*d*zfjkl

© 2010 International Monetary Fund

January 2010
IMF Country Report No. 10/28

Maldives: 2009 Article IV Consultation—Staff Report; Staff Supplements; Public Information Notice on the Executive Board Discussion; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Maldives

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2009 Article IV consultation with Maldives, the following documents have been released and are included in this package:

- The staff report for the Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 19, 2009, with the officials of Maldives on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 24, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of November 25, 2009 on the joint IMF/World Bank debt sustainability analysis.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 4, 2009 discussion of the staff report that concluded the Article IV consultation.

- A Press Release summarizing the views of the Executive Board as expressed during its December 4, 2009 discussion of the staff report that completed the review.

- A statement by the Executive Director for Maldives.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

MALDIVES

Staff Report for the 2009 Article IV Consultation and Request for a Stand-By Arrangement and a 24-Month Arrangement Under the Exogenous Shocks Facility

Prepared by the Asia and Pacific Department
(in consultation with other departments)

Approved by Kalpana Kochhar and Aasim Husain

November 25, 2009

Executive Summary

Context. The Maldivian economy is facing large external and fiscal imbalances, resulting from the severe impact of the global financial crisis and exacerbated by an unsustainable fiscal expansion. The global crisis has led to sharp declines in tourism and related investment, other net capital flows, and exports. This has caused a significant fall in fiscal revenue, compounding a large increase in public spending, and pushed the economy into recession. A rising share of the resulting fiscal deficit has been financed by monetization. Despite foreign exchange rationing by the Maldives Monetary Authority (MMA), international reserves have fallen to about two months of imports.

Program: The authorities are requesting assistance under a blended arrangement (600 percent of quota, or SDR 49.2 million, over 36 months under a Stand-By Arrangement, and 100 percent of quota, or SDR 8.2 million, over 24 months under the Exogenous Shock Facility-High Access Component), designed to provide financing to smooth adjustment to the external shock, restore fiscal and external stability while protecting social spending, and address weaknesses in the banking system. The core of the policy framework is a strong fiscal adjustment to contain aggregate demand and put public finances back on a sustainable medium-term path, complemented by monetary tightening and measures to strengthen the banking sector.

Discussions: A staff team consisting of J. Carter (head), C. Park, A. Pitt (all APD), and M. Oliva (SPR) visited Malé during June 3-16, 2009. Discussions continued in a second visit (August 3–19, 2009), staffed by J. Carter (head), R. Cubero, C. Park, A. Pitt (all APD), R. Basu (SPR), and R. Maino (MCM). The staff met with the President, the Minister of Finance and Treasury, the Governor of the MMA, other officials, members of the Parliament's Public Finance Committee, commercial banks, donors, and private sector representatives.

Previous Article IV Consultation: The Executive Board discussion of the 2008 Article IV Consultation is summarized in the Public Information Notice No. 08/115 at www.imf.org.

Exchange rate system: Maldives has a conventional fixed peg against the U.S. dollar. Maldives continues to avail itself of the transitional provisions of Article XIV, and has not yet accepted the obligations of Article VIII, Sections 2, 3, and 4. It maintains an exchange restriction and a multiple currency practice subject to Fund approval under Article VIII, Sections 2(a) and 3 of the Fund's Articles of Agreement, arising from the MMA's policy of rationing its supply of foreign exchange to commercial banks. The authorities plan to gradually eliminate this restriction over the course of the program.

Data provision is adequate for effective surveillance and program monitoring, but some weaknesses remain.

Contents Page

I. Recent Economic Developments and Outlook for 2009 3

II. Medium-Term Outlook 10

III. Program Discussions 14

IV. Other (Article IV) Policy Discussions....20

V. Program Modalities 22

VI. Risks 24

VII. Staff Appraisal....26

Boxes
1. Impact of the Global Crisis....4
2. Exchange Rate, External Sustainability, and Competitiveness 7
3. Open Market Operations 19

Figures
1. Macroeconomic Indicators 12
2. Policy Developments....13
3. Financial Sector Developments....14

Tables
1. Selected Economic and Vulnerability Indicators, 2004–12 28
2. Central Government Finance, 2004–12....39
3. Monetary Accounts, 2004–10 30
4. Balance of Payments, 2004–12 31
5. Medium-Term Projections, 2006–14....32
6. Financing Requirements and Sources, 2006–12 33
7. Reviews and Disbursements under the Proposed Arrangements, ...34
8. Indicators of Capacity to Repay the Fund, 2009–2021 35

Appendix
I. Maldives: Table of Implementation of Past Fund Advice 36

Attachments
I. Letter of Intent, Memorandum of Economic and Financial Policies....37
II. Technical Memorandum of Understanding 46

I. Recent Economic Developments and Outlook for 2009

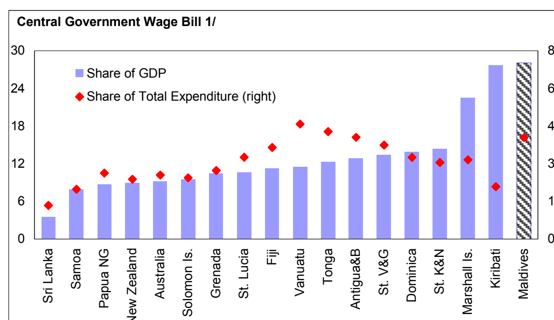
1. **Maldives is facing severe fiscal and external imbalances.** A rapid fiscal expansion after the 2004 tsunami, including steep wage bill increases, pushed public expenditure to 63 percent of GDP in 2008. From mid-2008, the global crisis significantly exacerbated the existing imbalances and severely weakened the country's balance of payments position (Box 1). As in other tourism-based economies, such as those in the Caribbean, tourism revenue has been badly affected by the global downturn, reducing fiscal and foreign exchange earnings and driving the economy into recession. Also, net capital inflows have fallen sharply. The loss in fiscal revenues, combined with the continued growth in public expenditures, have led to a dramatic increase in the fiscal deficit in 2008–09, much of which has been monetized. In the face of lax fiscal policy and the external shocks, supporting a fixed exchange rate—pegged to the U.S. dollar at 12.8 rufiyaas per dollar since 2001—has resulted in significant reserve losses, forcing the MMA to ration foreign exchange.

2. **External shocks have prompted a decline in economic activity and inflation.** After growth of 5¾ percent in 2008, real GDP is expected to shrink by about 4 percent in 2009, driven by the decline in tourism—arrivals are forecast to fall by 7 percent, compared to last year—and a retrenchment of the construction sector, which is projected to shrink by almost one-quarter as tourism projects are delayed. Inflation has been falling rapidly, to 3 percent year-on-year (y/y) in August, on the back of lower import prices. However, an increase in international fuel prices and domestic electricity tariffs is expected to push it up in the second half of 2009 to about 6¾ percent y/y.

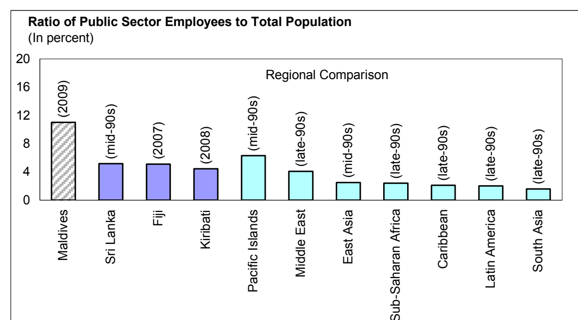
3. **The impact of the global crisis has turned an unsustainable fiscal expansion into a serious near-term risk to macroeconomic stability.**

- Government expenditure almost doubled as a share of GDP between 2004 and 2008, and, without adjustment, is on course to reach 69 percent of GDP by end-2009. A key driver has been the wage bill, stemming from large wage increases and a build-up in the number of public sector employees. As the charts below show, public employment and the wage bill are now very high by international standards.

Central Government Wage Bill 1/



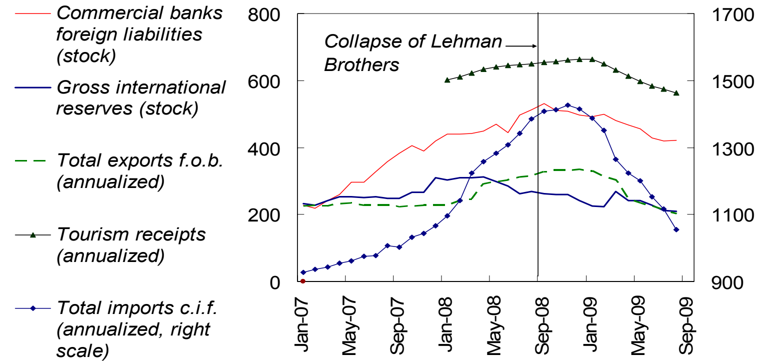
Ratio of Public Sector Employees to Total Population
(In percent)



Sources: ILO, WEO, IMF staff reports and country desks, Sugden and Taniguchi (2008), "The Growth Penalty of High Government Pay Rates", ADB.
1/ Ratios are based on 2009 projections for Maldives and on averages for 2000-2008 for other countries.

Box 1. Maldives: Impact of the Global Crisis

The sudden and severe impact of the global economic and financial turmoil has brought the country to the brink of a crisis. Earnings from traditional exports and tourism have turned down sharply. Also, foreign investment inflows into tourism-related activity have suffered a significant set-back, and banks have been having difficulty rolling over existing credit lines after the collapse of Lehman Brothers in September 2008 (see chart).



The net negative impact of the exogenous shock on the balance of payments is estimated at about US$309 million (24½ percent of 2009 GDP) in 2009–10. This includes cumulative losses on exports, tourism and net capital inflows, offset by reduced tourism- and investment-related imports and gains from the decline in food and fuel prices (see table).

Adjustment to these shocks will rely largely on import compression, supported by fiscal retrenchment. Significant import contraction started this year, reflecting reduced private sector income, stagnant domestic credit, and foreign exchange rationing by the MMA. With the large fiscal adjustment envisaged in the program, imports would remain subdued through 2011–12. The shock has also resulted in large reserves losses: reserves will remain below their medium-term target of about 3½–4 months of imports through 2011.

Multilateral financing will be critical to meet the residual balance of payments needs and support the adjustment effort. Total financing from the IMF, World Bank, and ADB is projected at US$81 million for 2009–10. Under the proposed Fund arrangement with an SBA/ESF blend, the ESF would cover the two years that are primarily affected by the fallout from the global crisis, while the 36-month SBA would support the strong fiscal adjustment needed over the medium term to restore the sustainability of the underlying external position.

Box 1. Maldives: Impact of the Global Crisis (concluded)

Maldives: Estimated Net Impact of Export and Capital Account Shock

	2008	2009	2010	Shocks1/ 2009 (change vis-à-vis 2008)	Shocks1/ 2010 (change vis-à-vis 2008)	Total Impact
	(In millions of U.S. dollars, unless otherwise indicated)					
CURRENT ACCOUNT	-647.9	-397.7	-337.6	-250.2	-310.3	-560.5
A) Exports (excluding re-exports)	125.9	88.3	100.2	37.5	25.7	63.2
B(i)) Food and Fuel Imports (price effect)	-448.3	-320.3	-358.9	-128.0	-89.4	-217.4
B(ii)) Tourism & Investment Imports	-253.8	-162.5	-176.4	-91.3	-77.4	-168.7
C) Travel receipts	663.6	521.2	629.9	142.4	33.7	176.1
CAPITAL AND FINANCIAL ACCOUNT	495.9	355.2	252.3	140.7	243.6	384.3
D) FDI, Banks, and other investment (excluding privatization)	431.6	166.2	241.0	265.5	190.6	456.1
EXOGENOUS SHOCK NET & GROSS IMPACT 2009 & 2010						
F) Gross Impact (A+C+D)				445.4	250.0	695.4
G) Net Impact (A+C+D+B(i)+B(ii)))				226.1	83.2	309.3
in percent of 2009 GDP				17.9	6.6	24.5
Memo:						
IMF	0.0	7.8	31.1	7.8	31.1	38.9
of which SBA	0.0	6.2	24.9	6.2	24.9	31.1
of which ESF	0.0	1.6	6.2	1.6	6.2	7.8
Other Multilaterals (World Bank and AsDB)	0.0	18.0	24.0	18.0	24.0	42.0

Source: Staff Estimates
1/ A positive number indicates a detrimental effect.

- The state-owned electricity company (STELCO) has been experiencing large operating losses, as electricity tariffs have not been raised in line with international fuel prices. The implicit electricity subsidies, financed through government transfers, have been budgeted at about 2½ percent of GDP in 2009, and could exceed that in the absence of tariff adjustment.

- The external shocks caused by the global crisis significantly intensified the fiscal imbalances. Revenue has been shrinking on account of slower imports (as customs duties represent a key source of revenue), lower tourism inflows, and postponed lease payments from embattled tourist resort projects.

- As a result, the fiscal deficit rose to 13¾ percent of GDP in 2008 and, if corrective action is not undertaken, could reach 33 percent of GDP in 2009 while public debt would soar to 97 percent of GDP.

4. **The external shocks have caused serious balance of payments difficulties.** With public expenditure rising fast and weaker tourism growth, the current account deficit widened to 51 percent of GDP in 2008. In 2009, the severe negative external shocks from the global crisis contributed to a decline in capital inflows and a domestic slowdown, and led to foreign exchange rationing by the MMA (Box 1). These forces, combined with lower import

prices, have prompted a very sharp import contraction, more than offsetting the decline in tourism inflows. As a result, the current account deficit is expected to moderate significantly in 2009, to 30 percent of GDP. The reduced availability of external financing, including credit lines for banks and funding for tourism projects, has led to an overall balance of payments deficit and continued reserve losses. Even after the recent SDR allocations, gross international reserves stood at 2¼ months of imports at end-September, 2009; usable reserves, which exclude foreign currency deposits at the MMA, were down to less than 3 weeks of imports.[1]

5. **Monetary policy has been constrained** by fiscal dominance—the government had been able to borrow without limit from the MMA—and the fixed exchange rate regime. In the absence of open market operations (introduced only in August 2009), any excess money supply from deficit monetization had ultimately been reabsorbed via reserve losses. Strong capital inflows kept the money supply growing at double-digit rates for several years through mid-2008, but the global shocks led to dollar shortages and significant reserve losses. The MMA has been rationing the supply of foreign exchange to the banking system at US$ 2.3 million per week, and a parallel market has emerged with a premium of around 10 percent over the official peg.[2, 3] While information is scant, this rate has apparently remained relatively stable over the past several months.

