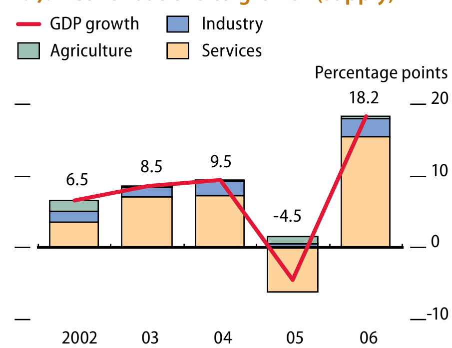
Maldives

The economy strongly rebounded in 2006, after the downturn in 2005 that stemmed from the impact of the December 2004 tsunami. The Government's expansionary fiscal policy adopted in response to the disaster, building on long-standing structural issues, such as expansion of the civil service and continued heavy subsidies for some social services, worsened the fiscal indicators. This deterioration presents a potentially serious threat to prospects of further recovery.

Economic performance

After 2005's contraction—essentially caused by the December 2004 tsunami—2006 saw an economic upswing, with GDP growth estimated at 18.2% (Figure 2.17.1). Tourism, traditionally accounting for about one third of GDP, grew by nearly half and its contribution to GDP rebounded to its former share as tourist arrivals recovered to close to pre-tsunami levels (Figure 2.17.2). Transport and communications recorded 12% growth. Growth in fisheries (accounting for 7% of GDP, though more important in terms of exports and employment) increased by 3.7% from its robust expansion of 17% in 2005.

2.17.1 Contributions to growth (supply)



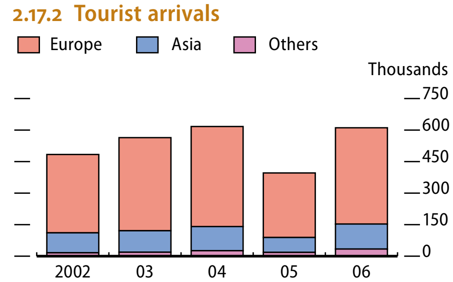
Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

Inflation measured by the consumer price index is volatile, as the heavily weighted food component fluctuates significantly. In 2006, inflation picked up slightly to 3.7% from 3.3% a year earlier. This was largely driven by price rises in transport and communications, and in housing, water, fuel, and power, in the main reflecting global oil price rises. The Maldives Monetary Authority tightened monetary policy in 2006 to address inflationary pressures, raising the interest rate on certificate of deposits from 4% to 5% in January. Broad money, however, accelerated to 21% growth from 12% in 2005, driven by a large expansion (50%) in private sector credit, mainly to the tourism and wholesale/retail trade sectors.

The 2006 budget planned for the deficit to widen to 18.1% of GDP from 12.5% in 2005 (Figure 2.17.3). Expenditures were set to grow by 51% (74.5% of GDP) mainly due to a more than doubling in capital expenditures, including those for tsunami reconstruction projects, while current spending was slated to rise by around 18%. Total revenues, including a large increase in grants, were to grow by 44% (to 56.4% of GDP). Preliminary fiscal data through the third quarter of 2006 show strong increases in both tax and nontax revenues. Import duties (about 70% of tax revenues) rose by around 40% from the previous year, reflecting a higher level of imports (as well as the Government's decision to withdraw the 2005 duty exemption granted for tsunami-related reconstruction) and a recovery in tourism taxes (about 20% of tax revenues) from the previous year's lower base. Large nontax revenues of advance payments from newly leased resorts were also collected. However, expenditures through the third quarter of 2006 have risen

2.17.2 Tourist arrivals



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

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less than revenues, on account of lower utilization of the development (capital) budget. This result is likely to hold for full-year 2006, as monetary data show that net credit to government decreased (by 22%) and balance-of-payments estimates no substantial increase in grants.

The Maldives is an import-dependent country, bringing in everything from staple foods to resort supplies, construction materials and petroleum products. The average ratio of imports to GDP in 2000–2004 was about 60%, while that for merchandise exports was about 20%. The trade balance deteriorated significantly after 2004, leading to a deficit of $604 million in 2006 (preliminary estimate, about 67% of GDP; (Figure 2.17.4). Imports increased by 27% in 2006 as both private sector and public sector imports grew. The increase largely came from petroleum products and from construction materials and related products. Exports (domestic and reexports) recorded a strong increase of 40%, mainly due to a pick up in marine exports, which now account for nearly all domestic exports. Garment production and exports virtually disappeared in 2005 with the termination of the quota system at end-2004.

Net services and income receipts about doubled and reached $185 million in 2006. Earnings from tourism were up by 51% to $434 million for the year but still were 8% lower than the 2004 pre-tsunami level. Grant transfer receipts estimated at $122 million were somewhat less than the $152 million of grants in 2005. Taking into account payments (mainly workers' remittances), net transfers amounted to $42 million. In sum, the current account deficit widened to $376 million (42% of GDP, from 36% in 2005).

