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EDITORIAL

Located off the coast of Africa, Madagascar differs from the continent in a number of respects. For the uninformed observer, Madagascar's economic evolution over the past twenty years seems to have been characterized by numerous symptoms of the "African syndrome" : across-the-board deterioration of the economy, inconclusive efforts at policy adjustment, temporizing with the Bretton Woods institutions, dashed hopes of recovery, missed opportunities, and so on.

These apparent similarities, however, obscure some real differences. Though in close proximity to Africa, Madagascar often seems more attracted to Asia. In this respect, the low cost of Malagasy labour is often mentioned as an asset for an "Asian"-type model of development. It may also be noted that Madagascar's worsening economic situation preceded that of the African continent and that adjustment efforts undertaken by the Malagasy authorities also predate those of numerous African governments. This makes it rather paradoxical that, at a time when the economies of sub-Saharan Africa are looking up, the recovery of the Malagasy economy seems belated and limited by comparison.

We thus consider it worthwhile to devote an issue of Dialogue to the Malagasy experience, in order to better understand the specificities of the country's recent history and, in doing so, to better situate it in relationship to the evolution of its continental neighbours. DIAL works on the Malagasy economy on a regular basis, through the assistance it gives to the MADIO project. The goal of this project, which was launched in late 1994, is to help the Malagasy authorities think about macroeconomic issues during the current transition process. In some ways, the analysis offered here of the Malagasy economy's recent evolution may be seen as a synthesis of MADIO's and DIAL's work on the subject in the same way as the June 1996 issue of Dialogue (no. 5) offered a synthesis of DIAL's work on the Cameroonian economy.

The approach taken in studying these two cases illustrates the method DIAL employs in its macroeconomic studies. This method includes, in particular, the direct involvement of researchers in all aspects of the information chain : assembling and processing statistical data, economic analyses, macroeconomic modelling, and so on. Upstream, this method favours the collecting of reliable, quantified information, upon which the understanding and representation of economic relations must be based.

The marked deterioration of statistical information in numerous countries south of the Sahara has been a problem for some time now and persists despite various commitments made by African officials, donors, and international institutions. So long as this situation is not remedied, the direct involvement of researchers in the preliminary collecting of information will remain indispensable in order to understand the economic situation and, consequently, to devise appropriate policies in these countries.

THE MALAGASY ECONOMY FROM 1990 TO 1998
A fragile return of growth and its dependence on reform efforts

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Madagascar has been involved in a process of economic adjustment for close to fifteen years now. Following the failure of past economic strategies, Madagascar, like other developing countries, changed course in the mid-1980s, embarking on liberalization and an opening up to the world economy.

Despite initial hesitation successive governments adopted a broad range of reforms designed to move the country in this direction, such as :

- abolition of export taxes;

- sharp reduction of import duties ;

- liberalization of previously administered prices and marketing networks ;

- implementation of a special free trade regime regarding, export-oriented enterprises ;

- establishment of a freely floating exchange rate in 1994.

Even if liberalization is still under way in certain areas and remains difficult (reforming the banking sector and the civil service, privatization, etc.), the steps that have already been taken attest to a high level of commitment to the goal of creating market-oriented economy.

Following two decades of recession-stagnation, hopes were revived at the end of the 1980s, when the Malagasy economy began to recover. Growth in GDP exceeded population growth in 1988 and 1989. Unfortunately, this incipient economic recovery did not continue. The process was interrupted by the events of 1991, notably the strike which paralysed the country and the political confusion that ensued.

This economic dynamic poses the basic question as to the connection between structural reforms and growth; a connection rendered that much more complex by the concomitance of economic transition (from an administered to a market economy) and political transition (from authoritarian rule to democracy).

Viewed over the long run, the mediocrity economic performance bears out the singularity of the Malagasy case. Neither radical changes in the political regime (1972, 1975, 1991) nor those observed in the realm of economic regulation seem to have succeeded in stemming the on-going process of retraction (see box). Are the causes of this regression merely the inadvertent result of a series of managerial errors? Or are they to be found in structural factors specific to Malagasy society ?