6. **The real effective exchange rate (REER) has appreciated recently, but remains below historical averages (Box 2)**. After depreciating steadily from 2001 to mid-2008, the REER appreciated over the last year, on account of a stronger US dollar and higher inflation in Maldives relative to its trading partners. However, the REER remains below its 10-year average, and its path has also remained below those of relevant comparators. A quantitative analysis, based on CGER-type methodologies, suggests that under baseline (adjustment) policies the current peg is consistent with medium-term fundamentals.

---

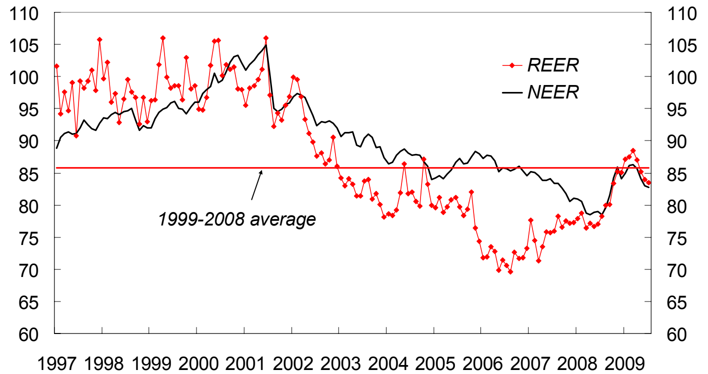
[1] The general SDR allocation provided SDR 6.1 million (US$9.6 million) on August 28, 2009, and a further special allocation of SRD 1.3 million (US$2 million) took place on September 9, 2009.

[2] The official foreign exchange market involves the MMA, commercial banks, and licensed money changers. The MMA sells foreign exchange to banks (at a rate of US$1 = 12.85 rufiyaas) and the public sector (at a rate of US$1 = 12.80 rufiyaas). The amount provided weekly to banks has been similar for several years, but became binding since mid-2008. Foreign exchange supplied to the public sector has so far not been subject to limitations.

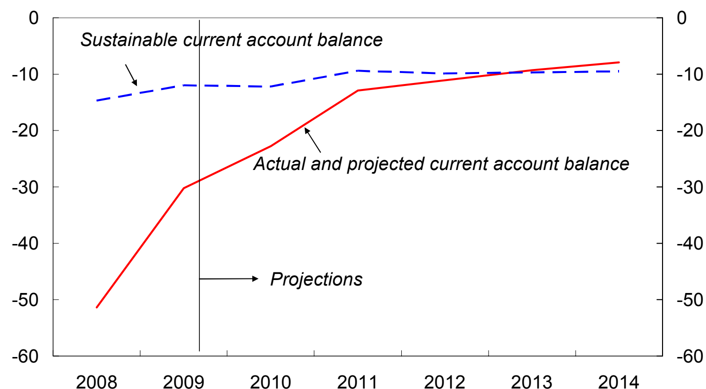
[3] There is no evidence that foreign exchange rationing to the banks has led to external payments arrears by the private sector.

Box 2. Maldives: Exchange Rate, External Sustainability, and Competitiveness

The Maldivian rufiyaa has appreciated in recent months, but remains below historical averages. From 2001 to mid-2008, the rufiyaa depreciated by 27 (25) percent in real (nominal) effective terms, driven mainly by the depreciation of the U.S. dollar against the currencies of Maldives' trading partners. A stronger dollar thereafter and high relative domestic inflation led to a slight real and nominal effective appreciation. Nevertheless, the real effective exchange rate (REER) remains below its average for the period 1999–2008. Unit labor cost data are not available, but would likely show a larger appreciation, as the rapid increase in public sector wages is likely to have had an impact on economy-wide wages.



CGER-type methodologies suggest that the REER is consistent with medium-term fundamentals under the baseline (adjustment) scenario. While the current account is currently inconsistent with its medium-term norm, by 2013 the external accounts would return to equilibrium under the envisaged program adjustment. For given elasticities, this implies that the REER is significantly overvalued at present but its medium term path under the baseline is consistent with fundamentals (Table 1). Risks to the program, including delayed or insufficient fiscal adjustment, would of course also affect external sustainability.



Box 2. Maldives: Exchange Rate, External Sustainability, and Competitiveness (concluded)

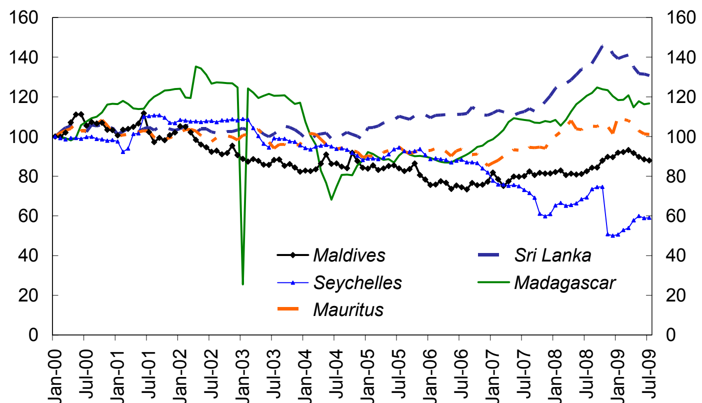
Table 1: Quantitative Exchange Rate Assessment 1/

	2014		
	Current Account Balance		Real Effective Exchange Rate
	Norm	Underlying	
Macroeconomic balance 2/	-9.5	-7.9	-3.4
External sustainability 2/	-6.2	-7.9	3.7

Sources: Fund staff estimates and projections.

1/ All figures are based on five year conditional forecasts, and are expressed in percent. Results reported are based on a GMM estimator applied to 182 countries.(Vitek 2009)
2/ Estimates are based on a medium-run semi-elasticity of the ratio of the current account balance to GDP with respect to the real effective exchange rate of -0.464, a NFA to GDP norm of -90.2, and a medium-run equilibrium nominal GDP growth rate of 7.3 percent.

Cross-country data suggest that the Maldivian economy remains competitive, but faces some structural weaknesses. For the past five years, the path of the Maldives' REER has remained below those of some relevant competitors for high-end tourism, except the Seychelles. Also, growth of international visitor arrivals suggests that Maldives remains competitive in international tourism attraction. However, broader indicators point to challenges to the business climate. Maldives' ranking in the World Bank's *Doing Business* index remains within the median mark, but declined from 71 in 2008 to 87 in 2009.



Maldives: Competitiveness Indicators

Countries	Doing Business 1/ 2008	Doing Business 1/ 2009	Tourism Competitiveness 2/ Average growth in arrivals (in percent)
Mauritius	24	17	4.6
Bahamas, the	59	68	1.1
Dominican Republic	102	86	4.2
Maldives	**71**	**87**	**7.1**
Sri Lanka	97	105	3.6
Seychelles	105	111	n.a.
Madagascar	144	134	22.3

Sources: World Bank, *Doing Business, World Travel & Tourism Council*
1/ Rank among 183 countries.
2/ Average growth in international visitors during the period of 2001-2008.

7. **The global crisis and the domestic downturn have put significant stress on the banking system.** With a high exposure to the tourism sector and the concentration of loans in a few large borrowers, some banks have experienced a significant increase in non-performing loans (NPLs). While banks' reported capital position is still strong, potentially large losses from NPLs could compromise their balance sheets. Also, the global financial crisis has reduced financing options (e.g., lines of credit, parent financing). Banks have substantial domestic liquidity buffers (including excess reserves at the MMA) and long net open positions in foreign exchange. However, their still large (though declining) negative net foreign asset position, large exposure to short-term external financing, and high loan-to-deposit ratio in foreign currency, makes them vulnerable to dollar liquidity shocks. Deteriorating asset quality, a difficult economic outlook, and constrained financing have led private sector credit growth to grind to a halt in 2009, after several years of very high growth rates.

8. **Political context.** President Nasheed was sworn into office in November 2008, following the 30-year tenure of President Gayoom. Parliamentary elections in May 2009,

Maldives: Structure of the Banking Sector

July 2009

		Assets			
	Number of Institutions	Billions of Rufiyaa	Billions of U.S. dollars	% of 2008 GDP	% of Total Assets of Banks
Commercial Banks	6	25.1	2	250	
Domestic	1	11.3	0.9	113	45
State-owned	1	11.3	0.9	113	45
Private	0	0	0	0	0
Foreign-owned	5	13.8	1.1	138	55

Source: Fund staff estimates, based on data from the Maldives Monetary Authorities

however, did not deliver a majority for the President's Maldivian Democratic Party, with the opposition (Mr. Gayoom's party) winning the most seats. Political compromises will therefore be inevitable. Prioritizing the government's ambitious legal reform agenda—which includes legislation on new tax measures, tax administration, privatizations, land tenure, and investment—will therefore be required.

II. Medium-Term Outlook

9. **In the adjustment scenario, the Maldivian economy is expected to return to fiscal and external sustainability over the medium term.**[4]

- Real GDP growth is expected to rebound in 2010. Tourism inflows and tourism-related investment are projected to recover as global economic activity picks up later this year and international financial markets normalize. This, combined with a more stable macroeconomic environment and renewed confidence in the economy, should boost investment and growth. Real GDP growth is projected to increase to 3½ percent in 2010 and reach about 4½ percent in 2014. The strong fiscal adjustment is expected to be a relatively minor drag on growth, given the high import intensity of public and private spending. But coupled with a more moderate pace of tourist resort expansion and supply constraints on fishing, growth is projected to average around 4 percent in 2010-14, compared with 6½ for the ten years to 2008.

- The moderation in international commodity prices, and tighter fiscal and monetary policies, should help inflation decline gradually to about 3 percent in 2012–14, after a temporary increase in 2011 due to the introduction of a goods and services tax.

- Stronger fiscal revenues, on account of tax reforms and the domestic recovery, combined with a sharp reduction in expenditure, should lead to a rapid fiscal improvement, with the overall deficit falling to 1 percent of GDP by 2014 and the primary balance turning to surplus from 2011.

- With the recovery in tourism, and imports held down by fiscal and monetary adjustment, the current account deficit is projected to narrow sharply to about 8 percent in 2014, within its sustainability bound (Box 2). Gross international reserves are projected to increase gradually to about 3¾ months of imports by 2014.

---

[4] The adjustment scenario under the program is the baseline scenario for projections in this report and the accompanying debt sustainability analysis. There are considerable upside and downside risks to the outlook. The key risk factors are outlined in section VI below.

Maldives: Key Macroeconomic Indicators, 2008-14
(Baseline scenario)

	2008	2009	2010	2011	2012	2013	2014
	Est.	Proj. (under the program)					
Real GDP (percent change)	5.8	-4.0	3.4	3.7	4.1	4.3	4.5
Inflation (y/y percent change)	11.9	5.5	4.5	6.3	3.5	3.0	3.0
Overall fiscal balance (percent of GDP)	-13.8	-28.8	-17.8	-4.2	-3.6	-2.3	-1.0
Domestic financing (percent of GDP)	10.0	16.1	13.6	2.2	1.1	1.2	0.0
Public debt (percent of GDP)	68.6	91.6	96.0	87.9	82.5	76.6	69.8
Current account (percent of GDP)	-51.4	-29.6	-23.4	-13.1	-11.1	-9.3	-7.9
GIR (in months of GNFS imports)	1.8	3.2	3.1	3.1	3.4	3.6	3.7

Sources: Maldivian authorities, and Fund staff estimates and projections.

Maldives: Key Macroeconomic Indicators, 2008-14 1/
(No adjustment scenario)

	2008	2009	2010	2011	2012	2013	2014
	Est.	Proj. (no policy change)					
Real GDP (percent change)	5.8	-3.8	2.8	2.5	2.8	3.2	3.6
Inflation (y/y percent change)	11.9	7.5	6.0	6.0	6.0	6.0	6.0
Overall fiscal balance (percent of GDP)	-13.8	-32.9	-28.3	-20.7	-20.3	-21.9	-23.4
Domestic financing (percent of GDP)	10.0	24.7	25.0	16.5	16.8	19.0	20.0
Public debt (percent of GDP)	68.6	96.6	113.7	123.1	130.6	138.8	147.5
Current account (percent of GDP)	-51.4	-29.6	-23.3	-16.3	-12.4	-11.0	-10.3
GIR (in months of GNFS imports)	1.8	1.4	1.0	1.0	1.0	1.0	1.0

Sources: Maldivian authorities, and Fund staff estimates and projections.

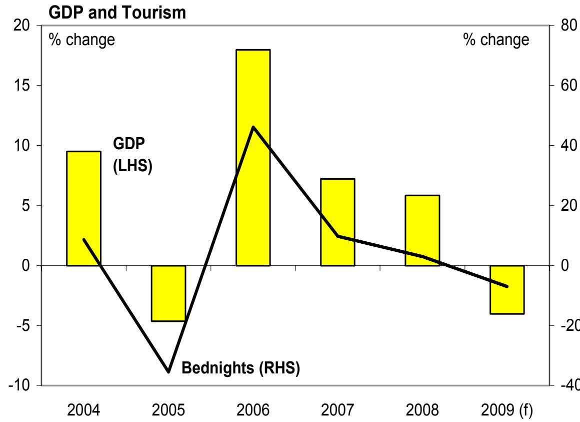
1/ Assumes that reserves will be maintained at 1 month of GNFS imports through borrowing at market rates.

