Markets, Trade and Development in Madagascar: Recommendations for G20 Support for Governance Reforms and Investment

Salim Ismail, Fabrice Lehmann, and Jean-Pierre Lehmann*

Introduction

This paper provides practical insight from the perspective of a least developed country (LDC) exporting industry, namely the textiles and clothing industry in Madagascar. The paper focuses primarily on the dynamics of reform, domestic governance, and integration, and is meant to provide a case study on the role of the private sector in supporting elements of the G20 trade and development agenda on poverty reduction and growth.

The paper also illustrates the distance from the peaks of G20 summits to the valleys of reality in many LDCs, such as Madagascar, where the rule of law and institutions are weak or indeed crumbling. Ultimately, the nature of domestic governance remains the most important criterion for growth, investment, and development.[1] This paper discusses the major problems posed by weak domestic institutions on job creation and development, using Madagascar as a case study. It then recommends ways in which the G20 — led by the United States and Europe, Africa's two most prominent historical partners — can play a supporting role in order to encourage better climates for investment and broad-based development.

The Importance of the Private Sector for Economic Development in Madagascar

Madagascar is one of the world's poorest nations, with over two-thirds of its population scraping together a living on $1.25 a day and 70 percent engaged in subsistence agriculture. Despite its wealth of arable land, ecological reserves, mineral deposits, and human resources, the magnitude of the developmental challenges confronted by the impoverished Malagasy economy is formidable.

Since independence from French colonial rule in 1960, the Republic of Madagascar has experienced recurrent political uprisings and a turbulent economic history. Social exclusion and intergenerational poverty continue to be important drivers of conflict and unstable governance structures. This instability has culminated, at the time of writing, in an unconstitutional power transfer that has held the country in political deadlock for the past two years — with the governing "Haute Autorité de la Transition" not recognized by the international community, the African Union (AU), or the Southern African Development Community (SADC). With the AU seeking to broker a negotiated roadmap out of the crisis, most official aid — which represented 40 percent of the state budget and 75 percent of investments — has been suspended. The country has temporarily been excluded from the

* Salim Ismail is chairman and CEO of Groupe Socota of Madagascar; Fabrice Lehmann is research fellow and editor of The Evian Group @ IMD; Jean-Pierre Lehmann is professor of international political economy at IMD and founding director of The Evian Group.

[1] This point was stressed by participants, particularly those from LDCs, at a workshop on 13 May 2011 convened by the German Marshall Fund of the United States and the Istanbul Policy Center on G20 support for trade and development in least-developed countries.

U.S. African Growth and Opportunity Act (AGOA) trade preference program on democratic criteria, the Millennium Challenge Corporation discontinued its Compact with Madagascar in 2009 and the economy remains both sluggish and vulnerable to external shocks.

Madagascar's unsteady institutions have partly been shaped by a history of collusion and shifting alliances between decision-makers and business interests in a patron-client system of governance, which is at odds with open and rules-driven arrangements. The state's economic history has seen import substitution industrialization give way to experiments in "scientific socialism" followed by deep structural adjustment programs. While competitive market reforms initiated in the late 1980s triggered reasonable economic growth, they failed to factor in important political economy considerations, which led to market distortions and instability that stifled employment opportunities and magnified social inequalities. This turbulent history has had ramifications on administrative and political structures as well as the capture of excessive and unequal profits (to which we will return when discussing the impediments to private sector involvement in development initiatives).

It is worth mentioning two corollaries to these poor developmental dynamics. First, in the absence of a fully functioning state, Madagascar's natural resources, host to unique ecosystems, have proven vulnerable to plunder.[2] Second, with a young population — a majority of which is living in poverty — projected to rise from 20 to 40 million people within a generation, issues of food security and gainful employment require urgent and effective long-term strategies.

It is well understood that foreign direct investment alone will not break the deep structures of destitution and marginalization in Madagascar. However, the reinvigoration of the domestic private sector for sustainable job creation and poverty reduction partly depends upon openness to productive foreign capital. Attracting this investment and guiding it towards socially desirable outcomes will require a "normalized" political environment framed by constitutional stability, peace-building processes, confronting favoritism and conflicts of interest, an improved business and regulatory environment, judicial reform, administrative strengthening, and building trade capacities. This paper outlines one particular case study in order to illustrate the need for these reforms, and makes recommendations on the ways in which the G20 can support them.

Private Sector Support to LDC Development: Textiles and Clothing in Madagascar

The experience of Groupe Socota, a successful domestic textile and clothing company in Madagascar, highlights the potential for private sector contribution to job creation in an unstable domestic environment and highly competitive international market. It further underlines the challenges faced by the broader textile and exporting industry, which struggles in the face of obstacles that would benefit from G20-assisted reforms.

