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Recent Developments in Consumer Price Inflation

1. Introduction

Inflation is generally defined as an increase in the overall price level of an economy. With economic development some level of inflation is expected and tolerated as long as it remains at low levels. However, persistently increasing levels of inflation are a major cause of concern as it impedes on economic growth and standard of living. To achieve and maintain low inflation it is important to understand the nature and causes of inflation. This paper attempts to shed some light on recent developments in inflation in the Maldives and identify the main factors influencing these developments.

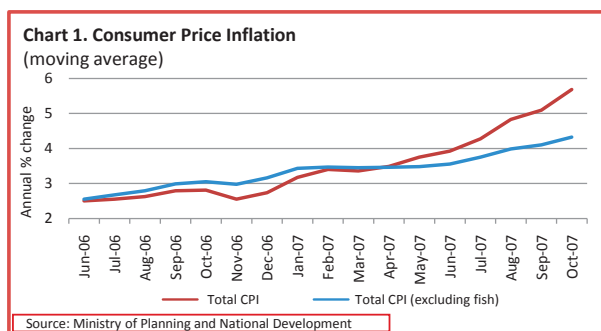
In the case of Maldives, there are various external as well as domestic factors contributing to inflation in the country. Maldives is a small and highly open economy, heavily dependent on imported goods. This makes the economy highly vulnerable to external price shocks, and the impact of such price shocks very quickly and significantly affects the country's price indices. Rising oil prices and the recent uptrend in global food commodity prices caused by weather-related supply disruptions and high global demand, driven mainly by the expansion of emerging markets such as China and India, coupled with the increasing use of biofuels have had an adverse impact on the domestic Consumer Price Index —mainly through higher food prices. In addition, the weakening of the US dollar is also significantly increasing the cost of imports into the country, although it has increased the export competitiveness of the country.

The reconstruction and rebuilding of the country following the tsunami of December 2004, coupled with the rapid expansion of economic activities as the economy began to recover in the latter part of 2005, has created excessive domestic demand throughout the economy. In addition, expansionary fiscal and monetary policies have also exerted further pressure on inflation. The rapid expansion in demand significantly outpaced the supply in the economy, given the capacity constraints in the country, especially relating to trade facilitating infrastructure such as ports.

This paper, following this brief introduction, analyses the recent developments in inflation in the Maldives in section 2 and identifies the main causes of inflation in the Maldives in section 3. Section 4 draws the main conclusions from the analysis.

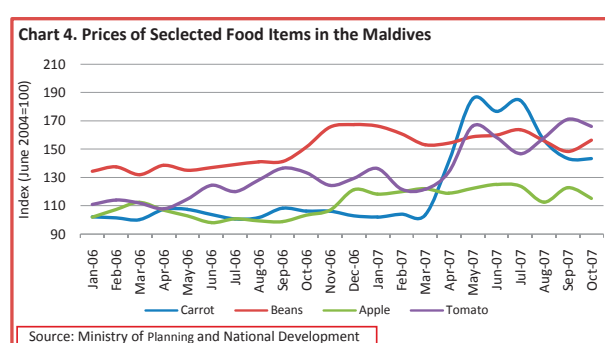
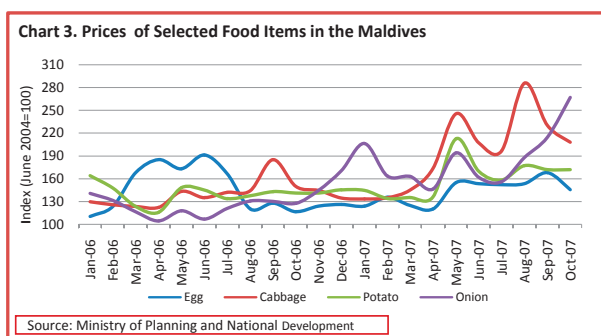
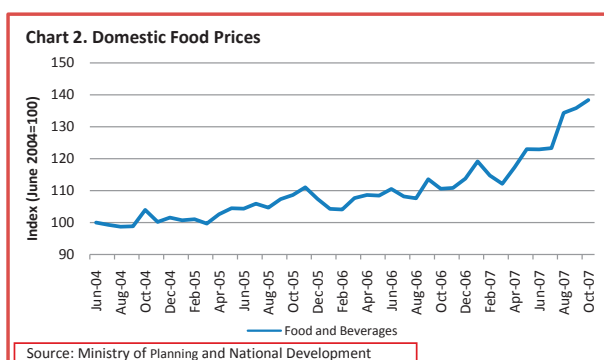
2. Inflation Developments during 2006 - 2007