I. 1990-1995 : An economic strategy compromised by political transition ?

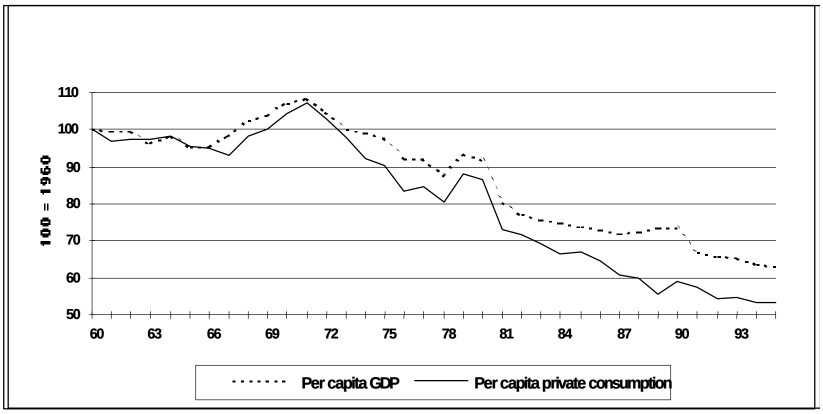
The economic trajectory during the political transition in the early 1990s bears the mark of an unstable environment. Political confusion and the absence of a clear economic orientation have had harmful consequences for growth. The decision of the principal international donors to limit their relationship with Madagascar has weakened the country's economy.

Following the sharp fall in 1991 (-6.3%) and despite a modest upturn since then GDP still remains below its 1990 level. From 1990 to 1995

An inexorable and long term decline in the standard of living

Madagascar has been characterized by a steady decline in the household standard of living, which, in 1996, reached its lowest point since independence. The majority of the population today have never known a lasting period of growth in income. Between 1960 and 1995 per capita GDP plunged by 36.8% and private consumption by 46.8%, for an average rate of growth of -1.8%. If the point of departure is 1971 the most prosperous year in terms of per capita income, the drop in per capita consumption reaches 50.3%. This negative trend in consumption is confirmed by survey data.

Evolution of per capita GDP and private consumption, 1960-1995
(1984 prices ; base 100 = 1960)



the average annual rate of growth was 0.3%, which represents a decline in per capita GDP of 2.5% a year. Weak growth is mainly pulled along by household consumption (1.4% a year).

The evolution of public demand is negative with adjustment impacting above all on investment (-9.4%), whereas consumption is contracting at an annual pace of -2.6%. Only private investment has seen significant growth (4.4%), though from an extremely weak base (4.6% of GDP). Mediocre export performance (1.9%) leading to the failure of the export-led growth strategy cannot prevent the deterioration of the trade balance when compared with the significant increase in imports (5% a year).

The degradation of public finances

The lethargy which characterized the Malagasy economy from 1991 to 1995 can be seen in the imbalance in public finances. The improvement observed at the end of the 1980s was short-lived.

The state has not been able to mobilize the necessary resources to finance its spending. The fiscal burden is light (less than 10% of GDP) compared with similar countries in sub- Saharan Africa, and has steadily decreased during the period. This counter-performance may be attributed for the most part to the degradation of the administrative apparatus.

Energetic measures to limit spending have been taken during this time (freeze in hiring, cuts in operating expenses and, above all, in investment). But these efforts have been cancelled out in part by the increase in debt servicing, which weighs heavily on public finances. In addition, they have already weak the administrative capacity of the civil service.

The overall deficit, which fell to less than 1% of GDP in 1990, has since increased, under the double impact of lowered tax receipts and increase in interest on the debt.

Finally, if a small improvement can be observed in 1995, with a near balance in the primary deficit and an overall deficit brought down under 6%, this downward adjustment remains fragile, since it results more in limitations on spending than on an increase in receipts.

