



Strategy and Program Assessment

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Maldives: Borrowing Capacity Assessment

A. Introduction

1. Debt sustainability is essential for economic stability and growth because a high debt level poses serious macroeconomic management challenges. Servicing a growing public debt requires resources that could be otherwise used to finance essential public services. At high levels of the public debt, the servicing requirements can put upward pressure on domestic interest rates, fuel inflation, and crowd-out the private sector from domestic financial markets. High levels of public debt also weaken the Government's ability to use monetary policy instruments and reduce the country's ability to withstand external shocks.

2. The Maldives has been experiencing a significant increase in external debt in recent years, a phenomenon which began well before the tsunami disaster. Between 1997 and 2006, the external DOD increased at a pace that was much higher than growth in nominal GDP. Consequently, the ratio of external debt to GDP increased from 35% to 65% during this period. The tsunami crisis has prompted the government to adopt an expansionary fiscal policy, which further added to the public debt burden.

3. Up to now the government has maintained an impeccable record with respect to its debt servicing obligations, but as the Maldives reaches middle-income levels, caution is required to ensure that the Government's capacity to borrow in a sustainable manner is not breached. Over the next decade, aid terms are expected to harden, and the government will have to rely primarily on commercial loans to finance its budget deficits. Moreover, given the country's narrow economic base, and vulnerability to external shocks, it would be prudent for Government to ensure that it has the capacity to borrow during periods of severe downturns or extreme need.

B. External Debt

4. **Growth of the External Debt Stock.** The total external DOD, which comprises public and publicly guaranteed debt (medium and long-term) and bank debt (short-term), has increased visibly in recent years. Some 88% of the total (recorded) external debt comprises public and publicly guaranteed debt. Total external debt stood at \$ 574 million in 2006 as against \$178 million in 1997. The corresponding figures for external public debt were \$361 and \$165 million.

5. External debt has grown at a far faster pace than has GDP over the past decade. The total external debt grew by an average of 11.1% per annum between 1997 and 2006. By comparison, nominal GDP growth averaged 7.2% per annum. The total external debt to GDP ratio increased from 35% in 1997 to 65% in 2006; the external public debt to GDP ratio from 33% to 41.1%; and the short term commercial bank debt to GDP ratio, from 2.5 to an alarming 24.2%, respectively (Table 1). During the above period, net transfers have been positive in most years, with principal repayments (amortization) and interest payments to private creditors exceeding corresponding payments to official creditors. Debt service has risen at a much slower rate—from \$28 million in 1997 to \$31 million in 2006—due to grace periods of much of the new debt incurred in recent years, and to the concessionary nature of the stock of outstanding debt.

Table 1: External Debt Outstanding and Disbursed and Debt Service, 1997–2005
(\$ million)

Item	1997	2000	2002	2003	2004	2005	2006
Total External Debt	178.1	211.6	259	289.5	331.8	397.3	574.3
Medium and Long-Term Debt	165.3	178	223.1	272.9	311.6	309.9	361.8
Official Creditors	135.2	139.4	164.7	186.7	212.5	220.5	267.3
Private Creditors	30.1	38.6	58.4	86.1	99.1	89.3	226.3
Short-Term Debt	12.8	33.6	35.9	16.6	20.2	87.4	212.6
Debt Service (\$ million)	28	19	21.2	21.5	28.4	31.1	31.2
Amortization	24.2	14.3	16.7	16.7	21.6	23.9	23.3
Interest Payments	3.9	4.6	4.4	4.8	6.8	7.2	7.9
% of GDP							
Total External Debt	35.0	33.9	40.4	41.8	42.7	51.9	65.3
Medium and Long--Term Debt	32.5	28.5	34.8	39.4	40.1	40.5	41.1
Short-Term Debt	2.5	5.4	5.6	2.4	2.6	11.4	24.2

GDP = gross domestic product.

Source: Ministry of Finance and Treasury.

