March 2009
IMF Country Report No. 09/97

Maldives: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Maldives

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with the Maldives, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 30, 2008, with the officials of the Maldives on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 30, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of September 3, 2008, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 3, 2008, discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for the Maldives.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

MALDIVES

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with Maldives

Approved by Daniel Citrin and Adnan Mazarei

July 30, 2008

- **Consultations:** Held in Male during June 18–30, 2008 with President Gayoom, Finance Minister Ibrahim, Governor Jihad, other economic ministers and senior officials, and market participants.
- **Team:** Messrs. Weerasinghe (Head) and Aiyar, and Ms. Oura (all APD).
- **Previous Article IV consultation:** The 2007 Article IV consultation was concluded by the Executive Board on July 30. Directors agreed that the main challenge for Maldives will be to ensure that broadly favorable growth prospects are supported by a prudent fiscal policy and a viable macroeconomic framework. Many Directors disagreed with the staff assessment that the Maldives' exchange rate was fundamentally misaligned, although they concurred with the view that fiscal slippages in 2007 and beyond could eventually undermine competitiveness and the dollar peg.
- **Exchange rate system:** Maldives' exchange rate regime comprises a conventional fixed peg against the U.S. dollar. Maldives continues to avail itself of the transitional arrangements under Article XIV of the Fund's Articles of Agreement, but no longer maintains Article XIV restrictions. Maldives is yet to accept the obligations of Article VIII, Sections 2, 3, and 4, but maintains no restrictions on the making of payments and transfers for current international transactions.
- **Economic statistics:** Maldives' statistical base is adequate to conduct effective surveillance. Technical assistance is being provided to improve coverage in certain areas.
- **Publication:** No staff report has been published thus far, although PINs have been. The authorities have not yet indicated their consent to the publication of this year's documents.

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EXECUTIVE SUMMARY

The Maldives continues to grow robustly, underpinned by a tourism sector that has rebounded strongly from the Asian tsunami. Rapid bed-night growth, together with construction activity, has kept growth high in the face of a fall in the fish catch. Inflation has picked up markedly due to soaring food and oil prices. The exchange rate peg to the dollar is appropriate and will continue to serve the country well provided it is supported by prudent fiscal policies.

The main challenge for the Maldives is to ensure that favorable growth prospects are not undermined by fiscal excesses and consequent macroeconomic instability. In recent years, government expenditure, especially domestically financed current expenditure, has increased to remarkably high levels. Although some increase in expenditure was fully justified in response to the tsunami, most of the additional spending is unrelated to relief or reconstruction measures. The authorities' laudable commitment to zero domestic financing is therefore premised on a series of ad hoc nontax revenue measures, which carry high implementation risks and would be difficult to sustain over the medium term.

Key issues discussed during the consultation were:

- **The 2008 budget.** A substantial planned increase in domestically financed expenditures was initially to be offset by a large receipt from a transshipment port. However, that receipt has been delayed until 2009, and the authorities intend to fill the shortfall by leasing an additional 30 island resorts. Staff urged the government to identify contingent expenditure cuts in case these ad hoc revenue measures fail to materialize fully. The alternative—monetizing the deficit—would stoke already high imported inflation and increase external vulnerabilities.

- **Fiscal reforms.** Going forward, a medium-term fiscal framework (MTFF) should be developed to prioritize spending within a realistic resource envelope. Current expenditures will need to be substantially scaled back in order to accommodate necessary infrastructure investments. Revenue reforms are also needed, including the introduction of corporate taxation, a broad-based sales tax, and replacing the current "per head" tourism tax with an ad valorem tax.

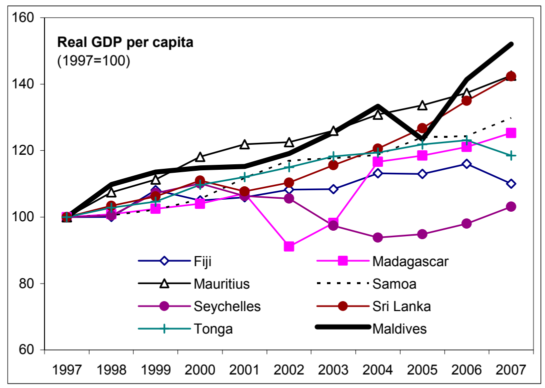
- **Competitiveness and external vulnerabilities**. Notwithstanding the recent increase in inflation, the economy remains competitive, largely due to the depreciation of the dollar against the euro together with the predominance of European tourists to the country. There has been an increase in external debt ratios due to the financing of new resorts, and with planned further expansion, these ratios are expected to climb sharply before peaking in 2010. Most of the rise in debt levels is attributable to private sector borrowing, channeled through the commercial banks. The elevated level of private sector debt should be closely monitored, while bank supervision should remain vigilant.

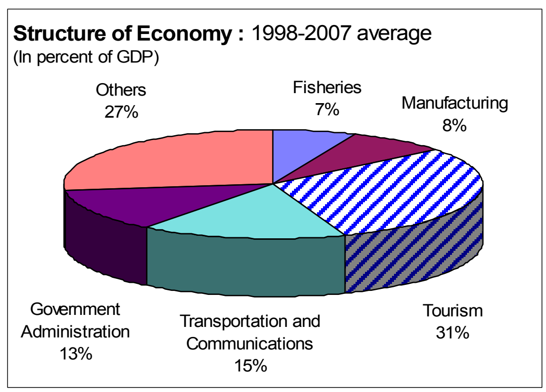
I. Political and Economic Background

1. **President Gayoom's sixth term in office ends on November 11, 2008, with multi-party elections** expected in October**.** After considerable delays, a special Majlis (parliament) passed a new constitution. Parliamentary elections are scheduled for February 2009. Soon after the Article IV mission, the Finance Minister resigned, and is expected to become a presidential candidate. He has been replaced by the Governor of the central bank.

2. **The Maldives has achieved solid growth over the past decade, but continues to face serious challenges due to its dependence on tourism and fishing, its vulnerability to environmental shocks, and its dispersed population.**

- Per capita income has doubled, and real per capita GDP has risen substantially. This has been accompanied by a marked improvement in social indicators. An exchange rate regime comprising a peg to the dollar has anchored macroeconomic stability.





- Tourism and fishing are the mainstays of the economy. Diversification has proved difficult because of the country's geographic isolation and its small and dispersed population, which also render public services and transport links difficult to provide. In addition, the country faces several environmental challenges, including rising sea levels due to global warming, vulnerability to natural calamities (such as the devastating Asian tsunami at end-2004), limited supplies of fresh water, and scarce arable land.[1]

[1] The Maldives consists of some 1,200 low-lying coral islands, 200 of which are inhabited, spread over an area of the Indian ocean of 900,000 square kilometers. The average height is 1.5 meters above sea level. Its population is about 300,000.

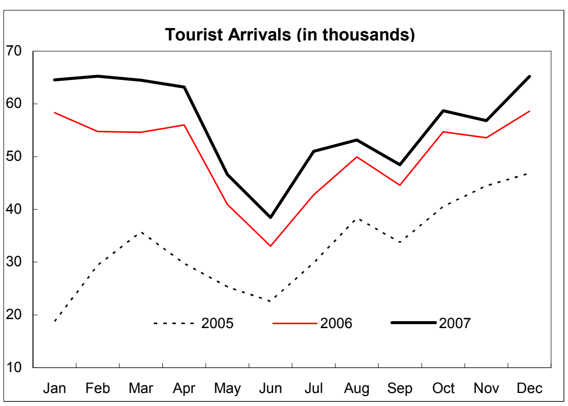
II. Recent Developments

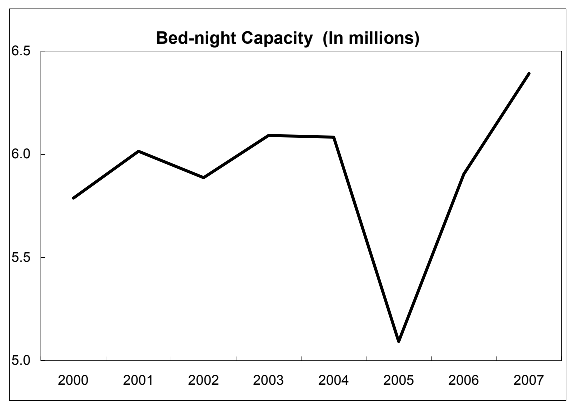
3. **Real GDP growth was a robust 7.6 percent in 2007, down from the 18 percent growth rate of 2006 associated with a rebound from the tsunami.** The tourism and construction sectors continued to lead growth, offsetting an unusually low fish catch.

- **Tourist arrivals increased by 12 percent in 2007, contributing to an increase in tourist revenues of about 14 percent.** Currently there are 91 island resorts in operation, a number that the authorities plan to almost double by 2010. Bed capacity increased by 8.3 percent in 2007, surpassing pre-tsunami levels. Associated infrastructure such as harbors and airports are also being upgraded or constructed, including Gan International Airport which was opened in 2007. These tourism and infrastructure-related activities, in conjunction with tsunami reconstruction work, have led to a boom in construction.

Island Resort Capacity
(Government Plans)

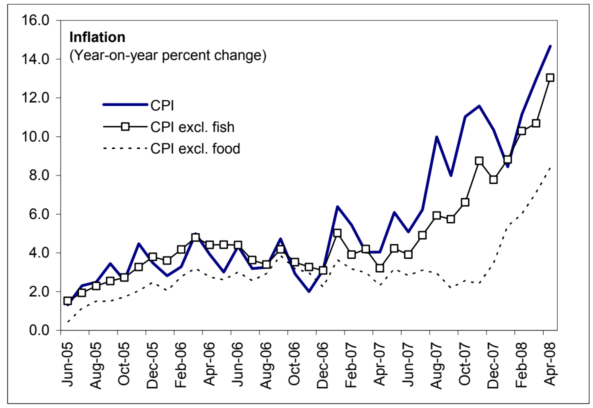
	Number of Island Resorts	Increase in Capacity (In percent)
1995	73	
2007	91	25
2010	175	92





- **The fish catch fell by about 38 percent compared to the previous year.** Fisheries employ about 11 percent of the workforce and account for the bulk of nontourism exports. The causes for the fall in the catch are poorly understood, but could include changing ocean currents and warmer surface temperatures. Net of the fishing sector, GDP grew by 9.6 percent, well above the pre-tsunami average.

4. **Inflation increased markedly to 14.7 percent (year-on-year) in April, driven by rising food prices.** After several years of relatively subdued inflation, the increase in global food prices and the fall in the domestic fish catch contributed to a sharp rise in prices. Fish prices alone surged by 47.5 percent. The rise in international oil prices also played a significant role in this cost-push inflation, although oil comprises a smaller share of the CPI basket than food.



5. **The fiscal balance for 2007 was better than staff projections, but in line with the budget.** The government cut planned expenditures in line with a shortfall in revenues, thus eliminating the need for domestic financing of the budget, in contrast with a staff baseline projection of domestic financing of 9 percent of GDP. In particular, planned domestic capital expenditures were held well under budget, partly due to capacity constraints. As for the overall fiscal deficit (comprising the domestically financed or "regular" budget plus the foreign financed budget, which channels mostly concessional foreign financing into tsunami-related and infrastructure projects), the actual level was about 8 percent of GDP, much lower than the planned deficit of about 28 percent of GDP, due in addition to a shortfall in foreign financing and a corresponding reduction in capital expenditures tied to that financing.

Domestic Budget Outturn Vs. Projections
(In percent of GDP)

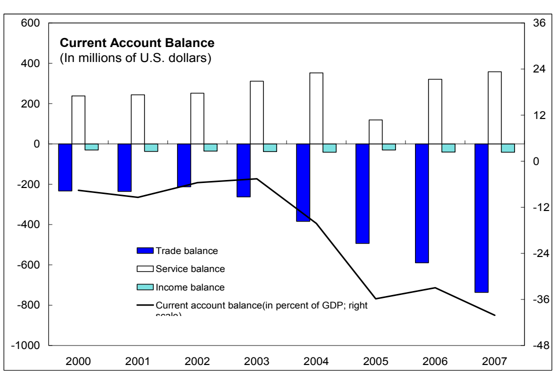
	2006	2007		
		Est.	Budget	Staff Proj. 2007 Art IV
Domestic revenue	45.1	49.2	54.5	45.0
Domestic expenditure	48.4	49.4	54.6	54.6
Domestic financing	2.3	-0.7	0.1	9.0

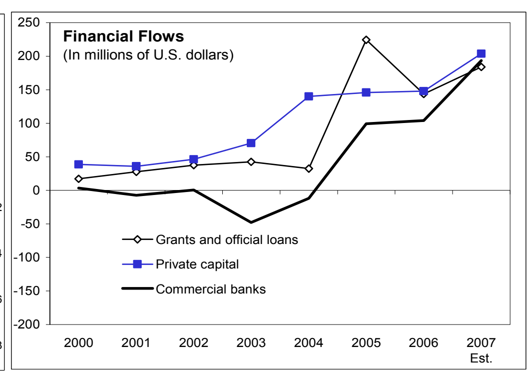
6. **However, government expenditure rose to an extremely high 65.8 percent of GDP.** About three-quarters of this comprised current expenditure, notably payments to the civil service of about 16.5 percent of GDP and social welfare contributions of about 18 percent. Government expenditure in the Maldives was comparable with that of broadly similar island economies before the tsunami in 2004, but has since reached new highs. Moreover, the rise has not been primarily driven by tsunami-related spending (about 95 percent of the increase in domestically financed expenditure since 2004 is unrelated to the tsunami).

Government Expenditure as a Share of GDP					
	Average 2000-03	2004	2005	2006	2007 1/
Barbados	37.3	38.0	41.5	38.9	40.5
Fiji	28.2	28.0	27.8	28.4	24.8
Maldives	**36.9**	**36.0**	**59.0**	**59.3**	**65.8**
Mauritius	23.2	25.6	25.1	25.5	23.6
Samoa	34.1	47.6	47.2	32.8	38.2
Tonga	28.15	26.2	34.9	34.2	32.3
Vanuatu	25.3	20.7	19.7	21.3	23.4

1/ Estimates.

7. **The current account deficit widened to over 40 percent of GDP in 2007 from 33 percent the previous year, driven by a surge in construction-related imports and rising commodity prices.** With tourism booming, exports grew by a robust 10 percent in 2007, despite declining fish exports. However, imports rose by 18 percent, primarily owing to demand for construction materials for resorts and infrastructure projects, but also due to high oil and food prices. These developments caused the current account deficit to widen from 33 percent of GDP in 2006 to over 40 percent in 2007. The deficit was financed mainly through a large increase in private capital inflows, including foreign borrowing by commercial banks. In addition, there was an increase in official financing from bilateral and multilateral sources. External debt increased sharply, from 49.1 percent of GDP in 2006 to 69.6 percent of GDP in 2007. Most of this increment was attributable to private sector activity, with government external debt registering a relatively small increase from 32.4 percent of GDP in 2006 to about 39 percent in 2007.





8. **Corresponding to the above, the banking sector—comprising one local and five international banks—has presided over a recent boom in private sector credit, with a 40 percent increase in 2007**. The robust trend dates from 2004, when the government commenced an ambitious program for leasing new islands. Much of the expansion has been

financed by foreign-owned banks borrowing from their head office and on-lending locally, with risks contained through the country risk exposure limits of the banks, and through collateralizing the property in the case of loans for resort development. On-site bank examinations are being conducted with MCM technical assistance (TA). NPLs as a share of total loans decreased to 1.7 percent in March 2008 from 6.6 percent in December 2005, mainly due to the recovery of the tourism sector and improved banking supervision.