The stagnation of exports…

Export sectors are characterized by a weakness that is incompatible with the expressed goal of economic liberalization. Overall volume has stagnated and indeed decreased for certain products. In addition, the trend to diversification which was pronounced in the late 1980s (the share of the three leading exports going from 70% to 50% due to the emergence of new products: shrimp, textiles) stalled from 1991 on. The evolution of world prices was admittedly not favourable to the country in the early 1990s and the trend only began to shift in 1994, with, most notably, the steep rise in the price of coffee. But, as with the rest of the economy, the evolution of exports is less a result of the international context than of internal supply problems. A long-run analysis shows that world prices only have a slight effect on the volume of exports. On the other hand, internal constraints inhibiting export expansion are determinant (insufficient infrastructure, limited access to credit, lack of information on export markets, unstable socio-political and economic climate, etc.).

...which is accompanied by an increase in imports

The inertia in exports poses a particular problem given that local supply is incapable of satisfying the domestic market, which thus results in an increase in imports. The lack of local substitutes for imported goods and the uncompetitiveness of

THE MADIO PROJECT

MADIO (MAdagascar-Dial-Instat-Orstom) is a project that was established to support macroeconomic analysis and reflection regarding the transition process in Madagascar. Part of its work involves the rehabilitation of the national statistical gathering capacity.

The approach adopted by MADIO has three components: generating statistics, thematic analyses, and macroeconomic modelling. The project's work mainly focuses on :

- living conditions of the urban population (employment, consumption, education, health, etc.) ;
- the state of the countryside (activity, income, consumption, etc.), analyzed by rural observatories ;
- performance of the formal industrial sector ;
- macroeconomic analysis (GDP, evolution of prices, public finances, foreign trade).

MADIO consists of a team of seventeen European and Malagasy researchers (four of whom are funded by grants) in different disciplines (economics, geography, history). The project works closely with the researchers at DIAL.

The project is funded by the European Union, ORSTOM, and the French government's State Secretariat for Cooperation and the French-Speaking World. Based in Madagascar, it formally collaborates with the Institut National de la Statistique (INSTAT).

domestic supply (both in terms of price and quality) make the Malagasy economy exceedingly dependent on the outside world.

The trend toward increased imports should not, however, be viewed as a negative phenomenon in and of itself. If this increase results in a growing trade deficit, the finger here must be pointed at the lack of dynamism in the export sector.

II. 1996 : A year of mixed results

Despite ongoing domestic political vicissitudes perpetuating a climate of instability unfavourable to economic growth, the end of 1996 was marked by Madagascar's return to the international financial community.

Progress in reforms liberalizing the economy

1996 was an eventful year regarding economic reform. A number of important measures were taken: disengagement of the state from certain areas, restructuring of the telecommunications sector, opening up air traffic, international invitations for participation in the petroleum distribution network, commitment to amicably settle litigation ensuing from nationalization, easing up on the obligation of exporters to transfer hard currency, and the adherence of Madagascar to Article VIII of the IMF regarding payments and transfers on international transactions.

a more explicit definition of the orientations of economic policy

Another positive sign despite successive political uncertainties resulting from President A. Zafy's many difficulties and the holding of early presidential elections is the finalization of a white paper on economic policy. This document provides the broad contours of general policy, with a list and precise timetable of measures which must carried out by the year 2000. This clarification of strategy and objectives contrasts sharply with the vagueness and uncertainty surrounding economic policy in previous years. It reasserts the will of the Malagasy government to continue along the path of economic liberalization. This positive development resulted in the signature of agreements at the end of the year with the Bretton Woods institutions (Enhanced Structural Adjustment Facility of 81.6 million SDRs over three years and $70.6 million in Structural Adjustment Credit with the World Bank in early 1997).

but with unconvincing economic results

Growth remained sluggish in 1996 of the order of 2%, as in 1995 and household purchasing power continued to erode. Only public investment witnessed a significant rise, accounting for close to a third of total growth. But this result must be interpreted more as the beginning of a catching up after two years of sharp decline than as a sign of a permanent increase in public investment. As for the other components of domestic demand, they remain stagnant.

...despite a process of disinflation and stabilization

Madagascar is on the road to stability again, due to the stabilization in prices and the exchange rate. This contrasts with the trauma engendered by the inflation/depreciation spiral of the Malagasy franc over the previous two years. The floating of the Malagasy currency in May 1994 led to its sharp depreciation. In the absence of accompanying measures the float immediately resulted in an inflationary surge, reaching levels never before witnessed in Madagascar.

