Maldives

The economy resumed normal growth after the post-tsunami contraction in 2005 and the sharp rebound in 2006, though it experienced an unexpected drop in the fish catch. The deteriorating fiscal balance, prompted by the tsunami, is a major concern. With narrow economic concentration and openness keeping the country vulnerable to external shocks, the authorities need to diversify activity by fostering private sector initiatives. Developing human resources and institutional capacity as well as establishing stronger financial sector institutions are also required.

Economic performance

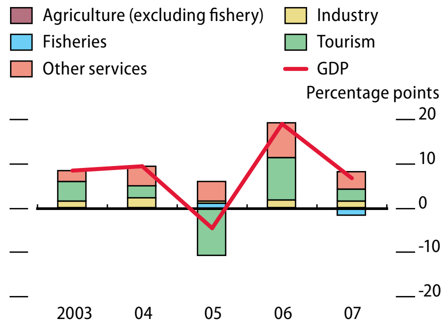
The economy grew by 6.6% in 2007, reverting to its historical growth path after the post-tsunami contraction in 2005 and the rebound in 2006 (Figure 3.18.1). Performance in 2007 would have been even better were it not for a sharp drop in the fish catch that took 1.5 percentage points off overall GDP growth. Tourism, the leading sector with a near one-third share of GDP, grew by 10.0% as a result of growing tourist arrivals that, in 2007, finally exceeded the pre-tsunami peak level of 2004 (Figure 3.18.2). A 14.8% expansion in transport and communications and 19.3% growth in construction underpinned continued strong contributions to growth by services and industry, respectively. Value added in fisheries, which has only a GDP share of 4.5% in 2007 but is important in terms of employment and exports, dropped by 23.7% due to a fall in the fish catch of nearly 70,000 metric tons.

Inflation, as measured by the national consumer price index, averaged 7.4% in 2007 compared with 3.5% in the previous year. It accelerated in the second half, and exceeded 10% year on year in the fourth quarter. The pickup was due to food prices (food has a weight of one third in the index), which came in nearly 30% higher in the final 3 months of the year than a year earlier (Figure 3.18.3). As the country imports almost all the commodities it consumes, such as petroleum, food, and construction materials, global commodity prices, especially of petroleum, affect domestic inflation and tourism's cost structure.

Although the rufiyaa's peg to the depreciating United States (US) dollar has contributed to tourism's sharp recovery by benefiting Europeans (three quarters of tourists in 2007), the weakening of the US dollar has added pressure to prices.

Deterioration in the fiscal balance is worrisome. The Government included large reconstruction project expenditures in the budget after the tsunami, but also pushed up current expenditures to raise public sector wages and continue power and water subsidies in the capital, Malé. Limited implementation capacity reduced capital spending such that

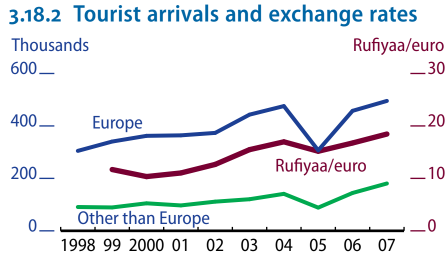
3.18.1 Contributions to growth (supply)



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 9, No. 2, February 2008.

Click here for figure data

3.18.2 Tourist arrivals and exchange rates



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 9, No. 2, February 2008.

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the 27.6% of GDP budgeted deficit for 2007 was reduced to 7.9% of GDP. However, even this level of borrowing cannot be sustained in the medium term. The 2008 budget has an expenditure plan of 73.5% of GDP with a deficit of 10.2% if implemented as planned (Figure 3.18.4).

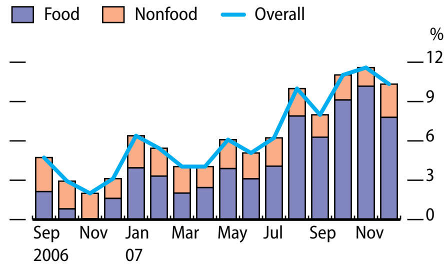
Stronger policy measures should be adopted for fiscal consolidation to keep government debt at a sustainable level, including a reduction in domestic expenditures, together with introduction of the business profit tax and adoption of additional lease charges related to tourism development. Moreover, the current, fixed, bed tax should be converted into an ad valorem tax.

The increase in public debt from 37.6% of GDP in 2000 to 56.4% in 2007 raises sustainability concerns. Debt would jump to 59.7% of GDP in 2008 to finance the budgeted deficit if expenditure plans are fully implemented. A debt-sustainability assessment by the Asian Development Bank in 2007 concluded that it is essential to pursue policy reforms for balancing the budget and reducing the country's debt burden.

