INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No 06/21.
FOR IMMEDIATE RELEASE

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2005 Article IV Consultation with Maldives

On February 22, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Maldives.[1]

Background

Prior to the tsunami in December 2004, the Maldives had achieved high real GDP growth supported by expanding tourism and sound macroeconomic management. Income per capita rose by 60 percent over the decade up to the tsunami to above $2,500 and social indicators had improved significantly. The economy has, however, remained vulnerable to external shocks due to its undiversified production and small size. It is also at risk from rising sea levels due to global warming.

Economic consequences of the tsunami were severe. Physical damage relative to the size of the economy was the highest among affected countries; the cost of reconstructing housing and infrastructure is estimated at $375 million (about 50 percent of 2004 GDP) and tourism sustained significant damages as well. Real GDP is estimated to have contracted by 3¾ percent in 2005, as tourist arrivals fell by a third. With the decline in tourism, foreign exchange earnings also plummeted, and a current account deficit of 37 percent of GDP is estimated for 2005—exacerbated by higher oil prices. Official reserves declined to 2½ months of imports at end-2005 from 3½ months a year earlier.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the February 22, 2006 Executive Board discussion based on the staff report.

The implementation of reconstruction was initially slow—donor pledge of $260 million, notwithstanding—due to problems in local consultation, limited capacity, and insufficient coordination. Measures have recently been taken to address them and reconstruction work has started to accelerate. Tourist arrivals also started to recover strongly toward the end of 2005 and real GDP is expected to rebound in 2006.

Fiscal management became difficult after the tsunami. The 2005 fiscal deficit was 12 percent of GDP as tourism revenues dropped and the government decided to provide new subsidies and expand social sector spending. A gap of 9 percent of GDP was financed by the Maldives Monetary Authority (MMA). Furthermore, the 2006 budget also suffers from a risk of a similarly large deficit as it includes a large spending program based on highly optimistic revenue assumptions. This stance may in part reflect caution the authorities appear to be exercising in adjusting policy against the backdrop of ongoing democratic reforms.

Despite high MMA financing of the budget, inflation has been subdued as domestic currency lending was modest. Commercial banks borrowed from abroad to finance reconstruction of tourist resorts—which in turn used the loan proceeds for imports. This borrowing from abroad also helped finance the balance of payments gap and limited official reserve loss.

The authorities have embarked on several structural reform initiatives—fiscal, state-owned enterprise, and financial sector reforms—to create a business environment conducive to private investment and to support diversified growth. Progress has, however, been slow due in part to limited implementation capacity, and more recently to the tsunami disaster. The authorities have expressed their commitments to accelerate the implementation of structural reforms in 2006.

Executive Board Assessment

Executive Directors expressed deep sympathy for the losses suffered by the Maldives due to the December 2004 tsunami and, noting its serious economic consequences, stressed the importance of reducing the country's vulnerability to external shocks. Directors called for fiscal and monetary reforms to enhance the authorities' capacity to conduct timely demand management along with structural reforms to expand private sector activities.

Directors commended the authorities' recent acceleration, with donor support, of work on post-tsunami reconstruction. These efforts focused on removing constraints to project implementation including, problems in local community consultation, limited capacity, and insufficient coordination within the government and among donors. The donor community is encouraged to commit the additional resources necessary to finance recovery work fully.

Directors urged a return to the firm commitment to fiscal viability and prudent fiscal policy that had been in place prior to the tsunami. They noted that the fiscal stance adopted in the 2006 budget, in which government spending—including on new recruitment and for initiatives unrelated to tsunami recovery—is well above previously envisaged levels and revenue and financing assumptions are optimistic, could jeopardize stability. Directors observed that the high domestic borrowing requirement that could ensue would place significant pressures on inflation and official reserves. Some Directors, however, argued that a delay in the introduction of fiscal adjustment measures would be warranted, given the extent of tsunami damage and taking into account the authorities' past record of fiscal prudence.

Against this background, Directors welcomed the government's recent decision to prepare contingency plans that could be triggered in the event its borrowing from the MMA exceeded certain thresholds or official reserves declined rapidly. At the same time, they noted that the potential impact of the plans on the fiscal balance remained uncertain, and stressed the importance of early action to contain risks of future serious fiscal imbalances. Directors cautioned against inadvertent cuts in spending slated for tsunami recovery.