6. Table 2 provides a breakdown of external public DOD by official and private creditors, i.e., concessionary and commercial lending, respectively. During the period 1997–2006, official lending averaged 75% while private lending averaged 25% of external public DOD. But commercial lending is growing at a faster rate than official lending, primarily due to increasing recourse to private supplier credits.

Table 2: Composition of Public and Publicly Guaranteed External Debt, 1997–2005
(\$ million)

Item	1997	2000	2001	2002	2003	2004	2005	2006
Debt Outstanding and Disbursed (DOD)	165.3	178.0	181.5	223.1	272.9	311.6	309.9	363.7
Official Creditors	135.2	139.4	141.3	164.7	186.7	212.5	220.5	262.2
% of Total DOD	(81.8)	(78.3)	(77.8)	(73.8)	(68.4)	(68.2)	(71.2)	(72.0)
Multilateral	102.1	114.9	118.6	140.4	164.4	182.4	181.1	—
Bilateral	(61.8)	(64.6)	(65.3)	(62.9)	(60.2)	(58.5)	(58.4)	—
Private Creditors	33.0	24.5	22.7	24.3	22.3	30.1	39.4	—
Suppliers' Credit	(20.0)	(13.7)	(12.5)	(10.9)	(8.2)	(9.7)	(12.8)	—
Financial Markets	30.1	38.6	40.2	58.4	86.1	99.1	89.3	101.4
Suppliers' Credit	(18.2)	(21.7)	(22.2)	(26.2)	(31.6)	(31.8)	(28.8)	(28.0)
Financial Markets	23.4	23.5	25.2	48.7	77.3	89.7	78.1	—
	(14.2)	(13.2)	913.9)	(21.8)	(28.3)	(28.7)	(25.2)	—
	6.7	15.1	15.0	9.7	8.9	9.4	11.2	—
	(4.0)	(8.5)	(8.3)	(4.4)	(3.3)	(3.1)	(3.6)	—

() = negative, — = data not available.

Source: Ministry of Finance and Treasury.

7. The composition of Official Development Assistance (ODA) has shifted during the past decade, with more grants provided in the period immediately following the tsunami, and a reversal to more loans in 2007. Foreign grants (excluding tsunami assistance) averaged Rf132.6 million per annum during the first half of this decade and are estimated at Rf105 million in 2006. Bilaterals and multilaterals accounted for 78.1 and 21.9% of the above average, respectively. Japan and the UNDP have been the leading providers of bilateral and multilateral non-tsunami grant assistance, respectively, during the current decade. Tsunami assistance

totaled Rf793 million in 2005 and is estimated at Rf1,620.4 million in 2006, which represents an increase of 104.3% over 2004 grant levels. Roughly 96.9% of the total grant assistance to be provided in 2006 consists of development grants, compared with 93.7% in 2005.

Table 3: Sources of Government grant Finance, 1999–2005

Grant Financing	1999	2000	2001	2002	2003	2004	2005
	(in Rf million)						
Bilateral	148.3	142.1	183.8	107.5	97.1	35.0	51.4
Brunei	-	-	-	-	1.0	-	-
Darussalam							
Denmark	6.1	13.9	6.2	6.4	-	-	0.1
Germany	18.7	-	-	-	-	-	-
Japan	108.6	107.6	129.9	57.9	65.1	12.6	10.1
Kuwait	-	-	1.4	0.0	0.2	-	-
Saudi Arabia	-	-	18.4	16.6	6.4	0.9	-
United Kingdom	-	-	-	-	-	-	-
India	-	-	9.4	-	-	0.2	0.0
France	-	-	-	-	-	-	0.6
Australia	-	-	0.6	0.0	-	-	0.7
China, People's Rep. of	14.2	-	7.7	-	-	6.2	25.5
Sri Lanka	-	-	-	-	3.9	7.9	7.9
Qatar	-	-	-	26.6	19.9	6.4	6.4
America	-	-	-	-	0.6	0.7	-
Sweden	0.3	-	0.2	-	-	0.1	-
Canada	0.4	-	0.0	-	-	-	-
Pakistan	-	-	-	-	-	-	0.1
The Netherlands	-	-	10.0	-	-	-	-
Multilateral	14.4	23.8	27.9	25.0	26.5	37.9	773.2
WHO	3.4	4.3	3.6	5.7	2.9	3.8	5.3
UNDP	2.7	4.7	5.6	4.1	8.5	9.7	10.4
UNESCO	0.7	0.2	1.2	0.4	0.3	1.0	0.3
UNICEF	2.4	2.3	3.8	4.4	3.0	3.7	3.7
UNFPA	3.1	5.2	3.9	2.0	0.8	1.8	2.2
UNEP	-	-	-	-	-	-	0.4
British Council	-	-	-	-	-	-	3.6
Asian Football Federation	-	-	-	-	-	-	3.6
Other	2.1	7.1	9.8	8.4	11.0	17.9	9.9
Tsunami Assistance	-	-	-	-	-	-	733.8
Total Grants	162.7	165.9	211.7	132.5	123.6	72.9	824.6
Proportion							
Bilateral	0.91	0.86	0.87	0.81	0.79	0.48	0.06
Proportion							
Multilateral	0.09	0.14	0.13	0.19	0.21	0.52	0.94