The process of disinflation that began in 1995 continues apace. The inflation rate, which approached 40% at the beginning of 1996, dropped to under 10% by the end of the year. This positive evolution in prices can mainly be attributed to three factors :

- *the maintenance of a restrictive monetary policy*. The objective of controlling the money supply, and notably Treasury advances, was set in motion through the increase in compulsory reserves and the raising of nominal interest rates ;

- *increase in the exchange rate*. The Malagasy currency which reached a historical low in August 1995, with

Inquiries led by the MADIO Project
Statistics in the service of economic analysis

MADIO has established four large-scale statistical operations and ensured the progressive transfer of the methodology to INSTAT, which will eventually take them over :

- an annual study of employment, focusing on the Antananarivo metropolitan area, to which is added specific modules according to the 1-2-3 methodology (informal sector consumer spending in 1995 ; education and health transfers in 1997) ;
- an annual survey across the country in industry and covering all large enterprises ;
- rural observatories dealing with specific issues on an annual basis in four regions of the island (Marovoay : the reconversion of large rice-growing areas; Antsirabe : small family rice farms; Antalaha : cash crops and liberalization) ;
- Toliary : opening up an area of fishing and animal husbandry ;
- updating and extending the consumer price index to five other large cities in the country (outside the capital).

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a rate of 945 Malagasy francs per French franc started to strengthen in 1996. With less daily volatility in the rate due to the improvement in the Interbank Currency Market (Marché Interbancaire des Devises, MID) this stabilization represents a positive factor that clarifies the environment in which enterprises operate (investment decisions, etc.). The stabilization in the exchange rate combined with the easing of regulations on the repatriation of hard currency and adherence to Article VIII of the IMF, seriously undermined the parallel market in hard currency.

- *stagnant demand*. The mechanism of disinflation has also benefitted from the deindexation of wages, which translates into a low wage-price elasticity, of the order of 0.3. Wages in 1996 only witnessed a moderate rise, after sharp increases in 1994 and 1995. The minimum wage scale, which impacts on the private sector labour market, has remained constant. For the primary sector, the 1995-96 season was marked by a drop in real producer prices for crops (producer price/consumer price) and by a steep decline in cash crops in nominal terms, following a falloff in the world price. In other respects, the good quality of the harvest of notably for rice was also reflected in a downward pressure on prices, eliminating the necessity to resort to imports.

III. 1997 : The return to growth

In comparison with preceding years, 1997 marked an improvement in the politico-economic context and in the confidence of donors.

In the political arena, concerns expressed over the record 50.3% abstention rate in the presidential election of 29 December 1996 and the narrow victory of Didier Ratsiraka in the second round with 50.7% of the vote turned out to be unfounded. The alternation of power did not jeopardize the country's economic course, which the recently elected president had himself embarked on in the late 1980s.

The backing of the government's strategy by the Bretton Woods institutions has led other bi- and multilateral donors to resume their activities in the country. But, above all, the conclusion of these agreements has enabled Madagascar to go before the Paris Club and obtain an agreement, in principal, regarding the cancellation and rescheduling of a part of its external debt, which is estimated at three billion SDRs, ie, 118% of GDP, close to half of which consists of payment arrears.

A recovery in the secondary and tertiary sectors

In 1997 the rate of growth in the secondary and tertiary sectors was estimated (for both) at 4.1%. All branches of activity seem to have benefitted. Growth is aided by the privileged relationship with the French-speaking world, particularly in services, construction and public works, and telecommunications.

A drop in underemployment in the urban labour market...

