerous type of fragmentation.

2.3 The Institutional Environment: Effect on Economic Integration and Private Sector Diversification and Growth. Even if weaknesses in the communications and informational infrastructure could be addressed, the integration of all actors into the formal decision-making arena would continue to be hampered by other institutional impediments:

2.3.1 Economic integration has been limited by a weak legal/judicial[6] infrastructure. Few firms see a benefit in uniting for specific marketing, financial or productive ends. Relatively few firms, particularly the smaller firms see the benefit of joining associations. Such reluctance is understandable given the institutional environment. Expanding one's base of business contacts entails new risks and considerable costs and in Madagascar few of the mechanisms necessary to enable entrepreneurs to manage/reduce these risks presently function properly.

For example, there are no reliable sources of information on new companies and suppliers, on past performance and firm references. Nor is the civil/commercial legal/judicial infrastructure for the enforcement of contracts (relationships between entrepreneurs) and protection of intellectual property adequate. Survey responses and follow up interviews have confirmed that contract enforcement remains a problem for local businessmen. Nor does the legal structure adequately protect intellectual property. In the absence of easy access to a sound legal system, Malagasy entrepreneurs rationally choose to reduce risks involved in new business ventures or expansion of business contacts.

2.3.2 The lack of adequate mechanisms to cover risks limits small firm investment and expansion possibilities. This is related to the preceding point. Economic liberalization provides new opportunities for private sector actors, but it also presents new risks. Again, even if firms have adequate information about new markets, or suppliers, or buyers, they may not be willing to engage in new types of transactions or enter new markets if they lack the means to cover the risks implied in new behavior. Imperfect insurance and credit markets may make it difficult to diversify their client base since, in the absence of other means to limit risk, operators depend on personal contacts and trust. The lack of an adequate insurance market also means that most firms, especially smaller firms, must self insure. This reduces the amount of capital available to invest in their own production and operations. This situation is exacerbated by thin

[6]In this section, "legal" refers to the problem of conflicting, out-dated, or inadequate laws; "judicial" refers to the problem of fair, impartial, and knowledgeable enforcement of the laws.

capital and credit markets, since in the absence of credit firms must be able to save enough personal capital to reinvest in the company.

2.3.3 High effective corporate tax rates reduce the flow of accurate information necessary to create efficiently operating credit and capital markets, artificially restricting credit allocation and availability of risk capital for new entrants. The tax rate has been decreased; tax holidays have been provided for firms qualifying under the new Investment Code (IC). But the reform of taxes, and the reduction of the effective corporate tax rates, is required nationwide.

Under the present system, incentives for accurate financial disclosure are minimized; companies may be encouraged to keep two sets of books to minimize their tax liability. This lowers lenders' confidence, leading to high loan security requirements. Reduction of the tax rate may not only lead to greater compliance, and thus help in the longer run to improve revenue, but lead also to greater willingness to disseminate accurate information on company operations.[7]

2.3.4 High tax rates, coupled with the weakness of the Malagasy Franc (FMG), act as a disincentive for increased domestic investment. Firms that choose to protect their assets from fiscal authorities and from devaluation exercise this choice by investing in non-productive and off-shore assets. This acts as a drain on domestic capital formation and hinders even the largest firms' ability to achieve economies of scale in domestic projects. Underinvoicing on imports and overinvoicing on exports is another effect of high tax rates, decreasing value of the local currency. Inadequate tax and customs administration systems result in the flight of potential domestic capital to Europe rather than to local productive investment.

2.3.5 Existing rules and regulations for business transactions are not applied evenly. Uneven application of regulations has protected companies from additional competition. For example, one French processor and exporter of agricultural products has been able to secure use of radio communications to relay market information from their points of

[7] The figures for annual corporate revenue obtained by research, and where reported in this document, are to be taken as relative indicators of size and not as true volume of business.

production and their markets quickly and efficiently. However, Ucofruits, a Malagasy fruit growers' cooperative, was denied permission to do the same thing. Limited freight space, particularly maritime and air, is often distributed on the basis of personal contacts, rather than through an open market, at times in violation of contractual agreements.

2.3.6 Existing internal trade regulations encourage the informalization of commerce. The assignment of regional/provincial quotas by the state, requiring a certain percentage to be sold intra-provincially before it can be marketed outside, has led to growth in the illegal (but demand-responsive) transport of produce from one market to another. As government-assigned quotas fail to meet local market demand and result in surplus in some local markets and shortage in others, there is evidence that informal operators are responding by transporting contraband produce from one market to another. A similar picture is found in the informal (export) marketing of live cattle from western ports, a commerce which the GDRM is attempting to control through edicts.

2.3.7 Financial institutions are not adequately meeting the needs of individuals or business for safe, profitable investment or for credit demanded for potential growth. Due to an antiquated system of allocating market share to banks, portfolio share to specific industries, and preferential interest rates to certain sectors to encourage investment in those sectors, the financial system in Madagascar has not been allowed to function freely, leading to serious distortions and providing monopoly rents to certain large operators. Some changes in process should alleviate this situation however:

- Allocation by bank and by sector is in the process of being eliminated. However, since this system (known as "encadrement de credits") is also used to control money supply, it is still in place as a transitional measure in conjunction with reserve requirements and a nascent money market auction system. (N.B. Reserve requirements and US Treasury auctions are the main means used by the Fed for controlling US money supply.)

- The "preferential" and "normal" discount rates set by the Central Bank and used as the basis for determining rates charged to customers by the commercial banks have been eliminated. Interest rates approaching "real" are being set by the

weekly Treasury bill auctions, although the thinness of the markets makes "real" somewhat difficult to determine.

- As a result of the elimination of the discount rates, borrowing rates are now high enough to be positive (17-22 percent vs. inflation of 12-15 percent). A deposit rate of 9 percent (the only generally accessible investment rate) is still, however, negative in real terms.

- The money market is a first step in the direction of financial market development. For the moment, the only issuer is the government and the only investors are the four commercial banks, which are for the most part controlled by the government.

There is talk of developing centralized supervisory capacity at the Central Bank to forestall another banking crisis. At present, banks are audited when they request an audit. The Central Bank needs to take charge of this situation and make information on individual banks available to the public. So doing should develop public confidence in the banking system as a starting point for developing confidence in the financial system as a whole. While statistics vary, the monetized economy is estimated to be between 10 and 20 percent of GDP. Thus, in spite of the fact that few depositors actually lost money during the banking crisis, there is still a lack of confidence in the system as a whole.

3. CASE STUDIES

This section illustrates how the issues highlighted in the preceding section affect entry and growth in three important sectors. These sectors are central to Madagascar's economic development because they will be the first benefitting from much of the donor investments in infrastructure scheduled for the next 5 to 10 years, and because there is a considerable reservoir of interest and skills on the part of Malagasy entrepreneurs.

3.1 The transport sector. The transport sector is examined in depth because, in the first place, the users of Madagascar's transportation network have the greatest interest in supporting its improvement; they can be a source of strategic information to help focus donor activity on those projects most immediately required to ameliorate the present flawed infrastructure. Second, efficient transport is one condition for actual growth in the construction sector. Third, should the construction sector be stimulated, it should exert a demand-pull on the manufacturers of construction inputs, who will be in a better position to compete with the delivered price of imports due to greater availability of transport.

The decision in 1986 to change from an attempted command economy to a free market stimulated growth and acceleration in business activity and new entrants. Pent up demand for goods as yet unavailable in the transition period, as well as an interest in new export activities, suggest that activity in this sector will increase appreciably over the medium term. Demand for transport services by new actors, either new producers or people who had never aspired to leave their traditional locale is evident and can only increase.

Moreover, transport services to the still-nascent tourist industry have provided an increasingly attractive entry point to the transport sector since 1986. In May 1991, 12 car rental firms created the new Groupement des Loueurs de Vehicules de Madagascar. This sector also includes motor tours of scenic areas (Eco-tourism).

GDRM and international donor activity in the transport sector has been substantial, and will continue to increase. The highway network has been addressed by at least seven World Bank projects. The Port of Toamasina has been under the co-management of the World Bank and CCCE for several years in an attempt to address deficiencies. On the other hand, some very specific issues remain to be fully addressed:

- Present roads and bridge infrastructure continues to restrict loads to inefficient levels. The Fianarantsoa-Antananarivo-Toamasina-Mahajanga axis is the main route for commercial activity. However, heavy trucks can use the national highway route between Toamasina and Fianarantsoa (via Antananarivo) only with partial loads, and are unable to penetrate the rich Lac d'Alaotra region and the coffee/vanilla producing region north of Toamasina. A key bridge ten kilometers north of the port has been rendered impassible by the recent cyclone, effectively shutting down the limited access once available. The route between Antsirabe and the west coast port of Mahajanga is likewise unsuitable for efficient loads due to gaps in the system.

  Due to the load restrictions imposed by the condition of the national commercial highway network, one mineral producer has learned that his cost for a container of his product delivered in Mauritius has a freight component twice as large as a South African producer shipping from South Africa to Mauritius.

- Transit between Antananarivo and Toamasina is characterized by inefficiencies resulting from an absence of dispatching services and telecommunications. Those trucks which ascend from the port typically are unable to organize return loads; those which descend to the port return to the plateau empty. The harvest period around Lac d'Alaotra reveals the same pattern. Haulers simply arrive in the region about harvest time and make personal contacts on the spot to get contracts to haul rice, an especially lucrative load at that season. As there is no central dispatching service, and respondents indicated either lack of knowledge or confusion about the availability, price and application of radio communications, they are unable to schedule pick-ups.

- Rate structure is also unclear. While the government fixes suggested per kilo tariffs, small operators and long distance haulers both reported a system of rebate cash payments to freight forwarders of between 5 and 10 percent of the value of the load, as a condition to receive the order.

- The legal infrastructure and insurance markets have not yet evolved to improve transport sector efficiencies. Uncertainties created by the road and bridge infrastructure prevent either shipper or hauler from signing more efficient long term contracts. Producers believe that the haulers refuse to get locked into a contract they might be prevented from fulfilling, and

the haulers believe that the shippers prefer the present load distribution system. A proper contract, however, would contain reference to the force majeure of washed out bridges and impassable roads and relieve the hauler of liability.

- Due to cross-ownership, interlocking directorates and monopoly rate boards among the air and maritime transportation firms, their best clients, and the government, there is de facto one transport company which effectively keeps out any new entrants. Kobama, Siramamy, Auximad, SMTM, CMN, Air Madagascar are deeply invested in each other, as is the State. As a result the small operator cannot ship and, therefore, afford to operate efficiently. The dutiable value of an imported truck consists of the purchase price of the vehicle, the cost of freight and the insurance. The freight rates and insurance premiums are established by these monopoly operators. As bank loans for trucks have to be repaid in 18 months, and the per kilo freight rates fixed by the same boards and the load factors, are low, few operators can finance new vehicle purchases from revenues and are forced to operate less efficient used vehicles.

- Therefore, as in other sectors of the economy, the transport sector reveals a two-tier structure. The established and economically successful merchant houses and major producers operate their own fleet of trucks for local transport and collection of agro-products. Habibo & Cie (1936) does FMG1-2.5bln annually; Ets Modrin et Cie (1946) does FMG2.5-5bln annually; Ets Djouma Lila Freres (1950), does FMG0.2-0.4bln annually. Similarly, SICE, Darrieux, Fraise, and other merchant houses are vertically integrated and offer little or no opportunity to independent transport firms to subcontract.

- Restrictive municipal regulations also impede transport sector efficiencies. Antananarivo and Toamasina municipalities have both instituted restrictions on trucks from entering the city center; Antananarivo between the hours of 6:00pm and 6:00am, and Toamasina for the full 24 hours. Truckers in Toamasina report that they learned of the restriction only after it was instituted, and are forced to break the law as their garages, gas stations and clients are located in the city center. Observation confirms that the regulation is skirted. The issue of insurance coverage, which will lapse in case of a loss incurred while breaking this regulation, is a great concern.

Implications

a. Until the national highway network is brought up to minimal standards, the transport component of domestic and export goods will make their delivered price uncompetitive with competing foreign sources, and the manufacturing industry will be unable to achieve necessary scale.

b. Until there is true competition on international freight tariffs, imports of inputs for the transport sector will not be "financiable" through company revenues and the Madagascar transport industry will operate with less efficient but lower purchase cost used equipment.

c. Until there is an open system of dispatching, haulers will be unable to realize necessary efficiencies of full load cycles.

3.2 The construction sector. Future trends and market conditions, including fairly large injections of foreign (especially donor) capital for public works construction, suggest that activity in this sector will increase appreciably over the medium term. Larger construction projects will center on projects such as the IFZ, and a new Hypermarket located on the grounds of the Bata shoe factory in Antananarivo. The demand for housing seems to be increasing (albeit slowly) judging from the number of new building permits. However, it should be noted that this is not the most reliable indicator of housing demand due to the preponderance of informal construction activity.

Research suggests that only 4 percent of the total demand for housing in Antananarivo is being satisfied by formal sector construction. Formal sector housing construction is generally targeted at the higher income groups, that is, the top levels of the civil service and the modern sector, in addition to the elite. These represent between 3 and 12 percent of the urban population. If informal housing construction, for the most part undertaken by the lower income groups, is included in the equation, then it is crudely estimated that 40 percent of housing demand is being satisfied. In short, the Antananarivo statistics indicate a substantial shortfall in the provision of housing by the formal sector, which is only partially being met by informal efforts.

- The Madagascar construction industry is characterized by an historic and now overwhelming presence of largely foreign-owned and operated firms which receive the lion's share of available business. It has also hitherto been characterized by limited opportunities

for new entrants into the field to gain experience and capital. Causes include lack of government funds, relatively high cost of imported materials, low level of formal new business activity including start-ups, physical plant expansion, and stagnation of the housing market.