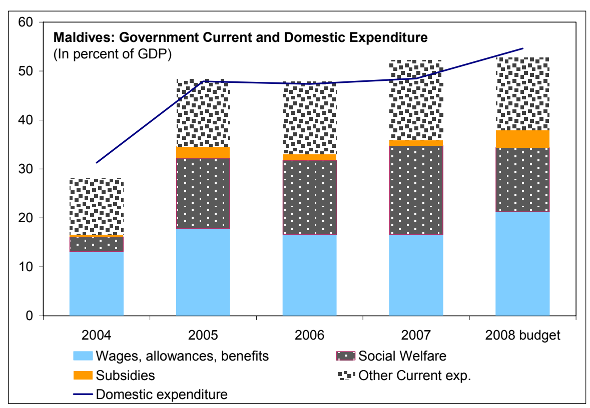
III. Key Policy Discussions

With the real economy booming and an election year in progress, staff's main macro message was the importance of maintaining fiscal responsibility. Discussions focused on the following areas:

- *The 2008 budget.*
- *The medium-term fiscal outlook including revenue and expenditure reforms.*
- *Competitiveness and External Vulnerabilities.*
- *Other Issues.*

A. 2008 Budget

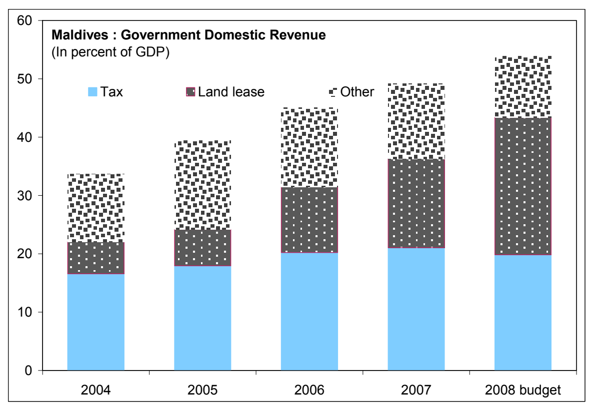
9. **While the 2008 budget calls for zero domestic financing, it entails a large increase in current expenditure in an election year and could have adverse macroeconomic consequences if its ambitious revenue plans—including some ad hoc measures—do not materialize fully**.



- *Domestic expenditure, particularly current expenditure, continues to increase sharply, and spending has risen to an extraordinarily high level by historical and international standards.* Overall, expenditure is set to increase by 27 percent and the domestically financed part of the budget—excluding foreign grants and loans—by over 38 percent compared to the 2007 outturn. About two-thirds of the increase is on current expenditure, including an over 55 percent increase in the civil service wage bill (provided as of January 2008) and quadrupled subsidies, mostly on account of administered electricity prices,[2] which more than offset the first phase down of tsunami-related social welfare expenditures.

- *Staff emphasized the need to resist mid-year pressures to increase expenditure beyond the budgeted amount*. The wage increase in January was implemented in an ad hoc manner, with an uneven distribution among different segments of the civil service, resulting in additional wage demands from some dissatisfied employees. The authorities should contain the wage bill and manage expectations in order to avoid an inflationary wage spiral. Staff also urged an immediate revision of electricity tariffs, in light of the fact that rising oil prices are progressively increasing the subsidy needed to maintain administered electricity prices at their current level.

- *Although the budget is balanced in terms of domestic financing, the mission again stressed the risk of a significant revenue shortfall risk*. The budget initially included a 34 percent increase in domestic revenues, based largely on a lease payment of about 14 percent of GDP (25 percent of domestic revenue) for a new transshipment port project. However, the finalization of the project has recently been delayed by a year. The government intends to fill the shortfall by leasing out 30 additional islands. Staff noted that the substitute measures still contain significant implementation risks.



- *The mission underlined the need for identifying contingency expenditure cuts in the event of a revenue shortfall.* Responding to revenue shortfalls through domestic financing of the deficit would risk exacerbating already high inflation, further expanding the current account deficit, and increasing external vulnerabilities.

10. **The authorities reiterated their commitment to achieving domestic budgetary balance for 2008.** They noted that they were well aware of the dangers that monetizing the deficit would cause in the current environment, and were resolved to avoid such an outcome.

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[2] In the Maldives, fuel price increases have been largely passed through. In particular, changes in the price of diesel—which accounts for the bulk of fuel consumption—are in line with international prices. Electricity, however, is produced by a state-owned electricity company, with administered prices unchanged since 2002. The majority of government subsidies go to this company, whose losses have increased in proportion with the cost of diesel. The budget also includes subsidies to maintain administered staple food prices (rice, flour, and sugar) and subsidies to fisheries for higher fuel costs.

At the same time, they pointed to spending pressures arising from the presidential election expected to take place in November, as well as from high international oil and food prices. On the other hand, there is usually some underspending of budgeted amounts—especially on capital projects—due to capacity constraints. While the authorities' primary focus remains on ensuring that the budgeted revenues materialize, they agreed to identify contingency expenditure cuts. In addition, they agreed that the current electricity tariff is not sustainable and requires early adjustment, but could not say when such a step might take place.

B. Medium-Term Fiscal Framework

11. **Staff argued that expenditure reforms are critical for achieving medium-term fiscal stability and creating room for needed capital expenditures.**

Maldives: Medium-Term Fiscal Framework
(In percent of GDP)

	Act.	Est.	Budget	Proj.		
	2006	2007	2008	2009	2011	2013
Total revenue	52.5	58.0	58.8	51.8	50.1	46.6
Domestic revenue	45.1	49.2	53.9	48.3	47.7	44.6
Of which:						
Tax revenue	20.2	21.1	19.8	19.5	22.6	21.6
Land lease	11.3	15.2	23.6	18.0	14.4	12.2
Grants	7.4	8.7	4.9	3.5	2.3	2.0
Total expenditure and net lending	59.3	65.8	68.3	55.2	47.1	44.3
Of which: Domestic Expenditure	47.4	48.5	54.6	48.3	46.3	43.5
Current expenditure	47.8	52.3	52.8	44.3	35.0	32.0
Of which:						
Wages, allowances, benefit	16.7	16.6	21.3	19.0	15.8	14.9
Social welfare contributions	15.1	18.2	13.1	8.9	4.5	4.5
Subsidies	1.3	1.1	3.6	2.7	0.9	0.4
Capital expenditure	12.4	14.4	16.6	12.0	13.0	13.0
Overall balance	-6.8	-7.8	-9.4	-3.4	3.0	2.3
Current balance	-3.2	-3.3	0.9	3.8	12.6	12.5
Domestic financing	2.3	-0.7	0.7	0.0	-1.5	-1.1
Foreign financing	4.5	8.6	8.7	3.4	-1.5	-1.3

1/ Including all the tsunami-related expenditures.

- *The medium-term revenue envelope is not expected to be as large as in the 2008 budget, although it will remain above the pre-tsunami level*. Staff's medium-term projections incorporate the successful introduction of a business profit and an ad valorem tourist tax, but domestic revenues are forecast to drop by nearly 9 percentage points of GDP by 2013. This is because the contribution of lease payments falls over time, [3] windfall payments from the transshipment project—if they materialize—fall only in 2009 and 2010, and import duty collection weakens in line with declining import needs for resort and infrastructure construction materials. Leasing out additional islands at a pace far exceeding the ambitious but sustainable pace envisaged in Maldives' tourism development master plan is likely to face heightened implementation risks by overburdening infrastructure and the financial sector.

- *Consequently, staff recommended that domestic expenditure be curtailed substantially over the medium term.* This is especially relevant because the large projected increase in private investment in new resorts could face capacity constraints

[3] Lease payments for a new island typically have the following schedule. A successful bidder makes an up-front payment of 15 percent of the cumulative lease amount for the first 10 years (equivalent to 18 months of rent). After an 18 month-grace period, annual lease payments as per the predetermined schedule start, providing medium-term revenues to the government.

and be crowded out if government expenditure is not successfully contained. Staff's framework incorporates about a 13 percent of GDP adjustment in current expenditures by 2013, excluding an 8 percent of GDP decline related to the completion of tsunami reconstruction. This could be achieved by (i) civil service reforms, including a nominal wage freeze and moderate downsizing based on natural attrition; (ii) the rationalization of social expenditures through progress on population consolidation in the islands; and (iii) cutting back on subsidies by adjusting domestic administered prices including electricity tariff. These measures will help create space for infrastructure investment to support the expanding tourism sector and enable small domestic surpluses that underpin declining public debt ratios.

12. **The authorities emphasized the need to respond to rising demand for basic social services, but also pointed to recent governance reforms that should help in rationalizing expenditures**. While providing social services is very costly given the Maldives' unique geography, rising income levels have raised peoples' expectations of government services. Moreover, the planned expansion of the tourism sector will require corresponding improvement of infrastructure, particularly transport links. The authorities noted that progress in population consolidation—by reducing the need to service thinly populated remote islands—would improve efficiency in the civil service. Thus, the nearing completion of a major consolidation project would yield considerable benefits and serve as a model for future progress. The government also pointed out that newly established independent agencies would enhance rules-based governance over the medium term, and would thus help contain expenditures. In this context, staff welcomed the recent formation of the civil service commission and its initial efforts at reform, including the downsizing of the civil service by 1,800 staff (about 5½ percent of total civil servants) by implementing mandatory retirement.

13. **Staff also observed that revenue reforms should be expedited**. Previous Article IV consultations have pointed out that the Maldives' tax structure is outdated, making it inflexible at adjusting to exogenous shocks. There is no personal or corporate income tax (except for a profit tax on the banking sector), sales tax, or VAT, and the main sources of revenues are import duties, resort and land lease payments, dividend transfers from state-owned enterprises (SOEs), and a tourist tax. The limited tax base is one reason the government has been recently resorting to lease income to finance rapidly expanding expenditures. The mission reiterated the benefits of the following key reforms, in line with FAD TA recommendations.

- *Business profit tax (BPT)*. The mission urged the authorities to introduce the BPT as soon as possible.[4] Over the medium term, to broaden the tax base and increase the revenue potential and fairness of direct taxation, a separate personal income tax

[4] After a number of years of preparatory work in consultation with FAD experts, a business profit tax was supposed to be introduced in 2008, bringing in revenues of about 2–3 percent of GDP.

should be introduced and the BPT should evolved into a more general corporate income tax.

- *Ad valorem tourism tax*. The specific tourism tax, which is levied on a uniform basis on every tourist, is inefficient and the existing fixed rate of $8 per bed per night is too low, especially for high-end tourists. The mission recommends that the tax should be increased, in particular by replacing the specific tax with an ad valorem tax.

- *VAT*. The mission encouraged the authorities to announce a clear timetable for their plan to substitute a VAT for a large portion of import duties. Introduction of the VAT could quickly follow the successful implementation of the BPT.

14. **The authorities reaffirmed their intention to broaden the tax base, but noted that a careful and equitable approach was needed**. They were optimistic about the prospect of adopting the BPT in 2009, after parliamentarian elections. However, they had some reservations about increasing the tax burden on the tourism sector by adopting an ad valorem tourism tax. Rather, they considered that a broad-based consumption tax, such as a goods and services tax (GST), would be more equitable across sectors. At present, however, there is no timetable for the introduction of a GST.

15. **Staff projects that the public debt ratio will decline substantially over the medium term, in line with the authorities' commitment to maintaining zero domestic financing.** Balanced domestic budgets (or small domestic surpluses), declining official disbursements for tsunami-related projects, and increasing repayment of foreign public debt—as per the existing amortization schedule—underscore a sharp turnaround of the primary balance into positive territory over the medium term. As a result, both domestic and foreign public debt ratios decline appreciably, falling well below the pre-tsunami level by the end of the projection period. The key to reducing public debt is achieving the government's ambitious domestic budget balance target. If the primary balance remains at its 10-year average level,[5] the debt ratio would continue to rise (Appendix I). However, the 10-year average includes a particularly expansionary phase following the tsunami. Based on the pre-tsunami average, the debt ratio remains constant.

16. **More generally, the authorities agreed with staff on the need for realistic budgets grounded in a Medium-Term Fiscal Framework (MTFF) so that they can serve as a useful policy tool.** In recent years it has become customary for the announced budget to incorporate unrealistic projections of domestic revenue, and correspondingly unsustainable expenditure plans. While the authorities have performed well in 2006 and 2007 in keeping

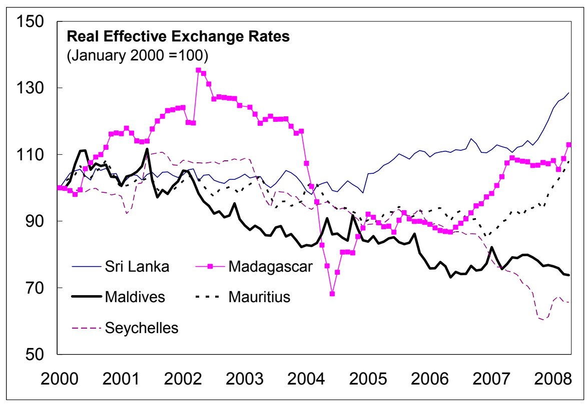
[5] The 10-year average includes a particularly expansionary phase following the tsunami. Based on the pre-tsunami average, the debt ratio remains constant.

expenditures in line with available financing, it would be better to frame a realistic budget to begin with, thereby underpinning the credibility of the macro framework.

C. Competitiveness and External Vulnerabilities

17. **The authorities agreed with staff that high inflation in 2008 was a concern because of its potential impact on competitiveness.** The forecast year-on-year inflation rate of 15 percent is driven mainly by food and oil price increases, and is likely to increase costs in the tourist industry correspondingly**.**

18. **Nonetheless, the Maldives appears to have enough of a cushion to maintain competitiveness, provided that fiscal discipline is maintained.** Most of Maldives' exports are to euro-denominated areas—with 80 percent of tourist arrivals coming from the EU—while the bulk of imports are dollar-denominated. Thus, the depreciation of the dollar against the euro in recent years has helped the country's competitive position. Since the beginning of 2000, the REER has depreciated by 27 percent, including 1.9 percent depreciation since end-2006. The REER has declined more than that of comparator tourism-based small economies. Hence the country is in a good position to weather some appreciation of the real exchange rate, provided that imported inflation is not exacerbated by fiscal slippages requiring domestic financing. Based on these considerations—although data limitations preclude the application of comprehensive CGER methodologies—staff view the exchange rate as broadly in equilibrium.[6]



19. **The authorities agreed that competitiveness was currently adequate.** Small island economies of the type that directly compete with the Maldives for tourism revenues are equally likely to be hit hard by imported inflation, so that in relative terms, Maldives' competitiveness may not erode as much as implied by the calculated REER. In addition, most tourism to the Maldives is at the high end of the market, which may be relatively price inelastic. The Maldives also performs well on survey-based measures of competitiveness. The country was ranked first in the World Bank's "Doing Business in South Asia" (2007) and in the top third of countries globally.

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[6] Rough calculations using the External Sustainability approach indicate that, once temporary factors influencing the current account have been accounted for, the REER is within 5 percentage points of its NFA-stabilizing value, and hence the misalignment should be regarded as about zero.

20. **External debt is projected to rise sharply in the next few years before starting to decline.** The current account should move toward balance in the medium term, with the present extraordinary rate of growth of imports slowing considerably due to (i) the stabilization of commodity prices in 2009; (ii) a cessation of tsunami-related reconstruction from 2010; and (iii) a gradual winding down of resort construction activity from 2011 onwards. Staff projects that the external debt-to-GDP ratio will climb to almost 95 percent in 2010, before declining gradually to about 83 percent by 2013. This debt accumulation does not reflect more government borrowing; public external debt is set to fall considerably in the medium term as tsunami-related disbursements wind down and amortization on concessional loans comes due. Rather, the debt accumulation would be caused by private inflows into resorts and infrastructure projects, which is assumed to be concentrated in the 2008–10 period. As shown in the debt sustainability analysis (Appendix I), the projected debt path is sensitive to current account and/or exchange rate shocks.

21. **The mission urged the authorities to closely monitor the elevated level of external debt.** To some extent, risks are mitigated through the country risk exposure limits of the banks, and through collateralizing the resort properties. Nonetheless, bank inflows could be sensitive to global economic and financial conditions, and hence bank supervision should continue to be vigilant, and the monitoring of private sector debt should be improved. Moreover, in staff's projections, the rise in private external debt is balanced to some extent by a fall in the external public sector debt-to-GDP ratio. These declines are, however, contingent on sustainable fiscal policies that result in small domestic surpluses over the medium term, underpinning the importance of fiscal reforms.

