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# Maldives Economic Update



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## Overview

- **Macroeconomic imbalances shock the system:** Maldives is currently experiencing a severe fiscal and balance-of-payments imbalance. In the absence of any adjustment, the fiscal deficit is expected to reach nearly 33 percent of GDP by the end of this year. With external financing sources limited by the ongoing global crisis, over 20 percent of this deficit is being monetized. The current account deficit is also expected to reach nearly 30 percent of GDP this year and, with reduced foreign exchange earnings from tourism, foreign exchange reserves have fallen well below prudential levels. Reserves, excluding commercial bank deposits at the Maldives Monetary Authority (MMA), have fallen to less than one month of imports. In response, the MMA is rationing foreign exchange, which is leading to a parallel foreign exchange market. Anecdotal evidence suggests that the rufiyaa (MVR)-US\$ exchange rate has climbed to between MVR14 and MVR 15, 10-20 percent above the pegged official rate of MVR12.8.
- **Combined fiscal adjustments and external interventions underway:** A sharp fiscal adjustment that includes significant recurrent expenditure cuts *and* a scaling-up of external financing from the IMF and other donors is necessary to stabilize the situation. The authorities are fully aware of the extent of the macroeconomic imbalances and have signaled their commitment to undertake the required fiscal adjustment. They have reached a staff-level agreement with the IMF on a Stand-By Arrangement that has at its core recurrent expenditure reduction to help put public finances on a sustainable path. The World Bank has committed to support the authorities both financially, through a budget support operation, and by helping organize a donors forum. A return to macroeconomic stability can be achieved with both fiscal adjustment and external financing, but implementation risks will be high – not least because democracy in the Maldives is a fragile 10 months young and the presidential government lacks a majority in parliament.

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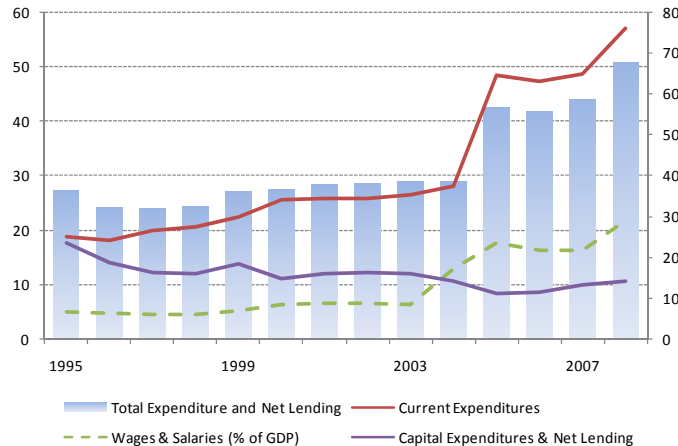
<sup>1</sup> The brief was put together by Francis Rowe, Kirithsri Rajatha Wijeweera and Daminda Eymard Fonseka.

## Macroeconomic Ailments Require Strong Medicine

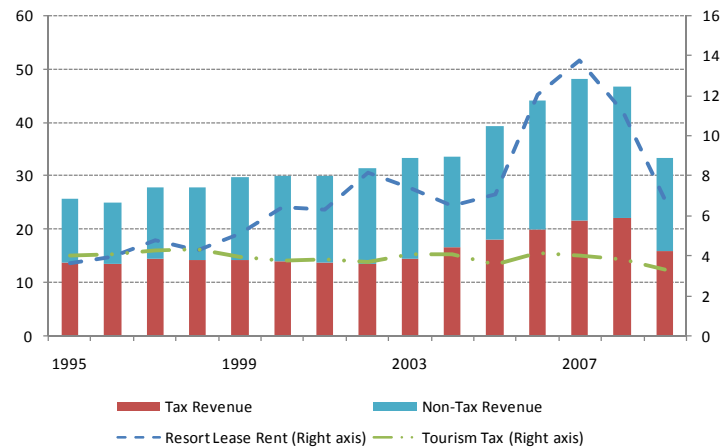
**Government Expenditures Soar, Global Crisis Hits Revenues:** Expansionary government budgets characterized fiscal policy in the wake of the December 2004 tsunami. Government spending increased from 38 percent of GDP in 2004 to 62 percent of GDP in 2008, initially on reconstruction efforts, but increasingly on recurrent expenditures unrelated to reconstruction efforts. The civil service wage bill, in particular, was a primary source of the increase in recurrent expenditures, as both the number of civil servants and their wages have increased in recent years. The total pay package has increased by 150 percent from 2007 to 2009.<sup>2</sup>