Sources: Ministry of Finance and Treasury, budget data files.

8. Foreign official loans averaged Rf457.5 million (\$35.7 million) per annum during the first half of this decade, with the 2006 level estimated at Rf1,408.5 million (\$110.0 million). Multilateral financiers have accounted for the vast bulk (87%) of official loans between 2000 and 2005. Between 2000 and 2005, the largest bilateral lender was the Kuwait Fund, with a total DOD of Rf271.2 million (\$21.2 million). Among the multilaterals, the largest was the ADB, with total lending of Rf346.8 million (\$27.1 million), followed by IDA, with a total of Rf255 million (\$19.9 million), and the IDB, with a total of Rf250.1 million (\$19.5 million). In 2006, the largest

lenders are the ADB (Rf189.6 million), the European Investment Bank (Rf186.2 million), the Kuwait Fund (Rf164.8 million), and the Bank of Ceylon (Rf163.7 million).

9. The Maldives' balance of payments current account balance has been negative during the 2000–2006 period on account of a negative trade balance as well as a net outflow of private remittances. Due to the impact of the tsunami, the current account deficit increased by more than 146% in 2005, with the deficit estimated at about \$ 330 million. In 2006, the current account deficit reached a record of \$369.2 million, or 40.7% of GDP. Due to a recovery in tourism, the overall balance in 2006 was a positive \$45.1 million. Gross international reserves (GIR) stood at \$232.2 million in 2006, as against \$ 123.6 in 2000, which was sufficient to finance 2.4 months of import requirements.

C. Public Debt

10. **Rapid Growth in the Fiscal Deficit.** The overall fiscal deficit increased from 4.4% in 2000 to 12.2% in 2005, in part because of the Tsunami relief, but also because of the granting of tax and import duty exemptions, continuation of subsidized economic services¹ and a 40% increase in public sector wage bill in 2005 (Table 4). An expansionary fiscal stance continued in 2006, with the deficit estimated at around 7.3% of GDP. The tax base remains narrow with little buoyancy and progress towards introducing a business profit's tax has remained elusive. Although reflecting in part urgent tsunami-reconstruction outlays, the current gap between the expenditure and revenue to GDP ratios is so large as to require an unsustainable level of deficit finance.

11. The Government uses a mix of foreign and domestic borrowing to finance the fiscal deficit. The domestic debt outstanding is made up exclusively of Ways and Means Advances taken from the MMA. The estimated level of total financing in 2006 (Rf846 million) is almost triple the 2000 level (Rf322 million) due to the rapidly expanding budget deficit. Although government endeavored to reduce domestic borrowing in 2003 and 2004, it has borrowed heavily again from the domestic financial market in 2005 and 2006.