22. **Staff reaffirmed the view that the dollar peg is an appropriate exchange rate regime**. The current arrangement has served Maldives well by reducing transaction costs and foreign exchange risks and providing an effective nominal anchor. The regime is also consistent with the limited institutional capacity to manage a foreign exchange market. The authorities concurred with staff that that it will remain important to support the peg with prudent fiscal polices, especially in view of the vulnerabilities present in the 2008 budget.

D. Other Issues

23. **Staff welcomed the appointment of a new central bank governor, following the passage of amendments to the Maldives Monetary Authority (MMA) Act enshrining the separation of the positions of finance minister and governor.** In another important move, an inter-agency agreement between the Ministry of Finance and the MMA empowered the MMA to set interest rates, and put a ceiling on the amount that the government can borrow through its Ways and Means Account. These developments, together with the introduction of treasury bill sales in 2006, should help move the MMA away from its traditional role of passively financing any outstanding fiscal deficit. The authorities noted, and staff concurred, that going forward it will be important to entrench the MMA's independence, through

upholding the principle of not financing budget deficits, and through moving ahead with the second phase of amendments to the MMA Act.

24. **Staff also welcomed the implementation of some key legal reforms.** Following the passage of the Civil Service Bill and the Audit Act, an independent Civil Service Commission and Auditor General have been appointed and begun work. The Civil Service Commission should play a vital role in rationalizing the structure of the civil service, and eliminating the current ad hoc nature of compensation increases, while the Auditor General will perform an important monitoring role. The authorities noted that other crucial legislative reforms—including the Banking Act and AML/CFT legislation—are being expedited, and are scheduled for passage by the current parliament. Moreover, the Maldives has recently indicated its strong commitment to implement the global AML/CFT standard established by the Financial Action Task Force by joining the Asia/Pacific Group on Money Laundering

25. **Staff urged the authorities to consider accepting the obligations of Article VIII, Sections 2, 3, and 4.** The Maldives does not maintain any restrictions on the making of payments and transfers for current international transactions. The authorities responded that MMA staff has prepared a note on the issue, which will be presented to its board expeditiously.

IV. Staff Appraisal

26. **The economy continues to rebound from the impact of the Asian tsunami, registering strong growth led by tourism.** Bed-night growth continues to be robust, with a corresponding boom in construction. Post-tsunami reconstruction activities continue along with numerous infrastructure and developmental projects. On the other hand, there have been recent sharp declines in the fish catch, which acted as a drag on growth in 2007.

27. **Inflation has risen steeply to 14.7 percent (year-on-year) in April.** The main driver of this acceleration is food prices, which increased by 26 percent over the year to April, with oil prices also playing a significant role. In the face of these exogenous shocks, it is imperative to maintain a prudent macro-economic stance, so as to limit the second-round effects on core inflation.

28. **The fiscal stance continues to pose risks to macroeconomic stability.** The fiscal outturn for 2007 was better than expected, with expenditures being kept in line with a revenue shortfall, thereby avoiding the need for domestic financing. However, expenditure as a share of GDP reached unsustainably high levels. The 2008 budget continues to show excessive expenditures. Of particular concern is the rapid increase in recurrent, domestically financed expenditures, with most of the spending unrelated to the tsunami. Furthermore, it is likely that some ad hoc nontax revenue measures may not materialize, which would endanger the government’s commitment to avoid domestic financing. Thus it is important to identify contingent expenditure cuts and make adjustments to the electricity tariff.

29. **Over the medium term, both revenue and expenditure measures will be needed to maintain fiscal stability, reduce public debt, and create space for necessary infrastructure spending.** On the revenue side, the business profit tax should be expedited, while an ad valorem tourism tax and a broad-based consumption tax (GST) would further help in broadening the tax base and limiting reliance on import duties and resort leases. On the expenditure side, current expenditure should be reduced through a combination of measures including civil service reform, a nominal wage freeze, progress on population consolidation, and cutting back on subsidies. Achieving the government's zero domestic balance target is crucial to reducing debt over the medium term. More generally, greater realism is needed in budgetary formulation, with budgets grounded firmly in the context of a MTFF.

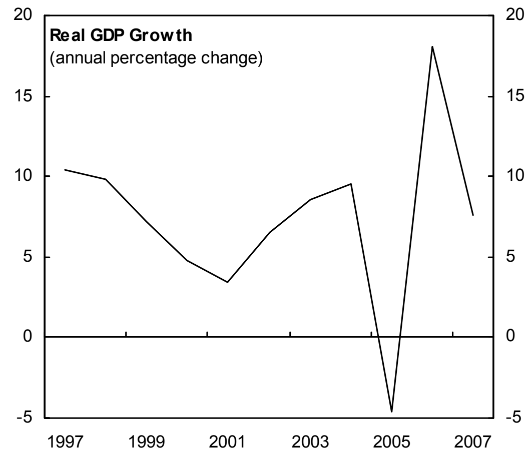
30. **External vulnerabilities have increased, although international reserves have so far been supported by grants and loans from both bilateral and multilateral sources, and by increased borrowing by commercial banks.** Exports in 2007 grew rapidly, supported by robust growth in tourism revenues, but imports grew at an even more rapid pace due to construction activities and rising food and oil prices, leading to a widening of the current account deficit. External debt, particularly private debt, has risen in line with booming private sector activity, particularly construction. The external debt-to-GDP ratio is projected to reach almost 95 percent in 2010 before falling with the completion of several resorts and infrastructure projects. Much of this debt has been and will continue to be channeled through the commercial banks. Thus bank supervision must remain vigilant, while the monitoring of private debt should be improved.

31. **The dollar peg remains an appropriate exchange rate regime, and the Maldives has retained its international competitiveness.** The peg continues to serve the Maldives well by reducing transactions costs and foreign exchange risks and providing an effective nominal anchor. Since the bulk of tourists to the Maldives are from Europe, the depreciation of the dollar against the euro in recent years has provided the economy with a cushion against an erosion in competitiveness due to the rise in inflation.

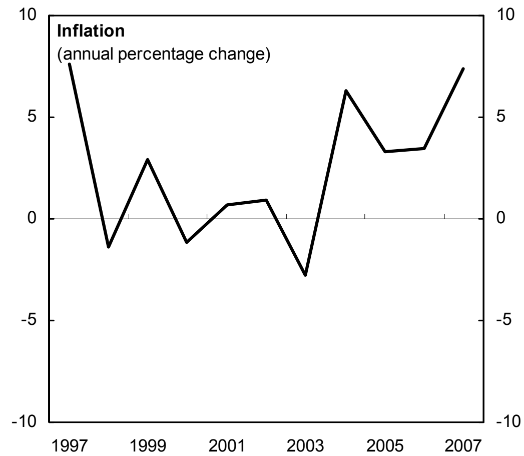
32. It is recommended that the next consultation with Maldives take place within the standard 12-month cycle.

Figure 1. Maldives: Real and External Sector Developments, 1997–2007

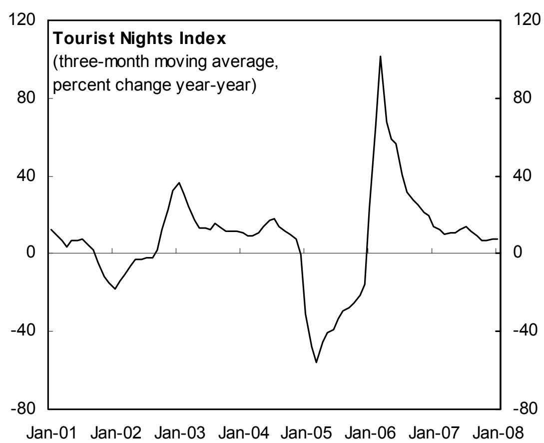
Output recovered from the tsunami-related contactions...



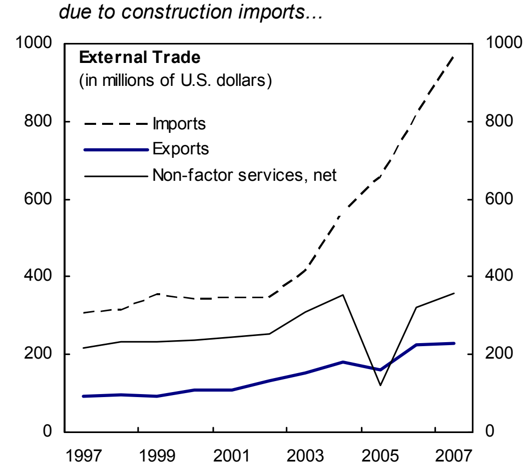
...but inflation has increased sharply...



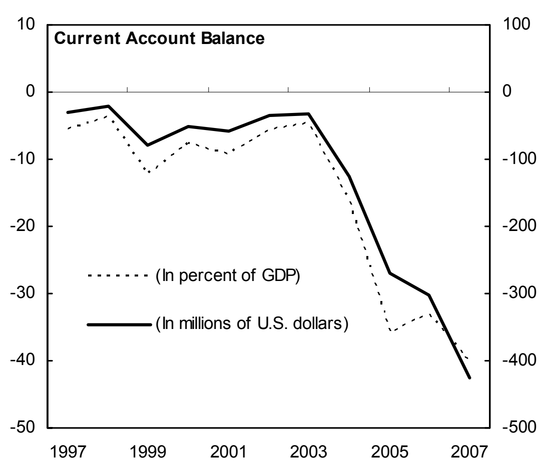
Tourism arrivals have bounced back...



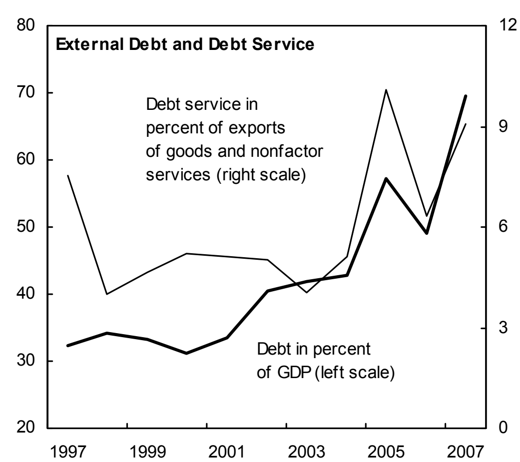
...although the trade balance has worsened due to construction imports...



...and the current account deficit has deteriorated...



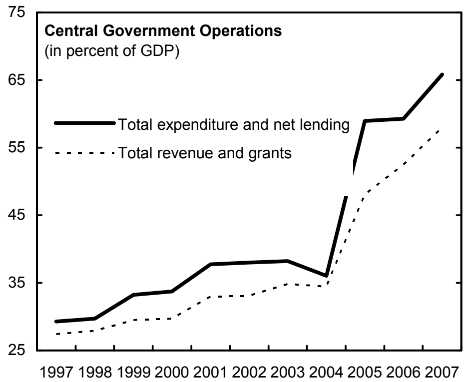
External debt and debt service has risen.



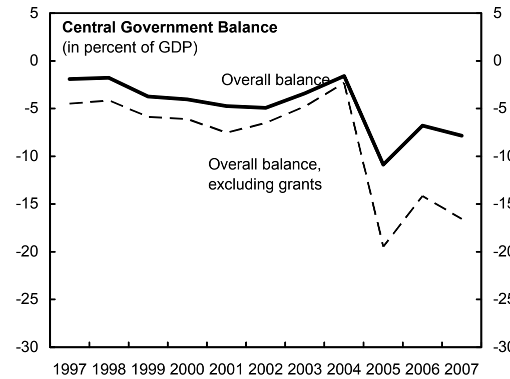
Sources: Maldivian authorities; and IMF staff estimates.

Figure 2. Maldives: Fiscal and Monetary Sector Developments, 1997–2007

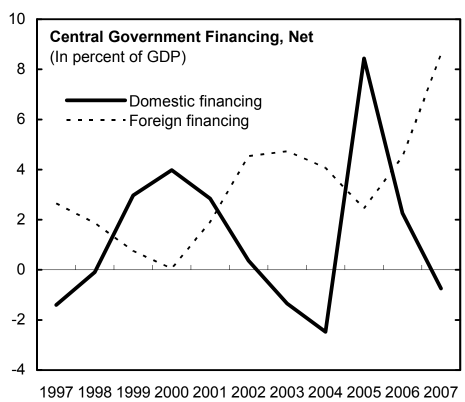
With expenditures growing faster than revenues...



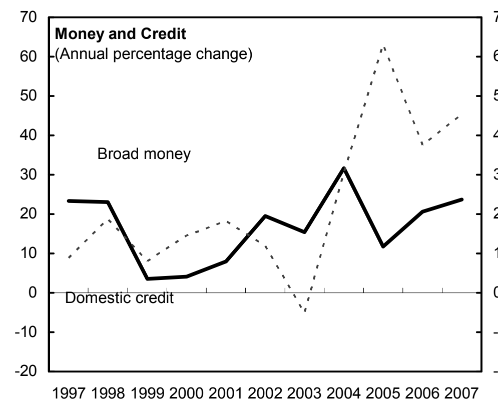
…overall deficit is large..



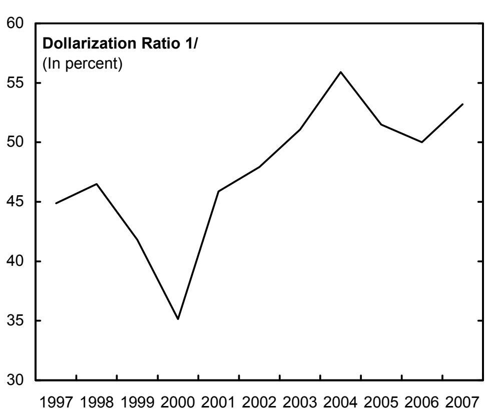
…and financing of the deficit rose.



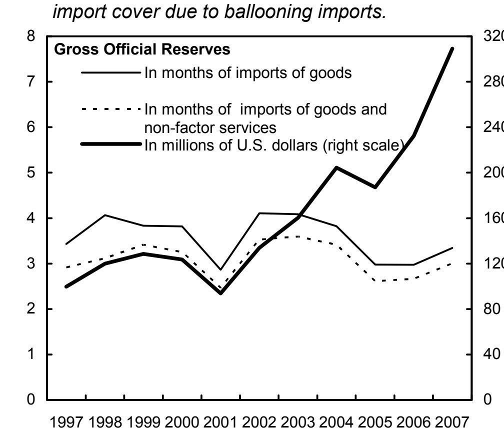
Broad money remained constant as falling net foreign assets offset rising net domestic assets.



Dollarization has fallen slightly since 2004.



The increase in reserves, deriving from foreign grants and loans, has failed to lead to better import cover due to ballooning imports.



Sources: Maldivian authorities; and IMF staff estimates.

1/ Foreign currency deposits as a percentage of broad money.

