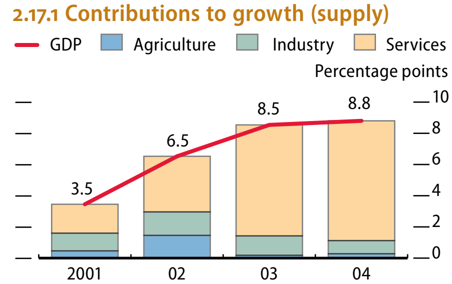
Maldives

Up to December 2004, Maldives' economic performance was impressive with robust growth, increasing per capita income, and macroeconomic indicators that reflected prudent policies. Since that month's tsunami, performance has deteriorated. Tsunami-related reconstruction is under way. What is worrisome is the worsening of macroeconomic indicators caused by non-tsunami-related factors. These include increases in government expenditure, continuation of subsidies, and stagnant revenues. Although tourism is showing good signs of revival, the Government needs to address its fiscal crisis to resume sustainable growth.

Economic performance

Impressive economic growth rates were recorded by Maldives in the past decade, with per capita gross domestic product (GDP) rising to above $2,500, or about 60%, during the period. Average growth rates of around 7.5% were achieved, while inflation was contained at an average of 2%. This led to general improvement in income levels and social indicators, although poverty remains significant on the outer atolls. Economic activity rebounded from the adverse affects on tourism and growth caused by the September 11 events, with output growing from 3.5% in 2001 to 8.8 % in 2004 (Figure 2.17.1). Liberalization and restructuring of the fisheries sector resulted in substantial increases in catches and significant growth in exports. Tourism made a strong growth contribution with receipts up 17.4 % in 2004. Since the rufiyaa is pegged to the United States dollar, the depreciation of the dollar against the euro has strengthened the country's competitive position. Although inflation has generally remained subdued, in 2004 it picked up to 6.4% in response to higher local fish prices that have a heavy weight in the consumer price index.

2.17.1 Contributions to growth (supply)



Source: Ministry of Planning and National Development, available: http://www.planning.gov.mv/publications/yearbook2005/yrb05/yearbook/16.National%20Account/16.1.htm, downloaded 25 January 2006.

The current account has continued to show deficits in recent years, but reserves have improved. Strong growth in external receipts from tourism and fisheries have been offset by high import growth, which generated a current account deficit of 16.1% of GDP in 2004. Strong revenue growth and a slowing in capital expenditure reduced the fiscal deficit in 2004 to 1.7% of GDP (Figure 2.17.2). With continued large foreign financing, domestic financing turned negative, and net repayments were made to the banking system. External debt at end-2004 amounted to $331.8 million, or about 41.5 % of GDP.

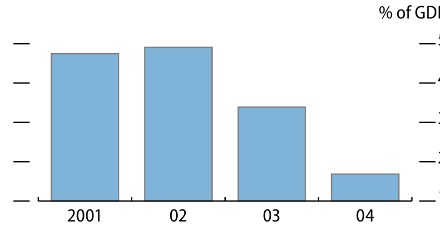
Broad money continued to expand in 2004, with a significant buildup of net foreign assets in the banking system. Growth in credit to the private sector increased to 57.8 % in 2004, with about half of new lending going into development of new tourist facilities. Credit to the public sector fell substantially with the lower deficit and the shift toward foreign financing.

A joint Asian Development Bank-World Bank-United Nations Tsunami Needs Assessment report estimated that GDP growth would drop to 1% in 2005, the budget deficit would increase to some 14% of GDP, and the current account deficit would hit some 25% of GDP. This analysis was based on prevailing international oil prices and, more important, the assumption that tourism would fully recover by end-2005.

