April 2010

Maldives Economic Update

Economic Policy and Poverty Team
South Asia Region

The World Bank

Overview

The rebound in tourism is driving a growth recovery. The global crisis led to a sharp decline in tourist arrivals in early 2009, which contributed to a 3.0 percent contraction in the economy in 2009. Based on the tourism rebound that started in the second half of 2009, real GDP growth is expected to be 4 percent or more this year.

The government's policy efforts to redress macroeconomic imbalances and external financing have helped to stabilize the macroeconomic situation. Developments over the next few months will determine whether these measures are sufficient to maintain the trend.

Looking beyond stabilization, the government has recently costed and prioritized its medium-term development plan – the Strategic Action Plan. Donors showed strong support for the government's plan at the recent Maldives Donor Forum, with pledges that cover over 80 percent of the required funding.

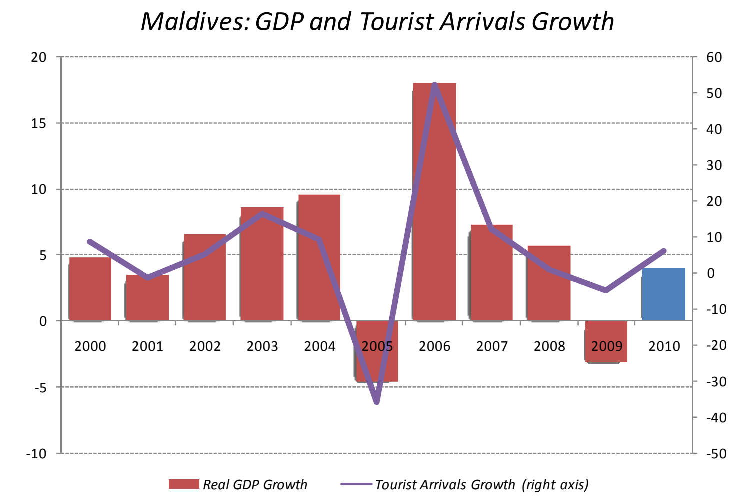
Key risks ahead include the challenge of implementing fiscal austerity measures while the government lacks a majority in parliament, and the consequences of a mounting current account deficit and rising consumer price inflation, if international commodity prices continue to rise. ■

[1] Prepared by Francis Rowe, Kirthirsri Rajatha Wijeweera and Daminda Eymard Fonseka.

Back from the Brink, but Some Distance to Go

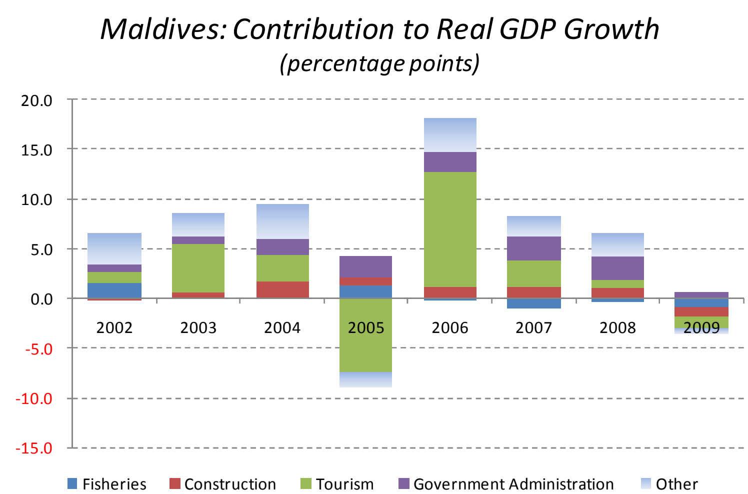
Back from the brink ...