- But indigenous entrepreneurial growth in this area has been significant. The largest **employers** in the construction sector are also locally owned; their reported **annual revenues**, however, are one half to one third of that of the top foreign-owned companies. On the other hand, their revenues per employee taken as a whole do not indicate that they are significantly less efficient producers when compared with those for the Italian and French-owned firms (see Exhibit 1). Research suggests the Malagasy entrepreneurs in the construction and contracting sector have the skills required to succeed.

  Moreover, Malagasy entrepreneurs have a long history of involvement with this sector. There has been a steady stream of Malagasy entrants into the construction sector from the 1950s. The largest employer in the sector is Establissement Sara & Cie (FMG2.5-5bln), Director General Samuelson Ranaivo, which entered the construction market as an SARL in 1976. It claimed to have employed 900 people in 1989, and is clearly one of the larger firms operation here. Similarly, founded in 1973, Vy Taobavy SA is a Malagasy owned metal construction company that employs about 250 people and does about FMG1-2.5bln annually. Taobavy also owns 50 percent of a maintenance company, EMS Ste d'Equippements, Maintenances et Service.

EXHIBIT 1

Major Formal Construction Firms: 1991

Firm	Revenue (FMG Bil.)	No. of Employees	Revenue/ Employee (FMG/person)
Malagasy Firms			
Sara & Cie	2.5-5.0	900	.005
SEIMad	2.5-5.0	273	.018
Vy Taobavy	1.0-2.5	251	.010
SEIMad	2.5-5.0	273	.018
Wm Anglesio	0.4-0.6	250	.002
SMATP	5.0-10	200	.050
DARRIEUX	2.5-5.0	200 (Est.)	.050
SMCT	2.5-5.0	141	.035
SOFIMA	0.1-0.2	110	.002
ETEMAD	2.5-5.0	105	.048
STE	0.6-0.8	85	.009
COMEPLAST	1.0-2.5	80	.031
ECBI	0.8-1.0	80	.012
SORANOF	1.0-2.5	75	.033
EntrNyAndre	0.6-0.8	32	.025
Foreign Firms			
CIMELTA (French)	2.5-5.0	400	.013
COLAS (French)	20-25	300 (Est.)	.083
Gambogi (Indo-Pak)	5.0-10	260	.038
SOGEA (French)	10-15	232	.065
Chapin & Cie (Fr)	.2-.4	184	.002
ETB (French)	.2-.4	170	.002
MACOMA (French)	2.5-5.0	132	.038
SOAM (French)	2.5-5.0	123	.042

- Data suggests that the pace of new entrants accelerated since the mid 1980s, despite the distortion of such tied-aid projects as the SMATP, Ste Sino-Malagasy de Travaux Publics. On the other hand, post-1986 entrants[8] have not as yet grown into major players in the market; they are currently doing between FMG 80 - 800 million in business annually, far below the level expected to provide for new investment and working capital.

- There have also been Malagasy take-overs. William Anglesio, founded in 1951, but now owned by Malagasy investors, is active in construction, forestry and real estate. If the numbers are to be believed, in 1989 it employed at least 200 people permanently, but did only about FMG500 million in business.

- Structural bottlenecks limit small firm growth in contracting, a traditional entry point into the construction sector. Without growth in the infrastructure, opportunities in contracting are limited by the market. Limited distribution of (and therefore demand for related services in) electricity, plumbing, air handling and telecommunications in Madagascar, continue to limit demand for new construction, and reduce both the number of new entrants and their opportunities for growth. Hence, although it is a typical entrepreneurial entry point, few formal new entrants of significance have been detected in the contracting area.

  Major contractors continue to be foreign. Cimelta Jeumont, a French-owned firm which does up to FMG5 billion in business, has been a major player in the contracting business in Madagascar since 1946. At a lower economic level, for electrical, plumbing, and communications contracting, SOMEXPA (FMG100mln), Electromad (FMG300mln), and MEI (FMG<100mln) all were founded before 1978 by non-Malagasy, and dominated this market. One exception may be found in the group of semi-formal Malagasy small contractors. Research has indicated, however, that these operators lack either cash reserves or overdraft facilities but work on a cash advance basis, purchasing inputs as required to finish stages of work until the next cash advance can be received from the client. In a weak construction market, which began with the clamp down on credit last

[8]Tera Felix, ECBI, Tany Malagasy 2000 bricks, Atlas Enterprises, and SOMACOPRIM.

year, entrepreneurs are being asked to front operational cash for the clients, which translates into a construction stop.

- The high cost of imported inputs limits small firm ability to operate and access materials required to compete with the larger players. Local production cannot feed the national market with the quantity and quality of inputs required, though Madagascar is richly endowed with certain construction materials, notably wood and stone. While it produces some semi-finished and finished construction inputs, including crushed stone, cement, steel rod, industrial but especially artisanal brick, plastic materials, plastic, concrete, clay and metal pipe, local firms continue to rely heavily on imports. Cement is now imported from South Africa and Romania, while the CIMA/Abacimal privatization has not yet been detected in the market as a major factor.

Implications

a. The potential to foster growth of the construction industry and to relieve housing shortages will depend on local firm ability to decrease reliance on imports and locate acceptable local sources of inputs for construction. While there are local manufacturers of such inputs as brick, porcelain fixtures, conduit, locks, even roofing slate, doors and window sashes and the like, quality has to improve, the market has yet to accept local manufactures as equivalent to accustomed imports. In addition, there must be marked improvement in the channels of distribution.

b. The potential for growth in the construction industry will further depend on relieving credit bottlenecks, allocation of (scarce) key inputs and their uniform distribution through the market. This includes timely availability of information of (potential) projects and contracts, both public and private, access to working capital and distribution of public contracts down the chain of contractors and subcontractors, perhaps through a set-aside program.

3.3 The manufacturing sector. The manufacturing sector has seen few new entrants and few successes. The post-1975 nationalizations added little to the inventory of successful local manufacturers. The domestic market includes fewer than 12 million people, most living in a demonetized and high-inflation economy. The practice of trocade, or bartering, both at the consumer/producer level and among larger entities, is not decreasing.

- Madagascar manufacturers produce mostly consumer perishables, such as food products, paper, cans, candles, packaging materials, footwear, clothing, and the like. Madagascar has one automobile assembly plant with limited production; one aluminum kitchen utensil stamper; several tire recappers; a few producers of construction materials. Survey and focus group information confirms that few domestic entrepreneurs are now considering the manufacturing sector, other than textiles and clothing.

- The self-employed artisan manufacturing sector continues to be a typical point of entry. Lack of formal sector opportunity forces many artisans into informal small scale manufacturing activities. Wood products, including furniture, doors and window sashes, are especially important entry points, as they use traditional skills and locally sourced materials. The artisan level producer is limited often by a lack of mechanized equipment, business and management skills and investment capital required to move to the level of a small manufacturer.

- Respondents in all sectors revealed that locally produced products, except for consumer perishables in the food and personal care sectors, are more expensive than imports, and are not as well and widely distributed as imported products. Distribution channels are largely controlled by the import/merchant houses (Sice, Darrieux, SCIM, Prisunic, Fama, etc); these are geared toward the sale of (imported) products for which they control the price rather than all potentially available products.

- Few Malagasy have the capital, are willing or have sufficient experience to establish medium-large manufacturing enterprises, though some role models have emerged. Before 1975, small manufacturers emerged largely from the Chinese and Indo-Pakistani community. After 1975, their operations were taken over by State enterprises. Post-1986 privatization is apparently being carried out by the sale of viable enterprises largely to non-indigenous operators. This reflects a lack of capital and experience on the part of the majority of Malagasy rather than inherent inability to produce manufactured products. It also reflects the universal fact that those entities with surplus cash or cash-generating operations will be in a position to take advantage of such opportunities. However, the fact that there have been indigenously owned

manufacturers (Savonerie Tropicale, Virio, Prochimad, Debra and others) suggests that Malagasy role models are available to new entrants.

- Inefficiencies in the transport sector and lack of access to established distribution channels are a major obstacle to successful creation of manufacturing enterprises. Taken with the clampdown on credit, the high cash requirement to finance a loan, the absence of indigenous venture capitalists, and the limited monetized domestic economy, communications inefficiencies make it nearly impossible to sell enough at home or abroad to bootstrap a new enterprise from cash flow.

Implications

a. Given the trends in construction and transport, some of the fastest growth in manufacturing can be expected in the area of spare parts and construction materials. These are areas where a large artisanal industry already exists. The extent to which it can be developed will depend on the extent to which local marketing and distribution channels can be opened and integrated.

b. Growth in manufacturing requires development of capital markets and expansion of distribution channels. At the moment, most indigenous manufacturers are in the informal/artisan sector. Their ability to expand beyond their present status will depend on the extent to which they can open up local markets, and access growth capital.

4. RECOMMENDATIONS FOR A PRIVATE SECTOR STRATEGY

The preceding sections pointed out that Madagascar's economic liberalization process is providing opportunities for new actors to enter Madagascar's economic arena. Research has indicated the private sector is responding, both to the opportunities of liberalization and to external donor intervention.

Increasing amounts of donor support are being channeled to address fundamental infrastructural and institutional bottlenecks impeding the smooth development of the private sector. Therefore, even if the level of resources available to USAID/Madagascar over the next 5 years for direct assistance to the private sector were to be limited, this need not imply a limited impact of USAID/Madagascar intervention. Mission resources can be effectively leveraged by a strategy which:

a) builds upon the investments in human, physical and financial resources made by the GDRM, other donors, as well as through the Mission's other programs; and,

b) takes advantage of Madagascar's increasingly dynamic environment for business.

In this context, the goal of USAID/Madagascar's private sector program should be to assist the Malagasy private sector to <u>respond efficiently to opportunities offered by economic liberalization</u>. To support this goal, **two basic strategic objectives are proposed:** (a) *to promote the integration of markets*, and (b) *to encourage expansion of the base of domestic entrepreneurship*. To achieve these objectives, the MAPS team proposes using a framework consisting of three basic elements:

- -- improving associations'[9] business support services,
- -- training,
- -- and policy dialogue.

4.1 <u>Activities and Targets: Areas of Priority</u>

This section identifies priority areas for intervention and concrete actions and support to facilitate and exploit opportunities emerging from the transition. It also identifies how these actions can be linked with other Mission and donor program areas. It is important to note that, as the situation is

[9] At least 18 business associations, of varying degrees of geographical influence, have been identified. These include the Chamber of Commerce, which has offices in all key cities, but whose effectiveness representing the private sector's interests varies greatly from office to office.

fluid, the activity areas mentioned below are meant to provide an indicative but not exclusive set of areas where Mission resources may be used most effectively to respond to targets of opportunities as they now exist, or may arise during the economic transition process. Possible areas for intervention are provided in order of priority, based on what is feasible and desirable in the short-term, given the need, and interest expressed by local entrepreneurs, as well as actions being taken by other donors.

4.1.1 Strategic Objective 1: Promote Market Integration.

Rationale: Fragmented markets have encouraged inefficient diversification and investment, impeded the achievement of efficient scale economies and specialization, and thus have created bottlenecks to business growth described in previous sections of this report. Other donors such as the World Bank are investing heavily in improvements to the communications and transportation infrastructure in the country. While building roads and improving telecommunications are absolutely necessary conditions to economic growth, they will not by themselves result in expanded growth opportunities for indigenous entrepreneurs. Such programs should be accompanied by technical assistance to enable Malagasy entrepreneurs to recognize and use the new marketing opportunities provided by these improvements.

Targets of Opportunities for Mission Assistance:
USAID/Madagascar can promote the efficient integration of markets through a variety of activities which focus on the development of more effective business associations and business support structures. By encouraging greater service orientation among organizations, entrepreneurial interest and willingness to join associations will be fostered, thus enhancing further economic integration. World Bank and French foreign assistance is currently directed at strengthening the management of associations.[10] Experience with institutional strengthening projects in other countries, however, suggests that in the absence of additional incentives and support mechanisms, central management strengthening does not necessarily lead to an immediate increase in the services provided to members, or more effective delivery of existing services. Hence Mission funding should depend primarily on the type of service to be provided, and an analysis of the magnitude of the benefits to be derived by the users, and not according to the type of organization providing the service. Key service support activities which should receive priority in Mission funding are:

[10]For example, the World Bank is currently seeking to revitalize the Chamber of Commerce. The French have been working with GEM. The Germans are providing vocational and technical training to a variety of institutions.

- Diagnosing service provision needs and developing cost effective delivery options. Discussion with association representatives suggests that the current lack of service provision is not necessarily due to bad faith on the part of association management, but often due to lack of experience in diagnosing member needs. USAID has world-wide experience supporting and strengthening service provision in business associations. Technical assistance funds could be provided to assist associations undertake a comprehensive and precise diagnosis of membership demands.

- Developing new information exchange programs and databases among associations. Madagascar's fragmented market structure has encouraged the development of a number of location-specific business associations. These have concentrated on the needs of a limited membership base and therefore lost sight of national market opportunities. Research suggests that one of the indigenous private sector's greatest needs is information on its own national market. Economic integration can be fostered by encouraging contacts and linkages among these business associations. A series of national conferences/workshops with provincial and local associations can facilitate the exchange of information among them. This will not only allow association members to understand the demands and opportunities presented by non-local markets, but also strengthen the associations themselves as information exchange at their level will provide management with the opportunity to learn from the experiences of others. These conferences could be sponsored through HRDA. Sessions focusing on agro-export can be convened under MAELSP auspices. These information and collaborative exchanges among associations can be institutionalized through organizations such as CONECS, which has ambitions to become an umbrella association of small scale business associations.