10. **In a scenario with no policy changes, the fiscal and external paths would remain unsustainable.** In the absence of policy adjustment, the fiscal deficit would remain high despite a cyclical (non-discretionary) increase in revenue, deficit monetization would continue, and public debt would soar. The current account deficit would decline more slowly, with international reserves falling to a minimum (assumed here at one month of imports), forcing the country to increasingly ration foreign exchange.[5] While tourism would still recover on the back of a stronger global economy, private investment would be dragged down by a loss of confidence in the domestic economy, and crowded out by high interest

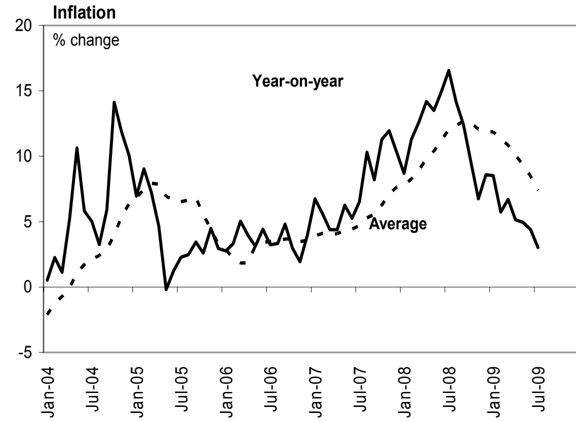
[5]This scenario assumes no currency crisis (the official peg is maintained at the current level), but increasing rationing would force more transactions into the parallel market and keep a lid on the current account deficit.

Figure 1. Macroeconomic Indicators

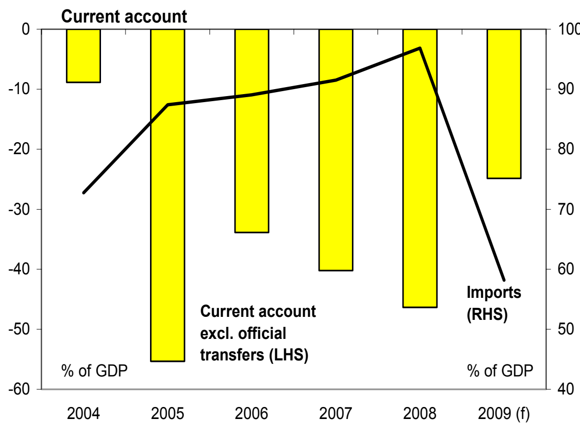
Following a strong post-tsunami recovery, growth of tourism, the main driver of the economy, is declining.



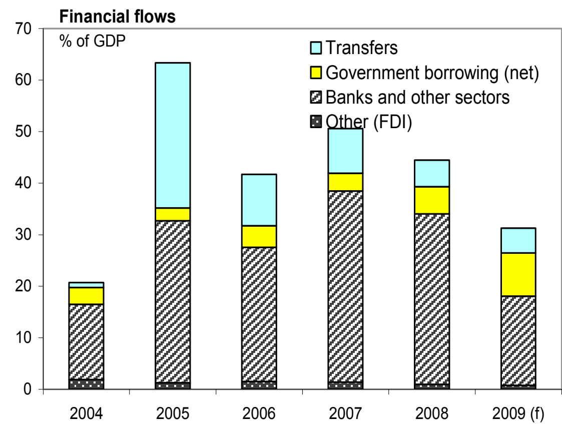
Rising import prices fueled inflation through 2008, …



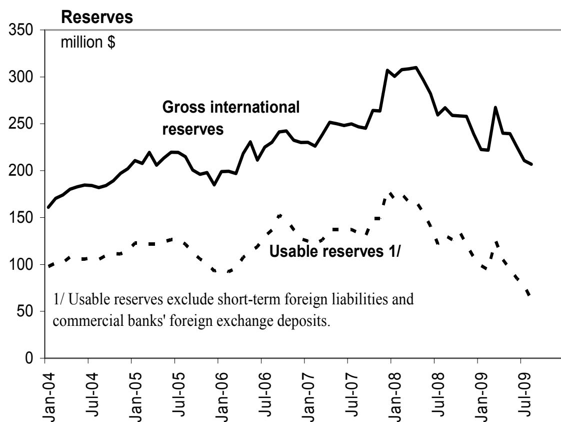
… and contributed to a current account deterioration.



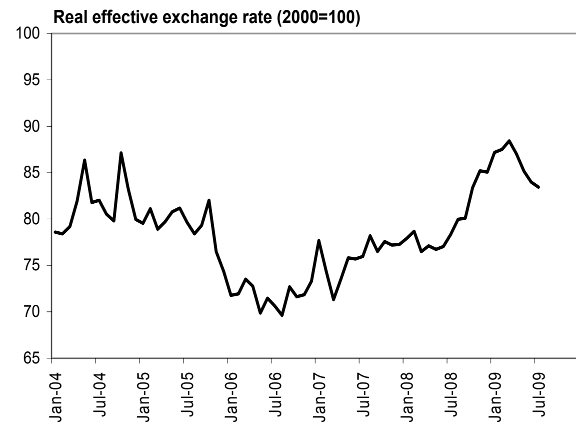
Private capital inflows have fallen as tourism pojects are being delayed and external financing to banks has declined.



Consequently, international reserves have been falling since early 2008.



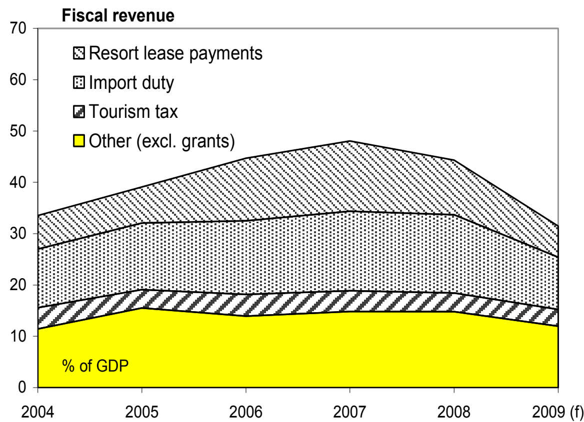
While the REER has recently appreciated, it remains below historical levels.



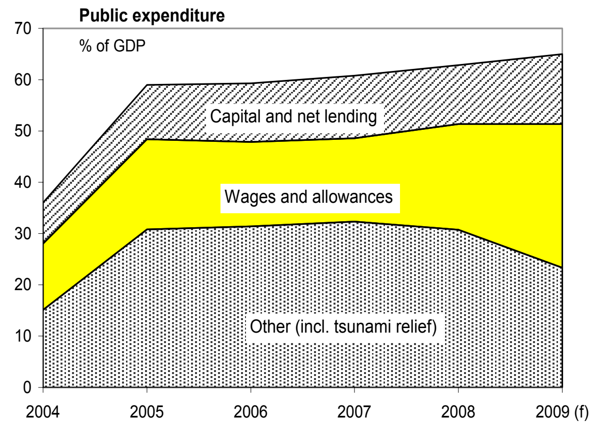
Sources: Maldivian authorities, and Fund staff estimates and projections.

Figure 2. PolicyDevelopments

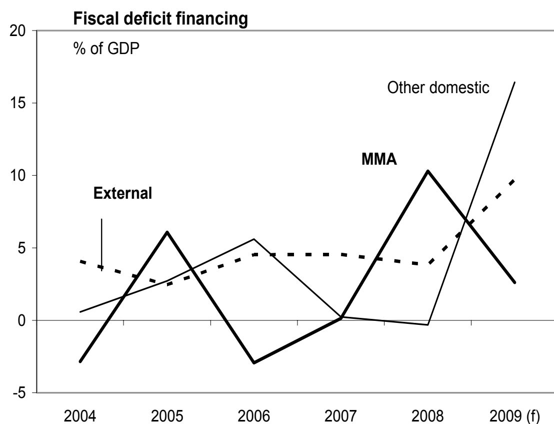
After rising with the domestic economic recovery and post-tsunami grants, fiscal revenue has begun to decline …



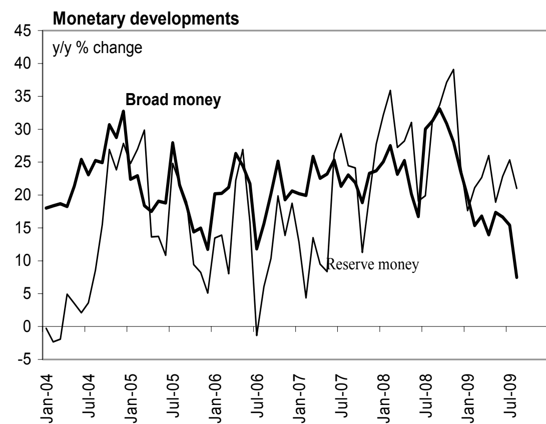
… while spending has risen substantially, driven first by relief operations and later by increases in wages and allowances.



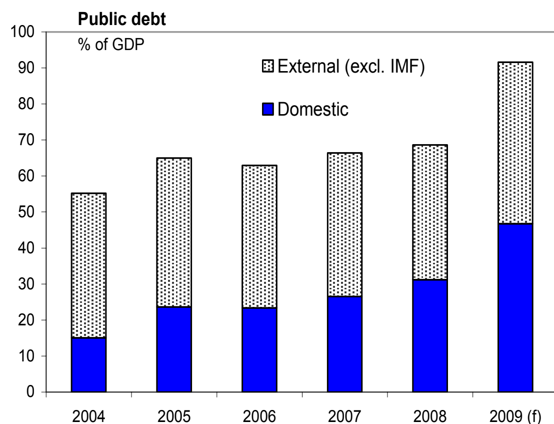
Deficit financing has increasingly relied on unsterilized monetization.



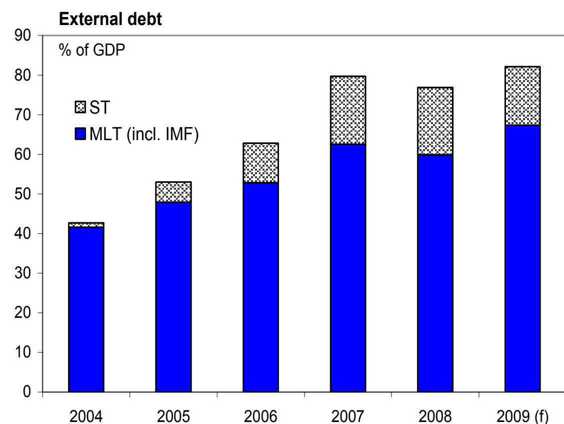
Such loose monetary policy has led to high growth of monetary aggregates.



Public debt has remained broadly stable but is projected to increase …



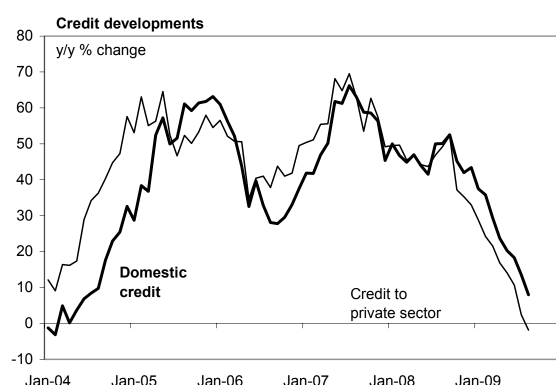
… while external debt had been increasing for some time.



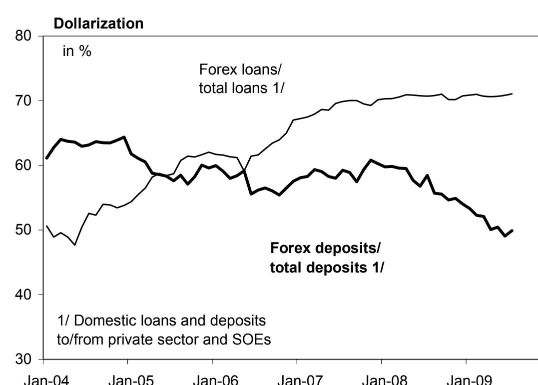
Sources: Maldivian authorities, and Fund staff estimates and projections.

Figure 3. Financial Sector Developments

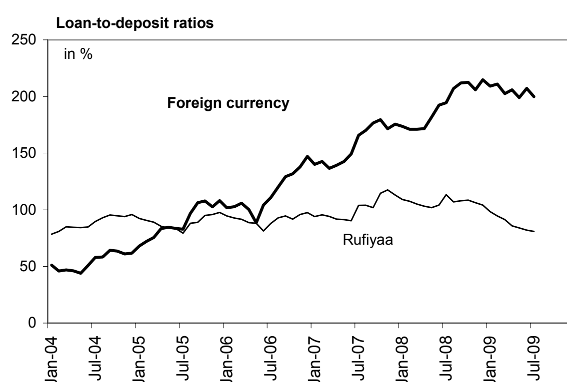
Credit growth has been strong but is declining rapidly, reflecting a more difficult environment for banks.



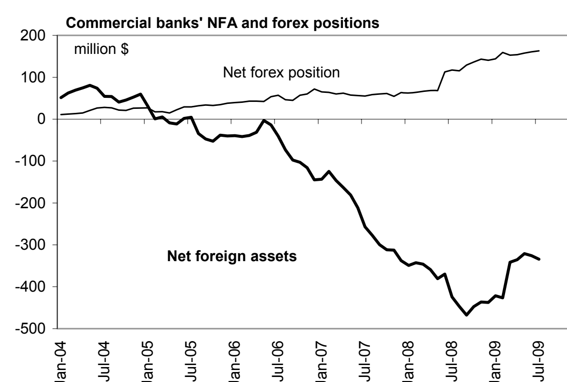
At the same time, loans are made increasingly in dollars, while dollar deposits are declining …



… leading to a sharp increase in the foreign-currency loan-to-deposit ratio …



… and a fall in banks' net foreign assets, reversed more recently due to more difficult external financing conditions.