A rebound in tourism will help drive a rebound in economic growth this year. Real GDP growth fell by a better-than-anticipated 3 percent in 2009, as a revival in tourism that started in the second half of 2009 gathered pace. Tourism is the lifeblood of the Maldivian economy, accounting for almost 30 percent of GDP. Tourist arrivals, earnings and duration of stay fell in the first half of 2009 as the global recession took hold in Europe, the primary region of origin for tourists.[2] A rebound in arrivals started in August 2009 and has continued into 2010, with February arrivals up over 30 percent from the same period last year. Occupancy and duration of stay have also rebounded, but have yet to reach pre-crisis levels. The renewed momentum in the tourism sector will help drive the rebound in growth to an expected 3-4 percent this year. This is below the 6.5 percent annual average real GDP growth rate realized over the last two decades, mainly because the fisheries sector is not expected to contribute to the rebound.



Source: Maldives Monetary Authority

The fisheries sector remains a drag on growth. The fishing industry is a distant second in its contribution to GDP (3 percent), but it is the second largest foreign exchange generator and an important employer. Fish-catch levels have declined continuously since 2006, falling an additional 22 percent in 2009 from those of 2008. The causes of the drop in fish-catch are poorly understood, but may be related to changing ocean currents and rising costs of fuel in recent years. The total volume of fish exports (excluding live fish) dropped 37 percent in 2009 from those of 2008, and earnings from fish exports dropped by 40 percent during the year. The recent rebound in international tuna prices fed into increased earnings in the last months of 2009 and could indicate some support to the sector going forward, if maintained.



Source: Maldives Monetary Authority and Bank staff estimates.

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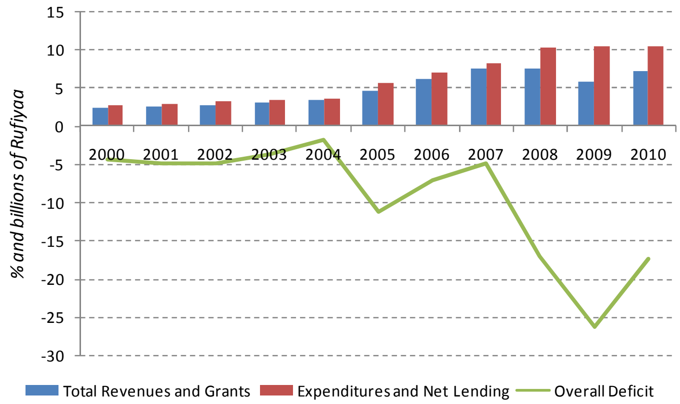
[2] Cumulative arrivals as of June 2009 were 10.5 percent lower than the corresponding period in 2008.

Policy Interventions Aimed at Reducing Imbalances

Fiscal policy has been the key factor behind the rise in macroeconomic imbalances in recent years and is now the key focus of the government's stabilization attempts. Government actions to reduce government expenditures from 63 percent of GDP in 2008 have centered on reducing the public service wage bill. Authorities have reduced wages of the public service from 10-20 percent, depending on grade, and have begun implementing redundancies.[3] They have also raised electricity tariffs by an average of 30 percent for Male residents. These efforts, plus under-spending in the capital account and a downward revision in overall expenditure outcomes, helped to contain spending in late 2009 and early 2010. The introduction of an airport tax helped bolster revenues that had been hard-hit by the decline in tourism. These factors helped to reduce the fiscal deficit to 26.1 percent of GDP in 2009, compared to mid-2009 projections of 30 percent.