Increased growth has resulted in a net improvement in the labour market situation and, consequently, in the household standard of living, which had stabilized in 1996. This may be measured in the annual employment survey carried out in the Antananarivo metropolitan area. Unemployment dropped by a point (from 6.8% to 5.8%). The rate of overall underemployment which covers three forms of underemployment (visible, invisible,

Foreign debt: constraint remains despite agreement with the Paris Club

1997 was marked by Madagascar's eighth trip to the Paris Club, which enabled the country's debt service to be treated on "Naples terms." This allows for a reduction of 67% of the debt service's current value. Though this measure may reduce debt service payments over the coming years, it will have the countereffect of increasing the liability to around 46%, due to the recapitalization of a substantial portion of payment arrears. The total amount of foreign debt (liability plus payment arrears) should add up to 114% of GDP in 1997 and 119% in 1998, as opposed to 109% in 1996.

After the rescheduling of the debt it is estimated that the reduction in the current value of debt service will be below 30%. This is for two reasons :

- the recapitalization of payment arrears has increased the amount liable to service and thus the amount of interest on the debt readjusted by the Paris Club.
- the preponderance of multilateral institutions in the servicing of the debt (around 55% in 1997 and 1998), for which rescheduling has not yet been programmed for Madagascar.

Obliged to reimburse payment arrears of 57.5 million SDRs over two years, the debt service is identical to what would have prevailed in the absence of rescheduling agreements in 1997 and 1998. The risk of a short term lack of liquidity is practically nil nonetheless, with the totality of service payments being covered by new loans and subsidies structural adjustment. After 1999 the problem of the solvability of the Malagasy government will once again arise if major efforts are not undertaken to increase the state's receipts. If the debt service ratio seems moderate (less than 15% in 1999 a priori), it is not the case relative to tax receipts (where the ratio is high, around 35%). 94% of the external debt liability is of public origin. A reduction in the debt service to multilateral institutions will probably be necessary after 1999 in order to maintain a balance in public finances.

and unemployment) receded by six points in two years.

...accompanied by a sharp increase in purchasing power of urban households...

One effect of the economic upturn has been a considerable improvement in the situation of urban households. In Antananarivo the latter have seen their wage income increase by 9.2% in real terms and per capita income by 11.2%. This surge has, moreover, benefitted all household categories.

...but by stagnation in the countryside

If the increase in urban income is clear, the situation is much less positive in the countryside. Despite incomplete data forecasts by the Ministry of Agriculture which are corroborated by the rural observatories established by MADIO in the four regions of the country offer only modest results.

In the rice-growing sector, it seems that the harvest has generally been good in volume but that producer prices have stagnated. In the cash crop sector, the vanilla harvest has been satisfying. But prices, though higher than in the preceding year, remain around half those in 1994-95. Though the price of coffee has more than doubled in a year, damage caused by cyclone Gretelle in the South-east the principal coffee growing area drastically reduced production and, thus, farmers' incomes. Overall, 1997 marks a relative stagnation in agriculture, which is not sufficient to reverse the trend toward the impoverishment of the countryside, where most of the pockets of poverty are concentrated.

Inflation under control

The improvement in urban purchasing power is the result of a lower level of anticipation of price increases. The deceleration of inflation that began in mid-1995 continued at a more rapid pace than anticipated. Between December 1996 and August 1997, the price level thus increased by only 0.7%.

This performance is especially remarkable given that the easing of monetary policy, depreciation in the exchange rate, and recovery of internal demand could have led to a bigger jump in the price level. The absence of inflationary tensions is likely explained by significant underutilized productive capacity and a more competitive environment, which leads to a reduction in the trading profit.

Despite the risk of accelerating inflation at the end of the year (broadening the VAT base, price hikes due to seasonal contractions in supply) the performance of prices will remain excellent for 1997. The average annual inflation rate should be contained within a range of 5 to 6%.

The Malagasy franc depreciates...

The Malagasy franc resumed its downward slide. This may be explained by a persistent imbalance between supply and demand of hard currency on the MID, partly explaining the poor performance of foreign trade (see below).

...bringing about a slight depreciation in the real exchange rate...

The good performance of domestic prices in 1997 induced a rise in competitiveness (measured by the evolution in the real exchange rate) of 11% compared to 1996. This, however, only represents a return to a situation comparable to that of previous years. Unfortunately, this improvement in monetary competitiveness has only a negligible impact on foreign trade.

...without significant impact on the trade balance...