- Providing membership with group business services. One barrier to market entry is the availability of necessary business services at an affordable price. The transport sector offers a ready market for business services such as group dispatching (to increase members' load factors), market information on business opportunities, and insurance. Access to such services at a reasonable cost will be sufficient reason for many group participants to join an appropriate association. The Mission can use HRDA to facilitate access to technical expertise from the region (in the form of

tours and exchanges, workshops) to educate and inform association leaders of ways and means for establishing these services.

- Providing professional certification and rating services. The Mission can sponsor workshops and seminars to present and disseminate information on international standards related to key agricultural products, through the MAELSP and HRDA projects. For example, HRDA can sponsor information and short-term training exchanges to help educate staff in key associations, as a way of helping associations to develop better services in this regard; MAELSP can sponsor seminars on agricultural product standards for export and the local international tourist industry.

- Improve information exchanges regarding the regulatory environment. Associations are not providing membership with needed information on GDRM regulations and their relevance to membership. This is another type of service which can be targeted for assistance under HRDA.

- Introduce brokering services to encourage partnerships, subcontracting and joint ventures. Associations can play a critical role in encouraging and brokering new partnerships and productive joint venture agreements among local, and between foreign and local, entrepreneurs. Associations can receive technical assistance to establish partnership brokering services (e.g. by establishing a computer data base of foreign and domestic firms operating in the country, helping to establish linkages between associations and commercial attaches in foreign embassies located in the country, and/or Madagascar's own commercial attache corps). TA, and general fora for stimulating policy dialogue and understanding among the economic operators of methodologies to achieve satisfactory partnerships can also be provided and supported.

  But the simple provision of information on partnership opportunities will probably not be sufficient catalyst, given the legal and judicial barriers described in section 2. The World Bank group is already embarking on a project to streamline and rationalize the legal code. Moreover, associations such as CONECS, and the Mission-sponsored HRDA committee, have begun to study and convene workshops and seminars to discuss changes required in the business law code to insure economic actors recourse in the event partnerships fail.

Hence, the provision of technical assistance to improve contacts and brokering services should be coordinated and timed to complement these initiatives.

The above technical assistance and training activities can be combined with non project assistance to encourage reformulation or changes in the tax laws to encourage more local sourcing and improve linkages between firms. In particular, tax and fiscal incentives can be used to encourage more subcontracting between larger and smaller firms. The possibility of creating Malagasy (small enterprise) set-aside programs for government contracts, paired with a tax incentive program, to encourage use of Malagasy-owned businesses by the private sector can be explored. Other fiscal incentives and mechanisms can be examined which would encourage larger firms to search within the country for suppliers of goods and services which they now import or provide in-house.

As a prerequisite, however, a policy dialogue should focus, as noted previously, on the creation, application and enforcement of contracts in Madagascar.

4.1.2 Strategic Objective 2: Expand the base of domestic entrepreneurship.

Rationale: Expanding the base of domestic entrepreneurship is important given the Mission's focus on the rational use of resources; the internal market's lack of alternative income generating options increases pressure on the land and natural resources and limits willingness to abandon traditional but potentially ecologically harmful land-use practices. Until alternative income generating activities exist at the local levels, the international community's efforts to preserve Madagascar's bio-diversity and environment will not be sustainable in the long-term.

While decentralization of economic activity and the privatization of state-owned enterprises offers potential openings for indigenous firms, as well as for needed growth outside the Antananarivo area, the modern sector remains a very small part of the overall economy. Most of the population remains in the non-monetized sector. Internal market demand remains limited, which creates barriers to entry and significant restriction to the growth of extant indigenous entrepreneurs. Given present institutional barriers and economic concentration, most of the benefits of the economic liberalization process have barely trickled down to the mass of indigenous (potential) entrepreneurs.

A series of donor programs are addressing the needs of new entrants, but their outreach remains limited. Indigenous

Malagasy entrepreneurs require direct assistance so that they can recognize and then seize the opportunities created by the liberalization process.

Targets of Opportunities for Mission Assistance:
USAID/Madagascar can complement programs that encourage the entry of new entrepreneurs, such as ILO's entrepreneur incubator program, by fostering the provision of follow-on ancillary and slightly more sophisticated services, including basic business skills training and training in business English, the use of fiscal instruments to encourage greater local sourcing, the development of instruments which reduce the costs and risks associated with the development of new markets or business relationships, and support for the creation and use of financial instruments and institutions which help reduce the risks of lending to small or non traditional producers. In particular:

- Provide training in marketing. Activities to provide information through associations must be closely coordinated with training in the uses of information. Respondents in both survey and focus groups emphasized their lack of knowledge not just of marketing information, per se, but also of techniques to apply the information effectively to expand markets and contacts. In order to aid Malagasy operators successfully sell product domestically and internationally, and build their business infrastructure, USAID could usefully provide marketing training programs, or work cooperatively with other providers of such training. A basic program would introduce concepts of information collection and manipulation, determination of consumer needs, and methods to deliver products and services efficiently.

  Marketing training for agro-exporters is already being provided by MAELSP, and its follow-up will continue to do so, though support will focus on just four crops. But, the provision of most of these training and technical assistance services are currently concentrated in the Antananarivo area. The Mission should explore options to expand marketing training to other sectors and in particular to expand the reach of these programs beyond the capital area, perhaps through "train the trainer" programs for specific association staff, with priority given to staff in associations located outside the capital or plateau area. HRDA can be used as a vehicle for funding short-term marketing training for association staff.

  Also, the Mission could provide assistance to builders in marketing and bid preparation by buying into the upcoming RHUDO project (RECAP).

- Provide training in basic business skills needed to enhance Malagasy expansion and contacts in the region. Much of the present donor aid aimed at business training proceeds from Francophone business climates and traditions. As the potential market for immediate expansion of new entrants may be among the Anglophone regional neighbors, the Mission may wish to consider the low level and widely based dissemination of training materials which reflect the Anglo-Saxon market economy tradition. A useful and immediately available instrument can be found in the Small Business Administration's small business pamphlet series intended for U.S. start-up entrepreneurs. Translated into French, or better, into Malagasy, and adapted to the structure of a largely demonetized agro-industrial island economy, these pamphlets can offer a useful and low-cost starting point for Malagasy entrance into the Anglo-Saxon economies. The Mission should explore the possibility of using Peace Corps Volunteers or SCORE volunteers to provide the basic knowledge of business English and business customs in Anglophone countries.

- Provide training in financial management and risk assessment to non-bank financial institutions (NBFIs). The new operators who have come into the system with the help of trade liberalization now find it difficult to sustain their entrepreneurial initiatives. As noted in preceding sections, in many instances this is not because their projects cannot bear the real cost of money but because they have difficulty in accessing credit, period. Liberalization of Madagascar's financial market appears to be lagging behind other liberalization initiatives, notably trade liberalization. Direct controls on the market (credit ceilings) are still the major instruments of control, rather than indirect mechanisms, notably interest rates. The use of direct instruments has an adverse effect on new operators.

  The IMF and the IBRD are working on a financial sector study to assess technical assistance and training needs. The Mission should use the findings of this study to decide the final shape and scope of assistance to the sector. But given the Mission's interest in housing finance (see Appendix D to this report, which contains the recent assessment of the housing finance market undertaken as part of MAPS), and the present liquidity crisis in the formal banking sector, priority should be given to training programs and exchanges to expose Malagasy to financial administration mechanisms and risk assessment and portfolio management for **non bank financial institutions (NBFIs) operating in a**

liberalizing economy. This implies that training and technical assistance exchanges should proceed, to the extent possible, from agents active in a country one or two steps ahead of Madagascar in development. If the mechanisms are too sophisticated or advanced for the country, it is too easy for the host country to say that the people involved do not understand the special structural development problems it faces. In the short-term again, training resources can be provided through HRDA, with priority being given to staff in existing or new NBFIs, such as FIVCAM, FIARO, APEM. Such exchanges and training can perhaps be coordinated with existing IMF/IBRD training programs for bank officers under the APEX scheme.

o Strengthen capacity of GDRM officials to manage the transition to a decentralized economy. Though the present transition process seeks to reduce the role of government in the economy, the public sector will always have a critical role in insuring the more efficient operation of decentralized decision-making systems. The Mission can complement the assistance to achieve this end provided through other donor programs. MAPS Research findings suggest that the following priority areas for GDRM training must be addressed to maximize the effect of other private sector support activities:

-- **Strengthen capacity to evaluate and manage fiscal policy within a decentralized economic structure.** The Mission can work with other donors in the design of a comprehensive training schedule which will help create in-country capabilities (down to, and perhaps especially at, the village level) to analyze and implement tax and budgetary reforms within a new economic context. The GDRM is discussing many reforms to the tax structure with the IMF and IBRD as part of a wider incentive framework to facilitate productive investment and business growth. Some areas for tax reform and simplified tax administration have been suggested in the preceding sections. But changes in policies will also require changes in the administration of tax policies.

Other donors are working with the central tax administration. Given the Mission's interest and its planned actions in local government strengthening (through the KEAPEM project), a natural complementary action would be to support mechanisms to train regional officials in revenue collection and administration,

with the specific goal of improving infrastructure (road and communications) development and maintenance, through user fee collection and administration.

-- **Facilitate re-orientation of key agencies charged with implementing investment and export promotion policies.** Facilitating trade and investment requires not just adequate policies. Suitable implementation is also a requirement. Priority areas of support in this regard include:

The Customs Authority. This institution is working with cumbersome sets of regulations and procedures which increases the transaction costs involved in all trade operations. Major donors such as the World Bank are already working to simplify and consolidate customs laws. Once laws are changed, officials still will need to be trained on new rules and regulations and their applications. An option for doing so, in terms of institutionalizing such training, would be to assist associations to provide roundtables and training workshops for Customs officials. Several years ago the Kenya Association of Manufacturers offered such short training courses to complement recent changes in Customs laws (an activity funded in part by USAID), with some degree of success. HRDA may serve as a vehicle to provide or identify some short-term training options for Customs staff.

Strengthening Madagascar's diplomatic service (commercial attaches) in investment promotion activities. Madagascar's commercial attaches are not in communication with the Malagasy business associations or the Chamber of Commerce. Nor are they apparently linked with their host-country business development and investment promotion authorities. In the course of focus group discussion, Malagasy entrepreneurs could not recall ever having received or expected market information from their foreign commercial service. There is no evidence that any business opportunities the service may in fact signal actually flow into the Malagasy economy in a timely and useful manner. To support its other goals, the Mission could usefully assist the Madagascar foreign commercial service to become an effective source of market intelligence for indigenous Malagasy entrepreneurs as well as a tool for investment promotion. With relatively low levels of resources, a program of Commercial Attache Training could be channeled through the Chamber of Commerce.

To complement the above training and technical assistance activities, the Mission can continue to support dialogue on critical fiscal policy dialogue issues. This type of dialogue activity is scheduled to take place within the context of the Mission's KEAPEM project and is already taking place within HRDA. Some specific issues which should form part of these dialogue agendas are:

- Encourage changes in the tax system which facilitate flow of resources to domestic entrepreneurs. The fiscal system can help encourage formal business entry and growth. Issue areas to explore include the creation of special tax allowances for small firms, thus making the corporate tax rate less regressive. The need to replace the taxe de consommation should also be explored. Regulations regarding depreciation allowances should be examined. On the other hand, additional revenue sources should be explored. For example, a program of raising road use fees, or a tax on gasoline can be suggested. MAPS Research indicates transporters would be willing to pay these fees, given assurances the revenues would be reinvested in infrastructure maintenance. Other benefits of simplified tax structures and reduced effective tax rates is the encouragement of greater financial disclosure in aid of partnerships of all types, and the improvement of the efficiency of credit and capital markets.

- Support the design of fiscal policies which encourage rational investment and use of domestic resources. For example, land and water use taxes and fees can help entrepreneurs to place a real scarcity value on these resources, and encourage more rational use. Fees can be used to raise revenues and encourage more rational use of existing infrastructure as well. Road fees and/or tax incentives mentioned above may also encourage more intensive use of the Pangalanes waterway canal between Manankara and Toamasina, thus helping to divert freight traffic away from already overused and indirect land routes. Moreover, at the present time all heavy truck traffic in Toamasina is forbidden from entering the city. An alternative to forbidding traffic, which is hardly enforceable at this point, and is a real constraint on business operations, would be to introduce greater fees for truck licenses or the use of certain city roads. Administering and enforcing these fees would not be any more difficult than enforcing present regulations, and the revenues could be channeled again to infrastructure maintenance and expansion.

5. IMPLEMENTATION

5.1 Issues and Mechanisms

The following principles should guide the implementation of the private sector strategy detailed in the preceding section.

5.1.1 In the short term, use the HRDA Committee to support and coordinate private sector activities. The Mission should consider expanding the role of the HRDA committee to one of coordinating and evaluating additional private sector support activities. The HRDA committee could serve as a sanctioning and evaluation body for general private sector support strategy actions. This committee has had experience working with the Mission, and has the mechanisms and contacts in place. By working with a local body, interest in private sector support becomes institutionalized locally, and the possibility for ongoing interest in these activities is therefore enhanced.

5.1.2 Use mechanisms which foster competition among economic actors and are performance-driven. Economic liberalization is about increasing choices and alternatives to mobilize resources within the economy. Donor assistance should, in this context, seek to foster the creation of alternative private sector support institutions, rather than selecting institutions which may later monopolize access to resources. Therefore, it is recommended that associations be awarded technical assistance or training funds solely on their ability to propose credible programs to improve members' operations. Assistance should seek whenever possible to establish clear cost recovery goals. This will maximize the probability that the program will continue to be viable after direct donor support is reduced or eliminated. This would not be applicable in every case, but at the least partial coverage of costs should be one criterion in each funding decision.