The government's revenue base is narrow and volatile; it consists largely of import duties, tourism receipts, dividends from state-owned enterprises and resort lease rentals. Both tax and non-tax revenues are driven mainly by the fortunes of the tourism sector. The sharp growth in government expenditures in recent years was made possible by the windfall gains from resort-lease rents as new tourist resorts grew rapidly, an unsustainable non-tax source at such levels. When new resort developments stalled in the second half of 2008 with the onset of the global financial and economic crisis, the unsustainable level of expenditures came into stark relief; tourism-tax revenues fell, import duties declined and the fiscal deficit rose to nearly 18.5 percent of GDP (excluding grants) – and with no adjustment, would likely reach 33 percent this year.

**Maldives: Government Expenditures (% of GDP)**



**Maldives: Government Revenues (% of GDP)**



Growing fiscal deficits are increasing the risk of debt distress. Deficit financing through unsterilized monetization has made up a growing share of total financing, as external options have diminished through the global financial crisis. Deficit monetization made up about 9 percent of GDP in 2008 and has accounted for another 10 percent so far this year. A key plank of the IMF program is to halt the government's recourse to financing from the MMA, implying that public external debt will have to fill in the gap. The total public debt-to-GDP ratio is expected to reach almost 90 percent this year. Private external debt has also been growing in the run-up to the global crisis as resorts sought financing for development. Given the rationing of foreign exchange in the economy currently, debt servicing on this debt is becoming increasingly difficult.

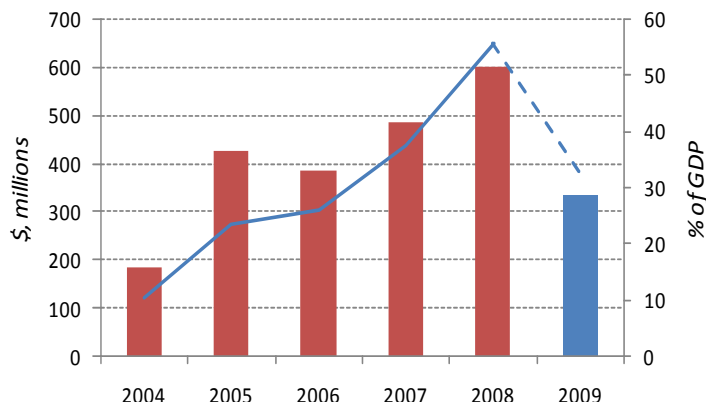
<sup>2</sup> All figures presented in the document are based on data taken from the Maldives Monetary Authority Statistical Bulletin. The exception is the data on the real effective exchange rate which comes from the IMF's International Financial Statistics.

### Fiscal Imbalances plus Food and Fuel Crisis Drive External Imbalances:

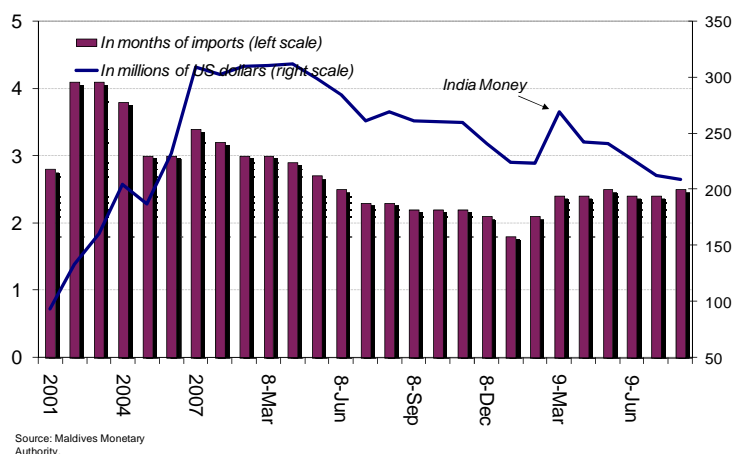
Accelerating government expenditure since 2004 also played a role in driving up imports to over 90 percent of GDP in 2008. The multi-year boom in food and fuel prices, and strong demand for resort-related construction materials prior to the onset of the global crisis, also played important roles in the exceptional import growth of recent years. The pace of import growth far outstripped robust export of services growth, as tourism flourished prior to the crisis. Consequently, the large and growing current account deficit resulted, reaching 53 percent of GDP in 2008. With the sharp decline in commodity prices in the first half of 2009 and extensive foreign exchange rationing, pressures on the import bill have eased and the deficit is expected to fall to 30 percent of GDP in 2009.