In terms of financing the current account deficit, the financial account saw an estimated large inflow of $318 million in 2006, largely private and commercial bank borrowing. Taking account of a large positive errors and omissions, the overall balance was estimated to post a surplus of $45 million in 2006 (switching from the $17.3 million deficit of the previous year). At $232 million as of end-2006, gross reserves offer 3.0 months of import cover.

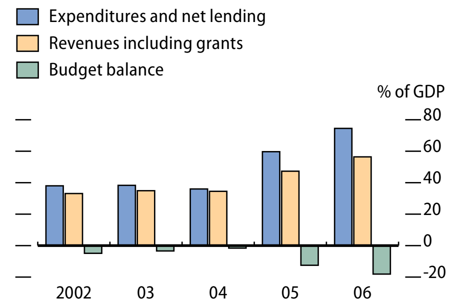
The rufiyaa's peg to the falling US dollar (Rf12.8/$1 since 2001) has contributed to tourism's sharp recovery. About three quarters of tourists in 2006 were Europeans, benefiting from a strong euro.

External debt statistics of the country cover only government and government-guaranteed borrowings, and the external debt of the banking sector. In the 2 years since the tsunami, external debt sharply increased by $250 million to reach an estimated $582 million at end-2006 (64% of GDP), about three quarters the expansion in debt was accounted for by sector short-term external borrowing of commercial banks for onlending to the private sector. At end-2006, about 63% of the outstanding debt was in medium- to long-term maturities (the bulk of which is concessional lending by official creditors), while the balance of $213 million was short debt of commercial banks. The debt service ratio at the end of 2006 was 4.6%.

Economic prospects

The Government estimates that GDP will continue its rapid growth in 2007, at 12.1%. This would appear realistic given that tsunami-related damage is being restored, tourism is rebounding strongly, and inflation

2.17.3 Fiscal indicators

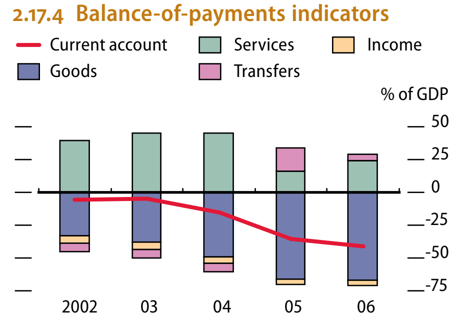


Note: 2006 is budget estimate for the year.

Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

2.17.4 Balance-of-payments indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

and the balance of payments are under control. Growth would likely slow in 2008, perhaps to about 8%. The Government estimates that the current account deficit could even exceed 60% in 2007 if development plans are fully put through. Inflation should stay at around 4%.

However, the deteriorating fiscal indicators are worrying. The large budgeted deficit stems not only from reconstruction, but also from long-standing structural issues such as expansion of the civil service (and large pay rises) and subsidized social services. Unless the Government addresses these issues before its debt reaches unsustainable levels, high economic growth cannot be maintained. Increases in commercial banks' short-term external debt also need careful monitoring.

The downside risks are grounded in the narrow economic base, shallow financial sector, structural issues that have been masked by tourism-led growth, and severe human resources deficiencies. On average, some 40% of the labor force is expatriate—both at the lower and higher skills end—and a large number of secondary school graduates are absorbed by the public sector, not on account of their skills, but as a social policy objective of keeping youth unemployment down. While absolute poverty has declined and the Maldives is in compliance with the Millennium Development Goal of poverty reduction, inequities and inequalities have increased between Male' and the outer atolls.

2.17.3 Selected economic indicators

	2007	2008
GDP growth	12.1	8.0
Inflation	4.0	4.0
Current account balance (% of GDP)	-60.9	-15.0

Sources: Government projections for 2007; staff estimates for 2008.

Development challenges

In the absence of any meaningful structural revenue-enhancement measures, there is a possibility that development expenditures will bear the brunt of the necessary fiscal adjustment. This is also evident from the Government's preliminary medium-term fiscal projections, which show development expenditures progressively declining to 9.6% of GDP by 2010, the final year of the Seventh National Development Plan.

The economy remains overdependent on a narrow and concentrated economic base with excessive reliance on tourism. Given its natural endowments, the Maldives will continue to rely on tourism to fuel its growth. However, the feasibility of expanding into business tourism (conference tourism) should be examined.

Other structural issues, such as the presence of many state-owned enterprises, coupled with the absence of a clear strategy for privatization, have flowed into the economic undercurrents that are now beginning to surface ominously in the fiscally constrained post-tsunami era. The process of political liberalization needs to be continued and higher standards of governance adopted to facilitate inclusive development.

In addition, given that the country now has middle-income country status with an average per capita income projected to increase to over $2,500 in 2006, the Government should decide whether to keep its role to providing and sustaining an enabling environment with a well-defined regulatory mechanism, including enforcement of contracts; or whether to become a more expansive provider of social goods and services.