Despite a more favourable internal economic situation, with increased competitiveness and improvement in the external environment, the capacity of domestic supply to react for exports as well as for import substitution is not sufficient to benefit from the present conjuncture. With imports steadily increasing, the trade balance continues to worsen. Not only are

Rice-growing in Madagascar: The market cannot be "decreed"

The rice issue is of strategic importance in Madagascar. The failure of the state's attempt to regulate the rice sector during the 1970s led the authorities to promote a strategy based on the market and private sector. If the adopted policy enabled a positive outcome in price, particularly in reversing the catastrophic trends of the early 1980s (drop in real producer prices, massive imports), it was an unmitigated failure insofar as growth in production and, above all, productivity were concerned. In particular, the decline in yield, which an among the lowest in the world, is especially worrisome in that it is accompanied by an increase in rain-grown rice, which has a negative effect on the environment.

The liberalization of Madagascar's rice-growing sector is a veritable case study. It shows that in a country characterized by an absence of infrastructure and the atomization of small producers weakly integrated into the market economy, price incentives alone are incapable of restoring lasting competitiveness and unleashing growth. Contrary to the philosophy of early structural adjustment programmes, the dismantling of state regulations does not create a market. The latter can only fully come about through the promotion of a partnership which has yet to be invented between a private sector playing the leading role and a state that produces collective goods (infrastructure, training, land tenure, information, etc.).

exports stagnating but, in addition, the increase in imports is accounted for by consumer goods for which local substitutes are available and not by capital goods.

...despite the contribution of the free trade zone

The only dynamic export sector is in the free trade zone (see box). Its share of exports has grown rapidly, reaching 30% in 1996-97. But the free trade zone, like the Malagasy textile industry outside the zone, remains heavily dependent on imported inputs. This phenomenon results in particular from the failures of upstream textile enterprises. They are not in a position to supply the free zone enterprises with the necessary inputs at competitive prices, while respecting accepted prices and quality standards. To the purchases of imported primary goods may be added capital goods that are not locally available. Despite the high volume of exports from the free trade zone, its net contribution to the balance of trade, though positive, is nonetheless limited.

The chronic deficit of the services balance

To the negative trade balance may be added that of services, which is even greater and has persisted with no noticeable improvement since the early 1980s. This observation reflects the existence of basic problems that Madagascar has not been able to solve. Constraints engendered by indebtedness is the main explanation for the chronic services balance deficit. Interest on the debt indeed represents half of all expenditures. Despite the shot in the arm coming from the recent trip to the Paris Club, which brought about a short term lowering of interest payments, the problem of the foreign debt remains intact. Concurrently, the fact that services linked to trade such as transportation, freight, and insurance are essentially secured from abroad contributes to aggravation of the imbalance.

Public finances : toward an improvement...

Projected fiscal receipts for 1997 confirm the favourable trajectory of the Malagasy economy. Estimations contained in the budget should be reached thanks to the rising level of economic activity, which almost automatically results in greater receipts, though also in an increased tax burden. The latter will go from 8.5% of GDP in 1996 to 9.1% in 1997.

...but insufficient given the stakes involved

The lowering of interest on the debt has allowed for a reduction in spending. But the scale of the drop is nonetheless limited, as the margin of manoeuvre has been used to increase the wage and benefits bill, as well as extra-budgetary expenditures. The improvement in public finances thus comes, for the most part, from a reduced debt burden, with the overall deficit going from 4.9% of GDP in 1996 to 2% in 1997.

IV. Outlook : 1998, a year of high risks

1997 marked Madagascar's return to growth after a long period of stagnation. Economic forecasts based on the neo- Keynesian model Prestomad count on a growth rate of 4.2% for 1997 and 5% in 1998.

Madagascar thus exhibits, for the first time since 1989, a growth rate superior to the rate of population increase, at a level that has not been

Monetary policy and financing the economy

The steady drop in the provision of credits to the economy in recent years is seen as the principal obstacle to the development of Malagasy enterprises. Economic credits advanced by the banking system indeed represented less than 10% of GDP in 1996, whereas they reached 17% in 1990. Three factors seem to be at the root of this reduction in the supply of credit to enterprises :

1 - The restrictive monetary policy adopted by the Central Bank has limited the supply of credit. The emission of bonds accompanied by high interest rates and the development of an auction market in Treasury bills has diverted the banks from their traditional activities. Treasury instruments, which are more profitable than issuing credit, make up a large portion of the commercial banks' net product.