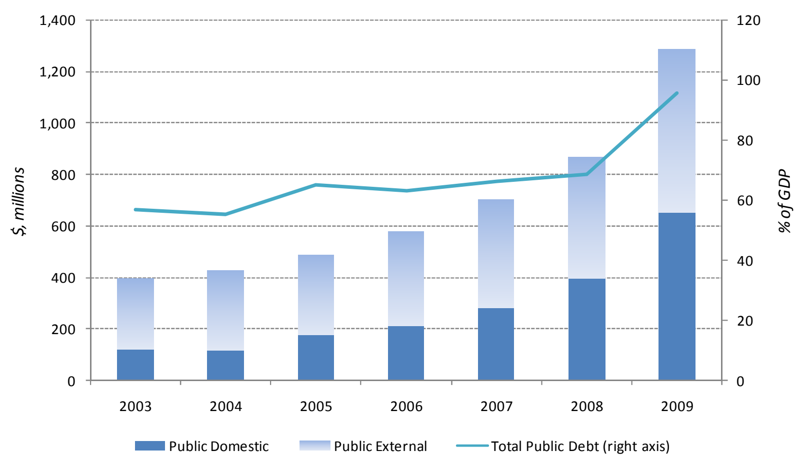
Maldives: Government Expenditures, Revenues and Fiscal Deficit



Source: Maldives Monetary Authority

Deficit financing has normalized. The government stopped receiving direct credit from the central bank from September 2009 and domestic financing is now made up of T-bills and bond issues. In December 2009, the Ministry of Finance, in conjunction with the Maldives Monetary Authority (MMA), introduced formal treasury auctions for 28-day and 91-day T-bills to market participants (largely state-owned enterprises (SOEs) and commercial banks). The MMA has fully securitized outstanding balances in the Ways and Means (WAM)[4] account to medium- and long-term treasury bonds. These instruments are being used to carry out open-market operations (OMOs) with the commercial banks in an effort to mop up excessive rufiyaa currency liquidity. This represents

Maldives: Composition and Stock of Total Debt



Source: Maldives Monetary Authority and Bank Staff Estimates.

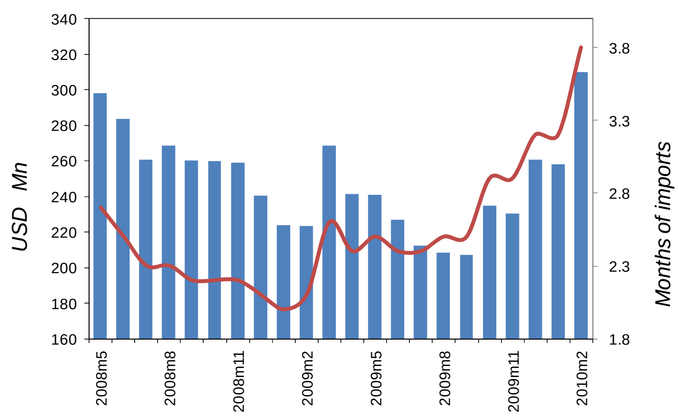
[3] Parliament has restored the wages of the salaried staff of independent commissions (see risks sections below).

[4] The overdraft financing account of the government maintained with the MMA.

an important breakthrough for monetary policy and will remain an important policy tool in future. Domestic financing will remain heavy for the remainder of this year, at about 7 percent of GDP, but the authorities are committed to non-monetary financing. The banking and SOE sectors has so far shown strong demand for government paper, given the lack of alternatives. The remaining roughly 7 percent of GDP will be made up largely of concessional external financing. The financing of unsustainable deficits in 2008 and 2009 has led to a sharp build-up of public debt, prompting the World Bank and the IMF to classify Maldives as being at moderate risk of debt distress. This risk should diminish with the continuation of the planned fiscal austerity measures.

Fiscal adjustment and the cessation of monetization have taken pressure off foreign exchange reserves. Until late 2009 the MMA was rationing foreign exchange and premium the parallel foreign exchange market was building. Since the recovery started in late 2009, foreign exchange reserves have grown, rationing is no longer intensifying and the premium in the parallel market has decreased significantly. External financing and proceeds from privatization have enhanced these favorable results.[5] The IMF approved a blended Stand-By Arrangement and arrangements under the Exogenous Shocks Facility for a combined amount of about US$92.5 million (700 percent of quota) on December 4, 2009.[6] The State Bank of India's Male branch purchased US$50 million of dollar-denominated T-bonds in December 2009 and another US$50 million in February 2009. The World Bank disbursed US$13.7 million in early April and the Asian Development Bank (ADB) is expected to disburse US$17 million in 2Q of 2010. The recent Donor Forum successfully garnered commitments of external financing that should underpin adjustment efforts and foreign exchange reserves this year (Box 1, pg 6).