The rate of inflation, as measured by the annual percentage change in the 12 month moving average of Consumer Price Index (CPI) for Male¹, rose by 1.4 percentage points from 1.3 percent at the end of 2005 to 2.7 percent at the end of 2006, and has continued to increase steeply during the first ten months of 2007, reaching 5.7 percent at the end of October 2007 (Chart 1).



1/ Although there is a separate CPI for the Atolls and for the whole country, for analytical purposes CPI-Male' (which is given a 48.9 percent weight of the national CPI) has been taken as the measure of inflation since this would be indicative of the overall price situation of the country given that all major financial transactions takes place in Male'.

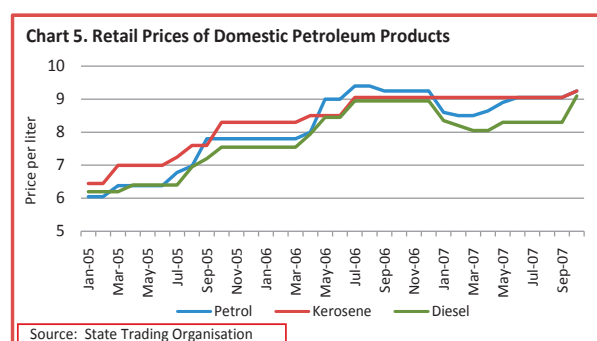
The higher inflation during 2006-2007 is largely attributed to the increase in food prices. Food items have the highest weight in the domestic consumption basket² and as a result strongly influence the changes in CPI. In October 2007, about one third of the increase in CPI came from the rise in food prices (Chart 2). Domestic prices of fruits and vegetables registered sharp increases during the period with price increases of 13 percent and 17 percent, respectively (Charts 3 and 4). Moreover, domestic fish prices continue to remain high and rose by a substantial 35 percent in October 2007 on account of the sustained decline in fish catch.



Housing related expenses—mainly housing rent— was the second largest contributor to CPI growth during the year to October 2007 as rent prices continues to climb up, given the strong demand for house rentals in Male' in recent periods. During this period, housing rent index rose by 3.0 percent

This was followed by health care prices which also registered strong gains, as fees of out-patient services such as doctors' consultation, various tests and x-rays were raised by hospitals and private clinics on different occasions. As a result, health prices index registered a significant growth of 11 percent at the end of October 2007.

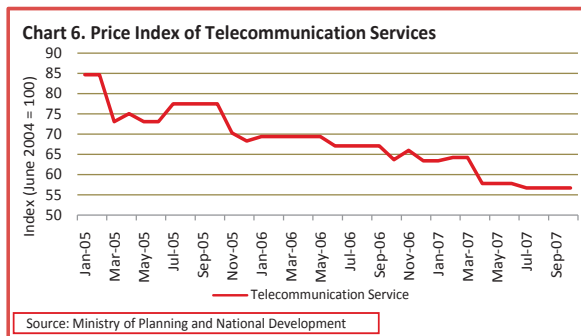
Transport prices were also a significant contributor to CPI growth during the review period. Transport prices rose reflecting higher global oil prices and were mainly driven by domestic air fare (11.5 percent growth) and the rise in retail prices of domestic petroleum products such as petrol and diesel (Chart 5).



² Household expenditure on food accounts for one third of total national consumption basket while it accounts for 27 percent of the consumption basket for Male'.

The cost of eating out at hotels and restaurants have also gone up notably over the last twelve months by 15.6 percent, as meals and takeaways in restaurants and cafés were pushed up by the rising food prices.