Financing the current account deficits has become increasingly difficult. Deficits were mainly financed through private capital inflows, foreign borrowing by commercial banks and official financing (multilateral and bilateral) until mid-2008. But since then, private capital inflows have slowed and foreign banks have cut credit facilities to domestic banks during the current financial crisis. The MMA has relied on drawing down foreign exchange reserves to cover the balance. Gross official reserves were bolstered in mid-March with the disbursement of US\$50 million of a US\$100 million loan from the Indian government. However, reserves quickly fell back from a peak of US\$267 million when the Indian money was received. While gross reserves stood at 2.5 months of imports in August, useable reserves which exclude commercial bank foreign exchange deposits at the MMA, stood at a critically low level of \$48 million in mid-September (less than two weeks of imports).

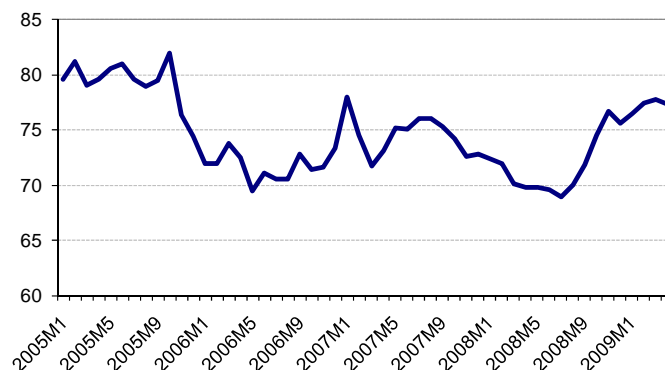
### Maldives: Current Account Deficit



### Maldives: Gross Foreign Reserves



### Maldives: Real Effective Exchange Rate (2000=100)



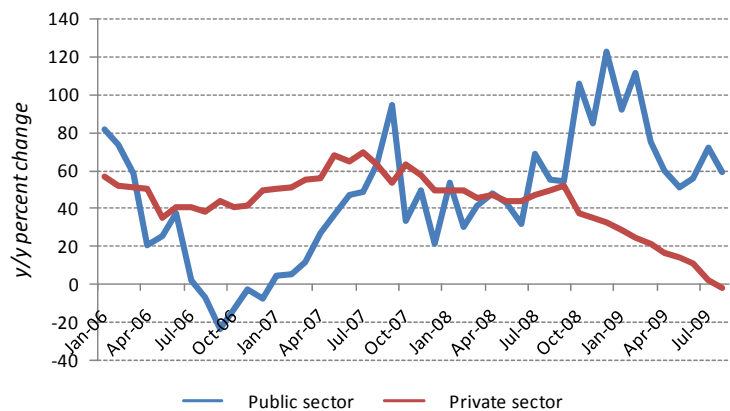
Low and declining foreign exchange reserves risks undermining the exchange rate peg. The rufiyaa has been pegged to the US\$ at a rate of MVR12.8 since 2001. The low reserve cover has meant that the MMA is rationing foreign exchange in the economy, contributing to the emergence of an unofficial currency exchange market, which anecdotal evidence suggests is MVR14-MVR15 rufiyaa per dollar. The real

effective exchange rate has appreciated 12 percent since mid-2008 but still remains below recent levels reached in 2005.