The actual outcome for 2005 has been quite different. This stems primarily from a deteriorating macroeconomic situation, in turn resulting from the combined effects of tsunami-related damage, increased expenditure associated with the restructuring of the Government, and rising global oil prices. These developments have cumulatively resulted in a significantly changed macroeconomic and balance-of-payments situation, with likely delay in resumption of pre-tsunami economic growth rates. Instead of growing by about 1%, the economy is now estimated to have contracted by 5.5% in 2005. In addition, work on tsunami-related reconstruction projects has been slow in taking off (in large part due to capacity constraints), and international oil prices steadily increased in 2005 (exerting additional pressure on the resource position). The Government was thus forced to present a supplementary budget in August 2005, containing a gross resource gap of some $135 million for 2005 alone. Of this amount, $39.4 million was expected to be financed from foreign sources, while an additional $39 million had already been monetized, leaving a net resource gap of $93 million. Even with full recovery of tourism, and no increases in spending, the resource gap for 2006 would also be in the order of $95 million.

The current account deficit in 2005 is projected to be about 40% of GDP, and it was likely that about $100 million would have to come from foreign exchange reserves unless additional external financing was identified. The domestic financing gap will eventually be made up by a combination of fungible resources from external agencies; reduction in expenditure and/or revenue enhancements; and domestic financing from the Maldives Monetary Authority. The last will increase inflationary pressure and lead to a drawdown of foreign exchange reserves.

2.17.2 Budget deficit



Source: Ministry of Planning and National Development, available: http://www.planning.gov.mv/publications/yearbook2005/yrb05/yearbook/13.Public%20Finance/13.2.htm, downloaded 25 January 2006.

Economic outlook

The Government is currently in the midst of a fiscal crisis that has contributed to a large budget deficit, a drawdown of reserves, and an increase in inflation. Maldives is a net importer of petroleum products, but the Government has long-term supply contracts with Kuwait and thus receives a limited price discount to the open market spot rates or to medium-term supply contracts. There is no subsidy on the sale of refined petroleum products and pump prices reflect actual costs. However, the Government subsidizes power rates in Malé and to that extent the cost is borne by the budget.

The Government needs to develop a medium-term expenditure framework, rationalize policy for tourism and lease of tourism resorts, and progressively reduce fiscal subsidies. Appropriate fiscal policies would likely result in GDP growth rebounding to 9% in 2006 and moderating to 6% in 2007 (Figure 2.17.3), while the current account deficit would be held to about 20% of GDP.

The major risk emanates from the current fiscal crisis that started in 2005 and is likely to persist through 2007—ending by that date

2.17.1 Selected economic indicators

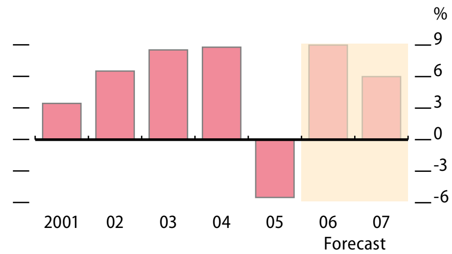
	2006	2007
GDP growth	9.0	6.0
Inflation	2.8	2.5
Current account balance (% of GDP)	-21.4	-16.9

Source: Staff estimates.

only if the Government restrains fiscal expenditure, increases revenue (especially the yield from tourism by making appropriate tax changes), and by encouraging further growth of the private sector in fisheries and tourism. Lack of fiscal discipline would send a strong negative signal and could affect the flows of much-needed foreign direct investment. The Government needs to devise medium-term macroeconomic policies with the principal objective of returning Maldives to its pre-tsunami growth levels. In addition, it should consider the equitable distribution of the benefits of growth so as to reduce the high poverty rate of around 40%. The Government is cognizant of the high unit cost of providing social service to far-flung atolls and its policy of population consolidation to "focus islands" merits further examination and support. The issue of employment is also important as the economy relies heavily on expatriate labor, especially for blue-collar jobs.

The Government has formed a task force to monitor expenditure, and to prepare a contingency plan in case the fiscal situation worsens. Due to a partial recovery in tourism arrivals, the foreign exchange reserves drawdown has not been as serious as anticipated earlier between 2004 and 2005. Foreign reserves declined by some $20 million.

2.17.3 GDP growth



Sources: Ministry of Planning and National Development, available: http://www.planning.gov.mv/publications/yearbook2005/yrb05/yearbook/16.National%20Account/16.1.htm, downloaded 25 January 2006; Maldives Monetary Authority, Economics Statistics January 2006 Vol.6, No.1; IMF Country Report No. 05/145, April 2005.