Madagascar's export processing zones (EPZ) are an example of a successful strategy to develop a sustainable manufacturing base in both an LDC and sub-Saharan Africa.[3] The Zone Franche Industrielle de Madagascar (ZFI), established in 1990, initially attracted Asian

---

[2] Madagascar is recognised as one of 17 mega-diversity countries with high biodiversity and endemism. Its natural forests are under threat from illegal logging, particularly for rosewood, as budget disbursements allocated to preservation have dropped by 80 percent.
[3] Other regional examples include Kenya, Mauritius, and Lesotho — the latter also classified as an LDC.

exporters through tax incentives, low labor costs, and the ability to circumvent textile quotas under the Multifiber Arrangement and benefit from Madagascar's duty-free and quota-free access (DFQF) to developed markets under multilateral and bilateral preference schemes. While the ZFI grew through foreign corporate investments, it gave rise to a competitive, vertically integrated textile and clothing industry and helped establish Madagascar as a new exporter of manufactured goods in sub-Saharan Africa. As a counterpoint to mostly declining traditional exports (coffee, cloves, shrimp, and pepper), Madagascar became the region's second-largest clothing exporter behind Mauritius. Although the ZFI has courted controversy over issues of productivity gains and labor management, its growth and poverty effects have been manifest through the creation of an estimated 250,000 direct and indirect jobs in the capital region, Antananarivo, by 2005.[4]

Groupe Socota, the largest clothing manufacturer and employer in the country, was founded in Madagascar in 1930 and has been active in the ZFI since 2003. The company has a turbulent history that mirrors the nation's political and regulatory shifts described above. When the 1990s liberalization process led to a surge in predatory imports, the group shielded itself and its thousands of employees from the governance deficit at home and redeployed the production that had been aimed at supplying the domestic market to Western and regional markets.[5] More recently, Madagascar's suspension from AGOA has forced a further redeployment to regional markets, principally South Africa. It is projected that regional markets could supplant the EU and the United States as the principal destination for Groupe Socota's exports.[6]

Challenges Discouraging the Involvement of the Private Sector in Initiatives for Economic Development in Madagascar

While large industrial players like Groupe Socota have proven able to weather difficult political conditions, the weak governance and structural difficulties faced by businesses prevent would-be major employers from reaching their full potential, and prevent new investment from settling in countries like Madagascar. This section builds on the issues outlined above and discusses their ramifications for three critical sectors of the Malagasy economy.

The deterioration of rural infrastructure and the erosion of local scientific research have led to the weakening of agricultural productivity and plummeting traditional cash crop cultivation (coffee and tobacco, although vanilla cultivation remains strong). Securing finance for agricultural development remains highly problematic.[7] The upshot is that despite its vast endowment in arable land and the potential for exports, the island imports staple food for its

[4] The ILO database on export processing zones estimates that direct employment in the ZFI was 115,000 in 2005/06, with over two-thirds of the workforce comprised of women. Madagascar's suspension from AGOA has since led to a sizable loss in export-related employment, especially in textiles.
[5] Fraudulent/predatory textiles imports were under-priced at the border to minimize customs duties, and then sold on the domestic market without an invoice to avoid VAT. These practices decimated local producers.
[6] Socota sees the long-term competitiveness of Madagascar as a growth accelerator. The re-orientation of a proportion of Chinese textile exports to their domestic market has created opportunities for countries like Madagascar that possess capacities to fill the gap in global supply.
[7] The share of FDI flows directed at agriculture slumped between 2005 and 2009 from 14.4 to 0.7 percent. A contentious agro-business corn and palm oil concession granted to Daewoo — which was Africa's largest land lease, covering roughly half of Madagascar's arable land — was suspended in 2009 following discontent over land rights that helped fuel the overthrow of the Ravalomanana government.

rapidly growing population, which raises fundamental and immediate concerns over food security and price vulnerability.

A harsh 1990s structural adjustment program, grafted onto a patronage-based system of governance, generated unemployment as local industries and SMEs that had been geared towards the domestic market collapsed in the face of cheap, often predatory, imports and regulatory capture by political agents. Groupe Socota developed a strategy to fully redirect its operations toward the export market, but many other companies suffered in the absence of a plan for the progressive opening and reorientation of production. Furthermore, the reform process created distortions that favored oligopolistic behavior detrimental to indigenous business growth. As a result, market competition remains the exception rather than the rule.

In addition to agriculture and textiles, mining is another important sector of the Malagasy and many other LDC economies. Over the coming decade, Madagascar could evolve from an artisanal mining nation — one of the largest sources of domestic employment — to a resource-heavy economy. In response to rising global demand and investment for commodities, it is expected that the contribution of industrial mining to Madagascar's GDP will rise from 1 to 15 percent in the coming year, with over 80 percent of FDI inflows concentrated in natural resource extraction — a fundamental reshape of the economy and future opportunities for economic distortions.[8] In the present climate of political bargaining and weak accountability, Madagascar is vulnerable to a "resource curse" dynamic in which mining proceeds could further debilitate formal institutions and destabilize the country.[9]

Under these conditions, and unless domestic institutions and the business environment improve, Madagascar runs the risk of stifling the modern sectoral activity turned towards export markets and being bypassed by productive investment flows.

