Maldives

Too rapid fiscal expansion in recent years and a global recession–induced drop in tourism have taken the economy to the brink of crisis. A new government is attempting to correct structural imbalances and restore sustainable growth, including broadening the revenue base, rationalizing expenditure, and retrenching public employment. It also supports privatization as part of a wider shift of the role of government.

Economic performance

After the December 2004 tsunami disaster, the economy rebounded on the back of large tourism-related investment and substantial increases in government spending. The fiscal expansion was, however, excessive, including as it did large increases in public sector wages and employment as well as subsidies. It pushed budget expenditure to 63.1% of GDP by 2008 and the overall deficit to 16.9% of GDP.

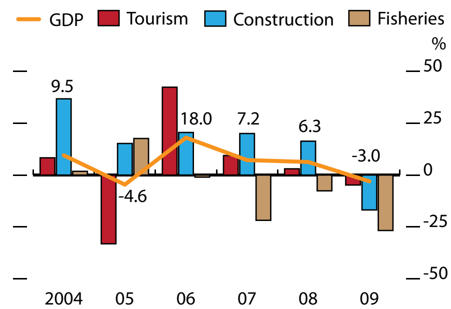
Given high import dependency, this fiscal expansion led to a marked balance-of-payments deterioration. When the country was hit by a drop in tourism after the start of the global crisis in September 2008, the heavy domestic and external imbalances threatened macroeconomic stability.

In these circumstances the economy struggled, with GDP dropping by 3.0% (a 9 percentage point tumble) in 2009, due primarily to contractions in tourism (the current economic mainstay), construction, and fisheries, by 4.8%, 16.8%, and 26.7% respectively (Figure 3.18.1). Tourist arrivals declined by 4.0% in 2009; indeed, the drop would have been even worse had it not been for a surge in arrivals from the People's Republic of China, which helped offset a 7.1% fall in European visitors, a market usually responsible for around two-thirds of visitors (Figure 3.18.2). Hotel occupancy rates declined to 70% from 78% the previous year. Fishing, the main source of employment, saw a 22% decline in the catch. Total fish and fish product exports fell by 36%, in part reflecting a drop in prices.

Since the country imports the bulk of its goods, domestic price volatility is largely attributable to price pressures in global markets. After consumer inflation peaked at 17.3% year on year in July 2008, the high price hikes quickly moderated, as evidenced by inflation declining to 4.0% by December 2009 (Figure 3.18.3). Inflation averaged 4.0% in 2009, down from 12.3% a year earlier. A drop in food prices—at one-third, the most heavily weighted component in the consumer basket—was the main factor in the decline.

Broad money grew by 12.5% in 2009 (Figure 3.18.4). This expansion was due primarily to a 14% increase in net domestic assets as net foreign liabilities were reduced. The expansion in net domestic assets was entirely due to continued large expansion in net credit to government,

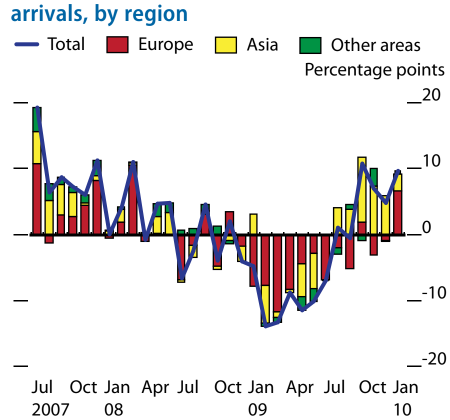
3.18.1 Selected GDP growth indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

Click here for figure data

3.18.2 Contributions to growth in tourist arrivals, by region



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

while credit to the private sector fell by 4.1% (in contrast to about a 30% expansion a year earlier) as the government bond issue, which replaced financing by the monetary authority as part of structural reform, crowded out private investment.

Total fiscal revenue, including grants, is estimated to have deteriorated by 20% in 2009 to 31.6% of GDP from 46.2% in 2008 (Figure 3.18.5). All major sources of tax revenue fell, reflecting a 30% drop in imports and the decline in tourism. Total expenditure climbed by about 7%, well below the near 23% increase in 2008, as the government tried to rein in the deficit, including wage cuts for civil servants. Still, the deficit expanded sharply to 26.1% of GDP from 16.9% a year earlier with just over three-quarters financed by the banking system.

The current account deficit surged from 15.7% of GDP in 2004 to 51.4% in 2008 owing to strong domestic demand led by new resort construction, large government expenditure, and soaring food and oil prices after 2007. As international prices stabilized and economic activity fell, the deficit is estimated to have fallen to a still-high 28.5% of GDP in 2009 (Figure 3.18.6).

Capital inflows have in large part financed the large deficit. The main items have been investment inflows for resort development, greater lending by Malé-based branches of two foreign commercial banks, and foreign borrowing by the government. Since the onset of the global crisis, foreign banks in Malé have sharply curtailed their lending, which has led to a shortage of dollars in the domestic market—a particularly acute problem in a dollarized economy. As the monetary authority intervened to maintain the fixed exchange rate with dollar, gross international reserves declined to $207 million in September 2009 before showing a slight retracement.

In an attempt to restore macroeconomic stability, the current President, who was elected in October 2008, began to implement an emergency economic reform program that includes substantial fiscal reform. On the revenue side, airport passenger service charge has been raised, a business profit tax will be introduced, and the tourism bed tax will be transformed into a tourism goods and service tax, yielding substantially higher revenue.