**Macroeconomic imbalances stressing the banking system:**

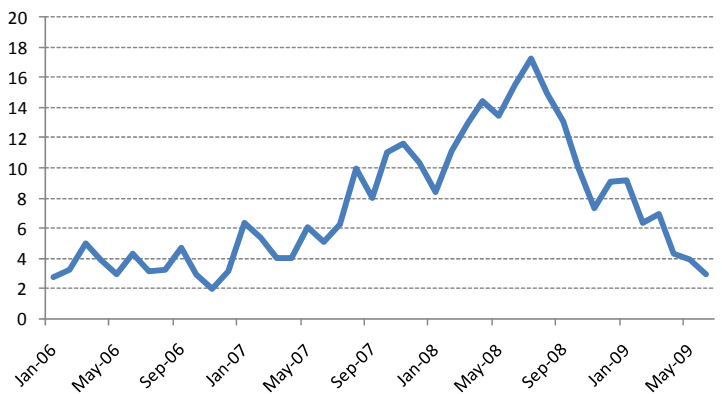
Expansionary fiscal policy and high budget deficits led to dramatic public sector credit expansion in 2008 and the first half of 2009. In the absence of an effective non-bank sector, much of the domestic financing requirement falls on the banking sector. This public sector credit expansion is crowding out private sector credit and putting the bank's balance sheets at risk. Foreign exchange rationing is also exposing banks to dollar liquidity shocks. These stresses are compounded by the bank's high exposure to tourism, the concentration of loans to a few borrowers, and limited financing options (e.g., lines of credit, parent financing) since the onset of the global financial crisis. Consequently, the risk of growing non-performing loans is rising. The state-owned Bank of Maldives (BML), which accounts for about 40 percent of commercial bank assets, saw its non-performing-loans ratio increase significantly last year; it is facing severe dollar liquidity shortages from the closing of external credit lines and has requested emergency dollar loans from the MMA. More broadly, the net-foreign-asset position of the banking sector has been negative since July 2008, leaving the banks exposed to a possible depreciation of the rufiyaa

**Maldives: Domestic Credit**



**Monetary policy highly constrained in such an environment:** The primary monetary policy objective for the MMA is to maintain the exchange rate peg. However, when the fiscal deficit can be financed by borrowing from the MMA, with no obvious limit, the excess supply of rufiyaa this creates greatly limits the MMA's ability to fulfill this policy objective. This is particularly true when there is no effective means to sterilize the rufiyaa liquidity in the system, given the nascent domestic debt market. Without an effective means to absorb the monetary overhang, this gets absorbed through a decline in foreign exchange reserves, leaving the MMA with little choice but to ration foreign exchange to hold the peg. In August, the MMA launched limited open-market operations (OMO) with a seven-day treasury instrument to absorb the excess liquidity. Given the scale of excess liquidity in the banking system, the OMO is a tentative first step in the right direction, but will have limited power unless monetization of the deficit is stopped.

**Maldives: Consumer Price Inflation (y/y growth rate)**



Reducing excess rufiyaa liquidity in the system is also necessary to help contain future inflationary pressures. Consumer price inflation (CPI) has been driven by both excessive rufiyaa liquidity and international commodity prices. While the CPI increased to 12.3 percent in 2008, from 7.4 percent in 2007, monthly data shows a deceleration in year-on-year growth rates. The national CPI peaked in July

2008 at 17.4 percent before falling to 3.0 percent in June 2009, in line with falling international commodity prices. The import weight of food and petroleum products make up 20 percent and 13 percent of total imports, and both make up about 40 percent of the CPI basket. The recent increases in international food and fuel prices underscore the importance of reducing excess liquidity to help limit inflationary pressures during the rest of the year and into 2010.

## A Delicate Balance in Rough Conditions

**Adjustment plan and external financing:** The government, fully recognizing the severity of the situation, has announced a number of fiscal measures designed to put the fiscal deficit on a sustainable path. On the expenditure side, it intends to reduce the wages and allowances bill and cut domestically financed capital expenditures. On the revenues side, it plans to introduce a “green tax”, or departure tax, at the airport. There are also plans to introduce an ad-valorem tax on tourism (replacing the existing flat-rate bed tax). In the medium-term, the authorities plan to introduce a business-profits tax and a goods-and-services tax to put the income-tax base on a firmer footing. Subsidy reform, including tariff increases by the state-owned electricity company (STELCO), is also part of the fiscal reform package. Taken together, these measures are expected to reduce the fiscal deficit by 15 percent of GDP over the remainder of this year and next. While the adjustment is significant, it will need also to be matched by significant external resources from donors.