With the entry of an additional mobile phone company to the mobile phone service sector in early 2006, competition in the sector has been fierce leading to significant reductions in telecommunication tariffs since then (Chart 6). As a result, the communications index shows an 8 percent decline at the end of October 2007, with a 0.2 point negative contribution from the communication index to overall CPI growth during the period.

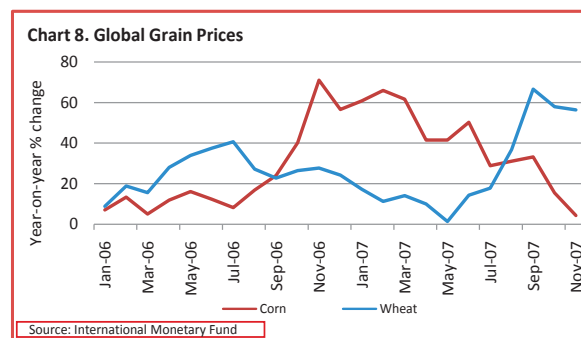
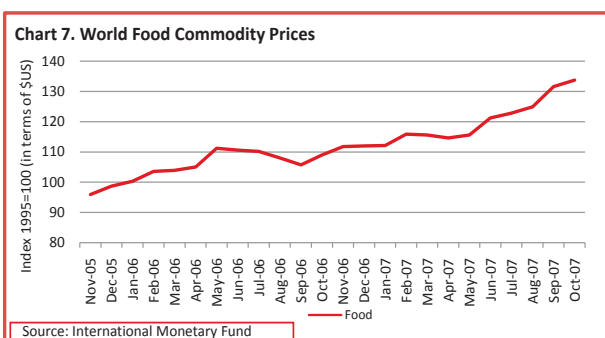


3. Factors contributing to inflation

3.1 External Factors

3.1.1 Higher Global Food Prices

Global food commodity prices have shown rapid increases since mid 2006 on account of both supply and demand side factors (Chart 7). Increasing demand for foodstuff from the bio-fuels³ industry is one of the main factors behind the recent surge in global food grain prices which fuelled the global food price hike. Bio-fuels such as ethanol and bio-diesel mostly use crops like corn, sugarcane, and edible oils as their feedstock, and increasing demand for these from the bio-fuels industry has strengthened the



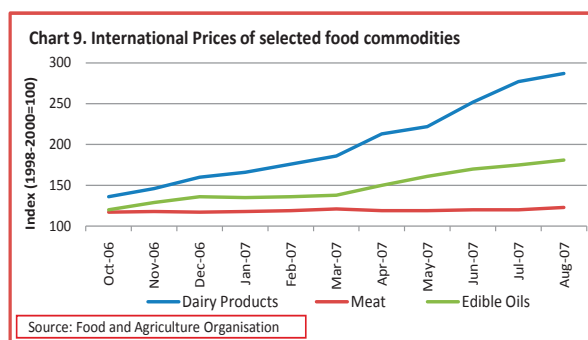
prices of most food commodities (Chart 8). The ethanol boom has also expanded the production of corn at the expense of other crops, like wheat⁴ and soybean, which recently pushed the price of wheat to new record highs, while higher cost of animal feed has translated into higher prices of meat and dairy products.

3/ Owing to the sustained rise in international oil prices many countries, especially industrial countries, have been promoting the use of biofuels and other alternative sources of energy on the quest to become oil independent.

4/ In the Maldives prices of staples such as rice, sugar and wheat are administered by the government.

The rapid pace of economic growth achieved by many emerging markets and developing countries over the past decade have extensively increased the global demand for food, contributing to higher global food prices. Thus, higher cost of animal feed, coupled with increasing demand for meat products by emerging markets, especially from China —as income levels rise people switch from staple food items to more expensive meat products —have raised the prices of meat and dairy products (such as milk and butter) to above record levels recently. Soaring dairy prices are owed to sharp rises in milk powders and butter, mainly on account of reduced supply in major exporting countries (Chart 9). Low inventory levels in the European Union region and severe drought in Australia along with suspension of milk powder exports by India, and Argentina’s export taxes are some of the factors contributing to shortages in export supply of milk in the short term.