Table 1. Maldives: Selected Economic Indicators, 2003–08

	2003	2004	2005	2006	Est 2007	Proj. 2008
	(Annual percentage change)					
Growth and prices						
Real GDP	8.5	9.5	-4.6	18.0	7.6	6.5
Inflation (period average)	-2.8	6.3	3.3	3.5	7.4	15.0
Central government						
Revenue and grants	34.8	34.5	48.1	52.5	58.0	58.8
Of which: Grants	1.4	0.7	8.6	7.4	8.7	4.9
Expenditure and net lending	38.2	36.0	59.0	59.3	65.8	68.3
Of which: Domestic spending	34.0	33.2	49.1	48.4	49.4	55.8
Overall balance	-3.4	-1.6	-10.9	-6.8	-7.8	-9.4
Overall balance, excluding grants	-4.8	-2.3	-19.5	-14.2	-16.6	-14.3
Financing						
Domestic	-1.3	-2.5	8.4	2.3	-0.7	0.7
Foreign	4.7	4.1	2.4	4.5	8.6	8.7
	(In millions of U.S. dollars)					
Balance of payments						
Exports, including re-exports	152.0	181.0	161.6	225.2	228.0	344.2
Imports	-414.3	-564.8	-655.5	-815.3	-964.7	-1,213.5
Nonfactor services (net)	311.1	352.4	118.8	320.7	357.6	385.4
Current account balance	-31.8	-125.8	-268.8	-302.0	-424.5	-613.0
(In percent of GDP)	-4.6	-16.2	-35.9	-33.0	-40.1	-47.3
Official capital (net)	29.9	25.0	18.6	42.1	39.2	128.3
Private capital (net)	70.3	140.1	145.8	147.8	212.7	295.0
Errors and omissions (net)	5.3	13.3	-10.9	52.9	56.2	0.0
Overall balance	26.5	44.2	-17.3	45.1	76.9	16.3
Gross official reserves (year-end)	160.3	204.4	187.1	232.2	309.1	325.5
(In months of following year's imports of GNFS) 1/	2.7	2.9	2.1	2.3	2.5	2.6
External Debt	289.5	331.8	429.5	449.2	736.3	1,070.6
(In percent of GDP)	41.8	42.7	57.3	49.1	69.6	82.6
Debt service	22.0	32.3	43.1	43.3	66.9	96.9
(In percent of domestic exports of GNFS) 2/	4.0	5.1	10.1	6.3	9.1	11.9
Exchange rate						
Rufiyaa per U.S. dollar (period average)	12.8	12.8	12.8	12.8	12.8	12.8
Memorandum item:						
Nominal GDP (in millions of rufiyaa)	8,863.2	9,938.7	9,596.6	11,722.0	13,543.0	16,586.8

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.

1/ GNFS = Goods and nonfactor services.
2/ Domestic exports are defined as merchandise exports net of re-exports.

Table 2. Maldives: Balance of Payments, 2003–08

	2003	2004	2005	2006	2007	2008
	(In millions of U.S. dollars)					
Current account balance	-31.8	-125.8	-268.8	-302.0	-424.5	-613.0
Trade balance	-262.3	-383.8	-493.8	-590.1	-736.7	-869.3
Exports, f.o.b. (including re-exports)	152.0	181.0	161.6	225.2	228.0	344.2
Imports, f.o.b.	-414.3	-564.8	-655.5	-815.3	-964.7	-1213.5
Services (net)	272.7	311.6	88.8	280.0	316.2	343.6
Balance on nonfactor services	311.1	352.4	118.8	320.7	357.6	385.4
Receipts	432.1	505.2	322.9	551.9	627.7	681.1
Of which: Tourism receipts	401.6	470.9	284.2	512.4	586.3	636.2
Payments	-121.0	-152.9	-204.1	-231.2	-270.1	-295.8
Balance on factor services	-38.4	-40.8	-30.0	-40.7	-41.4	-41.8
Receipts	6.2	10.3	11.8	15.6	21.7	23.2
Payments	-44.6	-51.1	-41.8	-56.3	-63.1	-65.0
Unrequited transfers (net)	-42.3	-53.6	136.2	8.1	-4.0	-87.3
Official	12.7	7.6	205.7	91.3	98.7	17.5
Private	-54.9	-61.1	-69.5	-83.2	-102.7	-104.8
Nonmonetary capital (net)	52.4	153.1	263.9	294.2	445.2	629.3
Official medium- and long-term	29.9	25.0	18.6	42.1	39.2	128.3
Disbursements	46.6	46.5	42.5	62.8	63.2	167.7
Amortization	-16.7	-21.6	-23.9	-20.7	-24.0	-39.4
Private capital	70.3	140.1	145.8	147.8	212.7	295.0
Commercial banks	-47.8	-11.9	99.4	104.3	193.3	206.0
Net errors and omissions	5.3	13.3	-10.9	52.9	56.2	0.0
Overall balance	26.5	44.2	-17.3	45.1	76.9	16.3
Monetary movements	-26.5	-44.2	17.3	-45.1	-76.9	-16.3
Memorandum items:						
Domestic export growth (value, in percent) 1/	24.5	8.7	-15.4	30.5	-20.2	20.2
Import growth (value, in percent)	20.2	36.3	16.1	24.4	18.3	25.8
Tourism receipts growth (in percent)	19.1	17.3	-39.6	80.3	14.4	8.5
Current account balance (in percent of GDP)	-4.6	-16.2	-35.9	-33.0	-40.1	-47.3
Gross official reserves (in millions of U.S. dollars)	160.3	204.4	187.1	232.2	309.1	325.5
(In months of following year's imports of GNFS) 2/	2.7	2.9	2.1	2.3	2.5	2.6
External debt (in millions of U.S. dollars)	289.5	331.8	429.5	449.2	736.3	1070.6
External debt (in percent of GDP)	41.8	42.7	57.3	49.1	69.6	82.6
Debt service (in millions of U.S. dollars)	22.0	32.3	43.1	43.3	66.9	96.9
Debt service (in percent of domestic exports of GNFS) 1/	4.0	5.1	10.1	6.3	9.1	11.9
Exchange rate (rufiyaa per U.S. dollar, average)	12.8	12.8	12.8	12.8	12.8	12.8
GDP (in millions of U.S. dollars)	692.4	776.5	749.7	915.8	1058.0	1295.8

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.

1/ Domestic exports are defined as merchandise exports net of re-exports.
2/ GNFS = Goods and nonfactor services.

Table 3. Maldives: Central Government Finance, 2003–08

					Est.	Budget
	2003	2004	2005	2006	2007	2008
			(In millions of rufiyaa)			
Total revenue and grants	3,087.9	3,424.7	4,612.8	6,154.1	7,852.6	9,757.0
Total revenue	2,964.3	3,351.8	3,788.3	5,286.7	6,669.4	8,944.5
Current revenue	2,936.8	3,331.1	3,753.3	5,237.2	6,637.1	8,911.5
Tax revenue	1,268.7	1,647.2	1,722.8	2,370.3	2,855.5	3,291.5
Import duties	817.1	1,135.9	1,245.7	1,683.9	2,033.5	2,409.3
Tourism	359.8	409.5	345.0	495.7	547.3	589.7
Other	91.8	101.8	132.1	190.7	274.7	292.5
Nontax revenue	1,668.1	1,683.9	2,030.5	2,866.9	3,781.6	5,620.0
SOE profit transfers	570.6	554.7	608.6	727.4	787.1	786.0
Lease payments	575.7	547.3	599.6	1,324.6	2,057.2	3,906.2
Other	521.8	581.9	822.3	814.9	937.3	927.8
Capital revenue	27.5	20.7	35.0	49.5	32.4	33.0
Grants	123.6	72.9	824.5	867.4	1,183.2	812.5
Expenditure and net lending	3,388.2	3,582.6	5,657.6	6,948.1	8,914.3	11,321.6
Of which: Domestic expenditure	3,009.1	3,302.5	4,715.9	5,669.6	6,690.3	9,254.3
Current expenditure	2,345.7	2,788.1	4,643.3	5,607.8	7,083.7	8,755.7
Of which: Tsunami related 1/	...	...	n.a.	1,257.0	1,842.0	1,331.7
Capital expenditure	1,206.2	991.0	1,132.1	1,458.4	1,952.6	2,760.7
Net lending	-163.7	-196.5	-117.8	-118.1	-122.0	-194.8
Overall balance	-300.3	-157.9	-1,044.8	-794.0	-1,061.7	-1,564.6
Overall balance, excluding grants	-423.9	-230.8	-1,869.3	-1,661.4	-2,244.9	-2,377.1
Current balance	591.1	543.0	-890.0	-370.6	-446.6	155.8
Domestic financing	-118.9	-245.8	809.8	264.8	-101.1	115.0
Foreign financing	419.2	403.7	235.0	529.2	1,162.8	1,449.6
Government debt (end of period)	4,087.6	4,282.8	5,052.1	5,965.5	7,578.6	9,189.8
Of which: Foreign	2,622.9	3,026.6	3,261.6	3,800.1	5,014.3	6,464.2
			(In percent of GDP)			
Total revenue and grants	34.8	34.5	48.1	52.5	58.0	58.8
Current revenue	33.1	33.5	39.1	44.7	49.0	53.7
Tax revenue	14.3	16.6	18.0	20.2	21.1	19.8
Import duties	9.2	11.4	13.0	14.4	15.0	14.5
Tourism	4.1	4.1	3.6	4.2	4.0	3.6
Other	1.0	1.0	1.4	1.6	2.0	1.8
Nontax revenue	18.8	16.9	21.2	24.5	27.9	33.9
SOE profit transfers	6.4	5.6	6.3	6.2	5.8	4.7
Lease payments	6.5	5.5	6.2	11.3	15.2	23.6
Other	5.9	5.9	8.6	7.0	6.9	5.6
Capital revenue	0.3	0.2	0.4	0.4	0.2	0.2
Grants	1.4	0.7	8.6	7.4	8.7	4.9
				45.1	49.2	53.9
Expenditure and net lending	38.2	36.0	59.0	59.3	65.8	68.3
Of which: Domestic expenditure	34.0	33.2	49.1	48.4	49.4	55.8
Current expenditure	26.5	28.1	48.4	47.8	52.3	52.8
Of which: Tsunami related	...	...	...	10.7	13.6	8.0
Capital expenditure	13.6	10.0	11.8	12.4	14.4	16.6
Net lending	-1.8	-2.0	-1.2	-1.0	-0.9	-1.2
Overall balance	-3.4	-1.6	-10.9	-6.8	-7.8	-9.4
Overall balance, excluding grants	-4.8	-2.3	-19.5	-14.2	-16.6	-14.3
Current balance	6.7	5.5	-9.3	-3.2	-3.3	0.9
Domestic financing	-1.3	-2.5	8.4	2.3	-0.7	0.7
Foreign financing	4.7	4.1	2.4	4.5	8.6	8.7
Government debt (end of period)	46.1	43.1	52.6	50.9	56.0	55.4
Of which: Foreign	29.6	30.5	34.0	32.4	37.0	39.0
Of which: Domestic	16.5	12.6	18.7	18.5	18.9	16.4
Memorandum items:						
Exchange rate (rufiyaa per U.S. dollar, average)	12.8	12.8	12.8	12.8	12.8	12.8
Nominal GDP (in millions of rufiyaa)	8,863.2	9,938.7	9,596.6	11,722.0	13,543.0	16,586.8

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.

1/ Including all the reconstruction related spending. Including both domestically and foreign financed expenditures.

Table 4. Maldives: Summary of Monetary Accounts and MMA Balance Sheet, 2003–08

	Dec.					Proj.
	2003	2004	2005	2006	2007	2008
	(In millions of rufiyaa)					
Monetary survey						
Broad money	4,543.7	5,983.7	6,685.0	8,063.3	9,972.0	12,213.3
Net foreign assets	2,613.4	3,357.1	1,787.7	1,031.6	-458.3	-2,886.1
Monetary authorities (net)	2,050.3	2,605.1	2,303.5	2,881.4	3,866.0	4,075.0
Foreign assets	2,060.5	2,616.1	2,394.9	2,972.8	3,956.9	4,165.9
Foreign liabilities	-10.2	-11.0	-91.4	-91.4	-90.9	-90.9
Commercial banks (net)	563.1	752.0	-515.8	-1,849.8	-4,324.3	-6,961.1
Net domestic assets	1,930.4	2,626.6	4,897.2	7,031.7	10,430.4	15,099.4
Domestic credit	3,246.6	4,239.6	6,911.4	9,509.1	13,820.2	18,489.3
Public sector	1,002.2	698.3	1,430.9	1,317.5	1,600.5	1,837.5
Central government (net)	911.8	456.3	953.0	745.0	583.7	698.7
Other	2,334.8	3,783.3	5,958.4	8,764.2	13,236.6	17,790.6
Public enterprises	90.4	242.0	477.9	572.5	1,016.8	1,138.8
Private sector	2,244.4	3,541.3	5,480.5	8,191.7	12,219.8	16,651.8
Other items (net)	-1,316.3	-1,613.0	-2,014.1	-2,477.4	-3,389.9	-3,389.9
	(Annual percentage change)					
Broad money	15.4	31.7	11.7	20.6	23.7	22.5
Net foreign assets	55.9	28.5	-46.7	-42.3	-144.4	529.7
Domestic credit	-5.1	30.6	63.0	37.6	45.3	33.8
Public sector	-23.8	-30.3	104.9	-7.9	21.5	14.8
Central government (net)	-17.4	-50.0	108.9	-21.8	-21.6	19.7
Other	0.7	62.0	57.5	47.1	51.0	34.4
Public enterprises	-57.2	167.8	97.5	19.8	77.6	12.0
Private sector	6.5	57.8	54.8	49.5	49.2	36.3
Memorandum items:						
GDP (in millions of rufiyaa)	8,863.2	9,938.7	9,596.6	11,722.0	13,543.0	16,586.8
Rufiyaa per U.S. dollar	12.8	12.8	12.8	12.8	12.8	12.8
Velocity	2.1	1.9	1.5	1.6	1.5	1.5
Official reserves (US$ million)	160.3	199.6	187.1	232.2	309.1	325.5
Commercial banks' NFA (US$ million)	44.0	58.8	-40.3	-144.5	-337.8	-543.8

Sources: Data provided by the Maldivian authorities; and IMF staff estimates.

Table 5. Maldives: Medium-Term Projection, 2006–13

	2006	2007	Proj. 2008	2009	2010	2011	2012	2013
			(Annual percentage change)					
Output and prices								
Real GDP growth	18.0	7.6	6.5	6.5	6.0	6.0	6.0	6.0
Consumer prices (period average)	3.5	7.4	15.0	4.0	3.0	3.0	3.0	3.0
			(In percent of GDP)					
Central government								
Revenue and grants	52.5	58.0	58.8	51.8	50.0	50.1	47.7	46.6
Tax revenue	20.2	21.1	19.8	19.5	20.3	22.6	21.9	21.6
Nontax revenue	24.5	27.9	33.9	28.6	26.9	25.0	23.5	22.8
Grants	7.4	8.7	4.9	3.5	2.6	2.3	2.1	2.0
Expenditure and net lending	59.3	65.8	68.3	55.2	48.7	47.1	46.2	44.3
Of which: Domestic expenditure	48.4	49.4	55.8	49.4	48.4	47.2	46.2	44.3
Current expenditure	47.8	52.3	52.8	44.3	37.4	35.0	34.0	32.0
Of which: Tsunami related	10.7	13.6	8.0	4.4	1.5	0.0	0.0	0.0
Capital expenditure	12.4	14.4	16.6	12.0	12.3	13.0	13.0	13.0
Overall balance	-6.8	-7.8	-9.4	-3.4	1.2	3.0	1.5	2.3
Overall balance, excluding grants	-14.2	-16.6	-14.3	-6.9	-1.3	0.6	-0.6	0.4
Financing								
Domestic	2.3	-0.7	0.7	0.0	0.0	-1.5	-0.1	-1.1
Foreign	4.5	8.6	8.7	3.4	-1.2	-1.5	-1.4	-1.3
Total government debt	50.9	56.0	55.4	53.5	47.7	40.8	35.8	30.5
Of which: Foreign debt	32.4	37.0	39.0	39.5	35.0	30.5	26.6	23.1
			(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments								
Domestic exports (in percent change) 1/	30.5	-20.2	20.2	9.0	11.6	8.2	8.5	7.5
Merchandise imports (in percent change)	24.4	18.3	25.8	-1.0	1.6	1.8	3.5	3.0
Tourism receipts (in percent change)	70.9	13.7	8.5	8.9	7.6	8.5	9.3	9.4
Trade balance	-590.1	-736.7	-869.3	-809.4	-790.0	-774.5	-773.2	-761.0
Nonfactor services (net)	320.7	357.6	385.4	435.3	482.2	537.6	605.2	680.0
Current account balance	-302.0	-424.5	-613.0	-467.7	-408.4	-302.9	-224.8	-132.3
(In percent of GDP)	-33.0	-40.1	-47.3	-32.6	-26.1	-17.7	-12.0	-6.5
Overall balance	45.1	76.9	16.3	73.1	52.7	55.0	46.3	38.8
Memorandum items:								
Gross official reserves (year-end)	232.2	309.1	325.5	398.6	451.3	506.2	552.6	591.4
(In months of imports of GNFS) 2/	2.3	2.5	2.6	3.1	3.4	3.7	3.9	4.1
External debt (year-end)	449.2	736.3	1,070.6	1,316.4	1,482.5	1,597.0	1,661.5	1,686.0
(In percent of GDP)	49.1	69.6	82.6	91.7	94.6	93.3	88.9	82.7
Debt service	43.3	66.9	96.9	115.4	138.1	150.5	155.2	162.8
(In percent of domestic exports of GNFS)	6.3	9.1	11.9	13.1	14.5	14.5	13.7	13.2

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.