The trade balance deteriorated significantly after 2003, mainly due to growing imports of construction materials and petroleum products, which amounted to 67.1% of GDP in 2007. While import growth moderated to 14.8% in 2007, because of the 20.7% drop in exports of fish and fish products (about half of all exports), the trade deficit failed to improve, with exports showing only a 2.8% rise.

A net surplus in services trade, most of which comes from tourism, had financed the trade deficit until 2004. Even though tourism earnings recovered to exceed the pre-tsunami level in 2007, larger services payments and the expansion in imports meant that net services covered only about 40% of the trade deficit. The current account deficit therefore widened further to 45.0% of GDP in 2007 (Figure 3.18.5). The financial account, however, saw large inflows in 2007, led by advanced lease rents for new resorts, to cover the current account deficit.

3.18.3 Inflation



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 9, No. 2, February 2008.
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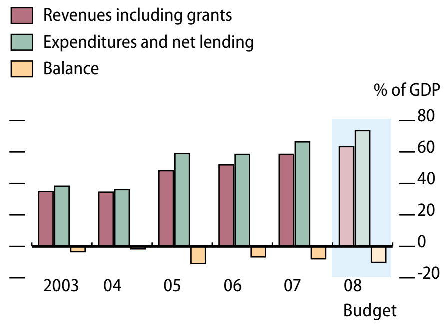
3.18.4 Fiscal indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 9, No. 2, February 2008.
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Economic prospects

GDP is projected to grow by 8.0% in 2008, bolstered by additional resorts becoming operational and a consequent steady increase in tourists. A rebound in the fish catch to normal levels is also assumed. Growth will likely moderate to about 7.0% in 2009. With higher global oil prices, inflation is penciled in at about 6.0% in 2008 and 2009. With continued growth in tourism and a rebound in fish exports, the current account deficit as a share of GDP will stabilize and then improve in 2009.

The deteriorating fiscal indicators are a concern, and pose a major risk. Unless the Government rationalizes its capital spending and improves targeting of the large subsidy for its social services, in order to keep the public debt at a sustainable level, rapid economic growth just cannot be maintained. External shocks will continue to be a downside risk for the country, as economic openness and a narrow base—with a heavy reliance on tourism—will leave it vulnerable.

The country is in a political transition. Since the Majlis (parliament) opted for multiparty democracy and lifted a ban on political parties in 2005, four parties have been formed. Parliamentary elections are scheduled for mid-2008, and a new constitution is being drafted for

3.18.1 Selected economic indicators

	2008	2009
GDP growth	8.0	7.0
Inflation	6.0	6.0
Current account balance (% of GDP)	-45.0	-40.0

Source: Staff estimates.

approval before that date. Maldives has, however, decided to maintain its current presidential system in a referendum on the form of government held in August 2007.

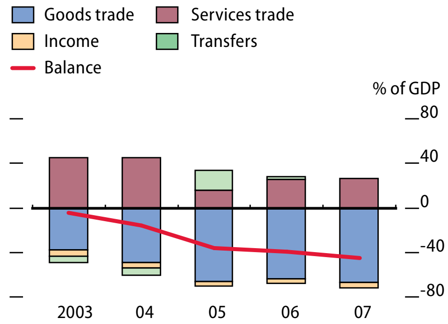
Development challenges

To mitigate the vulnerability that comes from the narrow economic base, the authorities need to diversify economic activity by promoting the private sector. Improving the legal framework to provide a conducive business environment is needed. The most serious constraints are, however, a shortage of skilled labor and weak public institutions. Since vocational and skills training is underdeveloped, the education system cannot provide the human resources that the labor market requires. This results in high youth unemployment (22% for men and 41% for women in 2005), and heavy reliance on expatriate workers (around 45% of the workforce, according to the 2006 census).

Government plays a large role in the economy through state-owned enterprises, including processing and export in fisheries. This role should be reconsidered, with the state changing from being a main producer of goods and services to that of a facilitator. This will require a well-defined regulatory mechanism, with means for enforcement of contracts and development of the present shallow financial sector.

Although the economy has reached middle-income status, with a per capita income estimated at $3,400 at end-2007, people in remote islands have been left behind in the distribution of gains. Efforts to narrow regional disparities between the growth center around Malé and the outer atolls are crucial.

3.18.5 Current account indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 9, No. 2, February 2008.

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