Sources: Maldivian authorities, and Fund staff estimates.

rates from the government's rising borrowing requirements. As a result, real GDP growth would at best recover along a very slow path, and higher domestic demand and monetization would keep inflation above the baseline projection.

III. Program Discussions

11. **Background.** The authorities are well aware that the current economic situation is very serious, with an unsustainable fiscal policy considerably aggravated by the sudden and temporary exogenous shocks from the global crisis. Confronting this calls for a combination of adjustment, to deal with underlying fiscal imbalances and absorb excess liquidity from deficit monetization, and financing, to accommodate the temporary shocks and rebuild international reserves. The authorities believe that a Fund-supported program would help them achieve those goals, by smoothing the impact of the exogenous shocks—including by mobilizing donor financing—and underpinning a strong macroeconomic policy framework to restore macroeconomic stability, achieve medium-term sustainability, and create the

conditions for strong growth and poverty reduction. (The policies in the authorities' program are described in the attached Memorandum of Economic and Financial Policies, MEFP).

12. **Fiscal policy objectives.** At the core of the program is a very large fiscal adjustment to restore fiscal sustainability. The authorities are committed to drastically bringing down the fiscal deficit, including by unwinding part of the recent large expenditure increases. This is in line with their campaign manifesto's aim to reform the civil service and reduce the state's role in the economy. They are taking immediate action to cut spending, and are planning to introduce new revenue measures. The impact of the adjustment will be limited in 2009, but will be felt more fully in 2010 and beyond. The fiscal deficit is projected to fall from an estimated 33 percent of GDP in 2009 if no corrective action is taken, to under 18 percent of GDP in 2010 and about 4¼ percent of GDP in 2011.

13. **Fiscal adjustment measures.** Fiscal adjustment combines expenditure and revenue measures.

- *Wage bill.* The wage bill, which as explained above has been a key driver of the unsustainable fiscal expansion in recent years, will be reduced through a combination of salary adjustments and staff retrenchment. Effective October 1, 2009, the Civil Service Commission (CSC) implemented a reduction in civil service wages of between 10 and 20 percent, depending on rank, for an average cut of 14 percent. The adjustment will be reversed when central government's domestic revenue reaches 7 billion rufiyaas, which under staff projections would be in 2011. Equivalent cuts have been extended to non-civil service government employees. Staff reductions in the civil service are to be completed by end-2010.[6] Of these, some civil servants will be transferred to the private sector, as part of a process of corporatization of certain public services (airports, public works, schools, hospitals).[7] With these measures, the wage bill is expected to fall from 28 percent of GDP in 2009 to 17½ percent by 2011, but would go up to 19¼ percent in 2012 as the recent wage adjustments are reversed. The 2010 Budget, reflecting these and other measures to be implemented in 2009 and 2010, was submitted to the Majlis (Parliament) in November.

---

[6] There are currently about 38,000 central government employees. Staff redundancies entail severance payments, which reduce the net fiscal savings.

[7] The rationale for the corporatization of services is explained in the MEFP.

- *Other spending.* Operational expenses have also been cut by about 2 percent of GDP, and non-priority, domestically-financed capital projects have been postponed, and will be temporarily trimmed by about 1 percent of GDP in 2010.

Maldives: Fiscal Adjustment measures under the Program

	Expected time of implementation	Expected Yield 1/ (In percent of GDP)				
		2009	2010	2011	2012	Full-year impact 2/
Expenditure		2.6	11.1	10.0	6.6	13.9
Reduction of wages and allowances	Oct, 2009	1.0	3.7	3.4		4.0
Staff redundancies	Oct 2009-Dec 2010	0.1	2.7	4.2	4.2	5.4
Cost of staff cuts		-0.1	-0.6			one-off
Increase in electricity tariffs	Nov, 2009	0.5	2.5	2.5	2.5	2.7
Cost of targeted subsidy		0.0	-0.2	-0.2	-0.2	-0.2
Reductions in other current spending	Sept, 2009	1.1	1.9	0.0	0.0	2.0
Reductions in capital spending	2010		1.1			one-off
Revenue		0.2	3.5	10.8	12.2	15.4
Airport tax		0.2	0.8	0.9	0.9	1.1
Transfer to government	Nov, 2009	0.1	0.7	0.6	0.6	0.8
Increase in rates	Nov, 2009	0.0	0.1	0.3	0.3	0.3
Business profit tax	Dec, 2009		1.6	2.9	2.9	3.4
Ad valorem tax	Oct, 2010		1.9	7.9	8.5	10.8
Foregone revenue from tourism tax			-0.8	-3.1	-3.1	-3.7
General sales tax	Jan, 2011			2.3	3.0	3.8
Total		2.7	14.6	20.8	18.8	29.3

Sources: Authorities, and Fund staff estimates and projections.

1/ In terms of each year's GDP, unless otherwise indicated.
2/ In terms of 2009 GDP.

- *Electricity subsidies.* Electricity tariffs have been raised, effective November 1, 2009, with the increase ranging from 40 to 60 percent, depending on consumption brackets, to reduce the impact on smaller consumers. Tariffs will be adjusted in future in line with a cost-based formula linked to fuel prices, with targeted subsidies to protect vulnerable segments of the population. This reform eliminates the need for central government subsidies to STELCO, and enables the electricity company to resume servicing of loans from the government.

- *Revenues.* On the revenue side, the airport tax has been transferred to the central government, effective November 2009, and its rate has been raised by about 29 percent. A business profit tax is planned to be passed by end-2009 (structural benchmark). In addition, in line with longstanding staff advice, the authorities are pressing on to introduce a new *ad valorem* hotel room tax by October 2010, expected to yield almost three times the revenues of the current specific tourism tax of US$8

per bed per night it replaces (structural benchmark).[8] Finally, they plan to introduce a goods and services tax by early 2011, with Fund technical assistance (structural benchmark). Together, the revenue measures are expected to yield as much as 15½ percent of 2009 GDP, once their full-year impact materializes.

- *Deficit financing.* From September, the monetization of the fiscal deficit has been stopped. Domestic deficit financing has been restricted to t-bill sales to commercial banks and state-owned enterprises. An auction system for t-bill placements will be set up by end-2009 (structural benchmark). In addition, the authorities plan to privatize a number of state-owned enterprises. They have already sold a stake of the telecoms company for US$40 million, and a majority stake in the airport is expected to be sold in the coming months. Privatization proceeds will provide a short-term source of financing. Funding is also expected to be assisted by the purchase, by the local branch of the State Bank of India (SBI), of 2–3 year dollar-denominated bonds for US$100 million.

14. **Social protection.** The current economic recession will undoubtedly have a negative impact on the most vulnerable segments of the population. The program aims to protect social spending and lay the foundations for sustained poverty reduction. Under the program, social welfare contributions, pensions, and spending on relief for the tsunami victims will be protected. As mentioned above, the subsidy for electricity—which disproportionately benefited the higher income strata of the population in Malé—has been replaced by a cost-based pricing scheme combined with targeted relief for the poor. The authorities are also committed to enhancing the targeting of food, medicine, water and other subsidies. Adjustments in public sector wages and allowances will be implemented in a manner that affects lower earners proportionally less. Measures are being taken to shield the poor from the effects of public service corporatization (for instance, through scholarships in the case of education). Finally, the authorities are committed to protecting expenditure on social housing and on improving transport links to the outer atolls.

15. **Growth promotion.** The program aims to stimulate faster real GDP growth by providing a stronger macroeconomic policy framework. This should help restore investors' confidence in the economy, and—through this and lower public sector domestic and external debt—reduce the country risk premium. The program also seeks to protect priority capital

[8] The authorities' planned *ad valorem* tax rate of 6 percent on tourism is low by international standards and relative to competing tourist destinations, and should not materially affect the tourist industry's competitiveness.

expenditure and spending on human development as much as possible. Though not directly part of program conditionality, the authorities' policies for state reform aim to make the public sector leaner and more efficient, including by privatizing enterprises and services that can be more efficiently provided by the private sector (paragraph 19).

16. **Monetary policy.** Monetary policy will support the fiscal adjustment efforts by tightening domestic currency liquidity in order to stem reserve losses. A key step, adopted in September, was to halt the monetization of the deficit. At the same time, the government debt stock with the MMA has been converted into tradable securities. Starting in August, the MMA has been using these securities as underlying collateral to conduct open market operations (OMOs) through reverse repos, contributing to reverse the impact of years of deficit monetization on liquidity (Box 3).

Box 3. Open Market Operations

With the purpose of absorbing the high levels of rufiyaa liquidity that deficit monetization has created, the MMA introduced in August 2009 open market operations through reverse repos (RRP), using government securities as collateral. While the current levels of excess liquidity could have justified the use of outright sales of government securities, RRP were preferred because: (i) the banks' appetite for long-term placements in government bonds was unknown; and (ii) reversible transactions increase the need for subsequent operations and hence contribute to creating a money market.

Features:

- Between August and September 2009, the total debt of the government with the MMA was converted into bonds, with maturities ranging between 1–15 years and fixed interest rates between 6–9 percent, payable semi-annually.
- RRPs are held weekly on Thursdays, with the settlement on Sunday (Friday and Saturday are not working days), overlapping the reporting period for minimum reserve requirements, to facilitate banks' liquidity management.
- The term of the RRPs is one week.
- The MMA does not announce the targeted amounts or interest rates.
- Each bank may submit 3 different bids specifying the amount (number of securities) and interest rate. Bids are binding for the banks.
- The MMA collects the bids and a newly-established Market Operations Committee submits a proposal to the governor regarding the result of the tender (accepted amount, marginal, and average interest rate). The final decision belongs to the governor, and the result (total bids, accepted amount, and average interest rate) is made public the same day.

The first RRPs were encouraging: accepted bids increased every week during the first four weeks, while interest rates remained low. Banks are reluctant to bid amounts that would leave them with low free reserves, and are testing the willingness of the MMA to accept bids at higher rates. Interest rates are likely to go up, once the MMA increases the amounts awarded.

17. **Exchange rate policy.** The authorities and staff concur that the pegged regime and its level remain appropriate, conditional on the implementation of the policy adjustment in line with the program.

- The fixed exchange rate regime has served Maldives well by providing an effective nominal anchor.

- Staff analysis indicates that, on the basis of the policy adjustment envisaged in the program, the peg remains appropriate. The real exchange rate is consistent with the medium-term fundamentals under the baseline scenario (Box 2). This suggests that it is the underlying domestic fiscal and monetary policies that are at the root of the large current external imbalances, not the exchange rate *per se*.

- The authorities and staff agree that a devaluation is not appropriate in current circumstances. A devaluation of the rufiyaa would have only a small impact on the composition of expenditure: given Maldives' high import dependence, based on natural and structural constraints, the scope for expenditure switching is very limited. Instead, a devaluation would impact mainly through expenditure reducing effects, by increasing the domestic currency cost of imports (with a rapid and large pass-through effect on domestic consumer prices). The net fiscal impact in 2009 would be limited if public sector wages are frozen, and could be negative if wages are increased. A devaluation could also lead to a loss of confidence and invite speculation, in a context of low reserves.

- The authorities' program aims to retain the current peg by containing demand pressures through a significant fiscal and monetary tightening, and by boosting confidence through the build-up of international reserves secured by new external financing. Should the policy adjustment not be implemented as envisaged in the program, the peg might become unsustainable. The appropriateness of the exchange rate level and the regime itself will be continuously assessed over the program period.

- As conditions stabilize, the authorities intend to gradually phase out the rationing of foreign exchange supplied to commercial banks, by increasing the amounts provided.

18. **Financial sector policies.** The authorities and staff agree that the financial system needs to be strengthened. The authorities have indicated their intention to restructure the Bank of Maldives (BML)'s portfolio, ensuring speedy action for the recovery of collateral on defaulted debt, and, as necessary, secure a capital infusion. Their preferred option is to find a strategic partner to take over the state's shares. The authorities have also agreed to seek passage of the Banking Law and the reforms to the MMA Act by end-2010 (structural benchmark). This legislation will provide a stronger legal framework for the operation, supervision, regulation, intervention and liquidation of commercial banks.

IV. Other (Article IV) Policy Discussions

19. **Staff supports the authorities' plans for the privatization of a number of state-owned enterprises and services.** The government has set up a Privatization Committee to

conduct and oversee the process. A central plank will be the privatization of the airport, but stakes in the telecommunications company have already been sold and other enterprises and services (such as electricity, water and sewage) could also be divested. The main goal of the government's privatization plan is to enhance the economy's productivity and boost long-term growth through the transfer of activities that can be more efficiently conducted by the private sector. In addition, privatization proceeds provide a helpful, though finite, source of deficit financing and, in case of foreign investor participation, provide a relief to dollar shortages. Privatization efforts, however, are not part of program conditionality.

20. **The authorities have initiated actions to improve public financial management**, with Fund and World Bank assistance. A recently completed Public Expenditure and Financial Accountability (PEFA) report concludes that there are significant shortfalls in the predictability and control of budget execution and in the management of cash, debt, and guarantees, and recommends preparing a comprehensive framework for fiscal risk assessment and management. Some steps have already been taken. The introduction of a treasury single account has strengthened the government's control of public revenue and spending, but several budget entities still retain separate bank accounts. The authorities are also adopting a new Public Accounting System (PAS), to enhance accounting and reporting, as well as budget control and execution. Staff welcome the commitment to introduce debt management units at the MMA and the Ministry of Finance, along with transparent guidelines on borrowing, on-lending and the provision of public guarantees. The staff supports the President's planned administrative decentralization, including the transfer of competencies to provincial and local authorities. This, however, should be achieved without increasing public expenditures.