5.1.3 Monitoring And Evaluation: Link Private Sector Program monitoring to Mission-wide mechanisms for strategic research and project evaluation. Coordination of activities between the private sector activities and other sectoral and other donor programs could be strengthened through the implementation of a Mission-wide Monitoring & Evaluation System. Such a system has been envisioned as part of the Mission's Development Education and Evaluation Project (687-0114). Some

suggestions regarding the implementation of this system, as it pertains to the private sector support activities described earlier, follow:

- Base the M&E system on impact indicators of achievement reflecting the objectives outlined. These would link activity outputs to activity impact, based on the final priorities and strategies identified in the CPSP. The indicators should cover and combine input, output and financial data. The indicators should also allow USAID/Madagascar to monitor and evaluate the cost effectiveness of various intermediary organization outputs in terms of their impact on beneficiaries, and program goals and objectives. Data can also be used to assess on an on-going manner the extent to which objectives need to be revised as the policy environment changes.

- Permit USAID/Madagascar and other institutions to assess the extent to which activities have increased self reliance. Self-reliance criteria could include the share of in-country consultants and expert advisors as a percentage of total advisors, and user fee income as a percentage of total association income. Targets of this type should be set for all private sector support activities, and periodic meetings should be held among HRDA, MAELSP, KEAPEM and the private sector coordinator to discuss attainment of these targets by activity.

5.1.4 Establish closer donor coordination mechanism. As noted above, donor assistance and interest in areas directly related to private sector support has been increasing. Complementarities between donor activities will not be achieved unless there is a continuous process of dialogue and information exchange on the nature and results of interventions among donors. The private sector committee which has formed within the Mission is a positive step towards increasing coordination among related components of various Mission programs. But the concept should be extended to include representatives of other donor organizations directly involved with private sector support such as UNDP, the French, and the World Bank, including the IFC.

5.2 Recommended Implementation Structure

The following section outlines a program for implementing key activities to achieve each of the objectives: enhancing market integration and expanding the base of domestic entrepreneurship. The steps outlined below have been selected within the strengths and constraints of the Malagasy environment, the Mission's staffing levels, and resources as they are understood.

a. First: Organize Task-Oriented Groups of Indigenous Operators The purpose of these groups will be: a) to develop a database on interested associations, b) to help disseminate information on Mission intentions c) to encourage the Malagasy private sector to assume greater responsibility for and control of their economic future.

   This process can begin by announcing (through HRDA) on national and regional media the intention to work through business associations to improve business efficiency. According to the response, this announcement can be followed up by holding working sessions in each of the provincial capitals. These short seminars (which can be organized with the support of HRDA, INSCAE and other institutions and mechanisms through which the Mission is already working), can serve as fora for a national dialogue on business support structures. One output of these working groups will be to establish concrete priorities for interventions. Another will be increased knowledge on the part of the Mission of economic operators and their significance within the domestic economy. These national meetings of business associations should become the starting point, after which associations can submit proposals for the development od specific business support services they wish to develop. HRDA can be used to screen these proposals.

b. Second: Respond to the needs discovered by and through the Working Groups. Given the fluid situation created by multiple changes of liberalization, and the intention to leverage other donor programs, the precise responses to the needs and proposals emerging from these workshops cannot be fully specified. But technical assistance (in the area of association service delivery mechanisms and cost recovery), and training (particularly related to marketing and finance/accounting) will remain important components, certainly in the short term. As noted in the preceding sections, at least some of the training and technical assistance and training can be funded through HRDA, MAELSP and even KEAPEM (in terms of assistance to local officials in revenue administration). But, to increase the Mission's flexibility to respond to emerging opportunities in private sector development, as the environment becomes increasingly

liberalized, steps should be taken to structure a separate delivery mechanism for long-term private sector interventions. This is discussed in the point below.

d. Third: Identify Training Priorities. One result of the working groups, and proposals, will be clarification of which areas of business activity can usefully absorb training. The preceding section suggested that some areas where USAID may enjoy a distinct advantage would be in Basic Business Skills of the Anglophone market, and International Business Practices. One area where the demand is already established is for English language instruction. Therefore, even before other training activities begin, the Mission should explore expanding Peace Corps activities immediately into Business English, in collaboration with business associations identified in "a" above.

At the same time, and given the enclave market structure of Madagascar, an obvious point for training is found at the village level. Local government officials can usefully receive training in techniques of governing, revenue collection and allocation in service provision. In addition, village level agricultural and manufacturing techniques suggest themselves as topics, given the agro-industrial strengths of the local economy.

A third area for training includes professional training, including such topics as (international product) standards, labeling, rating, certification, marketing, investment promotion. Given the low rate of entry of small manufacturers, marketing and production planning for manufacturers is a potential program. The Mission can facilitate the dissemination of international standards as well through activities such as the OPIC/AID investment mission and seminars on quality and quality of production sponsored by HRDA and technical assistance provided through MAELSP.

Training for GDRM officials can be offered through business and professional associations, such as GEM or CONECS. TAF or other Mission funds can be made available to assist business associations structure special training sessions for finance sector, customs, local tax officials, for example.

d. Fourth: Provide fora for policy dialogue. As previously discussed, on-going policy dialogues among the GDRM, the Mission and local operators will contribute greatly to the creation of a more transparent system of regulation and enforcement, as well as to an appreciation on the part of the Malagasy operators of which instruments are available to them to meet their business plans. Policy round tables can

include topics such as the tax structure, (business) law, tax incentives to development, and, upon completion of IMF/WB review, the financial structure. But the final agenda and timing for different topics will depend on the activities presently being carried out by other donors, and on the priorities established through the national and regional business policy issues workshops described above.

e. Fifth: Create a Technical Assistance Fund (TAF). The creation of a TAF would provide additional flexibility to respond to proposed private sector actions. The TAF would specialize in non agriculture/agro-processing sectors highlighted in this report -- transport, construction, manufacturing and finance -- which provide unique entry and growth opportunities for indigenous entrepreneurs and are not currently covered appropriately through any of the Missions on-going projects (MAELSP, KAEPEM). The TAF would be a "hub and spoke" arrangement, in which the TAF is the distribution point between agents of competence and requesting associations and organizations. The TAF's manager, reporting to the private sector coordinator, would be the point of contact and feasibility analysis for all domestic associations and organizations seeking project funding or technical support of USAID. The management of the TAF could be undertaken by a local or local-international contractor. Associations wishing to receive funds from USAID would be expected to compete for access to the TAF. Responsibility for the development of the M&E systems discussed above should rest with the private sector TAF manager.

Appendix A

Summary of Findings: Private Sector Description

The data presented below come from research based on secondary sources begun in January 1991 by SOA.TEG, a Malagasy economic consulting firm based in Antananarivo. This report highlights the key results of that research. The data will be complemented with information from a nationwide survey of 350 private firms begun in March 1991. It is hoped that this report, as well as the report on survey results, will contribute to on-going discussion regarding support strategies to the Malagasy economy and private sector.

The sections which follow summarize information on:

- the evolving role of the private sector in the Malagasy economy since 1984;
- the impact of changes in public policy, including the evolving role of parastatals, on private sector growth;
- emerging opportunities for accelerated private sector growth.

FINDINGS

1. *Overview: The Importance of the Private Sector in the Malagasy Economy*

1.1 The private sector accounts for more than 75 percent of measurable GDP. On average the Malagasy private sector accounted for 75 percent of measurable economic activity between 1984-89.

- The number of new enterprises has been increasing, averaging over 5,000 per year since 1985. Most of the new enterprises are located in the Antananarivo area.

1.2 The modern private sector employs 5.3 percent of the total work force, and 70 percent of the modern sector work force.[1] It is estimated that of the total labor force of approximately 5,390,000, 92 percent was involved in subsistence rural agriculture, and other non-monetarized activities. Of the 8 percent employed in the modern sector, the GDRM and public enterprises employed 3 percent. Of

[1]These figures are estimates. The GDRM has not kept accurate records since the last census taken in 1984, making it difficult to determine exact levels of employment.

those employed in the modern private sector, less than one fourth were involved in industrial activities. Most formal employment is concentrated in the Antananarivo area.

1.3 The modern private sector has not been able to absorb the growing labor force. Formal sector employment increased by only 30,000 jobs between 1983 and 1989--an annual compound growth rate of 1.4 percent. But over the 1985-90 period the total labor force increased 147,000 per year. Most of the growth in modern sector employment came from the public sector: over the 1984-1990 period public sector employment grew 120 percent, while modern private employment grew by only 58 percent.

1.4 The Private Sector is Small Scale.[2] Of the 30,845 registered and active firms in 1987 only 6% employed more than 10.

1.5 Malagasy-owned firms represent 91 percent of all registered firms, and these tend to be small scale. Ninety-five percent of Malagasy-owned enterprises employ less than 10 persons. In contrast, French-owned firms represent just over 2 percent of all registered firms, but only 67 percent of these employ less than 10 people.

2. *The Evolving Role of the Private Sector in the Malagasy Economy*

2.1 The private sector declined in importance over the 1984-90 period. Most private sector activity remains centered around labor intensive, family-owned operations, characterized by low productivity.

2.2 The primary sector: The private sector accounted for 81% of agricultural value added between 1984-89, but its share has been declining in most subsectors. Most of the growth in primary sector value added over the 1984-90 period came from the livestock and fishing sector (showing an average growth of almost 5 percent per year, compared to a growth of just 1.3 percent per year for agriculture and 0.9 percent for forestry). But private sector share in agriculture and livestock/fishing activities actually declined in real terms over the 1984-90 period.

[2]Throughout this text and the accompanying graphics and tables, "small scale firms" are defined as those that employ less than 20. This is the definition used by the Banque des Donnees in Madagascar.

- Food Crops: Private sector activity has remained virtually constant throughout the 1984-90 period, oscillating between 87.8 in 1984 and 87.2 percent in 1989.

- The private sector's role in major industrial crop production has been increasing. Most private sector activity has been concentrated in cotton and sugar cane production. Marketing, primarily controlled by the state until 1989, has been increasingly liberalized.

  -- In cotton production, private sector share of value added actually decreased almost 2 percentage points since the mid 1980s. State-owned cotton farms remain much larger than the private sector counterparts; they also use inputs more intensively[3] and their yields are on average two to three times higher than the yield of small smaller private producers.

  -- **Sugar** cane production remains concentrated in two state-owned sugar refining companies. All private sector production is by small farmers surrounding the state-owned plantations. Private sector share of sugar production increased from 34 to 38 percent over the 1984-89 period, but overall value added in the sector grew at only 1.6 percent per year. The increase in private sector smallholder production of sugar can be attributed, at least in part, to a 1986 increase in producer prices.

- Export crop production is primarily in the hands of small farmers. In particular:

  -- 94 percent of Madagascar's **coffee** (which accounted for over one third of export earning over the 1984-90 period) is produced by 300,000 smallholders farming 200,000 hectares using traditional methods.

  - **Vanilla** accounted on average for 18 percent of Madagascar's export earnings over the 1984-88 period. Ninety-nine percent of Madagascar's vanilla is produced on traditional farms. The GDRM controls the marketing of vanilla and has sustained prices by stocking vanilla surpluses.

  - **Cloves**, Madagascar's second leading export, until recently when Indonesia, the world's largest consumer of cloves, expanded its domestic production, are produced entirely by small private farmers along the

[3]Parastatals use approximately five times more insecticide and fertilizer per hectare than traditional private farms.

east coast of the island. Clove plantings per farmer average three fourths of an hectare; 70,000 out of 80,000 clove farmers plant less than 1 hectare. Clove marketing used to be controlled by the GDRM, but the market was opened to private traders in the late 80s.

- **Pepper** production grew at an average annual compound real rate of 7.3 percent between 1984 and 1990. All pepper is produced by small private farmers.

- **Litchis**, like vanilla, are harvested by private traditional farmers. Commercialization and export was entirely controlled by the Ministry of Commerce and a state marketing board.[4] But since the late 80s, the private sector has taken increasing control of marketing and exporting activities. The value of litchi production grew by only an average two tenths of one percent in real terms between 1984-90.

- Most of the growth in the livestock/fishing sector has come from fishing activities, but private sector share has been declining. Fishing production grew at an average annual real rate of 5.3 percent during the 1984-89 period. Within this sector, crab and lobster production showed the highest growth. Though the private sector accounted for over 90 percent of value added in this sector, since 1985 publicly owned enterprises have grown almost twice as fast. Over 99 percent of private sector activity is concentrated in small firms.

- Livestock production has stagnated in the last two decades, though the value of livestock production increased at an average rate of 4.4 percent per year. Though the public sector accounted for an average of only 3.1 percent of value added over the 1984-89 period, its share of value added grew at an average rate of 6.6 percent per year.

2.3 The Secondary Sector: Some significant growth areas for the private sector. During the 1984-89 period, industrial output grew at an average annual real rate of just 2.28 percent, fueled mainly by growth in manufacturing and energy sectors. Mining experienced very high growth, almost 10 percent per year, but it still represented only 2 percent of Madagascar's industrial output.

- All the growth in the manufacturing private sector came from the food processing subsector; private sector value added grew at over 5 percent per year, while the food processing sector as a whole grew at an average annual real rate of 1.3

[4]March 4, 1991, Ucofruits, Tamatave.

percent during 1984-89. Food processing includes rice processing, bakeries, meat, fruit and vegetable canneries and candy making as well as coffee roasting, spice processing and animal feed production. Rice processing is the most important of the food processing subsectors, accounting for 39% of the food processing value added in 1984-89.

-- **Private sector share of rice processing declined overall, but small firm share of value added increased.** The share of output of firms employing less than 20 grew from 17 percent of private value added in 1984 to 21 percent in 1989, partly as a result of the GDRM rice liberalization policies.