The above developments in global food commodity prices have led to substantial increases in retail food prices in the domestic economy, which as has been mentioned in section 2, contributed significantly to the overall CPI growth in October 2007. The impact of high food prices is so highly felt in the domestic CPI as a large portion (one third) of domestic household expenditure is spent on food. Generally, food accounts for the largest share of the total household expenditure in most of the developing and low-income countries.

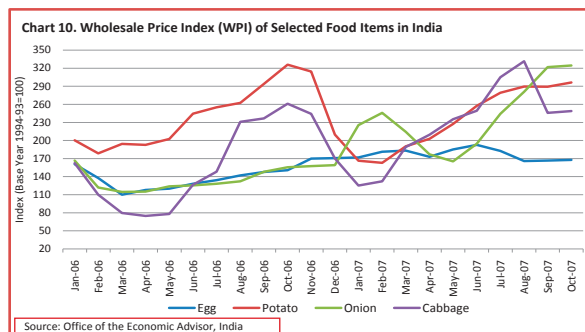


3.1.2 Prices in the source country of imports

Inflation has remained relatively stable or decelerated slightly in most of the Maldives’ major trading partners⁵, although in all these countries food prices have shown rising trends.

In Singapore⁶, CPI inflation edged up to 2.7 percent at the end of September 2007 with higher prices of imported food being a significant contributor to CPI growth. According to the Macroeconomic Review published by the Monetary Authority of Singapore on October 2007, inflation is likely to trend upward in 2008, influenced by both domestic (buoyant economic activity) and external (higher global food and oil prices) price pressures.

India, contributing to over 99 percent of total onion, egg, potato and cabbage imports into the Maldives, and also accounting for a quarter of beef imports, experienced high levels of inflation during the first three months of the year. Wholesale Price Inflation (WPI) in India reached a peak of 6.6 percent at end-March 2007 with prices of primary food items and manufactured goods being the dominant



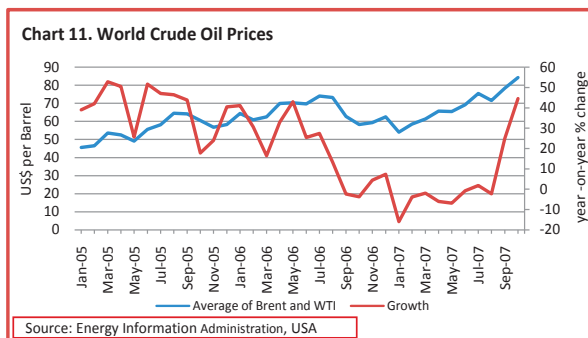
5/ Major importing countries include India, Singapore, Thailand, Malaysia, Australia, UAE, and Sri Lanka.

6/ Half of the country’s total poultry and edible oil imports come from Singapore (Brazil is the second major exporter of poultry to Maldives i.e. 1/3) while it is also the second largest source of milk powder imports to the country —Netherlands accounts for over 70 percent of total milk powder imports to Maldives. Moreover almost 20 percent of bovine meat to the country is imported from Singapore.

contributors to WPI. This was reflecting supply shortages, owed to adverse weather conditions and increasing demand by both the domestic and export sector, which has kept prices of fruits; vegetables; eggs; meat and fish at elevated levels in India since Nov 2006 (Chart 10). Nonetheless, inflation began trending downwards in April 2007 and eased to 3.1 percent at the end of October 2007 due to appropriate policy responses taken earlier during the year.