21. **Some progress has been made in financial regulation and supervision, but significant weaknesses and vulnerabilities remain.** Loan classification and provisioning are inadequate. Loan portfolio concentration has exposed banks to severe risks in case of impaired loans from a few borrowers. Banks have accumulated large imbalances between foreign currency-denominated assets and liabilities, i.e. long open positions in foreign currencies. In response, the authorities issued in May 2009 several regulations to strengthen the prudential framework, in line with Fund technical assistance, comprising *inter alia* rules on capital adequacy; limits on loans to related persons and single borrowers; asset classification and provisioning; external audits; publication and disclosure; and corporate governance. However, supervision and enforcement need to be strengthened, including standing firm on asset classification and provisioning rules. Staff also recommended adopting the regulation to limit open foreign currency positions, implementing and diligently enforcing the licensing regulatory framework, and passing the Banking Law and the reforms to the MMA Act (a structural benchmark under the program).

V. PROGRAM MODALITIES

22. **Facilities and access level.** The Maldivian economy has been hit by large sudden and exogenous shocks to exports, tourism, tourism-related investment, and external financing. These shocks exacerbated an unsustainable fiscal expansion and led to a significant balance of payments need (Box 1). Accordingly, the authorities have requested a blended arrangement, comprising a Stand-By Arrangement with access of 600 percent of quota (SDR 49.2 million) over 36 months, and an arrangement under the Exogenous Shock Facility (High Access Component), with access of 100 percent of quota (SDR 8.2 million), over 24 months.[9] The ESF would help smooth adjustment to the global shocks over the next two years, and the SBA extends over a third year to ensure that a sustainable fiscal position is reached (Box 1). The overall access level reflects the large financing needs caused by the exogenous shocks and the underlying fiscal imbalances, and takes into account the strong medium-term adjustment effort.

23. **Phasing.** Staff proposes an even pattern of disbursements for Fund financing under both the SBA and the ESF (Table 7).

24. **Financing.** Financing assurances from the World Bank and ADB in the amount of US$59 million over the program period have been secured. Together with the proposed Fund financing, these assurances would cover 100 percent of the projected residual external financing gap over the program period. In addition, the World Bank is organizing a donor meeting to seek further pledges from regional and bilateral sources. The additional financing would help the economy smooth out the adjustment and build up reserves, reduce the pressure on the private sector of increased domestic financing of the deficit, and support public spending on capital projects. The recent allocations of special drawing rights (SDRs) are reflected in gross and net international reserves. The authorities intend to save them to bolster the weak reserve position.

25. **Conditionality.** Program conditionality is focused on achieving the required fiscal adjustment and monetary policy tightening, while protecting spending on the poor. The quantitative and structural conditionality, including prior actions, are described in Tables 1–2, attached to the authorities' Memorandum of Economic and Financial Policies (MEFP). The fiscal targets are monitored through a deficit financing performance criterion (a below-

---

[9] Maldives qualifies for the ESF (the primary source of its balance of payments need is a sudden and exogenous shock; see Box 1). Fund support for Maldives is presumed to be a blend of GRA and concessional resources, given the country's relatively high per capita income level. The requested access level under the ESF is consistent with the new blending rules elaborated in SM/09/160.

the-line measure of the fiscal deficit), given the data limitations reported in paragraph 28. International reserves are monitored through a target on usable reserves, a variable which the authorities monitor regularly and which excludes encumbrances. The program allows nonconcessional external borrowing up to US$120 million through end-2010 for socially useful and economically viable projects, and because financing of the deficit entirely from concessional sources is not feasible.

26. **Prior actions.** All the prior actions have been implemented. The authorities have announced and mandated reductions in salaries and allowances, as well as adjustments in staffing levels, to reduce the government's wage bill in line with the program. The authorities have also raised electricity tariffs and introduced an automatic, cost-based electricity pricing formula, as well as a subsidy mechanism for the poor. They have converted the totality of the government's outstanding debt to the MMA into tradable securities. The airport tax has been transferred from the airport operator to the government. A 2010 Budget in line with the agreed measures and targets was submitted to the Majlis in mid-November.

27. **Reviews.** Quarterly program reviews will be based on quantitative performance criteria and indicative targets assessed quarterly during the program period, and on implementation of structural benchmarks. The first review is expected to be completed in March 2010, based on end-December 2009 performance criteria, indicative targets and benchmarks, while the second review is expected to be completed in June 2010, based on end-March 2010 performance criteria and indicative targets. The authorities will consult with Fund staff on the appropriate policy responses if there is a significant fall in usable reserves.

28. **Data issues.** Monetary and financial statistics are reported on a monthly basis. Upon request, preliminary monthly data on public expenditure and revenue have recently begun to be produced by the authorities, but the new reporting system is as yet untested. Staff will work with the authorities over the course of the program to improve the quality and timeliness of data provision, including possibly through technical assistance.

29. **Capacity to repay.** The government is committed to implementing the policy program outlined in the Memorandum of Economic and Financial Policies. The authorities' program represents a significant adjustment effort, and should restore Maldives' domestic and external stability reasonably quickly. In addition, the balance of payments need generated by the exogenous shock is expected to ease out over the next two years (Box 1). In particular, the tourism sector—a key source of economic activity and fiscal revenue—is expected to recover and further expand from 2010 onwards, on the back of the global recovery, and external financing should gradually normalize. Moreover, the Fund's exposure is relatively small, compared to Maldives' external payment flows (Table 8). These factors should give reasonable assurances of Maldives' capacity to repay the Fund. If disbursements are made as scheduled, there will be a peak in repayments to the Fund in 2015. Staff analysis shows that the MMA would accumulate enough reserves to repay the Fund and maintain a level of international reserves of more than 4 months of imports.

30. **Debt sustainability analysis (DSA).** Maldives' DSA indicates that the risk of distress for external public and publicly guaranteed (PPG) debt remains moderate; also, risks to total public debt are considerable.[10] The accumulation of large current account and fiscal imbalances in recent years has led to rapid increases in the country's external and public debt stocks. With the strong fiscal adjustment envisaged in the program, external and public debt would steadily decline, and no external PPG debt burden indicators would breach their indicative thresholds. The upward trajectory of the debt-to-GDP ratio under the historical scenario shows that fiscal policy in the recent past was not sustainable. Going forward, the key risks for debt sustainability are large export (tourism) shocks—which would simultaneously affect growth and the external and fiscal positions—and fiscal policy slippages.

31. **Safeguards.** A safeguards assessment of the MMA is currently in progress and will be completed before the first review of the proposed arrangement. The ongoing assessment notes that there are vulnerabilities in the present external audit of the MMA conducted by the Auditor General. The authorities have agreed to appoint an international firm to perform MMA's audit in accordance with international standards on auditing, and to take steps to modernize the MMA Act, strengthen its financial reporting practices, and develop its internal audit function.

32. **Exchange restrictions and multiple currency practices.** The rationing of foreign exchange provided to the commercial banks by the MMA is forcing some current international transactions to be conducted in the parallel market at a premium of around 10 percent over the official peg. This action by a government agency has given rise to a multiple currency practice due to the spread of more than 2 percent between the exchange rates in the official and parallel markets, as well as to an exchange restriction arising from the additional premium that has to be paid in the parallel market.

VI. RISKS

33. **There are substantial risks to the program.** These relate to political factors as well as to external and domestic economic factors.

---

[10] Additionally, external inflows to the private sector (comprising financing for privatization and tourism projects) are treated, consistent with the authorities, as non-debt creating. The authorities do not have adequate information to disaggregate these flows into FDI and arm's length borrowing. To the extent that part of these flows may be debt, the liquidity and solvency risks associated with external private debt may be higher. This also implies that the FDI account in the balance of payments is considerably underestimated.

- *Fiscal adjustment.* Resistance from civil servants or the broader public, and political opposition, could undermine the very large budget correction as well as the tax reforms that are key to the program's success. This risk is heightened by the government's lack of parliamentary majority. Delayed or insufficient implementation of the envisaged expenditure or revenue measures is a major risk for the program.

- *The global economy.* The turnaround of the economy and of fiscal revenues, the restoration of access to international market financing, the expansion of foreign direct investment, the recovery in external inflows to the private sector (projected to sum about 60 percent of GDP between 2009–2012, and which comprise flows to privatization and tourism projects), depend on a reasonably solid recovery of global economic activity, a normalization of international financial markets, and a pick up in tourism inflows. The global economic environment entails risks both to the upside and the downside.

- *Confidence.* The preservation of confidence in the economy is critical for the success of the program. The path of international reserves and the perceived sustainability of the peg are particularly important. Approval of the program itself should help boost confidence by boosting reserves and easing foreign exchange shortages. Nonetheless, a sudden shift in sentiment, resulting in losses of reserves or deposit withdrawals, cannot be ruled out.

- *Monetary policy.* Open market operations are new in Maldives; a more stable economic environment would have been desirable for their introduction. In addition, even though a strong fiscal adjustment effort is being made, substantial domestic financing requirements remain. These will compete with, and to a certain extent crowd out, the MMA's operations to absorb excess domestic liquidity.

- *Privatization.* The fiscal projections reflect substantial privatization revenues in 2010 and beyond, especially from the airport (also reflected as capital inflows to other sectors in the balance of payments). Although projections for such revenues have been made cautiously, there is a risk that unforeseen events, including political resistance, could postpone or derail the planned privatizations.

- *Financial system.* If banks' NPLs were to remain high or deteriorate further, credit growth could remain subdued. In the case of BML, the risk to the budget could increase.

34. **If any of these risks materializes to a significant extent, the policy measures in the program would have to be reassessed.**[11] This would involve a reevaluation of monetary, exchange rate, and fiscal policies, possibly including further tightening of monetary policy and additional fiscal policies, particularly on the revenue side.

VII. Staff Appraisal

35. **Overview.** The global crisis has hit Maldives hard. Growth, external financing, and budget revenues have all been adversely affected by the global economic downturn and the international financial crisis. This, combined with an unsustainable fiscal expansion, led to severe balance of payments pressures and put the economy on the brink of a currency crisis.

36. **Program.** The authorities have committed to a very significant adjustment program, aimed at addressing the severe impact of the global economic crisis and restoring macroeconomic stability and fiscal sustainability, thereby setting the conditions for renewed economic growth. In particular, they plan to: (i) bring about the large budget deficit reduction required to restore stability and medium-term fiscal sustainability; (ii) reduce excess rufiyaa liquidity and rebuild reserves to prudent levels; and (iii) strengthen the financial system.

37. **Fiscal policy.** The core of the program is a very large fiscal adjustment, intended to reduce aggregate demand pressures and restore fiscal sustainability. The adjustment comprises a partial reversal of the recent large increases in the wage bill, as well as cuts in other operational expenses and non-priority capital, complemented by revenue measures. Given its magnitude, implementing the programmed adjustment will require the authorities' full determination. The authorities' program should be commended for placing the burden of adjustment on current expenditure, while protecting the poor and keeping cuts in capital expenditure relatively modest. The authorities' resolve is buttressed by the fact that the envisaged fiscal policies are consistent with structural public sector reforms that the government intended to pursue from the outset. In addition to the fiscal policy measures under the program, sustained efforts are needed to strengthen public financial management.

38. **Monetary policy.** A shift towards a more active monetary policy is important to complement fiscal adjustment and reduce pressures on reserves. In this regard, the recent introduction of effective monetary policy instruments and the cessation of fiscal deficit

[11] A no-adjustment scenario is presented and briefly discussed in Section II. Staff discussed with the authorities the implications of failing to implement the necessary adjustment, as well as the emergency measures that would be required to attempt to avert, or to deal with the consequences of, a full-blown currency and fiscal crisis.

monetization represent a major step forward. The authorities are determined to pushing forward this transition. In this they have been, and continue to be, supported by extensive Fund technical assistance.

39. **Exchange rate policy.** The authorities' program aims to preserve the current exchange rate regime and the peg's current level. A balanced analysis suggests that the gains from a devaluation, or a move to a floating regime, would be small and uncertain, while the costs would be substantial. The envisaged fiscal adjustment and monetary policy tightening are designed to achieve the correction in demand required to maintain the viability of the current peg. External financing, including from the Fund, should boost confidence by increasing reserves. Staff supports the authorities' request for temporary Fund approval of the exchange restriction and multiple currency practice discussed above, which have been imposed for balance of payments reasons, are temporary, and do not discriminate against Fund members.

40. **Financial sector policies.** The program's financial sector reform agenda addresses the weaknesses in the system. The authorities' willingness to explore a range of options to strengthen BML is commendable. The MMA also needs to act decisively to ensure early compliance by all banks with new MMA regulations on loan classification and provisioning, as well as on foreign currency position, at the earliest possible date.

41. **Risks.** While risks to the program, as outlined above, are substantial, they need to be weighed against the benefits of Fund financial support. Those benefits are significant: without Fund support and the additional external financing it catalyzes, the authorities' very large adjustment effort could be insufficient to avoid a balance of payments crisis. This would imply a disorderly adjustment in the currency and potentially, given the economy's high import dependence, widespread social instability.

42. **The authorities' program is strong, comprehensive, and well-focused, and merits the Fund's support.** Staff recommend the approval of the requested blend arrangement, comprising a Stand-By Arrangement and an arrangement under the Exogenous Shock Facility.

43. It is expected that the next Article IV consultation be held in accordance with Decision No. 12794-(02/76), as amended.

