

### Introduction

The Republic of Madagascar is an island in the Indian Ocean, with Reunion and Mauritius to the east, and Comoros and Mayotte to the northwest. Mozambique is the nearest mainland country, located about 400 kilometers to the west. The capital and largest city is Antananarivo.

With an area of 592,800 square kilometers, Madagascar is the 22<sup>nd</sup> largest country on the continent and the world's 4<sup>th</sup> largest island. Its population of about 25.2 million inhabitants makes Madagascar the 16<sup>th</sup> most populous nation in Africa. Malagasy and French are the country's official languages. English is also widely spoken.

Madagascar's economy is overwhelmingly driven by the agriculture and the mining sectors. Agriculture, including fishing and forestry, is the mainstay of the economy, accounting for more than 25 percent of GDP and employing about 80 percent of the population. Madagascar produces the world's second-largest vanilla harvest, accounting for about a quarter of the global vanilla market. It also has one of the world's largest reserves of titanium, as well as chromite, coal, iron, cobalt, and nickel. The country also has a burgeoning tourism sector and, following readmission into the African Growth and Opportunity Act initiative in 2015, it has witnessed a boom in its apparel and textiles sector.

### Political Environment

Madagascar has a multi-party democratic system, whereby the president is popularly elected. The president selects a prime minister, who in turn recommends candidates to the president to form the Cabinet of Ministers. The bicameral

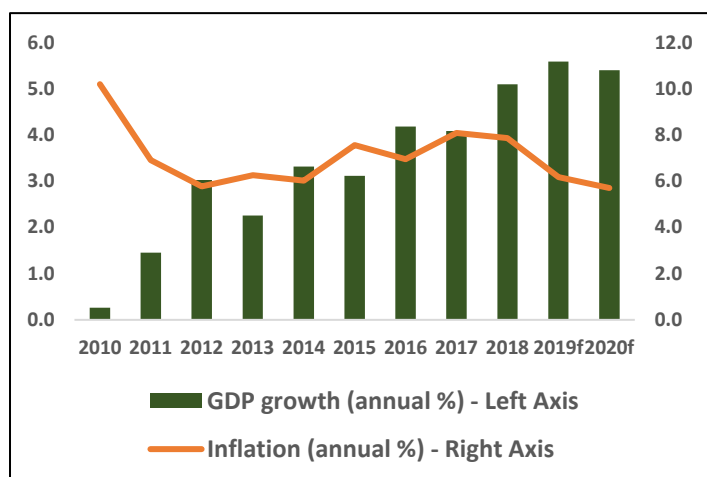
parliament consists of the Senate and the National Assembly. The president and the Cabinet exercise executive power, while legislative power is vested in the Senate and the National Assembly. Senators are appointed, while members of the National Assembly are elected by the public for five-year terms. The current constitution was enacted on November 17, 2010.

The current president is Andry Rajoelina, who assumed office on January 21, 2019 after defeating former President Marc Ravalomanana in the 2018 elections. The president is elected every five years and is limited to two terms. The next general election is scheduled for 2023.

### Economic Overview

**GDP:** Madagascar's economic recovery continued in 2018, despite challenges related to the global economic environment of escalating trade tensions. The country has enjoyed robust economic growth since 2013, with output growth increasing from 2.3 percent in 2013 to an estimated 5.1 percent in 2018. The country's growth performance over the past six years has been driven largely by the small but buoyant private sector, anchored on a flourishing services sector.

A key component of the services sector is trade, which posted 4.5 percent growth in 2018, up from 4.1 percent in 2017. Growth was also driven by strong public and private investments in infrastructure (roads, airports, energy, and the port of Toamasina) as well as increased external demand for essential oils, textiles, and vanilla.

**Figure 1: Madagascar GDP Growth and Inflation**

Source: IMF World Economic Outlook (2019).

The economy is projected to stay on an upward growth trajectory in the short to medium term, driven by enhanced export growth due to strong global demand for nickel and vanilla and increased public and private sector investments. Diversifying the sources of growth and exports, including manufacturing industries, will be key to mitigating exposure to adverse terms of trade shocks and supporting poverty alleviation.

**Inflation:** After steadily declining from 2010 to 2013, inflation began inching up again, driven mainly by rising food prices. Inflation eased slightly in 2018 to 7.9 percent, down from 8.1 percent in 2017, and it is expected to follow a downward trend driven by strong agricultural output in a context of favourable weather conditions. The projected decline in inflationary pressures is also expected to be supported by a tightening monetary policy stance.

**Exchange Rate:** Throughout the 1980s and until 1994, the government adopted an adjustable peg exchange rate regime, which maintained the country's competitive position in the export market. Since 1994, the government has abandoned the adjustable peg regime and moved to a more

market-based floating exchange-rate regime. In recent years, the country's currency, the Ariary, has gone through several episodes of volatility, driven largely by the end of the commodity super-cycle, a challenging political environment, economic slowdown in China, and a tightening monetary policy in the United States.