2 - Issuing credits in Madagascar has proven to be a risky business, given the lack of information about enterprises and the number of failures witnessed over the year. Variations in dubious and litigious loans in recent years are not necessarily linked to variations in real interest rates. It seems more likely that the number of solvent enterprises is limited.

3 - The deterioration in the financial situation of state- owned banks, whose capital stock is currently negative, has direct consequences for the volume of credit. These banks are obliged to reduce their commitments in order to guarantee their solvency. Nonetheless, the financial situation of state-owned banks will not a priori have repercussions on the entire system. The structure of private banks' balance sheets, which are extremely profitable, and the low volume of hedging between banks confers a high level of security. If the drop in rates on the money market in 1997 seems to have boosted the volume of credit to the economy (2.8% real increase from January through June 1997), this will remain limited due to the lack of information about and confidence in the system.

attained since 1979, which was the year of "extravagant investment."

In regard to the political/economic environment, the climate has also improved considerably after the chronic instability of the early 1990s. This has led to the restoration of the country's credibility on the international scene and the gradual return confidence among economic actors.

These results must, however, be put into perspective. Though exceptional when compared with its performance in the past, Madagascar's 1997 growth rate is still inferior to the overall rate obtained in sub-Saharan Africa. In addition, the new macroeconomic dynamic remains fragile.

In the short term, 1998 looks to be a high risk year. Encouraging forecasts that emerge from simulations count on a continuation and even acceleration of the current process. The forthcoming constitutional referendum and legislative elections could, however, jeopardize all this and on two levels. On the one hand, they could signal the return of political instability, thus leading entrepreneurs to defer investments or adopt a wait-and-see attitude. On the other hand, the current regime may be tempted to delay certain planned reforms (taxation, price transparency, reforming the state administration, privatization), which are economically necessary but politically risky. What is at stake in 1998 is the juggling of the timetable for structural reforms with the exigencies of democracy. The history of Madagascar since independence shows how perilous this exercise can be. On two occasions in the past (1972 and 1991) a promising economic upturn was nipped in the bud by major political upheaval.

In the medium run, the growth recorded in 1997 has been accompanied by structural imbalances which could compromise its viability. In the first place, the response of domestic supply has been insufficient. A major share of increased domestic demand has been satisfied by imports. Exporters have not been able to seize upon opportunities generated by the international environment and fiscal incentives. The trade deficit is widening considerably and has an impact on the exchange rate. This is a far cry from the standard model of export-led growth.

Secondly, the fiscal performance of the state is insufficient given what is at stake. Although the tax burden has

The Free Trade Zone: A hub of growth

Conforming to the strategy of economic liberalization and taking into account the weakness of internal demand and savings, a special regime establishing a free trade zone has been implemented, to attract foreign operators who are better integrated in world markets. The question as to the appropriateness of a free trade zone continues to be asked, however. Is it in a position to play a leading role in stimulating economic recovery or does it instead create an enclave economy ? Recent surveys carried out by MADIO on industry and employment provide some answers.

In 1996 the free trade zone comprised some 130 functioning enterprises with over 30,000 employees. Its potential for growth is clear. Promising signs have included the more rapid takeoff of the Malagasy zone than the one in Mauritius, the trend toward diversification of activities attesting to the existence of several niches, and a level of employment surpassing projections by 30%. With the performances observed in 1994 and 1995 in terms of job creation (70% in the zone as opposed to 9.5% in the formal industrial sector) and value added (145% and 7.3%, respectively), the dynamism of the zone is incontestable. It is indeed the main origin of Madagascar's industrial growth.