-- **Private sector growth has occurred in the fruit processing and canning sector in response to increased opportunities arising from the liquidation of parastatals.** On the other hand, private sector response in the meat canning sector has been sluggish.

o The beverage sector has been the fastest growing industrial activity, but growth has come primarily from the large parastatals producers. The beverage sector grew at an average annual real rate of over 17 percent during 1984-89, the highest growth rate over this period within the industry/mining sector. Beverage production, which accounts for over 5 percent of industrial value added, is dominated by STAR Brasseries, a beer and soda bottling company based in Antsirabe. STAR was a parastatal until 1990, when it was bought out by private investors.

o Small scale producers entered tobacco production in the late 1980s and accounted for all the growth in this sector. The private sector accounted for all the sector's value added in 1989. Most of the production in this sector comes from a large private cigarette manufacturer SACIMEM, which is 95 percent French owned. But a number of smaller firms entered the market in the mid 1980s and showed high growth.

o The textile and garment sector value added declined almost 2 percent per year over the 1984-89 period. The sector accounted for 11.5 percent of industrial value added in 1989. The private sector, which accounted for an average 41 percent of value added, saw its share of production decrease by 3.3 percent per year since 1984. But the share of small firm activity has actually been increasing over the 1984-89 period at a rate of almost 7 percent per year. According to the World Bank, the smaller private firms have adjusted to liberalization more easily than did the larger firms. The newer smaller units are geared toward the export markets.

- The mining sector has been among the fastest growing activities over the 1984-89 period, but its contribution to value added remains limited. The mining sector grew at over 9 percent per year between 1984-89, but accounted for only 1.8 percent of industrial value added by 1990. Most growth has come from the exploitation of non traditional minerals and semiprecious stones, such as monanzite, zircon and tourmaline. Small enterprise growth in this area has been very large.

2.4 The Tertiary Sector: the commerce sector remains the single most important area of private sector activity. The commercial sector in Madagascar accounts for 65 percent of all active registered firms. In real terms, the commerce sector has grown at an average annual real compound rate of just 1.95 percent during the period 1984-89. Most of the growth came after 1986, which can be attributed partly to liberalization of the economy and the implementation of the liberalized import regime in particular.

- The private sector has declined in importance in the commerce sector. The private sector, which accounted for an average of 94 percent of the value added of this sector over the 1984-89 period, saw its share of output decline 30 percent per year over this time. **Small firm share however increased 19 percent per year over the same time period.**

- The transport sector grew at over 3 percent per year, and most of the private sector growth came from small firms. The private sector accounted for an aggregate 88.9 percent of transport output during the period. Growth in the freight and road transport sectors came primarily from small scale firms. Small firm share of value added in the freight transport subsector increased almost 4 percent per year. Small enterprise share of road transport value added grew by 5.4 percent per year over the same time period.

- Construction sector output grew by over 6 percent, and small firm share increased by almost 12 percent.[5]

[5]The construction and public works sector, according to official statistics is considered all private. However, local analysts point out that groups such as SEIMAD, though considered private by the Malagasy authorities, should be considered public enterprises, since they are owned by other public enterprises.

3. *The evolving impact of the public sector and public policy on the private sector*

3.1 Price reforms: Policy reforms in agriculture are starting to show an impact in the form of increased investment, especially in rice production. Steep increases in retail prices of rice after 1986 have led to increased investment, particularly by small growers. The liberalized rice market has spurred the growth of private rice processing and increased commercialization in this sector.

3.2 Liberalization of foreign exchange: may have led to increases in capacity utilization. Industrialists surveyed by the World Bank in 1986 attributed low capacity utilization to problems obtaining spare parts and inputs due to the uncertain and discriminatory allocation of foreign exchange. Between 1986 and 1990, average industrial capacity utilization rose from 45 to 60 percent, despite the fact that local purchasing power remained weak. But local industrialists continue to complain that the most foreign exchange is being diverted to consumer goods imports, thus crowding out imports of raw materials and intermediate goods.

3.3 Devaluation: has spurred export production, particularly non traditionals. Since the major devaluation of 1987, the GDRM had allowed the Malagasy franc to depreciate in nominal terms against the SDR and the dollar. The growth in the garment and knitwear, and in the food processing industry, particularly among the newer and more flexible entrants, illustrate the positive effect of this measure on industry.

3.4 Parastatal reform: the state has pulled out of several important areas of industrial activity. Out of 167 public enterprises existing in 1988, by mid-1990 the GDRM had dissolved or divested itself of 26; the GDRM pulled out of canning and meat and fruit processing entirely. But:

- **Parastatals continue acting as a drain on the public accounts.** Public enterprise deficit to the central government accounted for nearly 9 percent of GDP in 1989. More recent figures have not changed much.

- **Parastatals continue to crowd out private sector credit.** Though parastatals accounted for less than 20 percent of national value added, they absorbed over 50 percent of bank credit, limiting the availability of credit to the private sector. According to the IMF, more than half the loans to parastatals have been nonperforming, a factor that has contributed to the precarious financial position of the state-owned banks and to the subsequent restructuring of their portfolios.

- **Parastatal inefficiencies reduce private sector producer margins and productivity.** For example, textile manufacturers have seen their productivity negatively affected by HAYSMA, a GDRM monopoly charged with the collection, processing and distribution of raw cotton. Though Malagasy cotton is generally of superior medium and long-fiber quality, poor processing by HAYSMA often reduces the quality of local textiles, affecting local producers' ability to compete locally and abroad.

3.5 Credit and Financial Sector Policy: Credit continues to be a major constraint to private sector development. On average, less than 18 percent of all credit awarded to the private sector is medium or long-term credit. Moreover, as noted in point 3.4 above, parastatals have received on average over 50 percent of all credit, crowding out private sector borrowers in general. Finally, demand management measures required by the international lending community, has led to an overall dampening of credit supply. Even large, well-established firms, perceived as minimum risks by the banking community, have faced an interest rate spread of 5 percent and delays of six months to a year between the application and approval of credit.

3.6 Poor infrastructure development remains a serious constraint to private sector development, and may be limiting private sector expansion outside the Antananarivo area. Communications and transport infrastructure in particular limits markets and investment outside the Antananarivo area. Roads in Madagascar remain in very poor condition, significantly adding to transport costs and limiting input resupplies in the interior. It is common to experience more than day-long internal telecommunications delays.

3.7 Labor and tax laws, unclear land tenure policies dampen private investment. The impact of these issues is difficult to quantify, but anecdotal evidence supports that the costs in terms of investment foregone may be high.

3.8 New investment incentives: implementation issues remain to be resolved. Application for Investment Code and Industrial Free Zone Regimes (IC/IFZR) incentives remains cumbersome and slow according to local investors.

3.9 The result: a cautious response by private investors. Private sector investment remains very low and reflects a cautious response to the liberalization process. Despite reforms in foreign exchange, pricing, privatization highlighted above, foreign and Malagasy private sector investment in 1989 remained virtually unchanged form its level in 1984.

4. *Emerging opportunities for accelerated private sector growth*

4.1 Small scale enterprises have accounted for most of the growth in key industrial sectors of the economy. While small scale firm contribution of small firms to private sector GDP has actually declined from 42.26 percent of value added in 1984 to 41.27 percent in 1989, there has been an expansion of small firm activity in several sectors heretofore limited to only large industrial enterprises. And in several subsectors small firms have accounted for all or most of the growth. To a great extent small firms have led private sector response to emerging business opportunities created by the economic liberalization process. **Small firm growth has been most pronounced in mining (of non-traditional minerals), fruit processing/canning, rice processing, tobacco and construction materials.** In addition to the growth of small scale formal sector enterprises, there has been an expansion of informal services in urban areas serving the growing urban populations.[6]

Small firm growth illustrates the growing level of entrepreneurship in Madagascar. But the figures cited above also show that small firm growth continues to be constrained by a number of bottlenecks. Their productivity is often lower than that of larger firms, caused in part by restricted access to inputs and markets. The March 1991 survey of the private sector, part of a series of private sector studies sponsored by USAID/Madagascar, provides details on bottlenecks faced by different types and sizes of firms in the country.

4.2 Sources of foreign exchange have diversified significantly, and non traditional foreign exchange generating activities present continuing opportunities for private sector expansion. Madagascar's ability to generate the resources necessary to meet its development objectives will depend on its ability to generate sufficient foreign exchange to sustain higher levels of investment in the medium term without adding undue pressure to the balance of payments or resorting to additional external aid. Expansion and diversification of foreign exchange sources will increase its control over its development agenda. Areas where foreign exchange generation potential continues to be significant:

[6]This expansion of urban activities is documented in detail in a series of International Labor Organization surveys of the urban informal sector and will be updated this year with the UNDP study.

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- **Litchis exports.** Madagascar has two large potential advantages over South Africa, currently the leading supplier of litchis to Europe. First, Madagascar has a labor cost advantage in litchi harvesting, which is very labor intensive. Second, Madagascar benefits from ACP preferential tariff treatment in Europe, while South Africa has to pay an 11 percent ad valorem tax on agricultural exports to Europe.

- **Garment/textile exports.** While the growth of this sector overall in the late 1980s has been lower than expected, the increase in the number of smaller export oriented firms in the late 80s presents the potential for faster growth in the future. Of the 59 new enterprises approved under the 1989 Investment Code and Industrial Free Zone Regime (through November 1990), 27 percent were in the textile and garment sectors. The local smaller firms have undergone a major transformation, becoming oriented toward international markets.

- **Fisheries/aquaculture exports.** Shellfish exports grew at an average 43 percent per year between 1984-89 (becoming Madagascar's third largest export in 1988 after coffee and vanilla). Madagascar has both abundant fresh water and sea water fishery potential. The World Bank estimates that offshore catch could be as high as 150,000 tons per year.

  Aquaculture offers particularly high growth prospects, specially given the fact that shrimp and other shellfish harvesting in Madagascar waters may currently be reaching maximum sustainable yield. It is estimated by the World Bank that 72 percent of the 600,000 hectares of inland water surface area could be cultivated for fisheries. A number of donor funded projects have had good results with small farm-based aquaculture activities, and aquaculture in the rice fields. Thus aquaculture presents an opportunity not just for export growth, but for helping to diversify income sources of small farmers.

- **Tourism.** The number of hotel rooms grew from 1,734 in 1988 to 2,112 in 1989, although 40 percent of all hotel rooms in the country continue to be concentrated in the Antananarivo area, with another 34 percent in Toliary and Anstiranana. Tourist arrivals since 1986 have been growing at an average rate of 13 percent per year totalling 38,954 arrivals in 1989. Tourist spending has been expanding rapidly, from 800,000 SDRs in 1984 to 18,000,000 SDRs in 1989. The growth of the tourist

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sector presents additional marketing opportunities for local food production and processing businesses as well.

4.3 The banking sector has expanded, as have options for mobilizing savings, though aggregate savings mobilization is still low. The introduction of private capital into the formal banking system in accordance with the banking law of 1988 led to large increases in private sector investment in the banking sector. The new laws may help spur competition and motivate a commercial banking system which has traditionally focused on the large, well-established customers or public enterprises, to seek business more aggressively with the growing number of new small firms. The entry of the Banque Malgache de l'Ocean Indien (BMOI) and the privatization of BNI and BFV should induce the banking system to create new instruments for mobilizing savings. The savings rate in Madagascar (8 percent in 1988) was among the lowest in Sub-Saharan Africa.

Final Observations: The private sector is prominent in all sectors of the economy, and most sub-sectors, except for sugar processing, beverage production, energy, communications and banking. But private sector growth, except for small scale firms in some specific subsectors, has been very limited. The experience of private sector growth over the last 6 years suggests that the Malagasy entrepreneurs can respond to emerging opportunities, but that they continue to face significant bottlenecks which are common across most sectors, particularly in the area of finance, input availability, technology and marketing.

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Appendix B

Summary of Findings: Private Sector Survey

The data presented in this report comes from a survey of 350 firms operating in Madagascar in the Spring of 1991. The survey data complements and updates data gathered from secondary sources[1] on the Malagasy private sector. The survey was implemented over the month of March 1991 by Cabinet RINDRA, a Malagasy consulting firm based in Antananarivo. The results of the survey will help the USAID Mission in Madagascar develop indicators with which to trace the evolution of the private sector over time. They will also be of use in identifying new program/policy priorities in private sector promotion and targeting on-going program activities to this end.

Key Findings

1. The economic liberalization process is yielding payoffs in the form of increased firm growth and efficiency. Firms of all sizes and operating in all sectors and regions of the country reported increases of at least 20 percent in capacity utilization over the last 12 months. Over one third of all firms interviewed reported over 20 percent growth in business turnover over the same time period. Over 60 percent expect to continue growing next year. There is also evidence that Malagasy entrepreneurs are diversifying into new activities. Small firm growth in agribusinesses, fishing/aquaculture and agro-processing, and mining of non traditional minerals has been particularly high.

2. The current regulatory environment has been improving. Generally, only the larger firms, and industrial sector firms continue to face any significant amount of "red tape" when establishing or trying to conduct routine business operations. Regulatory issues revolve primarily around unclear transport permits within city limits and road checks when transporting their goods to the market. Low barriers to entry into business are reflected in the fairly fast growth of newly registered firms in the late 1980s and early 1990s.

[1]See "The Private Sector in Madagascar: Role and Performance 1984-1991," April 1991, prepared by J.E. Austin Associates and SOA.TEG (Antananarivo).

