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Liberalizing Trade and Industry in Madagascar

In the late 1980s, the government of Madagascar attempted a series of structural reforms with help from the World Bank. Two IDA adjustment credits had very different outcomes. Trade liberalization and budgetary reforms succeeded because of strong government commitment and intensive Bank efforts, while reform of public enterprises and of the civil service suffered from the government's lack of determination and reduced commitment by the Bank.

An OED audit of the projects concluded that, had the Bank paid closer attention to early warning signals that the government was not fully committed to some of the reforms, the results might have been different. Privatization can be used as a tool to prevent reforms from backsliding. The Bank and the borrower must agree to a set of general principles for privatization in advance, to avoid getting bogged down in negotiating details later. Privatization must be carried out transparently; well-defined performance indicators can clarify conditions for all parties; and social safety net programs linked to reforms must be well publicized and carried out early in the reform process.*

Madagascar is one of the poorest countries in the world. The government that came to power in 1972, and the one that followed it in 1975, pursued a strategy of import substitution, giving public enterprises and marketing monopolies a dominant role in the economy and tightly controlling private enterprise. After per capita GDP declined and the external debt burden grew, the government began reforms aimed at financial stabilization supported by the International Monetary Fund, followed by Bank-assisted structural adjustment.

The Industry and Trade Policy Adjustment Credit (ITPAC, approved in 1987) sought primarily to liberalize international and domestic trade, and to take the first steps in reforming public enterprises, the banking sector, and public investment. The Public Sector Adjustment Credit (PSAC, approved in 1988) aimed at improving the allocation of public resources by strengthening the formulation and monitoring of public spending and investment, reforming the civil service, rationalizing public enterprises (through liquidation, divestiture, or restructuring), and restructuring the state-owned banking system.

Results

Early gains. Most of the ITPAC reforms were successful. The government reformed the exchange rate regime, reduced and rationalized import tariffs, lifted quantitative restrictions, removed most controls on prices and profits, and took steps to improve the public investment program and the condition of the financial sector. As a result, real income per head grew in 1988-90 for the first time since the early 1970s, more industrial capacity was used, and nontraditional exports surged.

PSAC recorded some gains—notably reform of the budget process and the first private participation in banking. But failure to resolve several basic issues led to delays in the second tranche and cancellation of the third. Project design was flawed. Reforms were rushed, under pressure from the Bank, even though the borrower lacked commitment and wanted more time to consolidate the reforms. Supervision and monitoring of targets were poor.

Lack of clarity on public enterprise reform. Conditions and targets were poorly defined, so it was difficult to ensure that the govern-

**Performance audit report, "Madagascar: Industry and Trade Policy Adjustment Credit," by Alice Galenson, Report No. 14774, June 30, 1995. Available to Bank executive directors and staff from the Internal Documents Unit and from regional information service centers. Précis written by Stefano Petrucci.*

ment was actually privatizing important enterprises and not just paper firms. The government apparently viewed the agreement to "rationalize the public enterprise sector" as an agreement to divest itself of non-performing public enterprises. It was never convinced of the need to privatize the seemingly successful enterprises. At the time of the audit in 1995, more than 100 commercial and financial enterprises remained under state ownership, burdening the economy.

Unfinished business. Despite the banking sector reforms, by 1990-91 the portfolios of two state-owned banks were again in serious trouble. Civil service reform never got off the ground. Economic liberalization led to a demand for political liberalization. During a period of political upheaval (1991-93), some policies adopted earlier were reversed and adjustment was disrupted. Project funding was ultimately canceled in 1993, after a new government failed to resolve some fundamental issues. In particular, it suspended public enterprise reforms, adopted a new civil service statute with several counterproductive measures, and failed to control public spending.

Social aspects of adjustment

Measures to alleviate the social impact of adjustment and provide technical assistance were included in a companion Economic Management and Social Action Support Project, approved in 1988. The project was extremely demanding on both local and Bank resources, was poorly conceived, and did not offer a coherent strategy to cushion the effects of adjustment on the poor. Few substantial measures were carried out until five years after the start of the project they were meant to accompany.

There is little evidence, however, that political unrest was linked to the social costs of adjustment, and none of the parties taking part in the ensuing elections advocated an end to reform efforts. In fact, the adjustment process appears to have had a positive impact on most of Madagascar's people. Nevertheless, more timely action on a number of fronts could have helped protect certain groups, and could have led to a more successful implementation of the reform program, giving the government greater credibility in its efforts to reassure the public.

Lessons

- *Trade liberalization and budgetary reform succeeded because of close government participation and intensive Bank efforts, whereas reform of public enterprises and of the civil service suffered from reduced commitment from both sides.* A strong active partnership with the government early on would have helped reinforce commitment to reform. Closer attention by the Bank to early warning signals of low government determination may allow the Bank to take actions either to increase the likelihood of success or to proceed more cautiously.

- *A general agreement on principles of reform is more effective than an approach that allows loan conditions to be met on an individual, case-by-case basis. Well defined performance indicators are essential for monitoring conditionality.* Instead of agreeing to the principles of privatization and applying them, the government and the Bank got bogged down debating whether various actions constituted "satisfactory progress," and supervision amounted to no more than counting the enterprises on the auction block. Conditions for trade reforms, on the other hand, were based on explicit steps to be taken.

- *Privatization is a powerful tool for preventing the reversal of public enterprise reform.* Cleaning up Madagascar's bank portfolios could not prevent excesses from recurring, but had all the banks been privatized, they would have been far less likely to permit the credit expansion that set off a liquidity crisis in 1991.

- *Divestiture of public enterprises should be transparent so that all concerned parties are convinced they are being treated fairly and given an equal chance to compete.* Creation of a fund to facilitate broader Malagasy participation in privatization would have alleviated fears of excessive foreign investment or of unbalancing ethnic relationships.

- *Sustaining reforms requires continued popular support.* It is important to develop a cohesive safety net, implemented in a timely manner, and to publicize it well, especially when there is public hostility toward adjustment.

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