12. Between 2000 and 2005, the public debt to GDP ratio increased from 41 to 52%. Given that some of the public debt is on concessionary and some on commercial terms, the more appropriate comparator is the ratio of the net present value (NPV) of public debt to various indicators of the Government's debt service carrying capacity. For example, between 2000 and 2005, the NPV of public debt to GDP ratio increased from 29 to 36%, and the NPV of public debt to exports ratio, from 56 to 95%. The total debt service (interest payments plus amortization) decreased from 8% to 6% between 2000 and 2004, but increased sharply to 13% in 2005 due to the drastic decline in exports of goods and services. The total debt service to government revenue ratio meanwhile showed an overall decrease from 14% to 13% between 2000 and 2005.

¹ Primarily in Malé for power and water.

Table 4: Summary of Central Government Finance, 2000-2006
(in Rf million)

Item	2000	2001	2002	2003	2004	2005	2006 ^a
Total Revenue and Grants	2,327.7	2,522.6	2,714.9	3,087.9	3,424.7	4,612.8	7,296.7
Total Revenue	2,206.8	2,310.9	2,582.4	2,964.3	3,351.8	3,788.3	5,203.3
Current Revenue	2,202.6	2,294.3	2,577.9	2,936.8	3,331.1	3,753.3	5,171.6
Capital Revenue	4.2	16.6	4.5	27.5	20.7	35.0	31.7
Grants	165.9	211.7	132.5	123.6	72.9	824.5	2,095.4
Expenditure and Net Lending	2,694.2	2,885.9	3,117.3	3,388.2	3,582.6	5,657.6	8,144.4
Total Expenditure	2,739.9	2,912.1	3,135.5	3,551.9	3,779.1	4,500.0	5,497.8
Current Expenditure	1,875.9	1,971.4	2,109.4	2,345.7	2,788.1	4,643.3	6,584.0
Capital Expenditure	864.0	940.7	1,026.1	1,206.2	991.0	1,132.1	1,631.2
Net Lending	(45.7)	(26.2)	(18.2)	(163.7)	(196.5)	(117.8)	(70.8)
Overall Balance	(321.5)	(363.3)	(402.4)	(300.3)	(157.9)	(1,044.8)	(845.7)
Nominal GDP	7,348.0	7,650.8	8,201.0	8,863.2	9,938.7	9,607.7	11,608.3
Overall Balance/GDP (%)	(4.4)	(4.7)	(4.9)	(3.4)	(1.6)	(10.9)	(7.3)
Financing	321.5	363.3	402.4	300.3	157.9	1,044.8	845.7
Domestic Financing	317.9	217.5	30.0	(118.9)	(245.8)	809.8	223.7
Foreign Financing	3.6	145.8	372.4	419.2	403.7	235.0	622.0

() = negative, GDP = gross domestic product.

^a Provisional estimate.

Source: Ministry of Finance and Planning.

D. Debt Sustainability Simulations

13. **Baseline Reform Case.** A debt sustainability analysis (DSA) has been prepared and covered the period 2006-2015. It entails four alternative scenarios: a baseline reform forecast and 3 shock simulations. The baseline reform forecast represents the best case scenario since it is devoid of external shocks and is guided by the 2006-2010 Medium Term Fiscal Framework (MTFF) of MOFT. The baseline reform scenario assumes that the fiscal deficit will be around 2% from 2009 onwards. In the MTFF, on the other hand, the target fiscal deficit is 1.9% for 2009 and zero for 2010. This may be difficult to achieve because although revenue targets appear to be on track, sector ministries are under pressure to finance a wide array of post-tsunami reconstruction and development programs. In order to reflect a greater reliance on commercial borrowing, the rate of interest on foreign loans is assumed to increase from 3% to 6% from 2008 onwards. The results of the debt simulations for the baseline reform scenario are summarized below:

- (i) Public debt outstanding peaks at \$670 million in 2007 and declines to \$610 million in 2015.
- (ii) Public debt/GDP ratio peaks at 60% in 2007 and declines to 26% in 2015.
- (iii) The NPV of public debt/GDP ratio peaks at 41% in 2006 and remains at this level in 2007, but declines thereafter to 19% in 2015.
- (iv) NPV of public debt/exports of goods and services (XGS) ratio peaks at 69% in 2007 and declines to 29% in 2015.
- (v) Total debt service/XGS ratio peaks at 10% in 2012 and declines slightly thereafter.
- (vi) Total debt service/revenue ratio peaks at 21% in 2012 and remains at that level thereafter.