3.1.3 Rising global oil prices

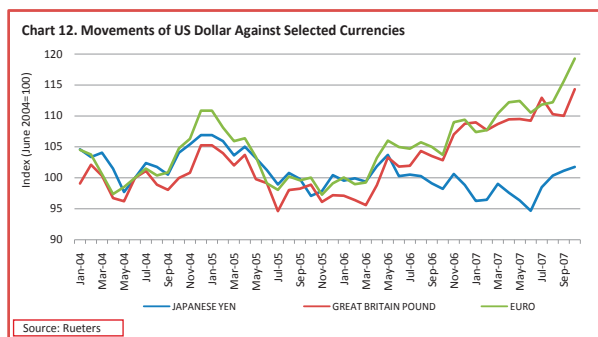
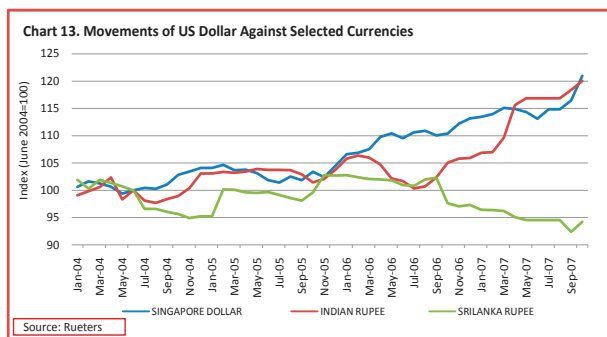
While rising global energy prices tend to have a lagged effect in domestic fuel prices⁷, prices of local petroleum products have registered substantial increases since the oil price hike of late 2004 (Chart 11), driving up domestic transportation costs. Given the dispersed nature of the country's islands, sea transport plays a major role in inter island transport and surging diesel prices continues to increase domestic sea transport fares. Moreover, domestic price of petrol has gone up by more than 50 percent since Jan 2005. Nonetheless the impact of rising oil prices on domestic CPI have somewhat been minimized as local electricity and water tariffs⁸ were not adjusted in line with oil price increases.



In addition to the above, higher oil prices have also increased freight costs further adding to import costs.

3.1.4 Depreciation of US dollar

The US dollar has been steadily declining over major currencies of the world, in particular the euro and pound sterling, since May 2006. Year-on-year terms, at the end of October 2007 the US dollar depreciated by 15 percent against the euro, by 11 against the pound sterling and by 4 percent against the Japanese yen. With respect to currencies of the major importing coun-



7/ State owned public company State Trading Organization (STO) is the main supplier of petroleum products to the country and its pricing policy regarding petroleum products is to balance the interest of shareholders and customers thereby not passing the whole burden of rising oil prices to its customers.

8/ In Maldives, electricity and water services are provided by two state owned utility companies, namely State Electric Company (STELCO) and Maldives Water and Sewerage Company (MWSC).

tries to Maldives, the US dollar depreciated against the Indian rupee by 14 percent and against the Singapore dollar by 10 percent. On the other hand, since September 2006 the US dollar has been strengthening against the Sri Lankan rupee, and at the end of October 2007 the US dollar appreciated in terms of Sri Lanka rupee by 3 percent (Chart 12 and 13).

3.2 Domestic Factors

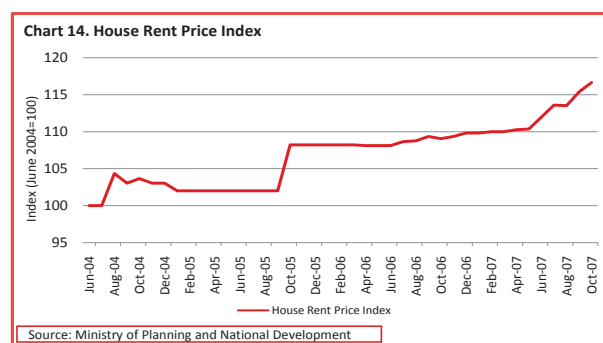
3.2.1 Rapid Economic Growth

Consumption demand has remained high and continues to increase due to strong recovery of the economy following the 2004 tsunami. Real output growth accelerated to 19 percent in 2006 —due to recovery in the tourism sector —after a contraction of 5 percent in 2005 and the economy is expected to expand further by 7 percent in 2007 which is largely driven by robust growth in tourism and construction sectors.

With the rapid expansion in GDP growth, there has been a surge in import growth which recorded a substantial growth of 97 percent over the past three years putting undue pressure at Male' commercial harbor and at the international airport. Current congestion at the seaport and airport has been identified as the major bottleneck in handling incoming cargo, especially unloading the cargo, into the country and lack of physical capacity and adequate facilities in the ports have increased inefficiencies and costs and at times been blamed for supply disruptions in the domestic market.