Maldives:Gross International Reserves



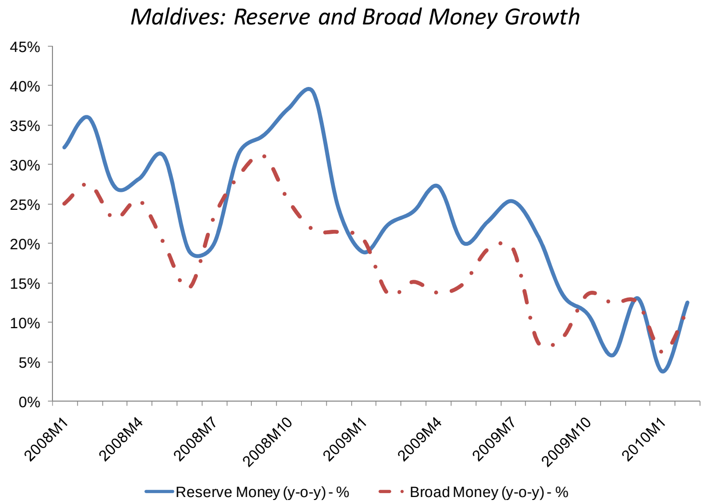
Source: Maldives Monetary Authority.

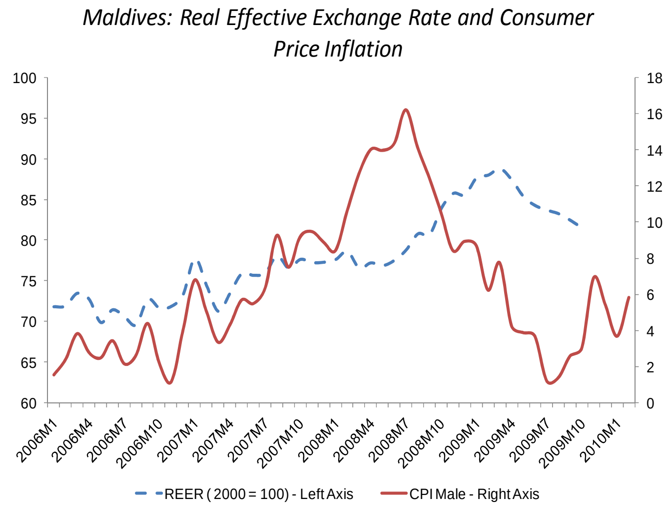
Rebound in Tourism and Policy Actions Reduce Balance of Payments Pressures

The rebound in tourism can be expected to support the balance of payments, but import prices will be the key determinant. The growth in travel receipts was much stronger in 2009 than many observers expected, contributing to an improvement in the current account deficit to an estimated 31 percent in 2009, from 51.4 percent in 2008. However, the main reason for the decline was the fall in international commodity prices. The multi-year boom in food and fuel prices had played an important role in the exceptional import growth of recent years, reaching 97 percent of GDP in 2008. But the subsequent decline in 2009 reduced imports to 63 percent of GDP and, with it, the current account deficit. Falling import prices have also contributed to the fall in consumer price inflation, from a high of 17 percent in July 2008, to 4 percent in February 2010. This, in turn, has driven the depreciation of the real effective exchange rate (REER).

[5] In January, the government obtained US$ 16Mn for a 20 percent stake of the Maldives Water and Sanitation Company (MWSA) acquired by the Hittachi Corporation of Japan.
[6] The IMF completed its first review of the program on March 26th, 2010 releasing the second tranche of the operation (approx. SDR 9 million).