1/ Domestic exports are defined as merchandise exports net of re-exports.
2/ GNFS = Goods and nonfactor services.

Table 6. Maldives: Indicators of External Vulnerability, 2003–07

	2003	2004	2005	2006	Est. 2007
	(In percent of GDP, unless otherwise indicated)				
Financial indicators					
Government debt 1/	46.1	43.1	52.6	50.9	56.0
Broad money (annual percent change) 2/	15.4	31.7	11.7	20.6	23.7
Private sector credit (annual percent change) 2/	6.5	57.8	54.8	49.5	49.2
External indicators					
Domestic exports (annual percent change, in U.S. dollars)	24.5	8.7	-15.4	30.5	-20.2
Imports (annual percent change, in U.S. dollars)	20.2	36.3	16.1	24.4	18.3
Current account balance 1/	-4.6	-16.2	-35.9	-33.0	-40.1
Capital and financial account balance	7.6	19.7	35.2	32.1	42.1
Of which: Official medium- and long-term loans (net)	4.3	3.2	2.5	4.6	3.7
Other	3.2	16.5	32.7	27.5	38.4
Gross official reserves (in millions of U.S. dollars)	160.3	204.4	187.1	232.2	309.1
Central bank short-term foreign liabilities (in millions of U.S. dollars)	0.8	0.9	7.1	7.1	7.1
Short-term foreign assets of the banking sector (in millions of U.S. dollars)	60.6	79.0	47.1	68.1	82.4
Short-term foreign liabilities of the banking sector (in millions of U.S. dollars)	16.6	20.2	87.4	212.6	420.2
Official reserves in months of following year's imports GNFS 3/	2.7	2.9	2.1	2.3	2.5
Broad money to reserves	2.2	2.3	2.8	2.7	2.5
Total reserves to short-term external debt (residual maturity)	419.7	463.9	133.3	208.4	122.7
Total external debt	41.8	42.7	57.3	49.1	69.6
Of which: Government debt	29.6	30.5	34.0	32.4	37.0
Total external debt to domestic exports of GNFS 4/	53.2	52.9	100.7	65.4	100.1
Debt service to domestic exports of GNFS	4.0	5.1	10.1	6.3	9.1
Exchange rate (rufiyaa/U.S. dollar, end-period)	12.8	12.8	12.8	12.8	12.8

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.

1/ The first entry is the average for 1995–96.
2/ Adjusted for the exchange rate change in 2001.
3/ GNFS = Goods and nonfactor services.
4/ Domestic exports are defined as merchandise exports net of re-exports.

APPENDIX I. MALDIVES: PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

Debt sustainability analysis (DSA) indicates a considerable rise in the external debt-to-GDP ratio over the next few years—driven primarily by private sector activity—while public sector debt ratios are forecast to decline from next year onwards. The baseline scenario is premised on GDP growth of about 6 percent per annum over the medium term, consistent with a cautiously optimistic forecast for expansion in the tourism and fisheries sectors.[7] The fiscal assumptions incorporate a substantial scaling down of current expenditure over the medium term, in conjunction with revenue reforms described in the main text of the staff report.

A. Public Debt Sustainability

The Maldives' public sector debt has increased rapidly owing to fiscal expansion following the tsunami. The primary deficit has jumped from an average of 2¼ percent of GDP during 2000–04 period to an average of 6⅔ percent of GDP during the 2005–07 period. Both domestic and foreign resources have been mobilized to finance the deficit, pushing up the overall debt ratio by over 13 percentage points of GDP between 2004 and 2007.

In the baseline DSA, the public debt ratio declines steadily over the medium term, reflecting the fiscal prudence embedded in the staff projection. The projection builds on zero or small positive domestic balances, by restraining expenditures within a realistic resource envelope (which builds in various revenue reforms). The zero or negative usage of domestic financing and the start of the net repayment of the government external debt as per the amortization schedule implies a sharp turnaround of the primary balance into positive territory starting in 2010. As a result, both domestic and foreign public debt ratios decline appreciably, achieving a level well below the pre-tsunami average over the medium term.

The major risks to the baseline are on the fiscal stance, indicating the significance of fiscal prudence for achieving macroeconomic stability. The historical scenario would imply an increasing trajectory for public debt, rather than the forecast decline. The major driver of this result is the historically high primary deficits, with a 10-year average of 3.4 percent of GDP. If the primary balance remains fixed at the elevated level of 7.4 percent of GDP (as budgeted in 2008), the debt ratio would continue to expand to and reach 75 percent of GDP by 2013. Sensitivity tests also show that the public debt path is susceptible to shocks to real GDP growth, with a one-fourth standard deviation shock to growth leading to a public debt ratio of 55 percent in 2013 (instead of the baseline forecast of

[7] The forecast assumes that roughly half of the resorts planned by the authorities will be constructed by 2013, which still comprises an ambitious schedule. In line with government plans, construction activity is expected to be particularly concentrated in the period 2008–10, after which it diminishes as some resorts are completed along with the transshipment port and various infrastructure projects.

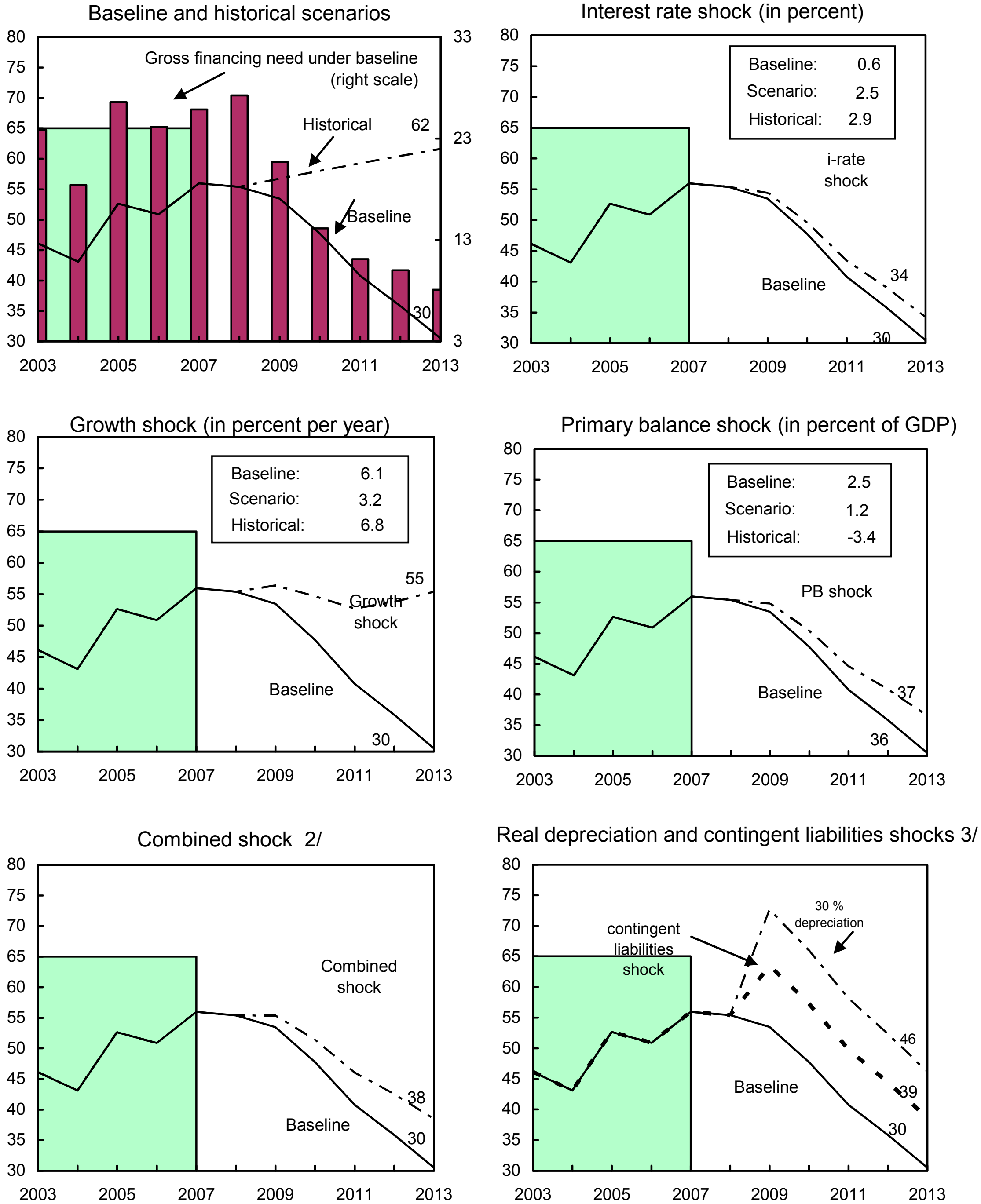
30). However, the impact of a GDP shock may be overstated by the standardized sensitivity test, because in the Maldives' case the tsunami and the sharp recovery thereof accentuate the volatility of GDP growth. Excluding the year of the tsunami and the following year, the growth rate shock scenario generates a falling path for public debt, which reaches about 40 percent of GDP by 2013.

B. External Debt Sustainability

The external debt-to-GDP ratio is forecast to climb sharply until 2010, before attaining a downward trajectory later in the projection period. Over the next three years, several new resorts will begin construction, while work continues on island resorts leased previously. The financing for these resorts is mainly expected to be channeled through commercial banks borrowing from their head offices and on-lending domestically, as in the past. In addition, work will commence on a transshipment port, while various other infrastructure projects continue. The external debt-to-GDP ratio is forecast to climb to about 95 percent in 2010, after which it will diminish as several projects are completed. Notably, this path is driven by private sector activity and borrowing. Government external debt, in contrast is forecast to decline from next year onwards—falling gradually from 39 percent of GDP in 2008 to about 23 percent by 2013—as amortization on existing loans comes due and loans for tsunami reconstruction activities winds down. Debt service follows a similar profile, rising as a percentage of domestic exports from 12 percent in 2008 to 14½ percent in 2010, before declining to about 13 percent by 2013.

The stress tests illustrate that the debt path is particularly vulnerable to shocks to the current account and the exchange rate. A real depreciation of 30 percent would cause the ratio to rise sharply to over 120 percent in the year that the depreciation occurred, before falling to about 90 percent in 2013. A large current account shock is potentially more worrying because the trajectory of the external debt ratio does not decline appreciably over the projection period, rising steadily to about 144 percent by 2013. While both scenarios are unlikely, neither can be ruled out entirely. A current account shock could occur due to Maldives' large exposure to tourism patterns and world commodity prices. A real depreciation could occur if fiscal slippages and attendant deficit monetization led to high inflation or if a surge in import demand—generated by excessive public expenditure—put the peg under pressure.

Figure I-1. Maldives: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table I-1. Maldives: Public Sector Debt Sustainability Framework, 2003-13

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary 9/**
1 **Baseline: Public sector debt 1/**	46.1	43.1	52.6	50.9	56.0	**55.4**	**53.5**	**47.7**	**40.8**	**35.8**	**30.5**	**-1.5**
Of which: foreign-currency denominated	29.6	30.5	34.0	32.4	37.0	39.0	39.5	35.0	30.5	26.6	23.1	
2 Change in public sector debt	-0.9	-3.0	9.6	-1.8	5.1	-0.6	-1.9	-5.7	-7.0	-4.9	-5.3	
3 Identified debt-creating flows (4+7+12)	-0.1	-3.4	12.4	-2.8	1.0	-0.8	-1.9	-5.7	-7.0	-4.9	-5.3	
4 Primary deficit	1.9	0.2	9.3	5.1	5.7	7.4	1.5	-3.1	-4.6	-2.9	-3.6	
5 Revenue and grants	34.8	34.5	48.1	52.5	58.0	58.8	51.8	50.0	50.1	47.7	46.6	
6 Primary (noninterest) expenditure	36.7	34.7	57.3	57.6	63.7	66.2	53.3	46.9	45.4	44.8	43.0	
7 Automatic debt dynamics 2/	-2.0	-3.6	3.2	-7.8	-4.7	-8.2	-3.5	-2.6	-2.4	-2.0	-1.8	
8 Contribution from interest rate/growth differential 3/	-2.0	-3.6	3.2	-7.8	-4.7	-8.2	-3.5	-2.6	-2.4	-2.0	-1.8	
9 *Of which*: contribution from real interest rate	1.7	0.3	1.1	-0.1	-1.3	-5.2	-0.2	0.3	0.3	0.2	0.2	
10 *Of which*: contribution from real GDP growth	-3.7	-3.9	2.1	-7.8	-3.3	-3.0	-3.3	-2.9	-2.6	-2.2	-2.0	
11 Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-0.8	0.4	-2.9	1.0	4.1	0.3	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	132.4	125.1	109.5	96.9	96.5	94.2	103.2	95.6	81.4	75.1	65.5	
Gross financing need 6/	23.8	18.4	26.6	24.1	25.9	27.2	20.7	14.1	11.1	10.0	8.1	
in millions of U.S. dollars	165.1	143.1	199.4	221.1	273.7	353.1	296.9	221.7	189.7	187.1	165.3	
Scenario with key variables at their 10-year historical averages 7/						**55.4**	**56.7**	**58.0**	**59.3**	**60.5**	**61.6**	
Scenario with no policy change (constant primary balance) in 2008-13						**55.4**	**59.3**	**63.7**	**68.0**	**72.0**	**75.8**	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.5	9.5	-4.6	18.0	7.6	6.5	6.5	6.0	6.0	6.0	6.0	
Average nominal interest rate on public debt (in percent) 8/	3.5	3.4	3.6	3.9	4.9	4.5	3.8	3.8	3.8	3.8	3.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.9	1.0	2.4	0.4	-2.5	-10.5	-0.2	0.8	0.8	0.8	0.8	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	-0.4	2.4	1.2	3.5	7.4	15.0	4.0	3.0	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	9.6	3.4	57.8	18.5	18.9	10.8	-14.2	-6.9	2.8	4.4	1.8	
Primary deficit	1.9	0.2	9.3	5.1	5.7	7.4	1.5	-3.1	-4.6	-2.9	-3.6	

1/ Defined as general government gross debt.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi$ (1+g) and the real growth contribution as -g. A large negative contribution from real interest rate reflect a large pickup in (imported) inflation, while domestic and foreign loan interest rates are expected to remain stable reflecting the peg to the U.S. dollar and the consessional nature of foreign loans.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