14. In the baseline forecast, the public debt to GDP ratio remains in a critical zone during the first two years (2006–2007). It is important to note that the peak levels of the ratio of the NPV of public debt to GDP (41%) is perilously close to the high-risk levels identified by the IMF-IDA of 45% for a countries whose policies are considered to be in the mid-range of comparable countries. Commercial financiers may interpret a high NPV of public debt to GDP ratio as a sign that Government is over-exposed, raising the risk premium attached to new loans to Government.

15. In terms of other debt indicators, the NPV of public sector debt to XGS ratio, on the whole, is well within the corresponding debt burden threshold of 200% for a medium policy nation. The declining trend after 2007 suggests that this ratio is unlikely to approach the danger zone during the forecast period. Total debt service requirements are also well within the threshold of 25% with respect to export earnings throughout the forecast period, but the trend with respect to the ratio of total debt service to revenue is somewhat disturbing. The ratio increases from 11% to 19% between 2006 and 2008 and further increases to 21% by 2012, as against the threshold of 30%. With total debt service absorbing one fifth of government revenue in the outer years due to increased commercial borrowing, the government may be forced to cut back on development expenditures, with adverse consequences for social and economic development. Thus, even under the baseline reform scenario, debt service obligations are likely to impose considerable stress on government revenue in the medium to long-term.

16. **Debt Sustainability Under Shock Conditions.** The ability of the Government to sustain its debt obligations should take into consideration the possibility that economic conditions will be less favorable than is envisaged. Accordingly, a set of simulations are prepared under a series of adverse conditions, including: (i) slower than expected GDP growth; (ii) a higher budget deficit; and (iii) an abrupt decline in tourism receipts, which is reflected in depressed earnings from exports of goods and services (XGS). These economic shocks have been cumulatively simulated as follows: (i) a decline in real GDP growth by 4% per annum less than the baseline forecasts for the years 2007 to 2009; (ii) a slowdown in GDP growth plus a fiscal deficit to GDP ratio that is 3% higher than the baseline forecasts from 2007 to 2009 caused by rising expenditures and a 1% decline in the revenue to GDP ratio below projected levels; and (iii) a worst-case scenario where the growth slowdown and fiscal slippage are added to a scenario in which tourism earnings cause exports of goods and services to be 20% below projected levels for the 2007 to 2009 period.

17. Under the first and second shock simulations, the debt burden indicators deteriorate for a period of a few years. In particular, the NPV of public debt to GDP and NPV of public debt to exports both increase, with the former approaching threshold ceiling levels. The greatest impact on the economy, however, would come from the third case, or a combined shock scenario, in which GDP growth is slower than anticipated; the fiscal deficit is higher than the projected level, and the exports of goods and services to GDP ratio falls below expectations. Under the combined shock scenario, the public debt peaks at 65% of GDP and the NPV of public debt peaks at 47% of GDP in 2007. It is important to note that the combined shocks cause the NPV of public debt to GDP ratio to exceed the corresponding debt-burden ceiling of 45%, which could have serious implications for the nation's ability to stabilize the macro-economy and service its debt.

18. Also alarming is the dramatic increase in the NPV of debt to XGS ratio, from 70% in 2006 to 117% in 2007, as against a corresponding threshold of 200%. Although it declines to 36% in the outer years, the steep increase in this ratio during the combined shock period illustrates the extent to which it could strain the economy under a worst-case scenario. Total

debt service ratios are also high in this scenario—i.e., 16% in respect of XGS in 2008 (as against 8% in 2006) and 20% in respect of revenue in the same year (compared to 11% in 2006).