Table 1. Maldives: Selected Economic and Vulnerability Indicators, 2004-12

Population (in 1,000; 2008 est.) 310
GDP per capita (in U.S. dollars; 2008 est.): 4,072
Quota (in million SDRs): 8.2

	2004	2005	2006	2007	2008	2009	2010	2011	2012
					Est.	Projection			
OUTPUT AND PRICES	(Annual percentage change)								
Real GDP	9.5	-4.6	18.0	7.2	5.8	-4.0	3.4	3.7	4.1
Inflation (end-of-period)	10.1	2.9	3.9	10.4	8.6	6.7	4.7	6.3	3.5
Inflation (period average)	6.3	2.5	3.6	7.6	11.9	5.5	4.5	6.3	3.5
GDP deflator	2.4	1.2	3.5	7.4	13.0	11.0	4.0	6.3	3.5
CENTRAL GOVERNMENT FINANCES	(In percent of GDP)								
Revenue and grants	34.2	47.7	52.1	55.8	49.0	36.3	37.0	43.4	44.2
Expenditure and net lending	36.0	59.0	59.3	60.8	62.8	65.0	54.8	47.5	47.9
Overall balance	-1.8	-11.3	-7.2	-4.9	-13.8	-28.8	-17.8	-4.2	-3.6
Overall balance excl. grants	-2.5	-19.8	-14.6	-12.7	-18.5	-33.6	-18.9	-5.2	-4.6
Financing	1.8	11.3	7.2	4.9	13.8	28.8	17.8	4.2	3.6
Foreign	4.1	2.4	4.5	4.6	3.8	12.7	4.2	2.0	2.6
Of which: Privatization receipts	0.0	0.0	0.0	0.0	0.0	3.0	4.4	2.1	1.9
Domestic	-2.3	8.8	2.7	0.4	10.0	16.1	13.6	2.2	1.1
Of which: Privatization receipts	0.2	0.4	0.4	0.3	0.3	0.1	2.6	1.3	0.8
Public and publicly guaranteed debt	55.2	64.9	62.9	66.4	68.6	91.6	96.0	87.9	82.5
Domestic	15.1	23.6	23.4	26.5	31.2	46.8	54.5	50.4	47.0
External (excl. IMF and currency swaps by MMA)	40.1	41.3	39.6	39.8	37.4	44.8	41.5	37.5	35.5
MONETARY ACCOUNTS	(Annual percentage change, unless otherwise indicated)								
Broad money	32.8	11.7	20.6	23.7	23.6	9.4	6.7	…	…
Domestic credit	32.6	63.2	37.6	45.8	43.4	5.7	7.5	…	…
Of which: To private sector	57.6	54.5	49.5	49.2	33.0	-4.1	-2.1	…	…
NFA of commercial banks (in millions of US$, e.o.p.)	60	-40	-145	-338	-437	-416	-466	…	…
Net forex position of commercial banks (in millions of US$, e.o.p.)	27	38	72	64	141	…	…	…	…
BALANCE OF PAYMENTS	(In percent of GDP, unless otherwise indicated)								
Current account	-15.8	-36.4	-33.0	-41.5	-51.4	-29.6	-23.4	-13.1	-11.1
Of which:									
Exports	23.3	21.6	24.6	21.6	26.2	16.1	17.7	17.7	17.8
Domestic	15.8	13.8	14.8	10.2	10.0	6.6	6.9	6.8	6.8
Re-exports	7.5	7.8	9.9	11.4	16.2	9.5	10.7	10.8	11.0
Imports	-72.7	-87.4	-89.1	-91.5	-96.8	-58.2	-58.8	-55.9	-55.9
Nonfactor services, net	45.1	14.6	35.0	36.0	29.4	22.0	28.4	33.0	36.3
Capital and financial account (incl. e&o)	21.4	34.1	37.9	48.8	46.0	30.5	20.6	11.1	12.5
Of which:									
General government, net	3.2	2.5	4.2	3.4	5.3	8.4	-1.9	-1.2	0.6
Banks and other sectors, net	14.6	30.6	26.0	37.1	33.3	14.6	20.4	10.3	11.1
Overall balance	5.7	-2.3	4.9	7.3	-5.4	0.9	-2.8	-2.0	1.4
Gross international reserves (in millions of US$; e.o.p.) 1/	204	187	232	310	241	277	291	305	347
In months of GNFS imports	3.4	2.6	2.7	3.0	1.8	3.2	3.1	3.1	3.4
In percent of short-term debt at remaining maturity	585	261	168	121	80	81	88	118	143
Usable reserves (in millions of US$; e.o.p.) 1/	117	95	129	182	110	105	130	108	132
In percent of short-term debt at remaining maturity	335	133	93	71	38	31	39	42	54
External debt 2/	43	53	63	80	77	82	80	71	65
Medium- and long-term	42	48	53	63	60	67	68	60	56
Short-term	1	5	10	17	17	15	13	10	8
In percent of domestic GNFS exports	53	93	84	111	114	169	147	124	109
External debt service (in percent of domestic GNFS exports)	5	9	9	12	12	17	24	22	15
Exchange rate (rufyiaa/US$, e.o.p.)	12.8	12.8	12.8	12.8	12.8	…	…	…	…
MEMORANDUM ITEMS									
GDP (in millions of rufyiaa)	9,939	9,596	11,717	13,493	16,137	17,192	18,480	20,354	21,935
GDP (in millions of US$)	776	750	915	1,054	1,261	1,343	1,444	1,590	1,714

Sources: Maldivian authorities, and Fund staff estimates and projections.
1/ MMA liabilities, include SDR allocation of SDR 7.4 million, equivalent to US$11.7 million, made available in Q3 2009, see http://www.imf.org/external/np/tre/sdr/proposal/2009/0709.htm. These are treated as long term liabilities of the MMA.
2/ Includes IMF but excludes domestic foreign-currency denominated debt.

Table 2. Maldives: Central Government Finance, 2004-12

	2004	2005	2006	2007	2008	2009	2010	2011	2012
					Est.	Projection			
					(In millions of rufiyaa)				
TOTAL REVENUE AND GRANTS	3,404	4,578	6,105	7,535	7,913	6,235	6,829	8,824	9,706
Revenue (excl. privatization receipts)	3,331	3,753	5,237	6,491	7,159	5,410	6,628	8,610	9,489
Tax revenue	1,647	1,723	2,370	2,905	3,393	2,674	3,301	5,017	5,725
Import duties	1,136	1,246	1,684	2,087	2,460	1,752	1,793	1,821	1,963
Tourism tax 1/	410	345	496	547	589	557	444	0	0
Other	102	132	191	271	344	366	1,064	3,195	3,762
Of which: New measures 1/	0	0	0	0	0	26	796	2,834	3,351
Nontax revenue	1,684	2,031	2,867	3,586	3,766	2,735	3,327	3,593	3,764
SOE profit transfers	555	609	727	789	1,135	913	539	565	625
Lease payments	646	675	1,424	1,854	1,723	1,041	1,863	1,916	2,003
Other	484	747	716	943	908	782	926	1,113	1,137
Grants	73	825	867	1,044	754	826	201	213	217
EXPENDITURE AND NET LENDING	3,583	5,658	6,948	8,201	10,142	11,179	10,123	9,676	10,505
Current expenditure	2,788	4,643	5,608	6,560	8,290	8,834	8,356	8,355	9,108
Of which: Salaries and allowances	1,286	1,687	1,925	2,196	3,332	4,824	3,910	3,592	4,227
Interest	139	155	199	234	325	339	656	876	854
Capital expenditure	991	1,132	1,458	1,765	2,027	2,353	2,014	1,596	1,644
Net lending	-197	-118	-118	-125	-175	-8	-248	-275	-247
OVERALL BALANCE	-179	-1,080	-844	-666	-2,229	-4,943	-3,294	-852	-799
OVERALL BALANCE, EXCL. GRANTS	-252	-1,904	-1,711	-1,710	-2,983	-5,769	-3,495	-1,066	-1,016
FINANCING	179	1,080	844	666	2,229	4,943	3,294	852	799
Privatization	21	35	50	37	41	524	1,300	700	600
External sources	0	0	0	0	0	512	811	427	427
Domestic sources	21	35	50	37	41	12	489	273	173
External debt	404	235	529	615	617	1,668	-39	-24	138
Domestic debt	-246	810	265	15	1,572	2,751	2,033	176	61
					(In percent of GDP)				
TOTAL REVENUE AND GRANTS	34.2	47.7	52.1	55.8	49.0	36.3	37.0	43.4	44.2
Revenue	33.5	39.1	44.7	48.1	44.4	31.5	35.9	42.3	43.3
Tax revenue	16.6	18.0	20.2	21.5	21.0	15.6	17.9	24.6	26.1
Import duties	11.4	13.0	14.4	15.5	15.2	10.2	9.7	8.9	8.9
Tourism tax 1/	4.1	3.6	4.2	4.1	3.6	3.2	2.4	0.0	0.0
Other	1.0	1.4	1.6	2.0	2.1	2.1	5.8	15.7	17.2
Of which: New measures 1/	0.0	0.0	0.0	0.0	0.0	0.2	4.3	13.9	15.3
Nontax revenue	16.9	21.2	24.5	26.6	23.3	15.9	18.0	17.7	17.2
SOE profit transfers	5.6	6.3	6.2	5.8	7.0	5.3	2.9	2.8	2.8
Lease payments	6.5	7.0	12.2	13.7	10.7	6.1	10.1	9.4	9.1
Other	4.9	7.8	6.1	7.0	5.6	4.5	5.0	5.5	5.2
Grants	0.7	8.6	7.4	7.7	4.7	4.8	1.1	1.0	1.0
EXPENDITURE AND NET LENDING	36.0	59.0	59.3	60.8	62.8	65.0	54.8	47.5	47.9
Current expenditure	28.1	48.4	47.9	48.6	51.4	51.4	45.2	41.0	41.5
Of which: Salaries and allowances	12.9	17.6	16.4	16.3	20.6	28.1	21.2	17.6	19.3
Interest	1.4	1.6	1.7	1.7	2.0	2.0	3.5	4.3	3.9
Capital expenditure	10.0	11.8	12.4	13.1	12.6	13.7	10.9	7.8	7.5
Net lending	-2.0	-1.2	-1.0	-0.9	-1.1	0.0	-1.3	-1.4	-1.1
OVERALL BALANCE	-1.8	-11.3	-7.2	-4.9	-13.8	-28.8	-17.8	-4.2	-3.6
OVERALL BALANCE, EXCL. GRANTS	-2.5	-19.8	-14.6	-12.7	-18.5	-33.6	-18.9	-5.2	-4.6
FINANCING	1.8	11.3	7.2	4.9	13.8	28.8	17.8	4.2	3.6
Privatization	0.2	0.4	0.4	0.3	0.3	3.0	7.0	3.4	2.7
External sources	0.0	0.0	0.0	0.0	0.0	3.0	4.4	2.1	1.9
Domestic sources	0.2	0.4	0.4	0.3	0.3	0.1	2.6	1.3	0.8
External debt	4.1	2.4	4.5	4.6	3.8	9.7	-0.2	-0.1	0.6
Domestic debt	-2.5	8.4	2.3	0.1	9.7	16.0	11.0	0.9	0.3
MEMORANDUM ITEMS									
Current balance	5.5	-9.3	-3.2	-0.5	-7.0	-19.9	-9.4	1.3	1.7
Primary balance	-0.4	-9.6	-5.5	-3.2	-11.8	-26.8	-14.3	0.1	0.3
Public and publicly guaranteed debt	55.2	64.9	62.9	66.4	68.6	91.6	96.0	87.9	82.5
Domestic	15.1	23.6	23.4	26.5	31.2	46.8	54.5	50.4	47.0
External (excl. IMF and currency swaps by MMA)	40.1	41.3	39.6	39.8	37.4	44.8	41.5	37.5	35.5
GDP	9,939	9,596	11,717	13,493	16,137	17,192	18,480	20,354	21,935

Sources: Maldivian authorities, and Fund staff estimates and projections.

1/ The tourism tax is expected to be replaced by an ad valorem tax in mid 2010 (receipts under which are shown under new measures).

Table 3. Maldives: Monetary Accounts, 2004-10

	2004	2005	2006	2007	2008	2009				2010
					Est.	Mar.	Jun.	Sep.	Dec.	
						Act.	Act.	Proj.	Proj.	Proj.
	(In millions of rufiyaa, e.o.p.)									
NET FOREIGN ASSETS	3,375	1,788	1,032	-458	-2,572	-968	-1,321	-1,843	-2,212	-2,739
Maldives Monetary Authority, net	2,605	2,303	2,881	3,866	3,027	3,399	2,847	2,551	3,109	3,221
Assets	2,616	2,395	2,973	3,957	3,089	3,450	2,899	2,582	3,552	3,732
Liabilities	-11	-91	-91	-91	-62	-50	-51	-31	-443	-510
Commercial banks, net	770	-516	-1,850	-4,324	-5,600	-4,367	-4,169	-4,394	-5,321	-5,961
NET DOMESTIC ASSETS	2,609	4,897	7,032	10,430	14,899	13,914	14,463	15,391	15,696	17,132
Domestic credit	4,223	6,890	9,478	13,820	19,813	19,617	19,910	20,737	20,941	22,520
Public sector	675	1,410	1,286	1,600	3,565	3,865	4,448	5,241	5,361	7,260
Central govt (net)	425	922	714	584	2,189	2,609	3,324	4,032	4,211	6,080
Public enterprises	250	488	573	1,017	1,376	1,256	1,124	1,209	1,150	1,180
Private sector	3,548	5,480	8,192	12,220	16,248	15,752	15,462	15,496	15,580	15,260
Other items (net)	-1,614	-1,993	-2,446	-3,390	-4,914	-5,703	-5,446	-5,346	-5,245	-5,388
BROAD MONEY	5,984	6,685	8,063	9,972	12,326	12,946	13,142	13,548	13,484	14,392
Narrow money	2,477	3,033	3,707	4,405	6,082	6,624	6,861	7,045	7,012	7,484
Currency	763	883	1,068	1,142	1,510	1,536	1,557	1,657	1,659	1,719
Public enterprise & local gov't deposits	52	44	15	42	11	6	21	19	17	18
Demand deposits	1,662	2,106	2,625	3,221	4,562	5,082	5,283	5,369	5,336	5,747
Quasi-money	3,507	3,652	4,356	5,567	6,244	6,322	6,281	6,503	6,472	6,908
MEMORANDUM ITEMS										
Velocity	1.66	1.44	1.45	1.35	1.31	1.33	1.31	1.27	1.28	1.28
Money multiplier	2.18	2.32	2.36	2.28	2.26	2.29	2.20	2.28	2.24	2.53
Reserve money	2,743	2,883	3,424	4,374	5,444	5,662	5,967	5,948	6,022	5,680
	(Percent change with respect to end of previous year)									
Broad money	32.8	11.7	20.6	23.7	23.6	5.0	6.6	9.9	9.4	6.7
Narrow money	19.7	22.5	22.2	18.8	38.1	8.9	12.8	15.8	15.3	6.7
Domestic credit, net	32.6	63.2	37.6	45.8	43.4	-1.0	0.5	4.7	5.7	7.5
Central government	-49.6	116.8	-22.6	-18.2	275.0	19.2	51.9	84.2	92.4	44.4
Public enterprises	176.6	95.2	17.3	77.6	35.3	-8.7	-18.3	-12.1	-16.4	2.6
Private sector	57.6	54.5	49.5	49.2	33.0	-3.1	-4.8	-4.6	-4.1	-2.1
	(In percent of GDP)									
Broad money	60	70	69	74	76	75	76	79	78	78
Narrow money	25	32	32	33	38	39	40	41	41	40
Domestic credit, net	42	72	81	102	123	114	116	121	122	122
Central government	4	10	6	4	14	15	19	23	24	33
Public enterprises	3	5	5	8	9	7	7	7	7	6
Private sector	36	57	70	91	101	92	90	90	91	83
	(In millions of U.S. dollars)									
Gross foreign assets of MMA	204	187	232	310	241	270	227	201	277	291
Usable reserves	117	95	129	182	110	128	87	64	105	130
Commercial banks NFA	60	-40	-145	-338	-437	-341	-326	-343	-416	-466
Commercial banks forex position, net	27	38	72	64	141	153	161	…	…	…
Assets	321	417	630	940	1,160	1,273	1,213	…	…	…
Liabilities	295	379	558	876	1,020	1,120	1,052	…	…	…
Of which: forex deposits	275	290	338	451	489	592	573	…	…	…