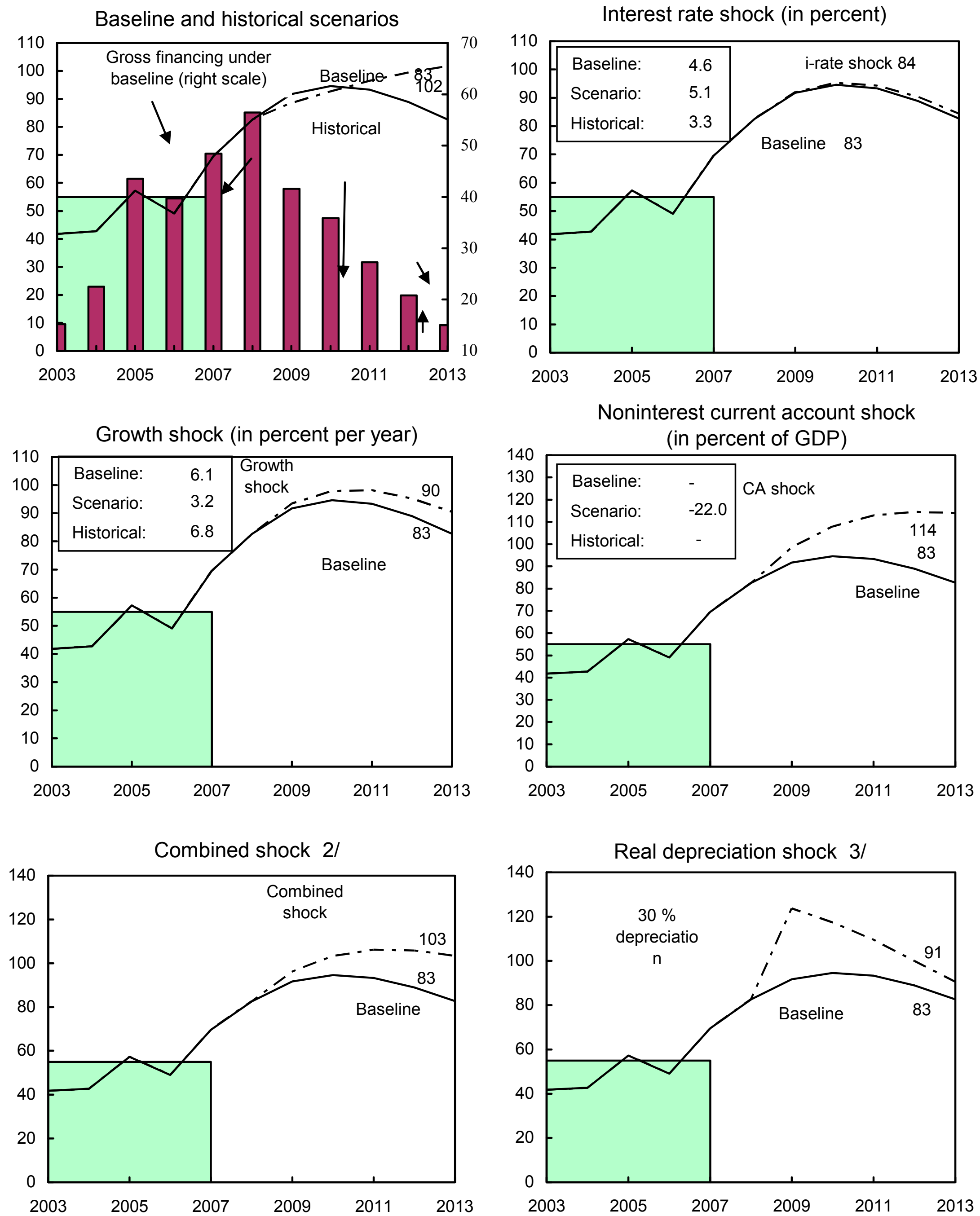
6/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure I-2. Maldives: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent one-fourth standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

Table I-2. Maldives: External Debt Sustainability Framework, 2003-13

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing noninterest current account 6/**
1	**Baseline: External debt**	41.8	42.7	57.3	49.1	69.6	**82.6**	**91.7**	**94.6**	**93.3**	**88.9**	**82.7**	**-10.7**
2	Change in external debt	1.4	0.9	14.6	-8.2	20.5	13.0	9.1	2.9	-1.3	-4.4	-6.3	
3	Identified external debt-creating flows (4+8+9)	-8.6	-6.4	17.9	6.5	13.4	20.8	7.2	2.2	-1.7	-4.2	-5.6	
4	Current account deficit, excluding interest payments	3.8	15.2	34.0	31.6	38.0	44.4	29.0	22.1	13.7	8.1	2.8	
5	Deficit in balance of goods and services	-7.0	4.1	50.0	29.4	35.8	37.3	26.1	19.6	13.8	9.0	4.0	
6	Exports	84.3	88.4	64.6	84.9	80.9	79.1	79.0	78.4	78.0	78.1	78.4	
7	Imports	77.3	92.4	114.6	114.3	116.7	116.5	105.0	98.0	91.8	87.1	82.3	
8	Net nondebt creating capital inflows (negative)	-10.2	-18.0	-19.4	-16.1	-20.1	-22.8	-20.6	-18.8	-14.2	-11.1	-7.2	
9	Automatic debt dynamics 1/	-2.3	-3.5	3.4	-9.0	-4.4	-0.8	-1.3	-1.1	-1.2	-1.2	-1.2	
10	Contribution from nominal interest rate	0.8	1.0	1.9	1.4	2.2	2.9	3.5	3.9	4.0	3.9	3.7	
11	Contribution from real GDP growth	-3.2	-3.5	2.1	-8.5	-3.2	-3.7	-4.8	-5.0	-5.2	-5.1	-4.9	
12	Contribution from price and exchange rate changes 2/	0.2	-1.0	-0.5	-1.9	-3.4	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	10.0	7.3	-3.4	-14.7	7.1	-7.8	1.9	0.7	0.5	-0.2	-0.7	
	External debt-to-exports ratio (in percent)	49.6	48.4	88.6	57.8	86.0	104.4	116.2	120.7	119.7	113.9	105.5	
	Gross external financing need (in millions of U.S. dollars) 4/	105.2	175.0	326.5	363.4	512.5	731.8	596.7	562.0	466.5	388.4	305.9	
	in percent of GDP	15.2	22.5	43.6	39.7	48.4	56.5	41.6	35.9	27.3	20.8	15.0	
	Scenario with key variables at their historical averages 5/						**82.6**	**88.6**	**92.7**	**96.5**	**99.5**	**101.8**	
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	8.5	9.5	-4.6	18.0	7.6	6.5	6.5	6.0	6.0	6.0	6.0	
	GDP deflator in U.S. dollars (change in percent)	-0.4	2.4	1.2	3.5	7.4	15.0	4.0	3.0	3.0	3.0	3.0	
	Nominal external interest rate (in percent)	2.1	2.7	4.3	2.9	5.1	5.1	4.8	4.7	4.6	4.6	4.6	
	Growth of exports (U.S. dollar terms, in percent)	17.9	17.5	-29.4	60.4	10.1	19.8	10.5	8.4	8.6	9.4	9.5	
	Growth of imports (U.S. dollar terms, in percent)	17.4	34.1	19.8	21.8	18.0	22.2	-0.1	1.9	2.2	3.6	3.2	
	Current account balance, excluding interest payments	-3.8	-15.2	-34.0	-31.6	-38.0	-44.4	-29.0	-22.1	-13.7	-8.1	-2.8	
	Net non-debt creating capital inflows	10.2	18.0	19.4	16.1	20.1	22.8	20.6	18.8	14.2	11.1	7.2	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency-denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

MALDIVES

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by Asia and Pacific Department
(In consultation with other departments)

July 30, 2008

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ANNEX I. MALDIVES: FUND RELATIONS

(As of June 30, 2008)

I. **Membership Status**: Joined 1/13/78; Article XIV

II. **General Resources Account**:

	SDR Million	**% Quota**
Quota	8.20	100.00
Fund holdings of currency	10.23	124.80
Reserve position in Fund	1.55	18.95

III. **SDR Department**:

	SDR Million	**% Quota**
Net cumulative allocation	0.28	100.00
Holdings	0.39	137.76

IV. **Outstanding Purchases and Loans**:

	SDR Million	**% Quota**
Emergency assistance	3.59	43.75

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**:
(SDR million; based on existing use of resources and present holdings of SDR):

	Forthcoming			
	2008	2009	2010	2011
Principal	1.03	2.05	0.51	
Charges/interest	0.07	0.08	0.01	0.00
Total	1.10	2.13	0.52	0.00

VII. **Exchange Arrangements**

From March 1, 1982 to June 30, 1985, the Maldivian rufiyaa was pegged to the U.S. dollar. Beginning in July 1985, the exchange rate of the rufiyaa was linked to a trade-weighted basket of currencies, but the exchange rate vis-à-vis the U.S. dollar remained relatively stable until February 1987. On March 1, 1987, the rufiyaa was devalued by 29 percent vis-à-vis the U.S. dollar. From 1987 to 1994, the exchange rate of the rufiyaa was adjusted periodically. Since October 1994, the exchange rate of the rufiyaa remained unchanged at Rf 11.77 per U.S. dollar until July 25, 2001, when the rufiyaa was devalued to Rf 12.80 per U.S. dollar.

Maldives continues to avail itself of the transitional arrangements under the provisions of Article XIV, but no longer maintains restrictions under Article XIV. Under these circumstances, any exchange rate restriction that arises is subject to approval under Article VIII.

VIII. **Last Article IV Consultation**

The 2007 Article IV consultation was concluded by the Executive Board on July 30, 2007.

IX. **Technical Assistance**

FAD: In April 1994, Mr. Potter and Ms. Bédague visited Male to advise on budget management. This was followed by periodic assistance from Mr. Webber (consultant) over the period November 1994 to December 1995. In July 1994, Mr. Faria and Mr. Kambil (consultants) assisted in formulating a strategy for revenue reform. This was followed by a visit by Mr. Kambil in August/September 1995 to draft tax legislation. In October 1996, a tax administration mission developed a strategy to establish an Inland Revenue Department and a follow-up mission by a consultant took place in June 1997. In May 2007, a mission conducted a diagnostic review of tax and tariff policy and administration.

LEG: In October 2003, Mr. Head provided assistance on the revision of the Maldives Monetary Authority Act (MMA Act). A series of missions (March and September 2005, and April 2006) were provided to revamp the banking law.

MCM: In March 1993, a consultant provided assistance on the introduction of treasury bills. In November 1994, a mission headed by Mr. Taniguchi provided assistance on monetary management, foreign exchange operations, and bank supervision. In February/June 1995, a consultant provided assistance for the development of a treasury bill and MMA certificate market. In February/March 1996, a mission headed by Mr. Swinburne provided advice on the reform of monetary operations and exchange system. This was followed by a visit of a foreign exchange advisor in May 1997. In early 2001, two consultants provided assistance on foreign exchange and monetary management, of two missions each. In July 2001, a consultant provided assistance on monetary management following the lifting of credit ceilings and further impending changes in the monetary framework. In October 2002, a multi-purpose mission took stock of developments and provided recommendations in the areas of banking, foreign exchange operations, and foreign exchange reserves management. In October 2003, in cooperation with the legal consultant, Mr. Dornseif (Deutsche Bundesbank) provided assistance on the drafting of the amended MMA Act. Two missions visited in 2006 on monetary operations, financial market development, and banking issues.

STA: In June 1993 and February 1994, assistance was provided on monetary and balance of payments statistics, respectively. In May 1995, a STA consultant provided assistance on the compilation of a new consumer price index, which was followed by further assistance in August 1996. In November 2005, TA was given on monetary and banking issues. In June 2006, STA provided advice government finance statistics. In January 2007, STA provided advice on balance of payments statistics.

ANNEX II. MALDIVES: RELATIONS WITH THE WORLD BANK GROUP[1]

(As of July 2008)

IBRD/IDA Lending Operations

	Net Commitments	Disbursements 1/	Undisbursed
Integrated Human Development	16.4 2/	3.7	8.6
Emergency Recovery Credit and Grant	13.9 3/	11.1	2.9
Maldives Environment Management Project	13.5	0.34	13.16
Mobile Phone Banking Project	7.7	0	7.9
Maldives Pension Administration Project	1.1	0.1	1.0
Sub-total	52.6	15.24	31.56
Closed projects (IDA)			
Fisheries I	3.2	1.6	...
Fisheries II	5.0	5.0	...
Fisheries III	10.7	9.4	...
Male Airport Upgrading	7.5	7.5	...
Education and Training	8.2	7.3	...
Education and Training II	13.4	12.9	...
Education and Training III	18.6 4/	16.8	...
Sub-total	66.6	61.0	...
Total	119.2	76.24	43.06

1/ Note: Disbursement figures subject to SDR/USD exchange rate fluctuations. Source: WB Operations Portal and Client Connection.
2/ US$10 million were cancelled to make IDA resources available under the Maldives Post-Tsunami Emergency Recovery Credit and Grant. Original commitment was US$21.3 million. US$5.7 million were then regranted as additional financing in 2006.
3/ Of this total, $8.4 million provided as credit and $5.6 million (40 percent of total financing) as grant.
4/ US$2 million cancelled to make IDA resources available under the Maldives Post-Tsunami Emergency Recovery Credit and Grant. US$1.4 million in additional financing was contributed to the project in 2006.

The World Bank's Country Assistance Strategy

The Bank's Country Assistance Strategy (CAS) FY08–12 aligns a joint IDA/IFC assistance program behind the Government of Maldives' (GoM) development strategy. The overarching

[1] Prepared by World Bank staff.

objective is to contribute to policy and institutional reforms to help maintain the country's successful development trajectory of the last two decades.

The country context has changed considerably since the last CAS was discussed by the Board in 2000. While the economy has continued to grow, the Maldives experienced a very real economic and social rupture in the wake of the Indian Ocean tsunami of December 2004, which caused damage worth 60 percent of GDP. The GoM has also initiated a wide-ranging reform program to modernize its governance in line with its middle-income status.[2] Furthermore, demands upon the government for better services are rising rapidly with income levels.

Much has changed in the seven years of the last CAS period, and the World Bank Group has had to be flexible. The country faces three serious challenges: (i) the sustainability of its fiscal policies, (ii) the completion of ambitious governance reforms, and (iii) adaptation to global climate change. Sustaining the Maldives' remarkable development progress hinges on the government's ability to address these key challenges in the short term, and to prioritize policies and programs that maintain the country's successful development trajectory over the medium to long term.

The CAS FY08–12 has built in flexibility. The CAS period straddles the end of the Seventh National Development Plan (7NDP) and the first half of the next five-year government strategy, the midterm review of the CAS scheduled for FY10 will coincide with the start of the government's next strategy. This will be an opportunity to review CAS progress against the indicators of the CAS Results Matrix as well as fine tune the program in line with government's priorities in the next plan. Pending fiscal adjustment, the strategy proposes a programmatic, policy-based investment model for the second half of the CAS period. The eligibility for the Maldives for IBRD funds will also be reviewed at that time.

This CAS has been prepared jointly by the World Bank and IFC and as such presents a common view of development objectives in the Maldives, together with a commitment to a shared strategy. During the last CAS period, the IFC committed a total of US$47.8 million (US$ 46.5 million in debt and the remainder in equity), consisting of four projects in the financial, tourism, logistics and telecommunications sectors. In addition, the IFC has expanded its South Asia Enterprise Development Facility (IFC-SEDF) with a dedicated advisory services program to cover Sri Lanka and the Maldives, and has established a framework to provide support to small- and medium-sized enterprise (SMEs) within an

[2] On December 20, 2004 days before the tsunami struck, the UN General Assembly endorsed a recommendation that the Maldives graduate from Lead Developed Country (LDC) status at the end of 2007. Given the impact of the disaster, the transition process was subsequently deferred and the Maldives will now formally graduate on January 1, 2011. The main implication for the Maldives is the loss of duty exemptions on tuna exports to Europe. Graduation from IDA and IBRD eligibility is not linked to this process.

enhanced investment climate. The IFC is considering further investments in the Maldives in the areas of infrastructure, access to finance and tourism.

The IMF has been actively engaged in the Maldives, fielding technical assistance (TA) missions and staff visits in addition to the regular cycle of Article IV consultations. The teams of IMF and other IFIs have been working closely with the World Bank's macro and fiscal team. This collaboration will continue to be of critical importance in the short run considering the risks posed by the expansionary fiscal policy and also recognizing the limited leverage that the Bank Group may bring to bear on its own on this matter.