The authorities have reached a staff-level agreement with the IMF to support their proposed adjustment package (see Box 1). A 30-month Stand-By Agreement has been reached with the IMF for an amount of about US\$60 million. The World Bank has agreed in principle to provide budget support of about US\$20 million over two years and the Asian Development Bank has agreed to provide about US\$35 million. In addition, the Indian government is extending new credit for US\$100 million through the State Bank of India. The World Bank is also organizing, with the government, a donor meeting in early December 2009, to seek further pledges from regional and bilateral sources. These sources of financing are expected to cover financing gaps into 2012 and provide additional financing to help the economy smooth out the adjustment, build reserves and support public spending on capital projects.

### Box 1. Key Elements of the IMF Program

The IMF program is expected to begin implementation in the last quarter of 2009. The three key pillars of the program are:

- reducing public spending to bring the public finances back to a sustainable footing, through a restructuring of wages, allowances, and the government payroll, and cuts in other expenses;
- tightening monetary policy, including by halting financing from the Maldives Monetary Authority to the central government; and
- strengthening the health of the financial sector.

It is expected that the fixed exchange rate regime will remain at its current level throughout the program period.

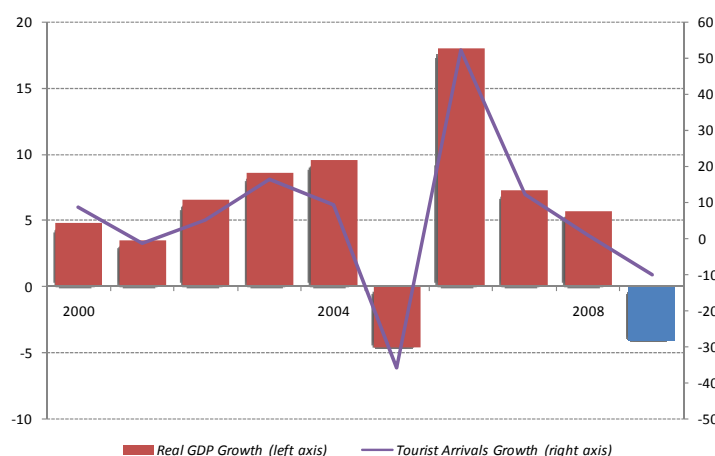
*Source: IMF press release No. 09/287, August 2009.*

**Implementation risks:** Implementation risks to the necessarily ambitious adjustment plan are significant. While the government has firmly signalled its intention to reduce the number and size of pay packets of public servants, implementation will be politically challenging. President Mohamed Nasheed was elected in November 2008 after the 30-year rule of former President Maumoon Gayoom. Democracy in the Maldives is therefore in a nascent stage and needs nurturing. The authorities will have to carefully communicate the adjustment measures to the wider public so as to manage potential resistance. Moreover, in the first-ever multi-party parliamentary elections, held in May 2009, former President Gayoom’s [Dhivehi Rayyithunge Party](#) (DRP) and its coalition partners emerged as the single largest entity, with 35

seats in the 77-member People’s Majlis. This implies that legislative measures in the proposed adjustment (e.g., tax measures) could get bogged down in the parliament and fall behind schedule.

The strength of the global economic recovery presents upside and downside risks to the adjustment program. A stronger-than-expected recovery in Europe - the largest tourist source - would help boost tourist arrivals, real GDP growth and government revenues, helping to ease the fiscal adjustment in 2010. Strong global growth and an easing of global credit constraints would also help foreign direct investment and stalled resort developments pick up. Alternatively, a slow and anemic global recovery would suppress a revival in tourism, GDP growth and FDI, making the fiscal adjustment more difficult. As matters stand, GDP growth is expected to slow considerably in 2009 with the slowdown in the tourism sector. Cumulative tourist arrivals contracted by 11 percent to July 2009 compared to the same period in 2008. Largely as result of the tourism slowdown, the economy is expected to contract by 4.5 percent in 2009 - the first decline since 2005, when the economy contracted by 4.6 percent following the tsunami. The outlook for 2010 is for a rebound in both tourism and real GDP growth. Real GDP growth is expected to rebound in 2010 to over 3 percent..