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3. Imperfect information about markets and high transport and communication costs continue to limit the size of the market and reduce sales growth of firms. Survey results suggest that there is little inter-provincial trade (less than 16 percent of goods are marketed outside the province), and very little export trade (on average firms export less than 6 percent). This is true for firms across all sectors, and in most size categories. In many ways, Madagascar remains an economy characterized by various "enclaves," dominated by regional buyer and seller monopolies, limiting new entrepreneur expansion capabilities. Survey responses suggest that there is a vast unmet demand for more and more accurate market information, and for improved contacts and linkages between suppliers and buyers. The key investment priority for most firms is to find relatively low cost ways of expediting and improving linkages among markets.

   The high interest in joint ventures (82 percent of all firms questioned expressed interest in working with an outside partner) as a means of injecting capital and providing access to new markets suggests one possible strategy currently being explored by local entrepreneurs. But the formation of new joint ventures, or other forms of linkages and partnerships between economic actors will remain limited unless there are clear rules of the games for commercial relations, and an infrastructure in place to facilitate the identification of opportunities for joint ventures and new marketing relations.

4. Linkages among firms may be hindered by the lack of well established legal framework for commercial relations. The vast majority of firms interviewed feel that contract enforcement is a critical problem. Problems enforcing contracts entered with small firms are felt to be particularly serious. This factor exacerbates communication problems between markets.

5. No private sector business associations are currently playing an effective bridging role between firms of different types and operating in different regions. Most business associations have a very homogenous membership base, and most association members continue to concentrate in major urban areas. Few small firms (less than one fifth) belong to any business association, and none belong to business associations to which larger firms belong.

6. Credit is a key constraint for a majority of firms in the country. None but the larger firms have access to formal credit sources. Supplier's credit is virtually non existent.
   Survey data showed that women-owned firms have been better able to access formal credit.

7. The current interest rate and credit ceilings reduce bankers' willingness to lend to riskier and less experienced ventures, as well as their willingness to extend credit for longer terms. Survey responses suggest that access to long- and medium-term credit is more difficult than access to short-term credit. Even a majority of the larger firms (over 60 percent), which are able to meet collateral requirements, are reporting difficulty obtaining term credit. The current bank regulations and liquidity problems faced by the formal banking sector make it difficult for firms of any size to obtain formal financing.

8. There is a substantial degree of interest in exporting. Although the survey indicates that most export activity is now confined primarily to relatively few larger firms, responses also suggest that there is considerable interest in export markets among entrepreneurs who are not now exporting any substantial amount. Survey responses suggest that information on product standards and prices, especially for export markets, may be the single largest constraint facing the potential exporter. There are preliminary indications that improving access to better and more timely market information would not be particularly expensive. Madagascar already has access to Soviet satellite transponders, something that other nearby countries such as Mauritius lack. Madagascar is already thinking using a series of ground links to improve the reach of their radio broadcasts to the countryside. If proper ground stations can be installed, which entails relatively low cost technology, Madagascar could become a regional supplier of market information.

   The promotion of joint ventures, particularly in the IFZ may also be another mechanism for encouraging greater information flow and contacts abroad.

9. Firms are interested in developing their human resource based, primarily in the area of technical and managerial skills. Access to quality technical labor was a serious constraint by the firms sampled. Smaller firms in particular seem to be having difficulty attracting and retaining their quality skilled personnel. The key investment priority of firms in the sample was managerial skill development.

Implications for Future Actions

a. A critical priority for private sector development should be to encourage greater national economic integration by promoting institutions and mechanisms which lower communication barriers among entrepreneurs. At a basic

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level physical transport and telecommunication infrastructure constraints must be addressed. This entails major physical capital investment projects which cannot be easily addressed by one donor or institution. But there are other means for lowering communication and trade barriers which can be explored and implemented in the short-run.

One possibility is to exploit or use local intermediaries or brokers, who are currently playing the bridging role between smaller firms and larger buyers. Their current role must be explored and opportunities to use them to extend communication and marketing information networks must be examined. Other bridging/networking support structures, such as an information clearinghouse of local suppliers, improved and clarified legal structures, supply of technical assistance in the area of quality control and procurement, either through joint ventures or expansion of business support services, can also help open new avenues for transferring technology and capital among firms. By encouraging the growth of networks among local firms, Madagascar also becomes a more attractive place for foreign investors. Positive experiences forging new linkages among entrepreneurs may also have positive demonstration effects and encourage greater integration throughout the economy.

b. On the policy side, there are other activities in this regard which could also offer large payoffs. Working to lower the effective tax rates (which are perceived as constraints by virtually all types of firms) could help encourage greater investment (particularly foreign investment) and increase the reliability of financial information currently available, with potentially positive effects on capital market growth.

c. The managerial base is very thin in Madagascar. There are many different means of building these skills. One is by increasing access to training services. Another one is by providing access to technical assistance, or even internship/apprenticeship positions in more experienced firms. Donors have already moving into this area, with UNIDO and the ILO providing entrepreneurship training and technical assistance services. USAID has helped sponsored a policy dialogue group in human resources development. All such assistance strategies should be results oriented however: building skills tied to specific results, to ensure that training or TA provided continues to be of high quality and responsive to the changing needs of what is becoming an increasingly dynamic and fast changing economy.

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Appendix C

Summary of Focus Group Discussions

A. Meeting with Agents, Soli Motel, Antananarivo, May 2, 1991.

Participants:

Mananjean, Merilda	**SOANALA**
Raveloson	**OMNIUM Commercial de Madagascar**
Gerboth, Herve Nirina Randrianasolo	**SIMEX**
Ranarivelo, Julie	**SIMEX**
Rakotonorainibe, Aime	**SOMADEX**

1. The participants gave a brief summary of the activities of their companies. Most are engaged in buying and selling of various goods, many of them agricultural based, including wood, fruits and fruit processed goods, ornamental plants, skins (including crocodile skins). All have a second office in another part of the country, close to raw material suppliers. All were engaged in exporting.

2. Their supply sources:

   a. Raw materials. All are locally bought; as noted above most are agro-based and most are bought from a variety of wholesalers and collectors, on average 5. SOANALA, which buys fruit to be processed into juices and jams sends its collectors throughout the countryside to gather the product. The same with mineral supplies. They, as well as others in the group, report difficulty obtaining enough material to meet their demand for finished products. Fore example, SOANALA reports to be currently be operating at 50 percent capacity because they cannot find enough fruit producers. Thus some companies such as SIMEX have actually integrated backward into direct production to ameliorate supply fluctuations. The raw material suppliers are paid upon delivery of their products; no credit is extended, or inputs supplied to their suppliers, since the agents themselves do not get paid until they sell their goods, and their own buyers do not operate on credit. Thus they transfer all the risk burden to their own raw material suppliers. They tend to operate with the same raw material suppliers or sub-collectors, and the amount of growth of these suppliers seems to be

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limited. SOANALA has tried to find additional fruit suppliers by going deeper into the countryside than before.

b. Other inputs. Most tend to be imported (office supplies, cans, bottles, fertilizers). They seldom get credit extended by their input suppliers. Most must be paid for upon delivery. Most of their suppliers of foreign goods are themselves agents of foreign companies. While the representatives of foreign input suppliers have been growing, they are still few. Since competition is limited, so is their bargaining power vis a vis foreign good suppliers. They do not actively seek additional input suppliers but rely on new agents or representatives coming to them to learn about new sources of input supplies from foreign firms.

3. Their markets:

a. They tend to market their product abroad with the help of intermediaries/expediters, who follow the paperwork, find freight space. They have developed a limited marketing network aborad. But they believe their foreign market sources are limited. Their ability to obtain information on marketing opportunities in Madagascar as well as abroad are very limited. The market for information works very poorly.

b. GDRM contracts are particularly difficult to track. The GDRM procurement contracts are announced in the press, but all agree that by the time the announcement appears the time to respond is very limited and chances are the contract has already been awarded. Their foreign contacts often find out about new opportunities within Madagascar before they do. Information from GDRM which is supposed to be free is must often be paid for, using personal contacts.

4. These agents do not believe it is their role to provide their raw material suppliers with inputs or technical assistance so that they can produce better product on time. They lack the money and the expertise. They believe this is the role of the GDRM.

But even if there was credit advanced to producers of raw materials, some of the agents noted that supply contracts are sometimes difficult to enforce. The courts work slowly if at all, and difficult to claim back payment. Hence they tend to stick with traditional suppliers on whom can depend and leery of extending out to other suppliers very rapidly. They would still require some form of collateral or security from the producer from who they were buying.

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5. One of their critical bottlenecks is credit. The banks used to extend credit, based on purchase orders and letters of credit, but no more. There also used to be contracts between the banks and large companies, whereby the large company would help employees buy their goods from a supplier by enabling them to pay for the goods on credit, with a set monthly payment being taken from their monthly paycheck. But this is not done anymore. OMNIUM has seen a heavy drop in consumer demand since this practice was eliminated.

6. The other critical constraint mentioned by all was lack of accurate and timely market information. There is no competitive bidding. It all depends on personal contacts.

7. Business associations do not work very well, if at all.

8. Most agree that the entry barriers to business are low, in the sense that there is to a lot of paperwork to fulfill or permits to acquire to set up a business, though exporting procedures continue to be cumbersome, and not all the paperwork requirements is well understood.

9. Suggestions:

   a. A private data bank to provide information on buying and selling opportunities, both locally and abroad. They believe this institution would be most effective if it were not an association, since associations are not dynamic. The best solution in the view of the group would be to start a private enterprise which would market the information, and in which all those interested could buy shares. Because it would be run as a business it would be interested in providing good services. because they would all be owners or shareholders they would have a say in the operations. But because it is an enterprise it would be more effective that an association. Foreign donors could assist by providing seed capital for such an enterprise, equipment and market information sources.

   b. A credit guarantee fund which would serve to provide security for producers and exporters.

B. Meeting with Small Manufacturers, Soli Motel, Antananarivo, May 2, 1991.

Participants:

Rakotondranaivo, Edmund
Gral. Ralivison, Pierre
Rabetsinatahodriana
Rananasoandro
COMINOR AVYMA
SOINCO/IMACO

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Harvel Andriamanampisoa

Rakotoarivony, Mme et Msieur
Razafindralambo, Hery

Explotation Miniere
Delorme
AINA Boutique
Societe Tsiory

1. The participants represented small firms producing a variety of goods, form metal and mining to fine wood products, pottery and textiles. Some exported, though the majority sold primarily in the local market. About half had a second line of business. That is, they were manufacturing a good, but they were also collecting and commercializing a variety of other goods outside their production specialty. One of the participants noted that this is because the local market for manufactured goods is not big enough to enable them to make a decent living. Since they cannot grow and specialize in one good, they must drum up business elsewhere and diversify their income source. Fore example, one of the manufacturers of textiles was also starting to export fresh vegetables in partnership with another exporter who had a foreign buyer.

2. <u>Supply sources</u>:

   a. Raw materials are basically bought locally, while office supplies and other inputs all come from abroad, including all the machinery. The overwhelming majority of inputs ad machinery comes from France. They have noticed that there is a growing number of representatives of foreign suppliers, and this has allowed some to get better deals for their inputs. On the other hand not all the equipment is of the right type for Madagascar. The equipment is often designed to produce a much larger amount than the local market can handle. One manufacture would like to upgrade his machinery but has not found adequate technology abroad. There was also interest in exploring the possibility of buying second hand equipment from abroad, rather than new very advanced machinery.

   b. Because they are tied to French equipment and standards, they feel that they are also often limited regarding what products they can produce. Their machinery is geared to European and particular Francophone standards, but they realize that their surrounding markets, if they ever want to export, are all Anglophone.

   c. They often but inputs from foreign suppliers not because they give them a better price, but because

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foreign firms give better pre sales service. Asian equipment may be less expensive but often give little service.

d. Textile manufacturers feel trapped by local textile monopolies, which provide the basic raw materials. These monopolies set the price.

3. Market sources:

a. Rely on traditional personal contacts for selling goods, especially selling goods abroad. But because they have no way of cheaply searching for buyers, they often lack bargaining power. They cannot determine price or payment mode.

b. Those who exports feel the lack of quality standards in Madagascar is a problem for penetrating foreign markets. The local market has not yet developed enough sophistication to make distinctions on price based on quality. Those that sell locally are ill prepared to sell abroad. But they feel that the only way of getting sufficient economies of scale in their operations and being able to compete with cheap manufactured imports is to widen their markets by selling abroad.

c. Transportation and communication costs are major bottlenecks to expanding in foreign markets.

d. They feel they are each too small individually to be able to set conditions or bargain for a better price or payment structure.

4. They feel squeezed by the present credit crunch. Their own suppliers have stopped giving credit. Thus they cannot extend credit to their clients. The bigger suppliers used to give credit, but no more.

5. While they feel the need to band together to achieve some economies of scale, in transport, in bargaining credit concessions from suppliers or better prices for buyers, just one of the participants belonged to a business association. They feel they are too small, and lack the time to spend going to meetings. They also are a leery of giving away too many trade secrets to the competition if they were to work together. There is no patent law, no way of protecting intellectual property.

6. <u>Suggestions</u>:

a. Freight consolidators. But would require a neutral party and transparency in the invoicing and transactions.

b. A journal of information on foreign buyers and sellers. Al;so information on local opportunities, including GDRM contracts for manufactured goods.

c. Export guarantee fund, perhaps administered or assisted by a new exporters/manufacturers association.

C. Meeting with Transporters, Soli Motel, Antananarivo, May 3, 1991.

Participants:

	RATP
Ramanarivo, Jean	**JRTRAEG**
Razanakolona, Jacqueline	**Pousse-Pousse Rentals**
Ramebeloaritsimba	**Pousse-Pousse Rentals**
Rakotoaritsimba	**Pousse-Pousse Rentals**

1. The group provided a cross section of the transport sector in Madagascar. One company manufactured, maintained and rented pousse-pousse to producers, another company (RATP) owned a 15 truck fleet (25-30 tons each) and specialized primarily in the import-export trade between Tamatave and Tana; a third company specialized in tourist transport, including a fleet of new hovercraft imported from France. The latter company was barely a year old, while the large truck operator had been in existence for over 20 years. The price of key inputs such as tires has decreased appreciably over the last year, but the still remain at over FMG 1 million each, a price most transporters find very high.