Pressures on the fixed exchange rate regime have eased. The rufiyaa has been pegged to the U.S. dollar at a rate of 12.8 rufiyaa per dollar since 2001. While recent CPI trends have helped drive the depreciation of the REER, this was also assisted by the nominal depreciation of the U.S. dollar in recent months. The rufiyaa has also depreciated against other major trading partner currencies into early 2010, although it has started to appreciate from those levels in March and April. Rising foreign exchange reserves give the authorities a slight buffer, in the event of another exogenous shock. Continued fiscal consolidation and maintenance of zero credit to the government by the MMA will be critical to ensuring that the growth rates of monetary aggregates continue to slow to more reasonable rates, thereby reducing pressure on the peg.





Source: Maldives Monetary Authority and Bank staff estimates.

Medium-Term Development Plan Costed and Prioritized

Returning to positive rates of economic growth is a prerequisite for sustaining Maldives' impressive progress in improving human development outcomes. The government is seeking to consolidate human development gains while also responding to current challenges, increasing the quality of service provision and decreasing inequalities. The focus of the government's efforts is found in the recently completed Strategic Action Plan (SAP)[7]. It aims to refocus the role of the state in the economy to: (i) achieve upper-middle income status; (ii) ensure more equitable access to services and opportunities; (iii) improve service delivery; (iv) facilitate economic diversification, and (v) support better environmental practices to sustain growth and adapt to global climate change. The development framework also seeks to make progress on key cross-cutting themes that are considered central to the government's reform agenda: (i) sustainability of the environment and climate change; (ii) gender rights; (iii) social protection; (iv) decentralization and regional development; (v) public-private partnerships (PPPs); (vi) human rights, and (vii) transport.

The government has identified five priorities in the SAP which it considers necessary for a stable framework to develop all other sectors. These priorities are closely linked to the SAP's key themes of good governance, social justice and economic development, which were the themes of the March 2010 donor conference (see Box 1, below). The five priorities are: (i) macroeconomic reform; (ii) public sector reform; (iii) good governance initiatives; (iv) social development, and (v) climate change and adaption.

[7] "Aneh Dhivehi Raajje", in the Maldivian language.

The World Bank is supporting the government's implementation of the SAP. The World Bank and its private-sector arm, the International Finance Corporation (IFC) jointly prepared the Maldives Country Assistance Strategy (CAS), which was discussed by the Bank's board on January 8, 2008. A CAS progress report is underway and initial expectations are that the Bank and IFC will support the government's SAP primarily through policy lending, advisory services, and IFC investments for the duration of the CAS period. This approach supports the government as it seeks to make major policy improvements. Investment lending through the Bank's International Development Association (IDA) will be considered if it can leverage additional resources. The Bank Group will also work to catalyze financial support from donor partners and private investors.

The IDA and IFC will use selective interventions to maximize development impact. Development Policy Credits (DPCs) will support critical policy reforms; as there will be fewer projects, resources will be freed up for additional analytical and advisory activities (AAA). Policy reform is needed in many areas and the government is advancing a number of proposals, some of which are already pending in the legislature. IFC investments are likely to continue to focus on tourism, the financial sector and infrastructure. The IDA and IFC will continue to collaborate in many areas, such as PPPs, the financial sector and climate change. In most cases, the Bank Group will support policy and regulatory reform, as well as broader program implementation, with the IFC providing financial and advisory support for strategic initiatives and key transactions.

Box 1. Maldives Donor Forum 2010

The Maldives Donor Forum (March 28-29, 2010) was an opportunity for the government to describe to development partners the challenges it faces and the measures it has taken in recent months to lay the foundations of an economic turn-around. It was also an opportunity for the government to present the five priority-development functions of its Strategic Action Plan (SAP).