In 2017 and 2018, an improvement in the political environment, together with support from donors, boosted the inflow of foreign exchange receipts and led to the appreciation of the national currency. However, the Ariary is expected to weaken in 2019 on account of a widening current-account deficit, as rising public spending to support the Emergence of Madagascar agenda (involving the financing of renewable energy and irrigation projects) increases import demand.

**Fiscal Balance:** Overall fiscal performance has improved in the last two years. The deficit narrowed from 2.4 percent of GDP in 2017 to 2.2 percent in 2018, despite the supplementary budget approved by the parliament to cope with higher-than-expected fuel prices, high wages and salaries, and transfers to the civil service pension fund. The reduction in the fiscal deficit has been driven largely by higher fiscal revenues due to reforms in tax administration, spending cuts, and a reduction in subsidies. The government's commitment to fiscal discipline, anchored by an IMF Extended Credit Facility Arrangement Programme, has also driven the improvement in the fiscal balance.

While efforts by the government to mobilise revenues continue, with tax and customs revenues projected to increase, spending pressure will remain high. The new government will seek to jump-start economic activities, including investment promotion through tax incentives and capital expenditure to further crowd in private investment. Losses incurred by JIRAMA, the country's water and electricity company, will

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also require significant government financial support. In this regard, the overall budget deficit is projected to widen by 3.4 percent of GDP in 2019 and 4.1 percent in 2020, from 2.2 percent in 2018. The deficit will be financed by both domestic and external (concessional) borrowing.

### Overview of Trade, Reerves and the Financial Sector

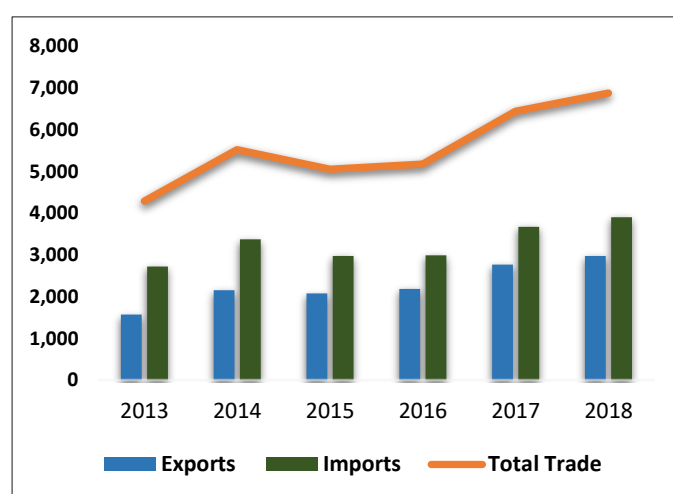
**Total Trade:** Madagascar is the 116<sup>th</sup> largest export economy in the world and was the 32<sup>nd</sup> largest export economy in Africa in 2018. It exported US\$2.97 billion and imported US\$3.91 billion in 2018, resulting in a trade deficit of US\$940 million. This trade deficit is largely due to a marked increase in imports of mineral oils and electrical machinery.

Madagascar's main exports are vanilla, nickel, cobalt, and clothing and textiles. Its top export destinations are the United States, France, Germany, Japan, and the Netherlands, which together accounted for around 61 percent of total exports in 2018. Madagascar's top imports include oil, rice, pharmaceuticals and capital goods such as machinery, electrical equipment, and vehicles. Its top import origins are China, the United Arab Emirates, France, India, and South Africa, which together accounted for more than 51 percent of total imports in 2018.

**Intra-African Trade:** Madagascar's total intra-African trade amounted to approximately US\$723 million in 2018, accounting for around 10.5 percent of its total trade, significantly below the regional average of 16 percent. South Africa, Mauritius, Morocco, Kenya, and Comoros are the top destinations for Madagascar's exports within the region, accounting for around 90 percent of Madagascar's total intra-African exports. The main export products are vanilla, cobalt, vegetable sap, and apparel.

Madagascar's largest African import partners are South Africa, Mauritius, and Egypt, which together account for around 69 percent of Madagascar's total intra-African imports. It imports mainly refined petroleum, machinery, and vehicles from South Africa; fabrics from Mauritius; and wheat flour and cereals from Egypt.

**Figure 2: Madagascar's Total Trade (in millions of US\$)**



Sources: ITC Trademap, IMF DOTS, Afreximbank Research.

**Reserves:** Madagascar's external reserves position has been trending upward and reached US\$1.65 billion in 2018, from US\$1.6 billion and US\$1.18 billion in 2017 and 2016, respectively. The upward trajectory in the stock of reserves arose as increased demand for vanilla, the largest agricultural product and main source of foreign exchange earnings, increased the country's overall exports.