2. Most heavy vehicles are imported from France, though some of the lighter tourist transport vehicles used by JRTRAEG are imported from Japan. Spare parts are imported but there is a lot of re-tooling which is done locally. The spare parts have also become easier to obtain over the last couple of years. The pousse-pousse manufacturer/renter uses all locally acquired, second hand materials to build the vehicles.

3. <u>Marketing sources</u>: These companies too rely on personal contacts and word of mouth.

a. For example, the large manufacturer does not have a dispatch service, or long term contracts with specific

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producers or importers/exporters. Instead he has his contacts ("antennas" he called them) to find out what company is expecting a major shipment form abroad and will need transport. His contacts get the shipping manifests for him and he contacts the importing company directly. He normally gets the manifests 2 weeks before the shipment arrives. While the train is cheaper per kilometer, he can compete with it because he moves his goods faster, and works door to door, whereas a shipment by train must be picked up and delivered to the station. Moreover the train between Tamatave and Tana does not have enough cargo space to meet the demand. Most of the freight traffic is Tamatave-Tana, and often trucks must go empty to Tamatave to pick up goods to be brought back to the capital, making the price of freight this way higher. The transporter does not have a good enough network of suppliers, and inter-provincial trade is not developed enough to assure him a full load both ways. Moreover, their trucks are too big and ar not able to travel in the secondary roads, so they have trouble reaching the producers directly.

b. The tourist transporter relies on about 10 local intermediaries, travel agents, to make the contacts and the bookings with tour agents abroad. They lack direct contacts with the big tour agencies, and as a result are not able to negotiate better margins and plan their local tours throughout the year. Most of the tourist trade is concentrated between May to November. Some winter trade is starting.

c. The pousse-pousse operator, which owns and rents 38 pousse-pousse. She does her marketing and determines the price through the local association of pousse-pousse operators. This association (total 33 members serving an estimated 700 clients in the Tana area), acts as a cartel, setting the local price (FMG 1000 pr day) for all operators. They must have a license for each pousse-pousse (cost of the license from City Hall: FMG 100). Neither the cartel nor City Hall limited the number of pousse-pousse which can be operated by an entrepreneur.

4. In theory the GDRM sets prices (FMG/kg) for agricultural goods transported between cities. But apparently these official freight prices are not enforced.

5. The transporters' main complaint is the condition of the road network. They would be willing to pay road tolls, but only if they could be assured that the tax would be used directly to improve the roads, which they find very

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doubtful. The RATP man was interested in starting an association of transporters, but nothing much has occurred. The tourist transporter noted the formation of a new group, the Groupement des Entrepreneurs de Tourisme (GET), begun last year to project a positive image of the industry within Madagascar and a positive image of the country abroad.

6. There are road blocks administered by the local governments to insure that the taxes on the agricultural commodities being transported have paid their taxes. These taxes must be paid by the producers, but the transporter must have verification of this payment.

7. If any goods are lost or stolen in transit, the transport is directly responsible. They carry insurance, but apparently making the insurance companies pay has been difficult. The insurance is also expensive. Imperfect insurance markets may make it difficult to diversify their client base, since in the absence of other means, they depend on personal contacts and trust. The security problem is particularly bad when they are transporting basic necessities. In such cases they take extra precautions, including arms, to protect the shipment en route.

   The pousse-pousse cartel is in the process of negotiating group insurance for their members (in case pousse-pousse are lost damaged or stolen). But the problem has been that no insurance company will cover them because those that rent the pousse-pousse are often not those who will operate them (e.g. rented by a producer in the field, who then hires others to haul the products).

8. Other institutional impediments: the present legal restrictions barring truckers from operating between 6AM and 6PM. This law was not always very strictly enforced, but apparently this has changed recently. It makes them waste entire days, and promotes idle capacity.

9. There are no relations between larger and smaller transporters. Though the larger transporter acknowledged that he could not very well penetrate into producer areas with his big trucks, it did not occur to them to use a network of smaller collectors or transporters to consolidate the shipments. They do not use consolidators either.

10. <u>Suggestions</u>:

    a. Improvement of the road infrastructure. This may include the introduction of a special tax on road users (toll roads) or gasoline, but they would need assistance that the revenues would be directed to road improvement and maintenance.

b. Better information on products, producers, shipments, used vehicles and spare parts, contacts with shipper abroad, or tour operators.

c. Smaller operators require working capital to buy spare parts and better maintain vehicles.

d. Business skills (basic accounting and managerial skills).

D. Meeting with Agents, Chambre de Commerce, Tamatave, May 6, 1991.

Participants:

Gabriel Jean Solo Julien	**SKCC Exportation**
Bako Rajeuinina	**S.G. Chambre de Commerce**
Ramperany Soloninrina Simon	**Service Provincial de Commerce**
Rasolomanana Rivo	**MALAZA**
Razanakolona S.	**Collecteur de produit (individuel)**
Rademaanzara	**Societe RAMEX**
Zabary	**AFAVE**
Ranirison Heriniana Ivette	**AFAVE**
Rafidison Dominique	**AFAVE**
Cham-Chok Narco	**SOMACI Toamasina**
Rarivoson Roger Robert	**Service Provincial de Commerce**
PINGOZA	**SOE (Societe Ocean Export)**
Rakotoarisoa Voahirina	**COREMA**
Mahamadaly Aziz	**SCIM**
Botanfolsy Jean	**Producteur/Collecteur Individuel 114 Bery Rose**

1. All the agents in the meeting were engaged primarily (and most of them, exclusively) in commerce of traditional agricultural products: coffee, vanilla, cloves. Some were dealing in some essential oils, primarily clove oil. About half were exporting. Two of the exporters were affiliated with a main purchasing house in Paris. They were also selling smaller amounts in Asia, primarily Singapore. There was one producer who also engaged in commerce for the local market.

   Representatives from the Chamber of Commerce and the Ministry of Commerce also attended the meeting.

2. Supply sources:

a. All the agents were obtaining their supplies from independent collectors, none had developed direct relationships with the producers. They usually advance money to collectors, but this situation had changed somewhat with the credit controls imposed late last year.

b. Some participants observed that there were some new collectors entering the market and trying to offer them supplies. But essentially everyone, despite the opening and liberalization, were staying with their traditional suppliers.

c. None actively seek new sources of raw material supplies. They are reactive and expect suppliers to find them, through the collectors. But all did agree that a major constraint was that their sources of raw material supplies were uncertain, and that while demand existed, they could not assure foreign buyers materials of sufficient quality and quantity on a regular basis. But none had integrated backwards to reduce supply uncertainties.

d. All agree that a major problem were the producers, who lacked the means and technology to produce quality and quantity desired.

e. The prices, while liberalized are still thought to be fixed by the GDRM for some goods (litchis for example). But the Ministry officials pointed out that GDRM announced pries are supposed to be indicative. The producer said this is used as an excuse for cartel-like behavior by collectors.

3. Markets. The same difficulties emerged as in other groups: lack of communication and poor road infrastructure seriously limit their ability to find buyers and bring their product to market at a competitive price.

Lack of maritime freight space was also said to be insufficient, causing delays in the delivery of their product.

Most exporters we talked to were linked to French buyers abroad. They are very interested in expanding their contacts abroad, but lack basic information regarding the volume demanded for diverse products, quality standards, names and addresses of contacts. The Chamber of Commerce provides, on a sporadic basis, names of contacts they obtain through their links with other Chambers of Commerce abroad.

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But CCAI's activities in this regard seem to e reactive rather than proactive; they will pass on names received through their contacts with other Chambers abroad, but do not seem to be actively searching for buyers on behalf of members. Nor are they linked in any formal way with the diplomatic corps abroad (e.g. the commercial attaches stationed in foreign embassies), or even with the consular representatives of foreign governments in Tamatave or embassies in Tana.

4. Contracts and risks. None of the agents contacted carried insurance against loss of product en route. Moreover, because their ability to stay in contact with foreign buyers is limited, and they lack representation abroad, they retain little control of payment schedules or quantities. If their foreign buyer tells them they will not pay the full amount because the goods arrived damaged, or some was lost on the way, they have no recourse but to accept the price set by the buyer. They have no way of verifying the arrival of their shipment.

5. Suggestions

a. Access to information on market contacts. They would be wiling to pay for the service. Basic information such as the names and addresses of foreign buyers are most desired; they hope to then be able to write to the buyer directly (since no one has a fax, and it is too expensive in any case). Information on international prices and quality standards and tastes is also desired. But no one seemed to be much interested in more in depth market analyses, including analysis of demand trends for non traditional products. It is not quite clear that they would know the value of additional information of this nature.

b. Infrastructure. In particular improvement of roads to improve access to raw material suppliers.

c. Establishment of direct linkages and twinning arrangements with foreign Chambers of Commerce, in particular the US Chamber of Commerce.

d. Organization of producers. Producers require technology and training on quality standards, new production techniques. The agents do not see it as their task, or that of the collectors, to provide better access to inputs and information on production and demand trends. This is seen as the role of Government.

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e. Export guarantee scheme or pre-finance for exporters. It is interesting to note that credit, though perceived as important by all participants in the focus group, was never among their first priority. Issues regarding information and infrastructure provoked far more discussion and concern that credit. They seem to rightfully sense that without a market, there is little sense in incurring additional risks by obtaining credit to expand business.

E. Meeting with Small manufacturers, Chambre de Commerce, Tamatave, May 6, 1991.

Participants:

Belamy Henri Paul	**MIEM**
Selamanana Pscal Alain	**ESP**
Rakotoarisoa Jean Gabriel	**Confection**
Rajaona M. Jean Thierry	**AFAVE**
Rabary I.	**AFAVE**
Rasoarivony Violette	**AFAVE**
Samy Cyrille	**Ebenisterie**
Rabarison Simeon Sylvain	**Technicien au Centre Regional de l"artisanat**
Ravaolantariovony	**Couturiere**

1. There were representatives from a variety of subsectors, including clothing/textile, brick making, wood working. There were several participants present who were interested in starting a business, and were looking for ideas and contacts. These were people who had a specific skill (carpentry, masonry) and were looking to go into business for themselves. They noted that there were no big manufacturers in Tamatave and as result small producers saw more possibilities for succeeding in this location

2. <u>Suppliers</u>.

   a. Most bought raw materials directly from retailers, few had enough volume to buy from wholesalers.

   b. They all bought from same network of suppliers with which they started their business.

   c. Technology a problem, in particular access to new machinery. New equipment was expensive, too expensive to be able to afford, and no suppliers extend credit or payment facilities. Many expressed an interest in finding sources of used machinery, especially machinery geared for their (small) scale of operations.

3. Markets. They all have their set client base, buyers with whom they have established a personal relationship. None advertised or thought about advertising to expand their clientele; all their clients have learned about their products through word of mouth.

Most expressed that they often felt caught in a bind because they could not fulfill big orders since they lacked the machinery and the capital needed to gear up for a large assignment. Asked why they could not subcontract out some of the work to other small manufacturers, they said it was because they had no way of controlling the quality and quantity of the work coming out of other shops, and were unwilling to take the risk.

They all expressed that their key constraint to expanding their operations, and the client base were poor transport and communication facilities.

4. Suggestions:

a. Marketing studies and assistance.

b. Basic business skills, including accounting.

c. Access to basic equipment (even if used) appropriate for their markets.

d. Credit, but with technical assistance (and training for basic business skills).

F. Meeting with Transporters, Chambre de Commerce, Tamatave, May 7, 1991.

Participants:

Wei Yung Chiag Germaine	**Societe MALAZA**
Rasoliananama	**Societe MALAZA**
Randrianasolo Bruno	**Etudiant Cur Barikadimy**
Rakotoarivelo Marie	**Taxi-Ville**
Randriarimalala Marius	**Ligne Suburbaine**
Sien Chi Siang Rene	**Ligne Tana**
Boviel Claude	**Toute Ile**
Rakotondrazafy Salomon	**FITATO**
Dara Mahabe Robert	**Entreprise Nanto**

1. The group in Tamatave represented a cross section of the transport sector in the area, including small taxi operators specializing in people transport as well as larger truckers,

dedicated exclusively to freight. There was a French national who had been operating a fleet of trucks in the area since 1985.

2. Suppliers:

a. The characteristics were similar to those seen in Tana. Transporters were dependent on foreign vehicles, and on representatives of foreign suppliers for all spare parts. Spare parts are very expensive, unless bought in bulk. But operators are too small to become bulk buyers.

b. New trucks are extremely expensive. Tax laws allow them to depreciate new vehicles over a maximum of 1.5 years. Given the prices they must pay for new vehicles (which include a tax not just on the value of the vehicle but the freight as well), the monthly payments are simply unaffordable to most independent transporters.

2. Markets/buyers:

a. The freight operators are on average functioning at only 50 percent of capacity, due to inefficient dispatching and marketing procedures. They go laden with imported goods from Tamatave to the capital and the plateau area, but on average come back empty (this is the opposite of what happens to the freight operators based in Tana). They realize that there are many large industrial operations in the plateau area who sell their products in the coast (e.g. the large textile operator COTONA or Star Breweries in Antisrabe), but these firms have no need for their services, since they own and operate their own fleets. Poor communications infrastructure and lack of market contacts outside their immediate area makes it difficult to arrange for other freight on the way back to Tamatave.

b. In sessions with the large industrialists in the Antsirabe area it was learned that though the large firms would in principle be willing to subcontract out more of their transport operations, the poor conditions of the roads, poor communications infrastructure and the legal and judicial system, which is outmoded and provides no set mechanisms for enforcing contracts, all conspire to limit the amount of subcontracting which takes place. Large firms, and small operators alike, are averse to entering long-term contracts for delivery of goods and services, because the poor road conditions

make it difficult for an operator to systematically and consistently guarantee the on time delivery of goods, and the legal system makes it difficult for any party to obtain recourse should enforcement become an issue.