The CAS is designed to mitigate the risks that could reduce the effectiveness of the World Bank Group's operations and to further develop the ability to monitor the impact of interventions. These include the immediate fiscal risks as well as the political risks due to the country's upcoming first multi-party elections. To mitigate these risks, the Bank Group will maintain close dialogue with the authorities and with other donor partners in Male'. In addition, the Bank Group is in close dialogue with the authorities and staff of the IMF with regard to the country's fiscal situation, which has worsened significantly in recent years. Flexibility has been built into the proposed program to adjust the mix and level of Bank instruments in response to emerging fiscal and political risks. Finally, given shallow capacity in many of the implementing agencies, there are some implementation risks. Hence operations will be designed simply and in close coordination with the government. Where possible, government M&E systems will be upgraded as part of the Bank Group's interventions so as to avoid the expense of developing project-specific monitoring systems.

Lending program

Applying the principle of selectivity and taking into account the changing country context and challenges facing the Maldives, the proposed World Bank Group assistance program seeks to further three strategic development outcomes: (i) a well-managed economy attracting increased investment; (ii) increased quality of education in support of a better skilled workforce; and (iii) improved capacity to manage the country's pristine, but fragile, natural environment. These strategic outcomes will be supported through IDA credits (mobile phone banking, education, and environmental management), strategic IFC investments and TA and a flexible program of AAA. In addition, two cross-cutting development themes have emerged as essential ingredients to the country's overall development program. These are: building stronger institutions and capacity to levels commensurate with the socio-economic development of the Maldives; and encouraging population and development consolidation (PDC) on larger islands.

The proposed CAS program is laid out in table below. The program for FY10, FY11 and FY12 will be further elaborated during the CAS period and reviewed as part of the CAS Progress Report. The content and product mix will depend on progress on the reform agenda.

Given the relatively small IDA allocation, making an effective contribution will mean that the Bank Group's work must be selective, catalytic and well-coordinated with other donors. The CAS spans the last year of IDA14, three years of IDA15, and the first year of IDA16. The overall size of the IDA envelope during the five-year CAS period is assumed to be about SDR 30 million (about US$45 million), including about SDR 13.2 million (US$20 million) in FY08 of resources remaining from IDA14, and annual resources of about SDR 4 million during each of the subsequent years (US$6 million per year).[3] [4]

Interventions are proposed that build on progress and relationships established by previous operations. They also aim to establish a three pillar platform: (i) economic and fiscal governance, (ii human development and social protection, and (iii) environmental management; for a more long-term or programmatic approach to Bank Group assistance, as proposed by the previous CAS, toward ensuring relevance over the next five years. Despite the short-term risks posed by an expansionary fiscal policy, World Bank Group management is committed to stay engaged with the authorities through a program that supports the long-term growth path.

While the IDA allocation is fixed, the mix of products is not. The World Bank Group will ensure that the instruments used are consistent with the country's development context. In particular, a responsive program of analytical work has proved constructive in the Maldives in the past and is consistent with the World Bank Group's strategy for middle income countries. In addition, the proposed sector lending program assumes that authorities manage the current risks and avert a crisis. However, it is also possible that expenditures may continue to rise, further endangering economic conditions. If this occurs the World Bank Group would have to adjust its program accordingly in partnership with other donors and the IMF to support resolution of the structural issues where possible.

Development policy lending is preferable, but will be contingent on demonstrated reforms. If the authorities are able to re-establish fiscal balance within a sustainable macro-economic framework that is satisfactory to the World Bank, then a development policy lending operation (DPL) would be considered. To this end, a DPL operation is under consideration for FY10, and is reflected in the program table above. The sector focus under the DPL would be consistent with the overall assistance framework set out in this document. If a DPL is not feasible, IDA resources will be channeled toward additional financing for sector operations.

In the future, the Maldives should aim for IBRD creditworthiness. Maldives' eligibility for IBRD lending could also be considered as part of the CAS Progress Report at mid-term. The

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[3] Under the small island exception, in recognition of exceptional vulnerability of small island states, the Maldives has access to IDA despite having per capita income in excess of the IDA cut-off.

[4] Estimates for IDA15 are based on performance in FY08 and assumptions about the size of the IDA15 replenishments. Actual allocations during the CAS period will be determined on an annual basis and will depend on: (i) total IDA resources available in IDA15 and IDA16, (ii) the country's performance rating; (iii) the performance and assistance terms of other IDA borrowers; (iv) the terms of IDA's assistance to the Maldives (credits or grants), and (v) the number of IDA-eligible countries.

uncertainties posed by recent expansionary policies and the political transition make it inopportune to consider an IBRD envelope at present. However, with fiscal correction, the conditions might be right to assess the creditworthiness of the country.

Proposed CAS Program (FY07–12)

<table>
<tr><th>Pillar</th><th>I: Economic governance</th><th>II: Human development</th><th>III: Environmental management</th></tr>
<tr><td colspan="4">IDA Credits (TA & Investment) (<u>New projects</u> - Ongoing projects)</td></tr>
<tr><td>FY08</td><td>• <u>Mobile phone banking (CGAP/IDA)</u>
• Public accounting system (EC Trust Fund)
• NLTA: Public Financial Management
• NLTA: MTFF & macro-fiscal</td><td>• <u>IHDP & Post-tsunami Reconstruction activities</u></td><td>• <u>Environmental management</u></td></tr>
<tr><td>FY09</td><td>• <u>Follow-up NLTA on PFM & MTFF</u></td><td>• <u>Additional financing for Human Development</u>
• <u>Pension Administration Project</u></td><td></td></tr>
<tr><td>FY10</td><td colspan="3"><u>Possible DPL</u></td></tr>
<tr><td>FY11</td><td></td><td>• <u>Possible follow-on financing</u></td><td>• <u>Possible follow-on financing</u></td></tr>
<tr><td>FY12</td><td>tbd</td><td>tbd</td><td>Tbd</td></tr>
<tr><td colspan="4">AAA (TA & ESW)</td></tr>
<tr><td>FY08</td><td></td><td></td><td></td></tr>
<tr><td>FY09</td><td colspan="3">• Cross-cutting AAA on economic diversification & population consolidation</td></tr>
<tr><td>FY10</td><td>• PEFA</td><td></td><td></td></tr>
<tr><td>FY11</td><td>• ROSC</td><td></td><td></td></tr>
<tr><td>FY12</td><td>tbd</td><td>tbd</td><td>• Fisheries Strategy follow-up</td></tr>
<tr><td colspan="4">IFC Investment & Advisory Services</td></tr>
<tr><td>FY08</td><td>• Investment and advisory services to the leasing sector.
• Possible advisory work with the Bank of Maldives to enhance SME financing.
• Advisory services to HDFC and possible investment in case of privatization.
• SME linkage program with existing investments.
• Possible advisory and/or investments in infrastructure and tourism</td><td>• Training programs as part of advisory work in: access to finance and SME linkages</td><td>• Environmental & Social due diligence on any future investments.
• Advisory work as necessary to help clients meet IFC Environmental Performance Standards</td></tr>
<tr><td>FY09</td><td>▪ As above</td><td>▪ As above</td><td>▪ As above</td></tr>
<tr><td>FY10</td><td>▪ As above</td><td>▪ As above</td><td>▪ As above</td></tr>
</table>

ANNEX III. MALDIVES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[5]

(As of May 2008)

Loans

- Since 1981, Asian Development Bank (AsDB) has provided 16 loans with total approved amount of $96.81 million.
- In terms of value, the transport sector is the largest recipient of AsDB's assistance comprising 31.3 percent of total lending to Maldives, followed by energy at 25 percent, education at 12.5 percent, multisector at 18.8 percent, water supply and sanitation at 6.2 percent, law, economic management, and public policy at 6.2 percent.
- As of end-April 2008, seven loans were active with a net loan amount of $48.143 million comprising of two projects in transport and communication amounting to $17.471 million (36 percent), two for agriculture, natural resources, and social services for $12.744 million (27 percent), two for energy for $11.646 million (24 percent), and one project in urban development amounting to $6.282 million (13 percent).
- In 2007, contract awards totaled $4.13 million, bringing the cumulative figure to $77.92 million. Of the total contract awards, $3.031 million (73 percent) went for two transport and communication projects, followed by $1.12 million (27 percent) for two education projects. The contract award ratio was 21.18 percent.
- In 2007, disbursements totaled $5.083 million, bringing cumulative disbursements to $67.26 million. The disbursement ratio was 16.43 percent, significantly lower than the AsDB-wide average of 25.440 percent.

Technical assistance

- As of end-January 2007, AsDB had approved 56 technical assistance (TA) projects for a total amount of $19.5 million of which 16 had been project preparatory and 40 had been advisory TAs addressing institutional strengthening and capacity development.
- In terms of TA amount, assistance is largest for law, economic management, and public policy at 47 percent for 22 projects, followed by transport and communications at 15 percent for 11 projects, education at 10 percent for 6 projects, energy at 7 percent for 6 projects, industry and trade at 7 percent for 2 projects, agriculture at 6 percent for 3 projects, finance at 5 percent for 4 projects, urban development and multisector at 3 percent for 2 projects.
- As of end-January 2007, there are 13 TAs in the active portfolio with a total amount of $5.175 million. Of these, 4 are project preparatory and 9 are advisory.

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[5] Prepared by Asian Development Bank staff.

ANNEX IV. Maldives: Social and Demographic Indicators

	Latest single year	
	1980–85	1997–2007
GDP per capita (U.S. dollars)	469	3,087
Land area (square kilometers)	300.0	300.0
Population		
Total population	180,088	300,292
Rate of growth (percent per annum)	2.8	1.7
Density (persons per square kilometer)	826	1,001
Population characteristics		
Infant mortality at birth (per 1,000)	115.0	26.3
Crude birth rate (per 1,000)	41.6	23.1
Crude death rate (per 1,000)	11.8	5.9
Life expectancy at birth (years)	57.1	67.9
Labor force (in percent of working-age population)		
Labor force participation rate	52.1	62.2
Male	77.7	60.4
Female	23.8	39.6
Unemployment rate (2000)	...	2.0
Health care		
Access to safe water	17	84
Immunization (DPT, percent of children under age one)	28	98
Physicians (per 1,000 people)	0.07	0.92
Nurses and midwives (per 1,000 people)	…	2.7
Hospital beds (per 1,000 people)	0.8	2.3
Education		
School enrollment, primary (gross)	…	116.3
School enrollment, secondary (gross)	…	79.7
Adult illiteracy rate (percent, ages 15 and above)	…	96.3

Sources: Data provided by the Maldivian authorities; Statistical Yearbook of Maldives, various years; World Development Indicators 2006; and IMF staff estimates and projections.

ANNEX V. MALDIVES: STATISTICAL ISSUES

Data provision has some shortcomings, but is broadly adequate for surveillance. Macroeconomic statistics have improved in recent years, with technical assistance from STA and the Asian Development Bank (AsDB). Remaining shortcomings affect the balance of payments, government finance, and national accounts statistics. The authorities have requested assistance from the Fund in the areas of balance of payments and government finance, in addition to the ongoing assistance on monetary statistics. Also, the authorities are receiving assistance from other agencies to improve the national accounts. The main official statistical publication is the *Statistical Yearbook of Maldives*, which contains data series up to 2004. APD also receives, albeit with a lag, the *Quarterly Economic Bulletin* and the *Annual Report* of the Maldives Monetary Authority.

Real sector

National accounts statistics are available only on an annual basis and with a considerable lag, and there are inconsistencies between GDP data from the production and expenditure sides. The AsDB is assisting the authorities in setting up a framework for compiling more comprehensive national accounts. The CPI has been compiled since June 1995 based on the 1993 income and expenditure survey. In 1996, a STA consumer price statistics mission recommended that the authorities develop additional price indices for a more comprehensive analysis of inflation. As 1995 is still used as the base year, the CPI may not reflect current consumer spending patterns.

Fiscal sector

General government data are reported for publication in the *GFS Yearbook* and the latest published data are for 2007. Data on the operations of state enterprises are limited.

Monetary sector

Comprehensive data are published in the *Quarterly Economic Bulletin* and the *Annual Report*, with a significant lag. Data for the accounts of the Maldives Monetary Authority (MMA), commercial banks, and interest rates are reported to the Fund for publication in *IFS* on a regular and timely basis. There are inconsistencies between monetary and fiscal data regarding the financing of the fiscal deficit due to issues of timing and coverage. The April 2007 STA monetary and financial statistics mission completed the standardized reporting forms (SRFs) for the central bank and other depository corporations, and developed the integrated monetary database that will meet the data needs of the MMA, STA, and APD. The regular reporting of the SRFs will begin in the coming months, when the MMA approves these data for dissemination. It is expected that similar reporting forms will be completed for other financial corporations in a follow-up mission.

External sector

Balance of payments data are compiled on an annual basis. There are problems of coverage and measurement in a range of areas. Travel receipts are still estimated on the basis of a small and outdated survey of resorts/hotels to determine daily average expenditure by tourists. Estimates of distributed and reinvested earnings in the tourism sector are still unsatisfactory and information on private financial flows is incomplete. A technical assistance mission in January 2007 proposed steps to include data on direct investment, travel receipts, and a range of other specific items.

Official reserves are reported monthly with a (variable) two-week lag. Predetermined outflows on foreign currency assets (mainly debt service payments) are known and reported at the time of the annual consultation missions, while other movements of foreign currency assets have not been identified. Quarterly data on external debt and debt service are available for the government and the monetary authority, and to some extent for the banking sector and state enterprises at the time of the annual consultation missions, but no data are reported for the nonfinancial private sector.

Maldives: Table of Common Indicators Required for Surveillance

AS OF JULY 17, 2008

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	6/08	7/09/08	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	3/31/08	4/21/08	M	M	M
Reserve/Base Money	5/08	6/10/08	M	M	M
Broad Money	5/08	6/25/08	M	M	M
Central Bank Balance Sheet	5/08	6/13/08	M	M	M
Consolidated Balance Sheet of the Banking System	5/08	6/25/08	M	M	M
Interest Rates[2]	5/08	6/25/08	M	M	M
Consumer Price Index	3/31/08	4/21/08	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2007	3/21/08	A	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2007	3/21/08	A	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2007	3/21/08	A	M	M
External Current Account Balance	2007	3/21/08	A	M	M
Exports and Imports of Goods and Services	3/31/08	4/21/08	M	M	M
GDP/GNP	2007	2/21/08	A	M	M
Gross External Debt	2007	2/21/08	A	M	M
International investment Position[6]	2006	10/17/07			

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

Statement by the IMF Staff Representative on Maldives
September 3, 2008

1. There have been some political changes to the composition of the government following the Article IV consultation mission. The Finance Minister, Mr. Qasim Ibrahim, has resigned and will be a presidential candidate in the forthcoming elections. He has been replaced by the former Governor of the Maldives Monetary Authority (MMA), Mr. Abdulla Jihad. No replacement has yet been named for the Governor.

2. To date budget execution is lagging a little, especially on capital expenditures. Monthly data to end-June indicate that the government has spent 41½ percent of budgeted current expenditures and 14 percent of budgeted capital expenditures.

3. The Ministry of Finance has revised down the budget and remains committed to the goal of zero domestic financing. The government is planning to cut expenditures by 19 percentage points of GDP for the year, the level that could be achieved if it maintains the same spending patterns in 2H as in 1H. In particular, it aims to cut 20 percent of expenditures from August onward. Measures include (i) limiting overtime work; (ii) reducing recurrent expenditures such as official travel and celebrations; (iii) suspending or deferring capital expenditures; and (iv) forfeiting a part of the salaries for cabinet ministers and other senior officials. The ministry expects at least Rf 596 million (3.6 percent of GDP, 5.3 percent of budgeted annual domestic expenditure) cuts from above measures. On the revenue side, the revised budget apparently includes no revenues from the leasing of additional island resorts. Accordingly, the revised budget, as is, leaves a domestic financing gap of 1.9 percent of GDP.