These sectoral vignettes point to the importance of strengthening domestic governance in order for the private sector to act as a principled and dynamic partner in the development of the Malagasy economy. Clientelistic leadership without a shared long-term vision of the effective management of the country's wealth in human and natural assets has bred instability, the marginalization of the honest economy, the diversion of public funds, and the capture of excessive profits by unchecked groups driven by an entrenched logic of short-term gains. Skewed incentives and vested interests have often subverted policy reforms targeted at opening institutions conducive to development, while restricting the ability and will of the private sector to play a constructive role as a *demandeur* of reforms.

Recommendations on the G20 Trade and Development Agenda for Madagascar

The challenge is to translate the lofty objectives of the G20 Seoul Development Consensus for Shared Growth into hard realities on the ground, in the midst of what are often very difficult domestic governance conditions, as is the case in Madagascar. This section includes recommendations on supporting reforms attuned to the needs of Madagascar — but

[8] Current and potential resource projects include two large-scale industrial ventures (QMM extracting ilmenite and Sherritt extracting nickel and cobalt): Total is exploring oil tar sand deposits; and a Chinese development fund is seeking to exploit the island's resources (oil, coal, gold, and iron ore).

[9] FDI inflows to Madagascar rose from US$93.1 million in 2001 to $1,125 million in 2010. This increase should be seen in the context of a high geographic and sectoral concentration of global FDI flows to resource-rich LDCs, which has strengthened commodity dependence at the expense of diversification.

applicable for transatlantic and G20 partners working in many LDCs — and targeted at the emergence of a vibrant private sector and efficient public sector that tackle the structures of poverty and instability.

First, the G20 Multiyear Action Plan on Development calls for enhanced trade capacity and access to markets for LDCs in line with WTO commitments taken in Hong Kong in 2005. Four issues of concern include DFQF market access to all LDC exports, simplified provisions on rules of origin, the reduction of trade-distorting subsidies in agriculture, and progress in "Mode 4" provisions on the cross-border movement of workers.[10] With the Doha Round of trade negotiations in limbo at best, the G20 has a concrete trade agenda it could extricate from the negotiations to promote the interests of sub-Saharan LDCs like Madagascar.

What the G20 (and other international policy forums) must note above all, however, is that while the actions taken in support of LDCs may have some limited impact, the distortions that many of the G20 countries impose as a result of pernicious trade and subsidy policies will limit the effectiveness of other trade-related assistance as long as they are in place. The first principle of the G20 therefore should be "Do No Harm." If rich-country subsidies and trade barriers could be eliminated, prospects for LDC economies and trade would greatly improve.

Secondly, one of Madagascar's weaknesses is its geographical isolation coupled with its lack of infrastructural and institutional connectivity. The third pillar of the G20 Development Principles emphasizes "actions that tackle global or regional systemic issues such as regional integration where the G20 can help to catalyze action." Sub-Saharan African markets are small and fragmented and the development and consolidation of regional initiatives and greater regional integration are, *a priori*, much to be recommended.

However, past support for regional integration schemes in sub-Saharan Africa, particularly from the EU, has often been counter-productive in that the models of integration have been externally driven and institutionally intensive in a context of weak domestic governance. In order to gain real traction and ultimate success, it is imperative that these initiatives should come from Africans and not be imposed from outside. Support can and must be given, especially in the form of trade facilitation, but here as well, the initiative and management must be left to Africans.

The G20 should seek to better support African leadership in regional projects such as SADC or COMESA, in which the core of the agenda now lies in reducing overlaps, trade facilitation (customs, standards, visas), and the creation of regional public goods (infrastructure and harmonization of rules).

Thirdly, in line with the orientation increasingly taken by multilateral development banks and the donor community in sub-Saharan Africa, cooperation and assistance should be governed by a conflict-sensitive approach. In an admission that previous reform policies have often been ill-adapted, a recent World Bank review paper recommends that "international partners [should] aim for tailored institutional reforms in awareness of the trade-off that institutions that enhance development effectiveness (e.g. competitive markets) may be detrimental to

[10] As yet unfulfilled DFQF pledges were made in 2005 by all developed countries and "developing country members declaring themselves in a position to do so." It is important that the G20 review past commitments, learn from mistakes, and introduce real metrics to measure accountability.

stability (e.g. by crowding out rents), thus advocating rather best fits than best practices."[11] Vigorous assistance on the part of G20 partners to redress the legal and security environment in Madagascar, as well as other African LDCs in similar positions of fragility, would seem appropriate.[12]

Finally, G20 development partners should avoid the temptation of reverting to business as usual once political crises in countries like Madagascar have been resolved and official aid and support channels resume. The disappointing legacy of development assistance in Madagascar over the past decades calls for greater sensitivity to domestic circumstances and participatory mechanisms.

This paper has put forward the example of a successful Malagasy textiles enterprise, which has overcome the odds in Madagascar to generate private investment and much-needed job creation. One of the lessons to draw from this account is that the company, its employees, and their counterparts across the least-developed world deserve far better structures of governance and external support.

[11] World Bank, Governance and Development Effectiveness Review: a political economy analysis of governance in Madagascar, Washington, DC: 2010.
[12] The planned instruments of the "G20 agenda for action on combating corruption, promoting market integrity, and supporting a clean business environment" could be an integral part of this process, with the private sector deeply engaged in G20 anti-corruption efforts and commitments.