Sources: Maldivian authorities, and Fund staff estimates and projections.

Table 4. Maldives: Balance of Payments, 2004-12

	2004	2005	2006	2007	2008	2009	2010	2011	2012
					Est.		Projection		
	(In millions of U.S. dollars, unless otherwise indicated)								
CURRENT ACCOUNT	-122	-273	-302	-438	-648	-398	-338	-209	-190
Balance of goods and nonfactor services	-34	-384	-269	-357	-520	-271	-183	-84	-32
Trade balance	-384	-494	-590	-737	-891	-566	-593	-609	-653
Exports (fob)	181	162	225	228	330	216	255	281	306
Domestic exports	122	103	135	108	126	88	100	108	116
Re-exports	59	58	90	120	205	128	155	173	189
Imports (fob)	-565	-655	-815	-965	-1,221	-782	-849	-889	-959
Tourism-related	-137	-142	-171	-232	-254	-162	-176	-185	-199
Other	-428	-514	-645	-733	-967	-619	-672	-704	-759
Nonfactor services, net	350	110	321	380	370	295	410	525	621
Of which: Travel receipts	471	287	512	602	664	521	630	701	774
Income, net	-35	-31	-41	-67	-64	-63	-65	-67	-73
Current transfers, net	-54	142	8	-14	-63	-64	-90	-58	-85
Receipts	8	211	91	91	65	65	21	17	17
Payments	-61	-70	-83	-105	-128	-128	-111	-75	-102
CAPITAL AND FINANCIAL ACCOUNT	153	264	291	442	496	355	252	156	214
Of which: 1/									
Foreign direct investment, net	15	9	14	15	12	10	10	11	12
Other investment, net	138	254	277	427	484	345	242	145	202
Monetary authorities 2/	0	6	0	0	-2	37	-25	0	0
General government	25	19	39	36	67	112	-27	-19	11
Of which: Disbursements of loans	47	43	63	65	101	154	72	86	65
Amortization	-22	-24	-24	-29	-35	-42	-99	-105	-54
Banks	-12	99	104	193	100	-22	50	-62	-43
Other sectors 3/	125	130	134	198	320	218	244	226	234
ERRORS AND OMISSIONS	13	-8	56	73	84	55	45	20	0
OVERALL BALANCE	44	-17	45	77	-68	13	-40	-32	23
Gross international reserves (increase: -)	-44	11	-45	-77	70	-35	-14	-14	-42
Use of Fund credit, net	0	6	0	0	-2	-3	0	0	0
FINANCING GAP	0	0	0	0	0	26	55	47	19
Of which: IMF	0	0	0	0	0	8	31	29	19
World Bank and ADB	0	0	0	0	0	18	24	17	0
MEMORANDUM ITEMS									
Gross international reserves (stock; e.o.p.) 2/	204	187	232	310	241	277	291	305	347
In months of GNFS imports	3.4	2.6	2.7	3.0	1.8	3.2	3.1	3.1	3.4
In percent of short-term debt at remaining maturity	585	261	168	121	80	81	88	118	143
Usable reserves (stock; e.o.p.) 2/	117	95	129	182	110	105	130	108	132
In percent of short-term debt at remaining maturity	335	133	93	71	38	31	39	42	54
Current account (in percent of GDP)	-15.8	-36.4	-33.0	-41.5	-51.4	-29.6	-23.4	-13.1	-11.1
GNFS balance (in percent of GDP)	-4.3	-51.2	-29.4	-33.9	-41.3	-20.2	-12.7	-5.3	-1.9
Exports (volume, percent change)	7.6	-12.7	29.6	-9.5	25.5	-24.9	17.4	9.3	7.7
Imports (volume, percent change)	19.7	4.4	12.4	7.3	9.8	-21.8	3.2	2.3	5.7
Tourism: bednights (percent change)	8.6	-35.4	46.1	9.8	3.0	-7.0	8.0	6.0	6.0
External debt (in percent of GDP) 4/	42.7	53.0	62.8	79.7	76.9	82.1	80.1	70.5	64.7
Medium- and long-term	41.6	47.9	52.8	62.6	59.9	67.4	67.5	60.5	56.2
Short-term	1.1	5.0	10.0	17.1	17.0	14.8	12.6	10.0	8.4
Debt service (in percent of domestic GNFS exports)	5.0	9.1	8.6	12.1	12.5	17.5	23.5	22.2	14.5
Exchange rate (rufiyaa per $; average)	12.8	12.8	12.8	12.8	12.8	…	…	…	…
GDP (in millions of US$)	776	750	915	1,054	1,261	1,343	1,444	1,590	1,714

Sources: Maldivian authorities, and Fund staff estimates and projections.

1/ There are no capital transfers or portfolio investments.
2/ MMA liabilities, include SDR allocation of SDR 7.4 million, equivalent to US$11.7 million, made available in Q3 2009, see http://www.imf.org/external/np/tre/sdr/proposal/2009/0709.htm. These are treated as long term liabilities of the MMA.
3/ These flows are treated as non-debt creating, as they mainly reflect intra-company financing for tourism-related projects.
4/ Includes IMF but excludes domestic foreign-currency denominated debt.

Table 5. Maldives: Medium-Term Projections, 2006-14

	2006	2007	2008	2009	2010	2011	2012	2013	2014
			Est.	Projection					
OUTPUT AND PRICES	(Annual percentage change)								
Real GDP	18.0	7.2	5.8	-4.0	3.4	3.7	4.1	4.3	4.5
Inflation (end-of-period)	3.9	10.4	8.6	6.7	4.7	6.3	3.5	3.0	3.0
Inflation (period average)	3.6	7.6	11.9	5.5	4.5	6.3	3.5	3.0	3.0
GDP deflator	3.5	7.4	13.0	11.0	4.0	6.3	3.5	3.0	3.0
CENTRAL GOVERNMENT FINANCES	(In percent of GDP, unless otherwise indicated)								
Revenue and grants	52.1	55.8	49.0	36.3	37.0	43.4	44.2	44.1	43.9
Tax revenue	20.2	21.5	21.0	15.6	17.9	24.6	26.1	26.3	26.5
Nontax revenue 1/	24.5	26.6	23.3	15.9	18.0	17.7	17.2	16.8	16.4
Grants	7.4	7.7	4.7	4.8	1.1	1.0	1.0	0.9	0.9
Expenditure and net lending	59.3	60.8	62.8	65.0	54.8	47.5	47.9	46.4	44.9
Current expenditure	47.9	48.6	51.4	51.4	45.2	41.0	41.5	39.1	37.6
Capital expenditure	12.4	13.1	12.6	13.7	10.9	7.8	7.5	7.5	7.5
Net lending	-1.0	-0.9	-1.1	0.0	-1.3	-1.4	-1.1	-0.3	-0.2
Overall balance	-7.2	-4.9	-13.8	-28.8	-17.8	-4.2	-3.6	-2.3	-1.0
Overall balance excl. grants	-14.6	-12.7	-18.5	-33.6	-18.9	-5.2	-4.6	-3.2	-1.9
Primary balance	-5.5	-3.2	-11.8	-26.8	-14.3	0.1	0.3	1.2	2.2
Financing	7.2	4.9	13.8	28.8	17.8	4.2	3.6	2.3	1.0
Foreign	4.5	4.6	3.8	12.7	4.2	2.0	2.6	1.1	1.0
Of which: Privatization receipts	0.0	0.0	0.0	3.0	4.4	2.1	1.9	0.0	0.0
Domestic	2.7	0.4	10.0	16.1	13.6	2.2	1.1	1.2	0.0
Of which: Privatization receipts	0.4	0.3	0.3	0.1	2.6	1.3	0.8	2.5	2.4
Public and publicly guaranteed debt	62.9	66.4	68.6	91.6	96.0	87.9	82.5	76.6	69.8
Domestic	23.4	26.5	31.2	46.8	54.5	50.4	47.0	42.5	37.1
External (excl. IMF and currency swaps by MMA)	39.6	39.8	37.4	44.8	41.5	37.5	35.5	34.1	32.7
BALANCE OF PAYMENTS									
Current account	-33.0	-41.5	-51.4	-29.6	-23.4	-13.1	-11.1	-9.3	-7.9
Of which:									
Exports	24.6	21.6	26.2	16.1	17.7	17.7	17.8	17.9	18.0
Domestic	14.8	10.2	10.0	6.6	6.9	6.8	6.8	6.8	6.8
Re-exports	9.9	11.4	16.2	9.5	10.7	10.8	11.0	11.1	11.2
Imports	-89.1	-91.5	-96.8	-58.2	-58.8	-55.9	-55.9	-55.8	-55.9
Nonfactor services, net	35.0	36.0	29.4	22.0	28.4	33.0	36.3	38.1	39.7
Of which: Travel receipts	56.0	57.1	52.6	38.8	43.6	44.1	45.1	46.2	47.3
Capital and financial account	37.9	48.8	46.0	30.5	20.6	11.1	12.5	12.5	11.1
Of which:									
General government, net	4.2	3.4	5.3	8.4	-1.9	-1.2	0.6	1.1	1.0
Banks and other sectors, net	26.0	37.1	33.3	14.6	20.4	10.3	11.1	10.7	9.4
Overall balance	4.9	7.3	-5.4	0.9	-2.8	-2.0	1.4	3.2	3.2
MEMORANDUM ITEMS									
Gross international reserves (in millions of US$; e.o.p.) 2/	232	310	241	277	291	305	347	398	441
In months of GNFS imports	2.7	3.0	1.8	3.2	3.1	3.1	3.4	3.6	3.7
In percent of short-term debt at remaining maturity	168	121	80	81	88	118	143	188	221
Usable reserves (in millions of US$; e.o.p.) 2/	129	182	110	105	130	108	132	190	253
In percent of short-term debt at remaining maturity	93	71	38	31	39	42	54	90	127
External debt 3/	62.8	79.7	76.9	82.1	80.1	70.5	64.7	60.0	55.8
Medium- and long-term	52.8	62.6	59.9	67.4	67.5	60.5	56.2	52.5	48.9
Short-term	10.0	17.1	17.0	14.8	12.6	10.0	8.4	7.6	6.8
External debt service (in percent of domestic GNFS exports)	8.6	12.1	12.5	17.5	23.5	22.2	14.5	13.0	9.8
GDP (in millions of rufyiaa)	11,717	13,493	16,137	17,192	18,480	20,354	21,935	23,559	25,354
GDP (in millions of US$)	915	1,054	1,261	1,343	1,444	1,590	1,714	1,841	1,981

Sources: Maldivian authorities, and Fund staff estimates and projections.

1/ Excludes privatization receipts.
2/ MMA liabilities, include SDR allocation of SDR 7.4 million, equivalent to US$11.7 million, made available in Q3 2009, see http://www.imf.org/external/np/tre/sdr/proposal/2009/0709.htm. These are treated as long term liabilities of the MMA.
3/ Includes IMF but excludes domestic foreign-currency denominated debt.