The government identified five priority areas which lack adequate resources to ensure meaningful outcomes. These priority areas are closely linked to the SAP's key themes of good governance, social justice and economic development. The five priorities are:

- **Macroeconomic Reform -** to support private sector-led economic growth. It entails reducing the role of the state in the economy - a core component of the SAP - and facilitating conditions for growth in tourism and fisheries;
- **Public-sector reform -** a key pillar of the structural adjustment program. The public sector is being streamlined to make it more efficient and effective in the delivery of quality government services;
- **Good governance -** entails strengthening democratic institutions and processes as a priority to ensure that the new democracy is entrenched;
- **Social development** – focuses on developing the human resources of Maldives in order to effectively deliver on all social development pledges, and
- **Climate change and adaptation -** an existential threat to the Maldives. The government is proposing a series of mitigation and adaptation measures, that require substantial funding.

The government has costed the five priority areas and estimates total costs will amount to approximately US$402 million over four years, in addition to US$45 million in general budget support that the government is seeking from development partners (. Participants of the Forum pledged commitments of $313 million to fund the five priority areas. Of this, the World Bank Group committed US$24 million in budget support, US$13.7 of it to be delivered in April 2010. This will support: (i) *public financial management*, specifically budget preparation, implementation and monitoring; (ii) *public enterprise reform*, specifically measures to help ensure that the government-planned PPPs properly minimize future fiscal risks to the government, and (iii) *social protection*, specifically efforts to lay the foundations for a harmonized national social protection system.

… still some distance to go

The authorities' policy commitments to reduce macroeconomic imbalances and re-accelerate economic growth have been impressive. However, a number of policy challenges and vulnerabilities still have to be carefully managed if the recent positive developments are to be maintained. Two key downside risks and one potential upside risk are worth highlighting:

- **The medium-term fiscal adjustment challenge.** The authorities presented the FY2010-FY2012 budget in late December, projecting a fiscal deficit, in relation to GDP, of 17.8 percent in 2010, 4.1 percent 2011 and a near-balanced budget in 2012. However, a number of amendments made to the budget by the parliament before ratification threaten to undo the public-service wage cuts. The wages of the salaried staff of the independent commissions have already been reversed representing about 1 percent of GDP. [1] Additionally, the government said it would pay civil servants' pension contributions (7 percent of base salaries) from May 2010 until wages are restored to September 2009 levels. The pension contributions represent 0.7 percent of GDP. It is unclear how or when these will be disbursed; the new Pension Act is open to interpretation as to whether they may be delayed until later in the year or must be in the form of cash transfers. A more problematic outcome would be a reversal of the wage cuts, which represent almost 4 percent of GDP. The government has said it intends to keep paying the wages and allowances of civil servants (and that of the political appointees and the armed forces) at their reduced levels until domestic revenues reach Rf 7 billion, which may be in early 2011. But, the Civil Service Commission[8] is seeking Supreme Court approval to retroactively restore wages of the civil service to 1 January 2010.

- **Delays in implementing revenue measures are also a source of risk**. Both the general sales tax (GST) on tourism[9] and business-profits tax (BPT) have been delayed, and with a minority government, it is uncertain when parliament will pass the legislation. The BPT was expected to be introduced in January 2010, but 2Q10 is now thought more likely. The GST on tourism was expected in early 2011 but, given the possibility that wages will be reversed earlier than expected, the authorities have committed to advance passage of the legislation to August 2010. The IMF estimates that expenditure slippages and revenue-measure delays could add 1 percentage point of GDP to the projected deficit in 2010 and 4.5 percent in 2011. The authorities will have to work with IMF staff to consider additional compensatory measures to bring the 2011 budget back to the targeted fiscal deficit of 17.8 percent.

- **The political environment is challenging.** Given its minority status, the government has had to rely increasingly on independent members of parliament to pass vital bills. While the governing Maldivian Democratic Party (MDP) has been strengthened in recent months by crossovers from opposition parties and independents, no single party commands a majority in the 77-member assembly. Partisan politicking appears to have strengthened in recent months, with the parliament temporarily shutting down during a recent debate over the Auditor General.