Reserves were also supported by improvement in the political environment. The peaceful transition of power and the restoration of partnerships with international donors, including the IMF through the Extended Credit Facility Arrangement,

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boosted investor confidence. International reserves at the end of 2018 remained at comfortable levels, with coverage exceeding 6.4 months of imports—well above the IMF's threshold of 3 months.

Looking ahead, a sustained improvement in the political environment, along with successful implementation of reforms under the IMF's Extended Credit Facility and continued demand for major export products, is expected to enhance Madagascar's reserve position, although increasing imports of capital goods to support economic transformation will continue to put pressure on reserves.

#### **Current and Capital Account Balances:**

Madagascar's current account deficit, which widened to 1.9 percent of GDP in 2015 from 1.2 percent in 2014, narrowed to 0.4 percent and 0.5 percent of GDP in 2016 and 2017, respectively. The reduction was due to strong export performance underpinned by high vanilla and mining receipts, alongside lower oil prices, which helped to reduce import bills. Despite the increased demand for major export products, the current account deficit widened to 4.9 percent of GDP in 2018 and is projected to remain under pressure in 2019 and 2020 as the government's national development strategy—the Emergence of Madagascar—continues to drive up import demand.

The capital account also faced some pressure as the end of the commodity super-cycle and associated macroeconomic challenges adversely affected the investment climate. Overall, the capital account is expected to improve, as gradual stabilisation of the political environment after the highly contested elections, improving macroeconomic fundamentals, along with stable non-oil commodity prices increase confidence and stimulate the inflows of foreign direct investment (FDI), portfolio investment, and remittances. In addition, the government's commitment the IMF's

Extended Credit Facility Arrangement and improving relationships with other donors will help attract more FDI to ease the pressure on the capital account.

**Financial Sector:** The financial system in Madagascar is relatively underdeveloped and dominated by the banking sector, which accounts for about 95 percent of total assets, followed by non-bank financial and microfinance institutions. Banks remain the only players in the foreign exchange market and the principal subscribers to government securities. Four large banks dominate the banking sector, accounting for over 84 percent of deposits, over 86 percent of receivables, and over 86 percent of total industry assets. Product offerings are insufficiently diversified and directed toward a customer base of predominantly large businesses. Accordingly, access to financial services continues to be limited, as is the supply of financial products. As a percentage of GDP, total outstanding loans average about 8 percent. About 41 percent of the population is classified as unbanked. Interest rates are high, averaging about 14.9 percent for a three-year loan, reflecting lack of competition among banks. Banks' funding structure is generally short term, with short-term credits representing an average of 55 percent of the total stock of credits.

The banking sector's performance reflects its aversion to risk. The sector must embrace the challenges inherent to development imperatives. These include competition within the sector, diversification of financial products, and expanded access to bank financing and services to mobilize domestic savings and promote private investment, economic growth, consumer protection, and sector resilience.

Digitalization is changing the financial landscape. Newly introduced Findex data show that the percentage of adults with an account at a financial institution or mobile money service doubled from about 9

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percent in 2014 to over 18 percent in 2018. As the country develops, the size of the potential customer base to be served by a financial system will also increase.

### Debt Sustainability

Madagascar scores 3.3 in the 2017 World Bank Country and Policy Institutional Assessment (CPIA)—up from 3.2 in 2016.<sup>1</sup> Although this is above the IDA borrowers' average of 3.1, it is indicative of weak quality in policy management for the country.<sup>2</sup> Historical data also show that Madagascar's score has deteriorated over the past decade, specifically the component on public sector management and institutions, which currently ranks lowest among the four components that make up the CPIA.

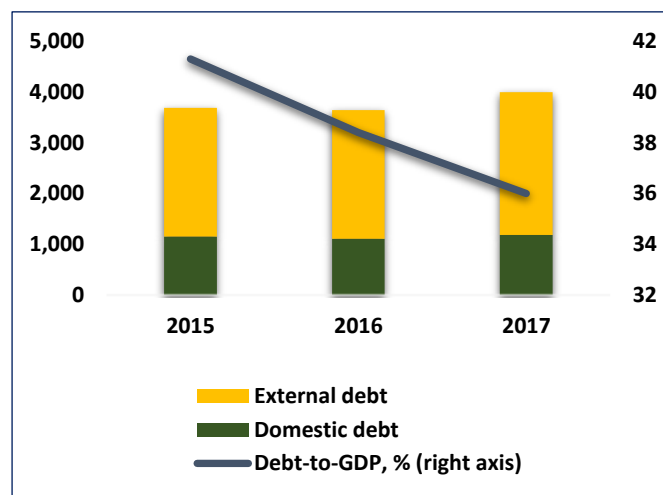
The overall CPIA score of 3.3 is indicative of the following thresholds for debt sustainability: present value (PV) of external debt to GDP of 30 percent; PV of total debt to GDP of 35 percent; PV of external debt/exports of 140 percent; and PV of external debt service/revenue of 14 percent. Madagascar's debt sustainability is assessed against the aforementioned benchmarks.