From the macroeconomic point of view, simulations have highlighted the scale of multiplier effects of the free zone's activities and refuted the notion of an enclave economy. Though free zone enterprises import three-fourths of their inputs and deal little with the local economy on this level, the sheer amount of income they generate for households and which is spent on local services more than compensates for this negative aspect. Despite the minor overall weight of the free trade zone in the national economy (on the order of 1% of GDP and of total employment), it contributed significantly to GDP (upwards of 4.9%) and employment (3%) in 1995. This performance ensues from the indirect effects of demand generated by revenue reinjected by free zone enterprises into the economy. Even the notion that the state gains little from the zone is contradicted by the increase in fiscal receipts on consumption and imports resulting from multiplier effects. To this may be added the increasing share of free zone enterprises in exports (attaining 30% in 1996), which offsets the rise in imports. This thus responds to the twin goals of increasing growth and reducing poverty through employment, without at the same time worsening the trade balance and public finances.

This experience represents the best example up to now of Madagascar's success in moving toward an internationally integrated market economy. The free trade zone should be expanded so that it may reach a size that will allow it to respond, on a larger scale, to the hopes it has generated.

improved somewhat it is still significantly below that in other countries at a similar level of development. Given the rigidity in spending reductions, the loosening of budgetary restraints will represent a high-risk gamble for as long as expenditures are not backed by stable fiscal receipts.

Thirdly, the upturn in internal demand seems limited mainly to urban areas, with the countryside lagging behind. This may lead to problems, given that economic development necessitates increased dynamism in the agricultural sector; the current situation, however, is generating widening inequality between the cities and the countryside.

Finally, the problem of the foreign debt remains intact, with an increase in the liability due to the 1997 recapitalization of payment arrears and the growing share of multilateral debt, whose further rescheduling has not been programmed.

V. Conclusion

In conclusion, the course taken by the Malagasy economy since 1990 is similar in many respects to that of other developing countries over the past fifteen years or so. A rapid opening up and liberalization of the economy, combined with a drastic adjustment in public finances, leads to both a sharp drop in revenue and financial destabilization, whereas the impact of structural reforms on domestic supply takes longer to be felt. The country's chronic political instability is aggravated by poor economic results and performance in uncertainty in the financing of the economy (eg, a wait-and-see attitude by economic agents, difficulty in negotiations with donors).

Still marked by the electoral calendar and improved expectations for external financing, 1996 and 1997 may be seen as a time of catching up in the areas of civil service and public sector salaries, the minimum wage, and public spending, and thus in the level of household consumption (rising urban incomes, increase in the volume of agricultural products, the return of capital). This pick up in growth nonetheless comes up against important structural constraints in the nature of productive capacity and budgetary receipts.

The success of the current transition process so that the country may find its way to enduring and equitable growth therefore depends more than ever on the implementation of structural reforms. The current imbalances clearly highlight the constraints that need to be removed. Two of the most urgent may be emphasized. On the one hand, that which weighs upon the financing of domestic supply (see box), be it oriented toward satisfying the internal market or toward exports. A special effort must be undertaken in financing agricultural production, so as to enable either the expansion of cultivated land or productivity gains through improved farming methods that could increase output. On the other hand, the state administration is deplorably inefficient. But in order to embark upon an ambitious development policy, the state must develop its tax collecting capacity ; an issue which is related more to the taxation authority than to its regulation. This expanded tax collecting capacity must be accompanied by increased productivity in public services, which would be a measure evidence of restored credibility.

A SAMPLE OF MADIO DOCUMENTS

I. Macroeconomic overviews

- M. RAZAFINDRAKOTO, F. ROUBAUD, « *L'approche à haute intensité de main-d'oeuvre (HIMO) : une opportunité pour Madagascar. Essai de cadrage macro-économique* », n°9625/E, May 1996, 27 pp.

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THE JOURNAL "ECONOMIE DE MADAGASCAR"

At the instigation of the MADIO project, the journal "Economie de Madagascar" was launched in December 1996. Sponsored by the Central Bank and INSTAT, the journal aims at promoting and publicising reflection and research on economic development in Madagascar. In the second issue, dated November 1997, which focuses on the constraints and stakes involved in the liberalization of the agricultural sector, the journal touches on an issue that is fundamental for the success of the economic transition process in Madagascar.