- **Return to rising international commodity prices.** Maldives is one of the most open economies in the world, largely because imports are so significant (over 90 percent of GDP in 2009). Food and fuel products make up almost 60 percent of imports and comprise 40 percent of the CPI basket. The recent rise in international food and fuel prices, therefore, raises concern that the current account deficit may widen more than expected in 2010 and put pressure on foreign exchange reserves. Rising international commodity prices will also feed through to consumer price inflation, which will cause

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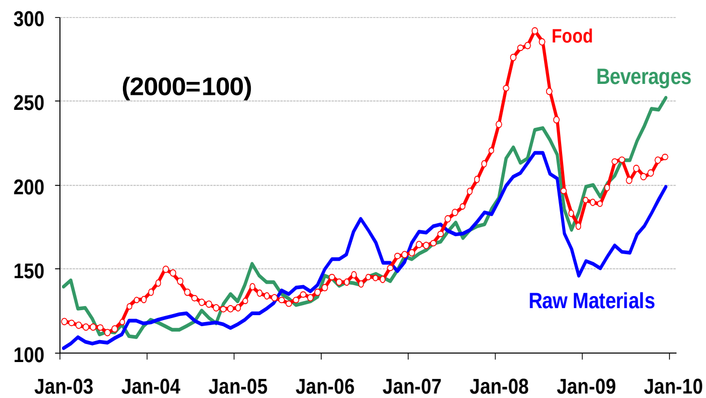
[8] Which is an independent body having the overall responsibility over civil service positions and pay.

[9] This bill would introduce an *ad valorem* rate of 4 percent, and coexist with the specific tax of US$8 per person per night until end-2010.

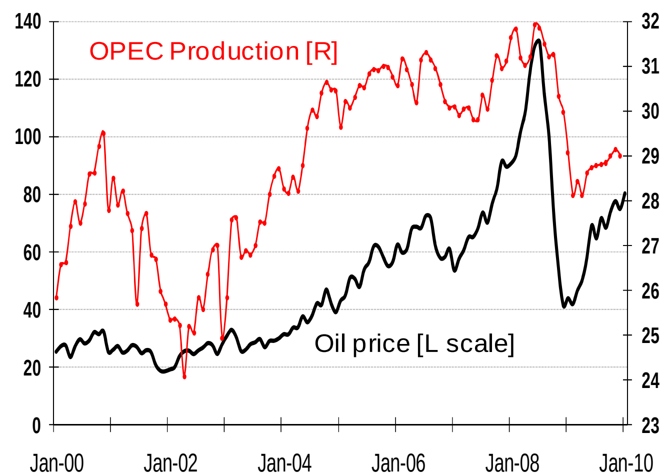
an appreciation of the REER and again destabilize the exchange rate peg. One upside to the rising value of commodity imports is that 30 percent of government revenues come from import duties, so fiscal outcomes could improve if planned expenditure cuts are implemented.

- **Tourist arrivals could rebound if the global recovery gathers pace.** Recent economic data from key tourist-originating economies in Europe indicate that that the recovery may be stronger than earlier anticipated. The IMF's World Economic Outlook update of January 2010 upgraded its growth forecasts for the Euro Area and the UK in 2010 and 2011, though they are still below pre-crisis growth rates. With such a recover, tourism could return to long-run trend growth; with an unchanged average duration of stay of around 8 days, total bed-nights could rise to about 15 percent higher than in 2009. This would raise real GDP growth to significantly more than the government's and IMF's forecast of 4 percent in 2010. It would also imply that government revenues would rise and thus ease the burden of fiscal adjustment.

International Commodity Prices



Oil Prices and Production



Source: World Bank Development Economics Prospects Group.

World Bank Assistance to Maldives in FY10

World Bank staff are currently preparing a progress report on implementation of the Bank's current CAS, in order to better support the government's implementation of the SAP and other key CAS objectives. The Bank currently has three investment projects in the country, a pension project, approved by the Bank's board in mid-May and the recently approved Economic Stabilization and Recovery credit.