The rate of debt accumulation in Madagascar over the period 2015-2017 has been moderate, with only a gradual increase in debt incurred to multilateral financial institutions, in particular the World Bank and the African Development Bank, which together account for more than half of all external debt. Domestic debt during this three-year period increased marginally, but there was a notable decrease in domestic debt arrears.

Overall, the profile of Madagascar's public debt is heavily concessional. Over the long

term, the importance of semi-concessional borrowing relative to concessional loans (and grant financing) could shift the debt profile and undermine the progress made on a path to debt sustainability.

**Figure 3: Evolution of Madagascar's External Debt Composition (in millions of US\$)**



Sources: IMF, Afreximbank Research

#### (i) PV of external debt/GDP

External debt indicators in present value terms remain below the policy-dependent debt burden thresholds of 30 percent for Madagascar mainly due to the concessional element of borrowing. The PV of external debt was 14 percent of GDP in 2017 and is projected to increase to 22.5 percent of GDP by 2023 before remaining broadly constant in the long term.

#### (ii) PV of total debt /GDP

The PV of total debt to GDP is forecast to rise slowly from low levels on the assumption that Madagascar will rely less on concessional financing over time. As such, when measured in PV terms, total debt is projected to increase in the long term but to remain below the 35 percent of GDP threshold by 2023 and beyond.

<sup>1</sup>(1=lowest, 6=highest); Debt thresholds corresponding to strong performers are highest, indicating that countries with good macroeconomic performance and policies can generally handle greater debt accumulation.

<sup>2</sup> There are currently 75 borrowing IDA countries spread across Africa, Asia, Latin America, and the Middle East.

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**(iii) PV of external debt/exports**

The estimate for PV of external debt to exports is 75.2 percent in 2018, down from 77.9 percent in 2017 and below the debt sustainability threshold of 140 percent. This ratio is forecast to increase moderately in the medium and long term, reaching 81.8 percent in 2023 but dipping thereafter. Overall, the dynamics in the external debt-to-exports ratio are consistent with a low risk of debt distress.

**(iv) PV of external debt service/revenue**

The PV of external debt service-to-revenue ratio is estimated at 6.6 percent and remains below the threshold of 14 percent. Baseline forecasts indicate that this ratio will only reach 7.4 percent in 2023 and 9.9 percent by 2028. The overall assessment of Madagascar's risk of debt distress is deemed moderate given that debt dynamics remain sustainable and within the external debt thresholds for countries classified as weak.

**Opportunities for Bank Support**

Madagascar's economy has been resilient during the last five years, with an average growth rate exceeding 4 percent despite global headwinds. This, along with an improving business and macroeconomic environment, untapped natural resources, a burgeoning services sector, and developing infrastructure, is giving impetus to economic activity and makes the country an attractive investment destination. As part of the Emerging Madagascar Initiative, key sectors, including energy, industry, agriculture, and natural resources, are prioritized for investment. These sectors offer tremendous opportunities for the Bank to enhance its presence in Madagascar and actively participate in the development of the country.

Specifically, there are opportunities for the Bank to help increase energy production and supply, to increase and sustain the productivity of firms, especially small and medium-sized enterprises (SMEs), in line with the country's aspirations and the Bank's ongoing SME support strategy. There is opportunity for the Bank in the context of the industrialisation of Madagascar, which is consistent with the Bank's industrialisation and export development strategy. There are also opportunities for the Bank to help develop agro-processing and other manufacturing/industrial facilities to promote value addition for natural resources and diversify the country's exports and sources of growth. Opportunities also exist in the blue economy, specifically, the tourism and fishing industries, which remain relatively underdeveloped despite their significant potential.

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**Table 1: Madagascar: Selected Macroeconomic and Financial Indicators**

	2012	2013	2014	2015	2016	2017	2018	2019(f)	2020(f)
<b>Real GDP, %</b>	3.0	2.3	3.3	3.1	4.2	4.1	5.1	5.6	5.4
<b>Inflation, %, Annual average</b>	5.8	6.3	6.0	7.6	7.0	8.1	7.9	6.2	5.7
<b>Current Account (% of GDP)</b>	-19.9	-18.3	-1.2	-1.9	-0.4	-0.5	-4.9	-6.1	-7.6
<b>Total Reserves (US\$ billion)</b>	1.1	0.78	0.77	0.83	1.18	1.6	1.65	n/a	n/a
<b>Gross Reserves (months of imports)</b>	4.93	3.44	2.74	3.35	4.74	5.2	6.41	n/a	n/a

Sources: World Bank, IMF, EIU

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