Looking ahead, Directors stressed that further fiscal reforms will be critical. Experience in the wake of the tsunami showed that the options for fiscal adjustment to macroeconomic imbalances are limited because of rigid revenue and expenditure structures. Directors urged the authorities to increase revenue and its buoyancy through the accelerated introduction of corporate profit taxation and a broad-based sales tax. Expenditure management should reflect realistic revenue projections, while protecting priority spending. Directors agreed that civil service reforms could contribute to containing general administration costs and help appropriately limit the size of the civil service and related wages.

Directors viewed that the exchange rate peg arrangement provides a credible nominal anchor and serves the Maldives well, given the economy's openness and small size and its constrained institutional capacity. They stressed that fiscal and monetary discipline is indispensable to its support and, in this regard, urged a reduction in the large fiscal deficits and an end to automatic financing by the MMA. They stressed that early enactment of the MMA amendment, with set legal limits to the government's MMA borrowing, will be crucial to making the institution more independent.

Directors commended the authorities' efforts to introduce indirect monetary management and improve banking supervision. They welcomed the progress made in preparing for the introduction of a more market-based monetary policy—once the MMA ends its automatic financing of the deficit—including introduction of auctions of MMA certificate of deposits or treasury bills. Directors also commended ongoing efforts to strengthen the MMA's supervision of commercial banks, which has led to a reduction in nonperforming loans.

Directors urged the authorities to accelerate the implementation of structural reforms to enhance the role of the private sector and broaden the productive base. Given the dominant roles played by the public sector and by tourism, Directors noted that a business environment conducive to broad-based private investment, supported by the privatization of public enterprises and the implementation of key economic and financial legislation, both of which had been stalled during the aftermath of the tsunami, would be critical to achieving medium-term viability. Directors welcomed the efforts of the government to put in place the necessary legal framework to combat money laundering and the financing of terrorism.

Directors appreciated the authorities' past efforts to improve the statistical base and encouraged that further resources be devoted to enhance data in a number of areas for effective policy design and evaluation.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise

Maldives: Selected Economic Indicators, 2001–05

	2001	2002	2003	2004	Est. 2005
			(Annual percentage change)		
Growth and prices					
Real GDP	3.5	6.5	8.5	8.8	-3.6
Consumer prices (period average)	0.7	0.9	-2.9	6.4	5.7
Consumer prices (end period)	...	-5.0	-1.5	10.1	5.0
			(Percent of GDP)		
Central government					
Revenue and grants	33.0	33.1	34.9	33.2	48.8
Expenditure and net lending	37.7	38.0	38.3	34.8	61.1
Of which: Capital spending	12.3	12.5	13.6	10.7	22.3
Overall balance	-4.7	-4.9	-3.4	-1.7	-12.3
Financing					
Domestic	2.8	0.4	-1.5	-1.3	9.0
Foreign	1.9	4.5	4.7	4.0	3.2
			(Annual percentage change)		
Money and credit					
Domestic credit	19.4	11.7	-5.8	31.7	56.4
Public sector	7.0	6.5	-25.5	-26.0	109.4
Central government (net)	8.4	5.1	-19.6	-45.2	118.1
Private sector	29.9	15.3	6.8	57.3	45.3
Broad money	9.0	19.3	14.6	32.6	9.1
			(In millions of U.S. dollars)		
Balance of payments					
Exports, including reexports	110.1	132.3	151.9	181.0	169.6
Imports	-346.3	-344.7	-414.3	-567.3	-686.8
Nonfactor services (net)	244.2	251.7	311.1	352.4	118.1
Current account balance	-58.8	-35.7	-31.9	-128.9	-297.9
(In percent of GDP)	-9.4	-5.6	-4.6	-16.1	-36.5
Overall balance	-21.4	39.8	74.3	57.7	-136.4
Gross official reserves (year-end)	94.3	134.6	161.0	205.2	187.2
(In months of imports of GNFS) 1/	2.5	3.5	3.6	3.4	2.5
External debt					
(In millions of U.S. dollars)	209.8	259.0	289.5	331.8	481.6
(In percent of GDP)	33.6	40.4	41.9	41.5	58.9
Of which: Public	29.0	34.8	39.5	39.0	41.4
Debt service	22.0	22.9	22.0	28.4	33.4
(In percent of domestic exports of GNFS)	5.1	5.0	4.0	4.5	7.6
Exchange rate					
Rufiyaa per U.S. dollar (period average)	12.2	12.8	12.8	12.8	12.8
Memorandum item:					
Nominal GDP (in millions of rufiyaa)	7,650.8	8,201.0	8,842.0	10,235.1	10,457.9

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.

1/ GNFS = Goods and nonfactor services.