3. Other issues:

   a. The legal/regulatory environment makes it very difficult to operate efficiently. As noted above contract enforcement difficulties limits the subcontracting.

   b. A city ordinance forbids all truck traffic inside city limits. This makes it difficult to pick up and unload goods. It also makes it impossible to get gasoline, since all filling stations are within city limits. Nobody knows why the ordinance exists. It increases the costs of door-to-door transport services, and also encourages corruption, since it is virtually impossible to operate within the law and still do business as a trucker in Tamatave.

   c. The state of the roads is so poor that truck size is limited to 15 tons for transport between the major cities. Bad roads cut entire communities, some of them rich in agricultural products, from major urban markets.

   d. Road blocks, to control the movement of the basic necessity (PPN) goods between regions also add to the cost of transport. The GDRM controls all the movement of PPN across provincial and municipal borders. No one is quite sure of the use or benefit of this policy.

   e. CB radios are allowed, and some use them in their trucks. But the use of this instrument for improving dispatching is not developed, and the price remains far above what an independent trucker can pay.

4. Suggestions:

   a. Form an association of freight transporters, to facilitate buying spare parts in bulk, improve dispatching, lobby for changes in regulations affecting transport adversely.

   b. Change the import tax laws so that the tax is levied on the cost of the vehicle only, and excludes an import tax on the cost of the freight.

c. Provide better financing and change the depreciation allowances to allow payments to be stretched for longer periods of time.

G. Meeting with Builders, Chambre de Commerce, Tamatave, May 7, 1991.

Participants:

Zara Mahabe	**Robert Adjoin Entreprise**
Misy Ambroise	**Representative, CCAI in Tamatave**
Rakotosolofo Simplice Gabriel	**Entreprise TOKY**
Razafindrabe	**Promoter, CCAI, Tamatave**
Rabenja Francois	**Societe Tamatairienne d'Entreprise**
Rabary Jose	**Entreprise Tatsinanana**

1. The credit crunch has affected the building industry in Tamatave tremendously. As a result government contracts for public works financed with foreign donor money had become of increasing interest, even for smaller operators. But the bidding process for these contracts was a mystery to them. They realized that by the time a piece of work was advertised it was likely that the "winner" had already been decided.

   They are given on average just 15-30 days to prepare a proposal. A big difficulty is that contract and procurement decisions are made in Tananarive, and they could not afford to travel there often to market themselves and make contacts. Some however had actually opened up small offices in the capital, as a way of establishing a presence.

   They prefer these foreign funded contracts because the likelihood of getting paid on time is much greater. The GDRM takes sometimes over 6 months to pay.

   They have heard that there will be potentially some work related to infrastructure development in the EPZ, but none had any details regarding the plans for the EPZ or any contacts among the firms involved; nor did they have any idea how to go about and obtaining information on this, and doubted the CCAI could obtain good information in this regard.

2. Most of the builders were too small to put credible bids individually for the public works contracts. But they are

averse to band together to bid. They are afraid their competitors will learn their trade secrets, or their pricing structures. Or steal their best artisans.

3. Suppliers:

   a. Raw materials are very expensive because few can afford to buy in sufficient bulk to obtain discounts on wood, cement, and other building materials.

   b. There is no builders association, or consortium of small builders.

   c. Skilled labor has been difficult to come by. There is an informal apprenticeship system ,but no formal system, and discerning the truly skilled technicians from the rest is difficult. Skilled technicians are prized and in demand.

4. Buyers:

   a. All market their "products" through personal contacts and word of mouth. The larger builders in the group had obtained some GDRM contracts through open bidding however. These were the ones who had also managed to open representative offices in the capital.

5. Suggestions:

   a. Start a formal apprenticeship program.

   b. Facilitate access to working capital.

   c. Start an association of builders in Tamatave to facilitate access to raw materials (through discounts obtained by buying in bulk), access to capital and maintain central information system on skilled personnel to contract for specific assignments.

G. Meeting with Industrialists, Antsirabe, May 8, 1991.

Participants:

Issak Abed	**Societe Maronjana**
Rakotoravo Huges	**Groupe SIPROMAD (Direccion Financiere)**
Andrianaivonjato Andre	**SOMADEX (DFA)**
Rasoamanambola Andriambelo	**SOMADEX (Ingeneur de Mines)**
Ramanakomiamefamanana Dauphin	**SOMADEX (Ingeneur Mecanique)**

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1. All the participants were keenly interested in obtaining contacts with US buyers and suppliers, but none had sought to establish a contact or directly seek an appointment with the commercial attache of the US embassy in Tananarive. Nor had they sought to use the services of the Malagasy embassy in Washington to facilitate contacts.

2. All the larger firms buy the bulk of their raw materials directly from foreign suppliers (or their representatives in Tana). Only textiles (acquired from COTONAT) and packaging material came primarily from local sources.

   One of the participants was manufacturing candles for local markets. All the paraffin cam from China. Chinese paraffin was very poor in quality but it was also very cheap. The company was investigating the possibility of starting to source more of the raw material locally by encouraging the local production of beeswax, to manufacture at least their higher quality candles. The firm is looking now at the possibility of opening export markets, to obtain needed foreign exchange and as a hedge against the stagnation in the local markets, specially as electrification proceeds to expand.

   All would like to subcontract out more, but expressed concern that there were no mechanism for assuring/enforcing delivery of goods and services.

3. The large industrialists in Antisrabe have shown their ability to band and work together for common goals, and to solve common problems. They got together to lobby and pay for the opening of an additional set of phone lines between Antsirabe and Tana (the Phone Plus system). It is interesting that the PTT did not have to invest in more infrastructure (e.g. install more lines) to operationalize the Phone Plus system, but simply made additional connections using the existing infrastructure.

4. The industrialists are now considering joint action to repair the roads in the city, which are in a very bad state of disrepair. But the costs are very high. More importantly, there have been problems deciding which level of government has responsibility for repairing the roads -- the county, provincial or central government -- and where the responsibility for one governing body ends and the other begins. Moreover, the central government has equipment to repair roads, while the local governing bodies do not. Sorting these issues is taking time and in the meantime the roads continue to deteriorate.

5. The industrialists complained about the lack of qualified middle level management. The universities produce highly

theory-oriented professionals, with little solid practical skills. Therefore the companies must invest considerably in their training after hiring them.

6. The industrialists are interested in expanding the concept of a FIARO, a venture capital company, as a means of facilitating access to expansion capital. Commercial banks are not fulfil;ling this role. But there is little knowledge and information about how venture capital firms operate and the country lacks the infrastructure for efficient capital market operations.

7. The participants would like to see more and better coordination between donors, and more information on the various donor assistance programs in operation.

Appendix D

Housing Finance Study

MOBILISING HOUSING FINANCE IN MADAGASCAR

RESUME OF FINDINGS

OBJECTIVES

1. The objectives of the study are as follows:

To establish if there is unsatisfied urban demand for housing in Madagascar.

In this event, to identify the constraints in the provision of housing.

Finally, to recommend measures to overcome the identified constraints, and specify areas where USAID could play a role.

THE PRESENT SITUATION

2. It is estimated that only 4% of the total demand for housing in Antananarivo is being satisfied by formal sector construction. Formal sector housing construction is generally targeted at the higher income groups, that is the top levels of the Civil Service (fonctionaires) and the Modern Sector in addition to the Elite. (Representing between 3 & 12% of the urban population.) If informal housing construction, for the most part undertaken by the lower income groups, is included in the equation then it is crudely estimated that 40% of housing demand is being satisfied. In short, the Antananarivo statistics indicate a substantial shortfall in the provision of housing by the formal sector which is only partially being met by informal efforts.

3. Primary constraints to the provision of housing are:

Uncertainties in the financial sector.

Purchasing power.

3.1. **Uncertainties in the Financial Sector.** Madagascar is in a period of transition. Liberalization objectives have not, as yet, been attained in the financial sector. This is marked by predominantly negative to only marginally positive real returns on savings; and the use of credit rationing rather than cost of money to determine allocation of financial resources.

Prevailing conditions in the existing financial sector do not, therefore, encourage saving. in addition they restrict access to credit through direct controls. (Savings in the middle income levels are estimated to constitute only 1 to 2% of total household outlays. Credit rationing tends to mitigate against new entrants and projects with longer pay back periods.)

3.2. **Purchasing Power.** The buying power of the broad mass of the urban population is widely reported to be very weak. This view is supported by initial calculations (albeit crude estimates because of the lack of adequate data) which indicate th

basic housing unit built by the formal construction sector with the provision of water, is not within the purchasing power of 88% of urban households without reccurse to subsidy.

4. Secondary constraints are as follows:

4.1. Provision of infrastructure is an important constraint which goes hand in hand with superstructure constraints. Increased supply of infrastructure will not in itself, however, solve the primary housing finance constraints.

4.2. Title of property is a constraint in that the property registration system has administrative inefficiencies which cause delays in furnishing full property titles required by the banks. This is not, however, the major constraint to accessing credit.

4.3. Sourcing building materials is less important a constraint to housing following trade liberalization in 1988. Given the devaluation of the FMG the cost of construction materials is reported, however, to be aggravating the purchasing power problem. Import substitution responses do appear to be taking place with greater sourcing of raw materials in Madagascar.

THE OUTLOOK AND USAID'S POTENTIAL ROLE

5. In raising housing finance Madagascar's first prize would be to mobilize savings and ensure their productive reinvestment in housing. This approach would maximise benefits to the national economy. The present financial sector situation and the weak purchasing power of the broad mass of the population detailed in 3 above, severely undermine this eventuality.

6. Savings can be mobilised at negative rates of return in situations where there is bottled up liquidity. With the advent of trade liberalization this situation does not prevail. Actors at all income levels are reported to prefer to put any excess liquidity into goods whose value will appreciate at acceptable levels.

7. Tax incentives to mobilise savings will only act as an incentive for the top bracket of tax payers. **This could be achieved by raising the 25% tax exemption ceiling on savings.** This will have a limited effect on the middle income groups whose effective tax rates are of the order of 8 to 12%.

8. Housing credits (whether they are linked or not to savings plans) could be made more attractive to the banks **if refinancing with the CB is allowed for periods over and above the present 5 year ceiling, and there is a redefinition of what is rediscountable for housing credits.** (Although technically this rediscount system no longer operates since the new Appel d'Offre system was instituted in November 1990, it is still used for management purposes by both the CB and the banks.) Implementation of this type of system is contrary, however, to the Government's and the IMF's intention to remove preferential rates. In addition it would simply pass all risk on to the CB.

9. **In short, under prevailing economic conditions raising meaningful levels of housing finance, whether it be through the existing banking system or through a new specialised housing finance organization (including the type SP MIEL) is likely to constitute a significant subsidy for any donor.** The outlook is somewhat brighter. Discussions with Government and the IMF/World Bank indicate that Madagascar is committed to a finance system determined by indirect controls and such a financial situation should be in place and stabilise in 2 to 3 years time. In addition there are indications that the rate of inflation is under control and coming down. The other major constraint, growth in purchasing power, will depend on the overall success of the liberalization program.

10. There are a number of alternative methods that could be used to facilitate the provision of housing.

11. **Housing built for rental** appears to be the most viable short term possibility. (Rents are not controlled) There are a number of groups of Malagasy entrepreneurs who plan either to purchase housing for rental, or build housing again for the rental market. It should be noted that they are targeting the upper middle to high income rent paying groups. The benefit to the nation would only, therefore, be through the "trickle down" or "ripple effect".

USAID, preferably with counterpart funding as no external liability is created, could contribute finance to such a project either:

11.1. Directly in the form of loan or equity (possibly debenture or B share) finance.

11.2. As a contribution to a guarantee fund in a Societe Caution Mutuelle (SCM). A SCM allows a small group of entrepreneurs to have access to higher levels of credit, with lower down payments for longer periods of time. This would therefore overcome the credit rationing problems.

Various mechanisms could be used to ensure that this form of funding was self perpetuating.

A legitimate question could be posed - Why are USAID funds needed to finance entrepreneurs? Three reasons are postulated; to bring new Malagasy entrants into the market who are presently precluded through lack of capital, to ensure that some credit does go to housing and not to short term more profitable projects as is presently the case, to gain larger borrowing over a longer period with greater bank confidence.

12. **Credit Savings Clubs (Credit Mutuelle)** could also be developed in organizations or companies where there is a shared interest among individuals. Here the savings or borrowing rate could be divorced from formal sector rates, either being artificially low (0%, and 5%) or represent real returns or cost of money rates.

It should be noted that these clubs will not solve purchasing power problems and consequently savings may be relatively low. It is constantly stated, however, that if the Malagasy develop confidence in a system they will [illegible]

be the answer. USAID's role would primarily be the provision of skills to get these clubs going. A pilot club would probably be advisable.

13. **Company Housing Credits.** A number of companies are providing housing loans to retain employees. These are either (a) company loans at very low rates or (b) a mixture of subsidised company loans and bank loans.

A number companies are reported not to be big enough to give this assistance. However, if they formed themselves into a group with the backing of a donor, they could raise enough finance on the local market following system (b). USAID's role would be both in the provision of capital and of skills. Maintaining neutrality amongst various companies vying for resources, would, however be a problem. Such assistance could be restricted to US companies and totally locally owned companies operating in Madagascar.