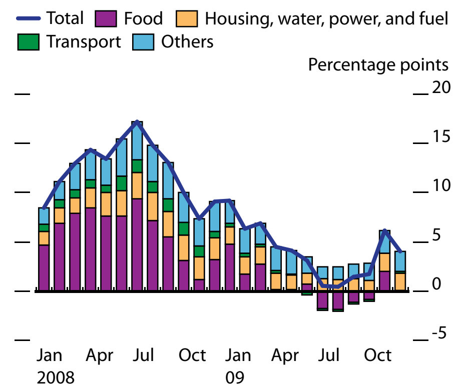
In order to align expenditures with revenues, the government is streamlining administrative machinery by downsizing the civil service, reducing electricity subsidies, and linking power tariff adjustments to cost of inputs twice a year. The government also plans to privatize parts of the extensive network of state-owned enterprises.

To support the government's reform program, the IMF approved in December 2009 a $79.3 million standby arrangement and $13.2 million under a program to deal with external shocks.

Economic prospects

The economic outlook heavily depends on performance of tourism and fisheries, as well as the government's ability to push through its reform measures. Although fisheries constitute a small fraction of GDP growth, they remain vital in the economy as they are the main provider of food and employment in many of the atolls. And, while tourist arrivals have

3.18.3 Contributions to inflation



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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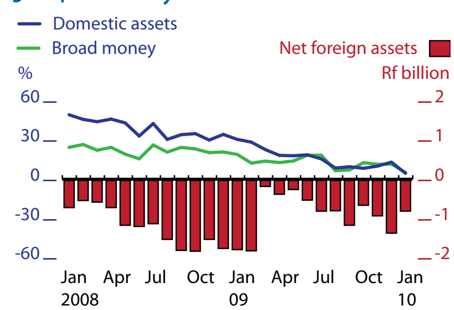
3.18.4 Monetary indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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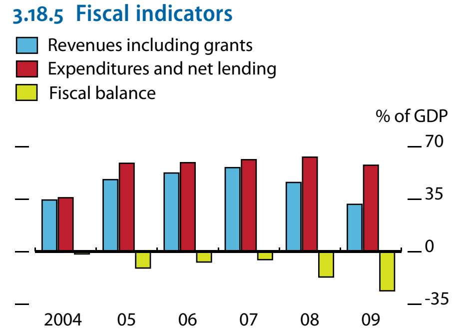
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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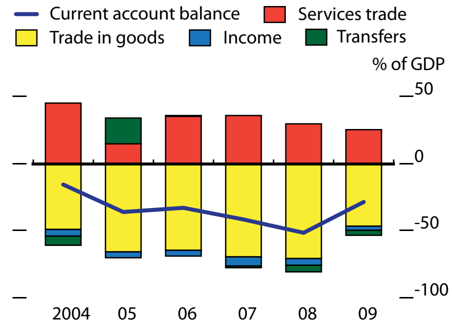
seemingly bounced off the bottom, driven by non-European arrivals, it will no doubt be some time before arrivals from Europe recover to precrisis levels.

With a better than initially expected economic outcome in 2009, the economy is projected to grow at 3.0% for 2010 and 3.5% in 2011. Inflation is put at 4.0% in 2010 and 3.0% in 2011, broadly in line with global commodity price assumptions where oil prices are expected to rise marginally and nonfuel commodity prices to remain stable. It is also assumed that the monetary authority will aim policy to support price stability and not provide financing for the fiscal deficit.

On the external front, lower commodity prices will ease the trade deficit, but receipts from tourism will recover only from next year. The current account deficit is expected to remain flat at 25.0% of GDP in the forecast period.

3.18.6 Current account indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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Development challenges

As a tiny, open economy the country is vulnerable to events beyond its control—including geopolitics, global economic developments, and climate change. Within its domain, however, the government needs to correct structural economic imbalances, primarily via fiscal reform and consolidation as well as privatization of state-owned enterprises. In view of the limited role of monetary policy under the currency peg with US dollar, fiscal policy has to play the greater role in demand management and economic stabilization. In addition, weak institutions and human resource deficiencies are major constraints, including the fragmented structure of government.

As the country lacks the natural capacity to expand its economic base beyond tourism and fisheries, increasing value added in those sectors is vital. The government aims, within tourism, to ensure better training of local staff to limit the current heavy reliance on expatriates, and within fisheries, to promote exports.

The significant income disparities between Malé and the atolls are continually widening. The government has an intention to group the atolls into seven provinces and develop regional administration and economic centers. Its hope is to concentrate and thereby improve service delivery, but given that it aims to reduce the cost to itself at the same time, this is a tall order.

Recognizing the country's vulnerability to climate change (none of the islands is more than 1.8 meters above sea level), in the short term, all the government can do is attempt to minimize the disaster impact, and therefore has strengthened mitigation responses for beach erosion. By 2019, the government has committed to switching from oil to 100% renewable energy production to serve as a model for other nations.

3.18.1 Selected economic indicators (%)

	2010	2011
GDP growth	3.0	3.5
Inflation	4.0	3.0
Current account balance (share of GDP)	-25.0	-25.0

Source: ADB estimates.