**Maldives: GDP and Tourist Arrivals Growth**



Retention of the fixed-peg exchange rate is also a risk. Reducing government expenditure under the adjustment would serve to reduce aggregate demand and pressure on the exchange rate. So, too, would eliminating the monetization of the deficit. The forthcoming donor-financing forum could help to build MMA reserves. Moreover, there is little evidence that the current level of the real exchange rate is highly overvalued, notwithstanding the parallel market premium of 10-20 percent. Nevertheless, given the large imbalances in the economy, tentativeness in global recovery and domestic political sensitivities, the program implementation risks are not inconsequential. A number of factors could trigger a run on the currency and sharp devaluation. The consequences of such a devaluation would be felt rapidly and broadly across the population through an acceleration in consumer price inflation.

## Sustained Growth and Poverty Reduction

The current macroeconomic crisis is delaying implementation of the government’s ambitious national development objectives, outlined in the National Development Plan. These are to:

- Establish an integrated transport network to facilitate travel between and within islands, atoll and the region;
- Ensure affordable living costs by keeping government expenditure within the limits of sustainable revenues;
- Provide affordable housing;
- Ensure affordable and quality healthcare by providing access to quality health services, and;
- Stem the entry of narcotics into the country.

While much of the plan is to be implemented through the private sector or public-private partnerships (PPPs), where possible, the costs of the main elements of the plan are still too high for the government to bear at present. The UN Development Programme is helping to cost, prioritize and present action plans for implementation of the main elements of the plan. Once this work is complete, and underpinned by a sustainable macroeconomic framework, the government intends to accelerate implementation. The World Bank has expressed willingness to support the government both financially and through technical assistance in a number of areas. Recent consultations with the government have helped to better define the areas of support - for instance, in the areas of climate change, civil service reform, PPPs and the medium-term fiscal framework.

## World Bank Assistance to Maldives in FY10

Bank staff are currently preparing a progress report on implementation of its current country assistance strategy (CAS), in order to better support the government's implementation of the National Development Plan and achieve other key CAS objectives. The Bank currently has three investment projects in the country and a pension project that was approved by the Bank's board in mid-May:

- A **Mobile Phone Banking Project**, requiring US\$7.7 million, was approved in April 2008. The project is designed to improve access to financial services by creating a single-currency payment system for mobile telephone-based accounts, enabling subscribers to transfer funds to and from bank accounts and to and from telephone-based accounts.
- An **Integrated Human Development Project**, requiring \$15.6 million, was approved in May 2004. The objectives of this project are to: (i) improve social outcomes and promote economic growth by strengthening the delivery of social services (education, health and nutrition services) available to the population; (ii) reduce poverty and promote regional equity by strengthening social service delivery and increasing economic opportunities in atolls remote from the prosperous Male region; and (iii) promote ecologically sustainable development by concentrating services and populations on ecologically viable islands within these atolls.
- An **Environmental Management Project**, requiring US\$13.2 million, was approved in May 2008. The main aim is to provide the Maldives with the capacity to manage environmental risks and threats to fragile coral reefs and marine habitats resulting from tourism development, increased solid-waste disposal, fisheries and global climate change. The project has two development objectives, to: (i) establish a solid-waste management system for inhabitants on targeted islands, reducing the risks of contamination associated with accumulated wastes and sea dumping, and; (ii) train people for environmental management.
- A **Pension Project**, requiring \$3.8 million, was approved in May 2009. The primary objective is to support the introduction of a new pension system comprising two elements - one contributory and the other non-contributory - in order to provide income protection for aged citizens. A secondary objective involves rationalizing the public administration by introducing a sustainable retirement scheme for civil servants. The project will seek to protect retirees from a decline in consumption, and lay the institutional and administrative groundwork for other social protection programs. ■