3.2.2 Construction Boom

The ongoing residential property boom reflecting the strong housing demand in Male', that followed especially in the months after the tsunami, has to a large extent influenced the CPI developments during 2006-2007. It has been estimated that following the tsunami, a significant proportion of the atoll population migrated to Male'. In addition, according to Census 2006, 46 percent of the total households in Male' lives in rented accommodation and hence the continued up-trend in accommodation costs (Chart 14)⁹ directly contributes to higher inflation. Indirectly, rising property prices¹⁰ continues to increase the costs of business which in turn is passed on to consumers through higher prices of goods and services.



Ongoing tsunami reconstruction activities, particularly those related to the reconstruction and rebuilding of housing and infrastructure damaged by the tsunami, have also expanded construction activities in the country. As of September 2007, 530 housing units have been completed and reconstruction of 1,456 houses is on-going. As for repair and reconstruction of harbors, 11 projects have already been completed while there are 13 projects ongoing.

9/ Weight of rentals for housing is 7.17

10/ While in most countries rent prices are adjusted every year, in the Maldives rents are fixed for the duration of the lease period and price changes when a new tenant moves in, so the effect of rent price changes will only be felt when a new rental agreement is made.

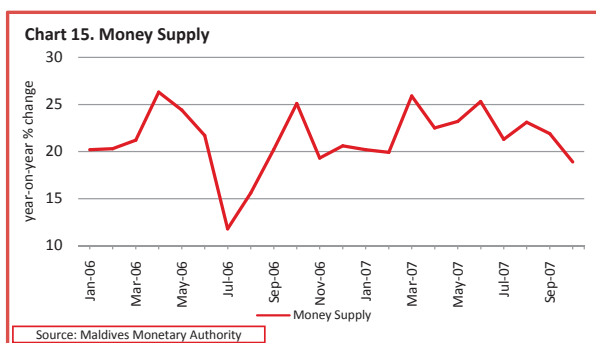
In addition to the above, the on-going new resort developments further adds to the construction activities in the country leading to substantial increases in construction related imports to the country. As such, the value of construction related imports to the tourism sector showed a significant rise of 79 percent (by 24.5 million) in the first ten months of the year, compared to the same period last year.

3.2.3 Fiscal Budget

The expansionary fiscal budget in 2006 and 2007 has created additional demand in the domestic economy, exerting further pressure on the domestic prices. Government expenditure is estimated to increase by 29 percent in 2007, with increases in both recurrent and capital expenditure. The higher expenditure has been financed from both external sources as well as from borrowings from the Maldives Monetary Authority. This leads to money creation and adds to inflationary pressures.

3.2.4 Monetary Expansion

The strong growth in the domestic economy has led to a substantial expansion in money and credit contributing to inflationary pressures in the domestic economy. In the twelve months to October 2007 the total money supply in the domestic economy or M2 expanded by 19 percent (by Rf1496.0 million) (Chart 15). The growth in M2 is largely driven by the expansion in domestic credit, especially to the private sector with the bulk of private credit has being lent to the tourism sector—owed



to the buoyant tourism activities —followed by commerce. Growth in net credit to government which moderated to 15 percent (91.8 million) in October 2007 following a growth of 76 percent in (US\$448.6 million) in the previous month also contributed significantly to monetary expansion. However, the expansionary impact of the rapid credit growth in M2 has been offset by the declining net foreign asset (NFA) position of the banking system with the decline in NFA owing to the significant decline (Rf2668.6 million) in the NFA of the commercial banks.

4. Conclusion

Recent developments in inflation in the country have been influenced by both domestic as well as external factors. On the domestic front, the rapid expansion in economic activities in conjunction with expansionary fiscal policy and the sharp increase in domestic credit in the banking system has created strong demand pressures throughout the economy. Given the supply side bottlenecks such as port congestions, the higher demand has quickly translated to higher prices, thus fuelling the consumer price inflation. The higher commodity prices in the international markets, especially oil and food, coupled with the steady decline of US dollar against the currencies of our major trading partners provided a further impetus to the rising inflation in the country.

Sources:

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Maldives Customs Service

Ministry of Planning and National Development

International Monetary Fund

Reserve Bank of India

Office of the Economic Advisor, India

FAO Food Outlook Report (November 2007)