4. While the planned expenditure reductions are commendable, the authorities should aim for deeper and less ad hoc reductions in expenditure, along the lines of the staff report recommendations. Immediate measures should include: (i) an increase in electricity tariffs (which would reduce government subsidies to the state-owned electricity company), and (ii) a nominal wage bill freeze for the civil service. The authorities would also need to raise revenues through additional island leases, while keeping well below the authorities' previous ambitious target of 30 islands discussed during the mission.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 08/115
FOR IMMEDIATE RELEASE
September 10, 2008

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with the Maldives

On September 3, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Maldives.[1]

Background

The Maldives continues to grow robustly, underpinned by a tourism sector that has rebounded strongly from the Asian tsunami. In 2007, rapid tourism growth, together with construction activities, has kept the headline growth rate in line with the pre-tsunami average despite an unusually low fish catch. Inflation has recently picked up sharply to nearly 15 percent year on year due to soaring food and oil prices.

The main challenge for the Maldives is to contain fiscal expenditures that have increased sharply following the tsunami. Expenditure has reached extraordinarily high levels by international and historical standards, with the majority of the increase in domestically financed expenditure unrelated to the tsunami. On the revenue side, there has been little progress with tax reforms. The government has been relying on extraordinary revenue measures, such as leasing out islands, to contain the fiscal deficit, and indeed has achieved its target of zero domestic financing in 2007. The 2008 budget continues to entail a large increase in current expenditures in an election year financed by extraordinary revenue measures with significant implementation risks. An over 50 percent increase in the wage bill and quadrupled subsidies, mainly because of administered electricity prices, pushed up overall expenditure to nearly 70 percent of GDP. The government planned to achieve zero domestic financing with a large receipt (about 15 percent of GDP) from a transshipment port project, but when the project was delayed by a year, the authorities planned to fill the shortfall by leasing an additional 30 islands. The government now realizes that this is too

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

ambitious and accordingly, has revised down the budget by cutting back on expenditure by 20 percent from August onward.

Dynamic private sector activities shaped the external sector. The current account deficit widened to 45 percent of GDP in 2007, driven by a surge in construction-related imports and rising commodity prices, notwithstanding the contribution from strong tourism earnings. The deficit was financed mainly through a large increase in private capital inflows, including foreign borrowing by commercial banks, which was then on-lend to resort developers. As a result, external debt increased sharply to near 70 percent of GDP in 2007.

The U.S. dollar peg has served the Maldives well and continues to be an appropriate exchange rate regime for the country. The Maldives appears to have adequate room to maintain competitiveness under the peg despite the recent rise in inflation, provided imported inflation is not exacerbated by fiscal slippages. Most of Maldives' exports are to euro-denominated areas, while the bulk of imports are dollar denominated. The real effective exchange rate has declined more than that of comparator tourism-based small economies.

There has been some notable progress with key legal reforms. A new central bank governor was appointed following the amendment to the Maldives Monetary Authority (MMA) act enshrining the separation of the positions of finance minister and governor. MMA was also empowered to set interest rates and put a ceiling on the amount the government can borrow through its Ways and Means Account. The Civil Service Bill and the Audit Act were passed and an independent civil service commissioner and an auditor general have been appointed.

Executive Board Assessment

Executive Directors were encouraged that Maldives' economy has rebounded strongly from the December 2004 tsunami, underpinned by a booming tourism sector and reconstruction activities. However, inflation has picked up markedly mainly due to high food and oil prices, and the economy remains vulnerable to external shocks.

Directors agreed that the main challenge for Maldives is to ensure that the broadly favorable growth prospects are not undermined by excessive fiscal spending and attendant macroeconomic instability. Government expenditures—in particular current expenditures unrelated to tsunami relief—have risen to extremely high levels. While welcoming the authorities' efforts to maintain their commitment to zero domestic financing of the budget, Directors cautioned that any revenue shortfall would put at risk these efforts, exacerbating already high inflation and increasing external vulnerabilities.

While the 2008 budget calls for zero domestic financing, Directors expressed concern that it accommodates a substantial rise in domestically financed expenditures with ad hoc revenues from the lease of additional island resorts, which might prove uncertain. They welcomed the authorities' intention to reduce the remaining 2008 budget allocation of line ministries by 20 percent, and encouraged the authorities to identify further contingent expenditure cuts if needed. Directors looked forward to early progress on steps to reduce subsidies to the state-owned electricity company by increasing electricity tariffs and to contain the civil service wage bill through civil service reform.

Directors stressed that ensuring fiscal sustainability over the medium term will require revenue-enhancing reforms, including the introduction of corporate taxation, a broad-based sales tax, and an ad valorem tourism tax. They called on the authorities to press ahead with their plans to develop a realistic medium-term expenditure framework to prioritize spending within the available resource envelope.

Directors agreed that external vulnerabilities will need to be monitored carefully, given the recent rise in external debt and debt service. While the rise in debt is attributable mainly to private sector activity, risks to the banking sector should be carefully monitored.

Directors generally acknowledged that Maldives' U.S. dollar peg exchange rate regime and the level of the exchange rate appear appropriate. The dollar's decline against the euro has enhanced the country's competitiveness in recent years, providing a cushion against any erosion in competitiveness arising from high imported inflation. At the same time, Directors emphasized that it will remain crucially important that the peg be supported by prudent fiscal policies.

Directors commended the authorities for implementing the Maldives Monetary Authority Act by appointing an independent Governor. They also welcomed the appointment of an independent Civil Service Commission and Auditor General. Directors encouraged early passage of the pending Banking Act and Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) legislation.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Maldives: Selected Economic Indicators, 2003–08

	2003	2004	2005	2006	Est 2007	Proj. 2008
			(Annual percentage change)			
Growth and prices						
Real GDP	8.5	9.5	-4.6	18.0	7.6	6.5
Inflation (period average)	-2.8	6.3	3.3	3.5	7.4	15.0
Central government						
Revenue and grants	34.8	34.5	48.1	52.5	58.0	58.8
Of which: Grants	1.4	0.7	8.6	7.4	8.7	4.9
Expenditure and net lending	38.2	36.0	59.0	59.3	65.8	68.3
Of which: Domestic spending	34.0	33.2	49.1	48.4	49.4	55.8
Overall balance	-3.4	-1.6	-10.9	-6.8	-7.8	-9.4
Overall balance, excluding grants	-4.8	-2.3	-19.5	-14.2	-16.6	-14.3
Financing						
Domestic	-1.3	-2.5	8.4	2.3	-0.7	0.7
Foreign	4.7	4.1	2.4	4.5	8.6	8.7
			(In millions of U.S. dollars)			
Balance of payments						
Exports, including re-exports	152.0	181.0	161.6	225.2	228.0	344.2
Imports	-414.3	-564.8	-655.5	-815.3	-964.7	-1,213.5
Nonfactor services (net)	311.1	352.4	118.8	320.7	357.6	401.6
Current account balance	-31.8	-125.8	-268.8	-302.0	-424.5	-596.7
(In percent of GDP)	-4.6	-16.2	-35.9	-33.0	-40.1	-46.0
Official capital (net)	29.9	25.0	18.6	42.1	39.2	128.3
Private capital (net)	70.3	140.1	145.8	147.8	212.7	295.0
Errors and omissions (net)	5.3	13.3	-10.9	52.9	56.2	0.0
Overall balance	26.5	44.2	-17.3	45.1	76.9	32.6
Gross official reserves (year-end)	160.3	204.4	187.1	232.2	309.1	341.7
(In months of following year's imports of GNFS) 1/	2.7	2.9	2.1	2.3	2.5	2.7
External Debt	289.5	331.8	429.5	449.2	736.3	1,070.6
(In percent of GDP)	41.8	42.7	57.3	49.1	69.6	82.6
Public External Debt 2/	272.9	311.6	309.9	361.8	523.7	652.0
(In percent of GDP)	39.4	40.1	44.1	40.7	38.9	41.7
Debt service	22.0	32.3	43.1	43.3	66.9	96.9
Exchange rate						
Rufiyaa per U.S. dollar (period average)	12.8	12.8	12.8	12.8	12.8	12.8
Memorandum item:						
Nominal GDP (in millions of rufiyaa)	8,863.2	9,938.7	9,596.6	11,722.0	13,543.0	16,586.8

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.
1/ GNFS = Goods and nonfactor services.
2/ Public sector debt, including government debt and government-guaranteed debt.
3/ Domestic exports are defined as merchandise exports net of re-exports.

Statement by Shakour Shaalan, Executive Director for Maldives
September 3, 2008

1. The Maldives economy has resumed its impressive growth trend as sound policies and generous international support have aided its recovery from the effects of the December 2004 Tsunami. Like other small island economies, the Maldives will likely remain highly dependent on tourism and tuna exports for some time. However, the ongoing concerted reconstruction drive and ambitious tourism development plan have boosted activity in the construction and services sectors in recent years, prompting deterioration of the fiscal balance. While steady growth in per capita GDP has helped propel the country to middle-income levels, the authorities recognize the need to reduce external vulnerabilities and ensure long-term fiscal sustainability in the period ahead.

2. **Growth and outlook**. GDP growth resumed its normal pace of around 7½ percent in 2007, in spite of an unexpected drop in fish catch, the main commodity export. This growth rate followed on the post-tsunami sharp contraction in 2005 and the exceptional rate of 18 percent growth in 2006 as the economy rebounded. Tourism levels have now returned to pre-tsunami levels and the fish catch has recovered in early 2008. With these trends, and assuming there is a lasting correction in commodity prices, the near-term outlook for GDP growth and the balance of payments are favorable as the ongoing expansion in rapidly building up hotel capacity. Over the medium-term, further expanding tourism and enhancing human and institutional capacity, as well as stronger financial institutions will help foster economic diversification.

3. **Inflation.** The Maldives has not been immune to the global trend of rising commodity prices stoking inflationary pressures since mid-2007. Headline inflation rose from 4 percent to nearly 15 percent in April stemming from rising food and fuel prices. Most food is imported and accounts for 30 percent of the CPI basket, and non-food inflation stands at 6 percent in April 2008, compared to 2 percent a year earlier. Although fuel has a small direct share in the CPI basket, its impact permeates domestic prices through transport, construction, tourism-related activities, and the delivery of health, education, and other services to a population that is widely dispersed among remote islands. A severe housing shortage has raised housing costs, partly resulting from the large increase in foreign labor, as elaborated below. The weakening dollar, to which the rufiyaa is pegged, has also contributed to rising import costs and inflation. A correction in commodity prices would allow inflation to revert back to previous levels of around 4 percent.

4. **External developments**. Because of the predominance of European tourists, competitiveness has not been hurt by the weakening of the dollar to which the rufiyaa is pegged. Indeed, the Maldives is in a good competitive position relative to its main comparators and can withstand some further real appreciation without adverse impact on tourism. Notably, and in contrast to staff's rash proposal last year, staff unambiguously confirms the absence of any exchange rate misalignment this time around, and reaffirms that the dollar peg provides an effective nominal anchor and remains the most appropriate regime. Intensive reconstruction of resorts and infrastructure has supported a rebound in tourism, with tourist receipts rising steadily in the last three years to surpass their pre-tsunami levels.

The current account deficit continued to widen in spite of the strong growth of tourism due to higher imports, with about one-half of the increase in the value of imports coming from capital goods and one quarter from higher payments for petroleum products. Imports were financed primarily by a steady flow of private capital and commercial bank borrowing, allowing for a modest addition to reserves to maintain adequate import coverage.

5. **Budgetary operations.** The 2007 fiscal outcome is considerably better than projected during the last Article IV consultation, and better than targeted under the 2007 budget. In the face of persistent spending pressures to finance the reconstruction effort, the Maldivian authorities have relied, to the extent possible, on grant financing, concessional borrowing, and private sector leasing in order to contain domestic financing. In 2007, domestic revenue increased by 5 percent of GDP primarily from resort lease payments and grant receipts exceeded the budgeted amount by 1½ percent of GDP. However, overall revenue fell short of the budget by about 2½ percent of GDP, as the anticipated increase in import duties did not materialize. Accordingly, current spending was contained to within ½ percent of GDP of the budgeted amount and capital spending was kept well below the budget target. As a result, the overall fiscal deficit including grants came in at 7.8 percent of GDP, well below the staff's projection of 24 percent of GDP, and the projected domestic financing (of 9 percent of GDP) did not materialize. This outcome is a clear demonstration of the authorities' resolve to address potential fiscal risks by reining in spending pressures and avoiding domestic financing.

6. With respect to the **2008 budget**, the authorities are confident that they can continue to maintain a balanced budget in terms of domestic financing and plan to adjust their spending in line with domestic revenue and foreign financing. As the expected revenue from the transshipment port project has been delayed, a cabinet decision was taken in August 2008 to reduce the remaining budget allocation of each line ministry/office by 20 percent, consistent with staffs' recommendation that they identify contingency measures other than lease of resorts. They are also currently in discussions with both the World Bank and Asian Development Bank, on possible budget support for this fiscal year, and have approached some bilateral donors for possible grant support. Spending pressures are unavoidable this year given the scheduled Presidential elections before the 10th of October 2008 and Parliamentary elections in March 2009. Moreover, the expanding tourism sector requires corresponding improvements in infrastructure and transport links. The demand for public services has also increased, not only from the citizen's rising expectations, but also from a large inflow of foreign labor. The number of expatriates nearly doubled since 2004, increasing the island's population by about 10 percent, and increasing the administrative burden on the public sector. Higher subsidy payments were necessary to ensure affordable food staples, assist fisheries in meeting rising fuel prices, and to mitigate the impact of higher fuel costs on electricity prices. However, there has been a full pass-through of the price increases of petroleum products and the authorities plan to adjust electricity prices in the near future so as to gradually remove electricity subsidies. Higher commodity prices, together with a weakening rufiyaa, also necessitated a correction to public sector wages in January 2008 to reduce the resulting erosion of real incomes, with larger increases given to those in the lower end of the pay scale. As in previous years, there will likely be some underspending in some budget categories.

7. **Debt and fiscal sustainability**. To ensure fiscal sustainability over the medium-term, the authorities remain committed to their policy of zero domestic financing underpinned by key expenditure and revenue reforms. The public debt ratio edged up with the reconstruction activity but is expected to rapidly recede over the medium-term. In anticipation of the decline in official disbursements and in the contribution of lease payments, the authorities plan to introduce a business profit tax in 2009. With respect to the latter, the Ministry of Legal Reform estimates that the bill will be submitted to Parliament before December 2008. They are also considering broadening the tax base through a consumption tax, but this will require further study to ensure an equitable and orderly approach. A number of infrastructure and public sector governance reforms are expected to assist in rationailizing public spending on social services in the wake of rising expectations from public services. Some savings are expected from the planned consolidation of the population to reduce high-cost services in remote areas. The newly formed civil service commission should facilitate downsizing of the civil service over the medium-term and avoid future ad-hoc compensation increases. Rising incomes should allow for greater provision of private health and education services that would reduce reliance on public services. The authorities fully recognize the importance of a medium-term fiscal framework to contain expenditure levels at a sustainable level and on par with realistic revenue estimates. To this end, the Ministry of Finance and Treasury is working to ensure that such a framework will be in place starting from 2009.

8. **Financial Sector.** Private sector credit continues to expand at a robust pace, in step with the ambitious tourism development plan that began in 2004. Most lending comes through the parent banks of international commercial banks and it has contributed to raising the external debt ratio. As the staff note, the external vulnerabilities are mitigated by the exposure limits of the parent banks and the fact that the loans are well collateralized. With strengthened off-site and on-site supervision, the share of nonperforming loans has seen a steady decline since 2005, and impaired loans currently account for less than 2 percent of total loans.

9. Recent reforms have strengthened the Maldives Monetary Authority (MMA) and its capacity to manage liquidity. A recent amendment of the MMA Act has provided for separating the leadership of the central bank and ministry of finance, previously held jointly, and reorganized the governing body of the central bank. In addition, an inter-agency agreement provides the MMA jurisdiction on setting of interest rates and places a ceiling on government borrowings through the Ways and Means Account. The authorities have initiated another amendment to further clarify that the central bank need not be a captive purchase of government bills. These reforms will strengthen the MMA's instruments and capacity to control domestic liquidity.

10. Finally, the Maldivian authorities would like to thank staff for their sound advice and thank the Fund and its membership for their continued support.