19. **Conclusions.** These debt simulations should be viewed largely as an illustrative exercise to ascertain how the various debt and debt service indicators would perform under different macroeconomic assumptions, including a best and worst-case scenario.² The overall analysis indicates that debt sustainability in the Maldives is at a critical juncture. Given that the Maldives is a small, open and narrowly-based economy, shocks cannot be ruled out. Although the public debt is currently within manageable bounds, aid terms are hardening, and by 2011, the Maldives will have to rely primarily on commercial sources of financing to meet its public savings-investment gaps. A combination of an already high level of public debt, large fiscal deficits and a high degree of dependence on tourism earnings exposes the country to a high degree of debt management risk: the simulations above show that a few years of multiple economic shocks could well catapult the country into a position at which its public debt could no longer be sustained.

E. Prudent Fiscal Policy and Public Debt Management

20. A combination of expenditure restraint and steady increases in revenues will be needed to restore a budget balance that can be sustained over the medium-term. To date, the Government has relied on leasing out new resorts and collecting 15% advance lease rental, while evenly spreading the balance over the following years. This is expected to yield some \$20 million in 2006, equivalent to only 20% of the existing budget deficit. A comprehensive fiscal reform program, including a defined time frame for rationalizing the state-owned enterprises, reducing public utility subsidies, sharpening public expenditure priorities, smoothing out adjustments in public sector wages, and reforming the tax system needs to be considered expeditiously. The Government is aware of the need for fiscal consolidation; however, Government forecasts rely mainly on a strong tourism-led growth rebound to bring expenditures and revenues into balance, with supporting domestic policy measures still to be defined.

21. Government can make use of its existing project screening machinery to sharpen priority-setting for its public expenditure. The Government has a well-organized system for reviewing and screening project proposals. Sector ministry project proposals are submitted to the MPND's Project Appraisal Committee (PAC) for technical review. Proposals accepted by the PAC, which includes representatives from the President's Office (PO), MOFT, and the Department of External Resources Department (DER), are prioritized and sent to the PO for approval. After approval has been obtained, they are forwarded to the Aid Management and Coordination Committee (AMCC) by the Planning Ministry for prioritization. The AMCC is chaired by the Foreign Ministry and includes the Ministers of Finance, Planning and Economic Development as well as senior government officials. A key function of the AMCC is to determine which proposals should be grant-funded and which should be loan-funded. Proposals requiring grant assistance are forwarded to the DER, which is under the Foreign Ministry, while those requiring loan assistance are forwarded to the External Resources Management Section (ERMS) of the MOFT for further processing.

² The findings of these simulations are similar to those generated by the IMF during their Article IV consultation mission of May 2007. The need for strong, near-term fiscal consolidation measures to ensure that debt remains sustainable in the near- to medium-term has been highlighted by the Fund.

22. The ERMS is responsible for monitoring the external public debt portfolio, and the Public Finance and Treasury Sections, for monitoring the domestic public debt portfolio. Preparation of medium-term external debt projections (on an annual basis) and periodic assessment of debt sustainability is also undertaken by ERMS. Two TA projects financed by ADB have significantly improved the debt monitoring and management capabilities of ERMS. The ongoing project is focusing on four areas: (i) strengthening the ERM Section; (ii) improving overall project management capability; (iii) overseas training; and (iv) improving the monitoring capacity of implementing agencies.

23. There are a number of institutional factors that impede effective management of the public debt. First, since the overall project monitoring capabilities of the implementing agencies are weak, ERMS has little knowledge of how loan funds allocated to the various projects are being utilized. Second, the loan disbursement data assembled by ERMS do not necessarily represent utilization because of the wide discrepancy between what has been allocated and what has actually been utilized in many of the foreign-funded projects. Third, while the MPND has instituted a simple project monitoring tracking system, some implementing agencies do not bother to fill the forms while others return the forms partially completed. Hence, although in theory, a project monitoring mechanism exists, in practice, it is not effectively implemented. A quarterly project progress reporting system has been developed, but has yet to be introduced. And fourth, Government's ability to forecast long-run public debt requirement, and to assess the effects of changing global and domestic market conditions on debt and debt service requirements are currently rudimentary at best.