- 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 US$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: (i) to 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) to train people for environmental management.

- A **Pension Project,** requiring US$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.

- An **Economic Stabilization and Recovery** credit was approved on March 4, 2010. The development policy credit aims to support the government's program to stabilize the economy, and puts in place some of the key elements needed for a sound recovery. There are three main areas of the government's reform plan that this proposed operation will support: (i) public financial management, specifically budget preparation, implementation and monitoring; (ii) public enterprise reform, specifically to help ensure that the government-planned PPPs appropriately minimize future fiscal risks to the government, and (iii) social protection, specifically to support the government's effort to lay the foundations for a harmonized national social protection system. The credit was processed under the IDA Financial Crisis Response Fast-Track Facility. ■

Maldives - Key Economic Indicators

Indicator	Actual 2007	2008	Estimate 2009	Projected 2010	2011	2012
National accounts (as % of GDP)						
Gross domestic product	100	100	100	100	100	100
Agriculture	7	6	8	9	9	10
Industry	17	18	23	25	27	29
Services	76	76	69	67	64	61
Total Consumption	..	..	97	90	86	79
Gross domestic fixed investment	..	..	21	21	21	21
Government investment	..	..	12	11	9	9
Private investment	..	..	9	10	12	12
Exports (GNFS)b	83	83	73	72	74	80
Imports (GNFS)	104	110	94	87	84	82
Gross domestic savings	..	..	3	10	14	21
Gross national savings	..	..	-5	2	8	16
Memorandum items						
Gross domestic product (US$ million at current prices)	1055	1261	1338	1441	1552	1669
GNI per capita (US$, Atlas method)	3190	3580	3690	4090	4470	4770
Real annual growth rates (%, calculated from 95 prices)						
Gross domestic product at market prices	6.6	5.2	-3.0	3.4	5.0	6.0
Gross Domestic Income	..	..	..	..	..	..
Real annual per capita growth rates (%, calculated from 95 prices)						
Gross domestic product at market prices	4.9	3.5	-6.3	1.5	1.8	1.9
Balance of Payments (US$ millions)						
Exports (GNFS)b	877	1034	981	1042	1150	1329
Merchandise FOB	228	330	313	333	356	399
Imports (GNFS)b	1234	1570	1260	1248	1297	1374
Merchandise FOB	965	1221	1124	1120	1167	1237
Resource balance	-357	-535	-279	-206	-147	-45
Net current transfers	-14	-52	-55	-55	-55	-55
Current account balance	-438	-651	-395	-320	-252	-139
Net private foreign direct investment	15	15	5	15	15	20
Long-term loans (net)	..	0	70	40	-7	-15
Official	27	37	35	44	5	-2
Private	..	-37	35	-4	-12	-13
Other capital (net, incl. errors & ommission	..	568	400	350	300	225
Change in reserves	-77	68	-81	-86	-56	-91
Public finance (as % of GDP at market prices)e						
Current revenues	48.1	44.3	39.0	40.3	40.2	40.3
Current expenditures	48.6	51.3	54.2	48.0	42.5	38.2
Current account surplus (+) or deficit (-)	-0.5	-7.0	-15.2	-7.8	-2.4	2.1
Capital expenditure	12.1	11.4	12.3	10.7	9.2	8.6
Foreign financing	12.3	8.5	2.2	1.5	-1.4	-1.6
Monetary indicators						
M2/GDP	32.6	37.7	78.1	80.0	82.6	82.6
Growth of M2 (%)	18.8	38.1	120.1	10.2	11.3	7.5
Private sector credit growth / total credit growth (%)	93.4	67.2	97.7	93.0	93.0	93.0
Real interest rates						
Consumer price index (% change)	6.8	10.0	7.4	6.4	4.5	4.8
GDP deflator (% change)	6.6	13.6	11.0	4.0	3.8	3.5

a. GDP at factor cost
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Consolidated central government.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.