Table 6: Maldives: Financing Requirements and Sources, 2004-12

	2004	2005	2006	2007	2008	2009	2010	2011	2012
					Est.		Projection		
External				(In millions of U.S. dollars)					
FINANCING REQUIREMENTS	197	308	419	653	905	737	695	553	491
Current account deficit	122	273	302	438	648	398	338	209	190
Amortization of MLT debt	23	26	34	47	74	87	144	149	99
ST debt (stock at end of previous year)	7	9	38	91	181	214	198	181	160
Increase in gross international reserves	44	0	45	77	0	35	14	14	42
Repurchases from the Fund	0	0	0	0	2	3	1	0	0
FINANCING SOURCES	197	308	419	653	905	711	639	507	472
FDI (net)	15	9	14	15	12	10	10	11	12
Porfolio investment (net)	0	0	0	0	0	0	0	0	0
Other assets (net)	110	162	113	183	342	226	244	226	234
MLT loans disbursement 1/	47	43	63	65	101	154	72	86	65
New ST debt	9	38	91	181	214	198	181	160	145
Other net flows 2/	17	39	138	209	166	123	132	24	17
Decrease in gross international reserves	0	11	0	0	70	0	0	0	0
Purchases from the Fund	0	6	0	0	0	0	0	0	0
Exceptional financing	0	0	0	0	0	0	0	0	0
FINANCING GAP	0	0	0	0	0	26	55	47	19
Of which: IMF	0	0	0	0	0	7.8	31.1	29.5	18.7
World Bank and ADB	0	0	0	0	0	18	24	17	0
MEMORANDUM ITEMS									
Rollover rate of ST debt (in percent)	122	433	243	198	118	93	91	88	91
GIR (million $, e.o.p.)	204	187	232	310	241	277	291	305	347
Usable reserves (million $, e.o.p.)	117	95	129	182	110	105	130	108	132
External financing requirement (in percent of GDP)	25.4	41.1	45.7	62.0	71.8	54.8	48.1	34.8	28.6
Fiscal				(In millions of rufyiaa)					
FINANCING REQUIREMENTS	415	461	507	605	768	876	1,927	2,216	1,549
External principal payments	276	307	308	371	443	537	1,271	1,340	695
Interest payments	139	155	199	234	325	339	656	876	854
Domestic	50	63	97	102	134	163	451	587	557
External	89	92	102	132	191	176	204	289	298
FINANCING SOURCES	415	461	507	605	768	646	1,619	1,998	1,549
Primary balance	-40	-925	-645	-432	-1,904	-4,604	-2,639	24	55
Privatizations	21	35	50	37	41	524	1,300	700	600
Domestic (net)	-246	810	265	15	1,572	2,751	2,033	176	61
External disbursements	680	542	837	986	1,060	1,974	925	1,098	832
FINANCING GAP	0	0	0	0	0	230	307	218	1
MEMORANDUM ITEM									
Fiscal financing requirement (in percent of GDP)	4.2	4.8	4.3	4.5	4.8	5.1	10.4	10.9	7.1

Sources: Maldivian authorities, and Fund staff estimates and projections.

1/ 2009 includes a US$100 million loan from India.

2/ Includes flows to the nonfinancial public and private sectors.

Table 7. Maldives: Reviews and Disbursements under the Proposed Arrangements

Date	Amount of Purchase				Condition
	In percent of quota		In millions of SDRs		
	SBA	ESF	SBA	ESF	
December 4, 2009	50.0	12.5	4.1	1.025	Approval of SBA and ESF arrangements
March 25, 2010	50.0	12.5	4.1	1.025	Completion of first review and observance of end-December 2009 performance criteria
June 25, 2010	50.0	12.5	4.1	1.025	Completion of second review and observance of end-March 2010 performance criteria
September 25, 2010	50.0	12.5	4.1	1.025	Completion of third review and observance of end-June 2010 performance criteria
December 25, 2010	50.0	12.5	4.1	1.025	Completion of fourth review and observance of end-September 2010 performance criteria
March 25, 2011	50.0	12.5	4.1	1.025	Completion of fifth review and observance of end-December 2010 performance criteria
June 25, 2011	50.0	12.5	4.1	1.025	Completion of sixth review and observance of end-March 2011 performance criteria
September 25, 2011	50.0	12.5	4.1	1.025	Completion of seventh review and observance of end-June 2011 performance criteria
December 25, 2011	50.0	0	4.1	0	Completion of eighth review and observance of end-September 2011 performance criteria
March 25, 2012	50.0	0	4.1	0	Completion of ninth review and observance of end-December 2011 performance criteria
June 25, 2012	50.0	0	4.1	0	Completion of tenth review and observance of end-March 2012 performance criteria
September 25, 2012	50.0	0	4.1	0	Completion of eleventh review and observance of end-June 2012 performance criteria
Total	600	100	49.20	8.20	

Source: Fund staff projections.

Table 8. Maldives: Indicators of Capacity to Repay the Fund, 2006-21 1/

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Projections												
Fund obligations based on existing credit																
(in millions of SDRs)																
Principal	0.0	0.0	1.5	2.1	0.5	-	-	-	-	-	-	-	-	-	-	-
Charges and interest 2/	0.2	0.2	0.2	0.0	0.0	-	-	-	-	-	-	-	-	-	-	-
Fund obligations based on existing and prospective credit																
(in millions of SDRs)																
Principal	0.0	0.0	1.5	2.1	0.5	-	-	5.1	13.3	16.8	12.5	4.7	1.6	1.6	1.2	0.4
Charges and interest 2/	0.2	0.2	0.2	0.1	0.2	0.5	1.0	1.2	1.0	0.5	0.2	0.1	0.0	0.0	0.0	-
Total obligations based on existing and prospective credit																
In millions of SDRs	0.2	0.2	1.7	2.1	0.7	0.5	1.0	6.3	14.3	17.3	12.7	4.8	1.7	1.7	1.2	0.4
In millions of Rfs	3.8	4.3	34.3	41.1	14.0	9.1	18.6	122.2	278.6	337.7	247.6	93.2	32.4	32.2	24.2	8.0
In percent of government revenue 3/	0.1	0.1	0.5	0.8	0.2	0.1	0.2	1.2	2.6	2.9	1.9	0.7	0.2	0.2	0.1	0.0
In percent of exports of goods and services	0.0	0.0	0.3	0.4	0.1	0.1	0.1	0.7	1.5	1.7	1.1	0.4	0.1	0.1	0.1	0.0
In percent of debt service 4/	0.5	0.4	2.5	2.8	0.6	0.4	1.0	6.5	18.0	23.5	17.4	6.4	2.5	3.0	2.2	0.7
In percent of GDP	0.0	0.0	0.2	0.2	0.1	0.0	0.1	0.5	1.1	1.2	0.8	0.3	0.1	0.1	0.1	0.0
In percent of quota	2.4	2.7	20.7	25.8	8.8	5.7	11.7	76.6	174.3	211.2	154.9	58.3	20.2	20.1	15.1	5.0
In percent of GIR	0.1	0.1	1.1	1.2	0.4	0.2	0.4	2.4	4.9	5.4	3.6	1.3	0.4	0.4	0.3	0.1
Outstanding Fund credit 4/																
In millions of SDRs	4.1	4.1	2.6	5.6	25.6	45.1	57.4	52.3	39.0	22.1	9.6	4.9	3.3	1.6	0.4	-
In millions of Rfs	77.2	80.3	51.9	109.5	497.7	874.3	1,114.6	1,017.5	759.4	431.7	188.0	95.9	64.0	32.0	8.0	-
In percent of government revenue 3/	1.5	1.2	0.7	2.0	7.5	10.2	11.7	10.0	7.0	3.7	1.5	0.7	0.4	0.2	0.0	-
In percent of exports of goods and services	0.8	0.7	0.4	1.1	4.1	6.3	7.2	6.0	4.1	2.1	0.9	0.4	0.3	0.1	0.0	-
In percent of debt service 4/	10.2	6.9	3.8	7.5	21.1	34.0	58.7	54.4	49.0	30.0	13.2	6.6	4.9	3.0	0.7	-
In percent of GDP	0.7	0.6	0.3	0.6	2.7	4.3	5.1	4.3	3.0	1.6	0.6	0.3	0.2	0.1	0.0	-
In percent of quota	50.0	50.0	31.3	68.8	312.6	550.0	700.0	637.6	475.0	270.0	117.6	60.0	40.0	20.0	5.0	-
In percent of GIR	2.6	2.0	1.7	3.1	13.4	22.4	25.1	20.0	13.5	6.9	2.7	1.3	0.8	0.4	0.1	-
Net use of Fund credit (millions of SDRs)	-	-	(1.5)	3.1	20.0	19.5	12.3	(5.1)	(13.3)	(16.8)	(12.5)	(4.7)	(1.6)	(1.6)	(1.2)	(0.4)
Disbursements	-	-	-	5.1	20.5	19.5	12.3	-	-	-	-	-	-	-	-	-
Repayments and Repurchases	-	-	1.5	2.1	0.5	-	-	5.1	13.3	16.8	12.5	4.7	1.6	1.6	1.2	0.4
MEMORANDUM ITEMS																
Nominal GDP (in millions of Rfs)	11,717	13,493	16,137	17,192	18,480	20,354	21,935	23,559	25,354	27,290	29,373	31,616	34,030	36,628	39,425	42,435
Exports of goods and services (in millions of Rfs)	9,947	11,226	13,457	10,011	12,027	13,829	15,486	16,959	18,603	20,133	21,788	23,546	25,446	27,498	29,677	32,028
Government revenue (in millions of Rfs) 3/	5,237	6,491	7,159	5,410	6,628	8,610	9,489	10,159	10,896	11,755	12,711	13,714	14,795	15,961	17,179	18,491
Debt service (in millions of Rfs) 4/	754	1,170	1,352	1,466	2,363	2,575	1,898	1,871	1,548	1,440	1,426	1,457	1,311	1,072	1,122	1,144
GIR (in millions of USD)	232.3	309.5	241.5	276.7	290.8	304.9	347.1	397.6	440.5	486.0	534.5	579.7	634.9	694.1	748.9	804.1

Source: Fund staff estimates.

1/ Arising from projected disbursements under the proposed stand-by arrangement and Exogenous Shocks Facility.
2/ No temporary interest relief assumed pending receipt of required consents to the LIC reforms from lenders and contributors to the PRGF-ESF Trust.
3/ Excludes privatization receipts.
4/ Total debt service includes IMF repurchases and repayments.

Appendix I: Maldives: Table of Implementation of past Fund advice

Advice from the 2008 Article IV Discussions	Implementation
Adhere to zero domestic financing of the 2008 budget as intended; identify contingent expenditure cuts in the event that revenues do not materialize.	The authorities did not contain spending in 2008, and revenues, in particular from land leases, fell significantly short of budget projections. As a result, domestic financing of the budget, excluding proceeds from the sale of assets, rose to 9½ percent of GDP, much of which was monetized.
Contain the wage bill through civil service reform.	A rationalization of the civil service pay scale was undertaken in March 2009, but this has led to substantial increases in wages. Recently, the government has announced cuts in wages and allowances, and in civil service staffing levels.
Reduce subsidies to the state-owned electricity company (STELCO), by increasing electricity tariffs.	The authorities have raised electricity tariffs and are introducing a cost-based formula for further price adjustments. A transfer scheme to protect vulnerable segments of the population is being implemented.
Enhance revenues in the medium term through the introduction of corporate taxation, broad-based sales tax, and an ad-valorem tourism tax.	The authorities are planning to transfer the airport tax to the central government, and introduce an ad-valorem tourism tax in 2010, and a business profits tax and a general sales tax in 2011.
Develop a medium-term expenditure framework (MTEF).	An MTEF was presented at a donors' meeting in May 2009. However, this will need to be revised in light of recently announced revenue and expenditure measures to reduce the fiscal deficit.
Pass Banking Act, AML/CFT legislation.	A draft Banking Act has been prepared with technical assistance from the IMF, and submitted to Parliament. A draft AML/CFT law, prepared also with IMF assistance, has passed various review stages and will be submitted to Parliament this year. Maldives has established a financial intelligence unit within the MMA.

ATTACHMENT I

Malé, November 24, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The economy of the Maldives is facing a critical economic situation. The impact of the global economic crisis on exports and tourism inflows, external financing, and fiscal revenue, has exacerbated an increase in public spending by the previous administration, and led to very large fiscal and external imbalances, and a loss of international monetary reserves.

To address these challenges, the Government of Maldives has adopted a package of economic policy measures for 2009-11, described in the attached Memorandum of Economic and Financial Policies (MEFP). In support of these policies, we request a blended arrangement with the International Monetary Fund, comprising a Stand-By Arrangement (SBA) for SDR 49.2 million (equivalent to about US$ 78.2 million, or 600 percent of quota) for a period of 36 months, and an arrangement under the Exogenous Shock Facility (High Access Component) for SDR 8.2 million (about US$ 13 million, or 100 percent of quota) over 24 months. We are also securing significant additional support from other international financial institutions and bilateral partners.

The Government of Maldives believes that the policies set forth in the attached MEFP are adequate to stabilize the economy and put it back on a path of sustainable and equitable growth. However, if needed, the Government stands ready to take additional policy measures to meet the objectives of our program. The Government will consult with the Fund on the implementation of the policies contained in the MEFP, and in advance of revisions to these policies, in accordance with the Fund's policies on such consultation.

The Government of Maldives has authorized the publication of the attached MEFP.

Sincerely yours,

/s/ /s/

Ali Hashim
Minister of Finance and Treasury

Fazeel Najeeb
Governor, Maldives Monetary Authority

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. BACKGROUND: RECENT DEVELOPMENTS AND OUTLOOK

1. **Maldives recently experienced a peaceful transition to democracy after the first ever multi-party presidential elections held in October 2008.** The new President Mohamed Nasheed was sworn in in November 2008, following the 30 year-rule of President Maumoon Abdul Gayoom. One of the key objectives of President Nasheed's Government is to strengthen Maldives' prospects for sustained economic growth and consolidate the gains achieved over the last three decades in poverty reduction and human development outcomes.

2. **While the Maldivian economy rebounded strongly from the 2004 tsunami, propelled by tourism-related investment and public spending, the new Government took office against a background of major economic challenges.** Even before the presidential elections, the global financial and economic crises had already started affecting Maldives' vitally important tourism sector from September 2008 onwards, as reflected in the falling tourist arrivals. It also lowered the public and private sector's access to international credit markets, and was the primary cause of the country's balance of payments need.

3. **The new Government also inherited serious fiscal imbalances.** The expansionary fiscal policy of the past two years, not related to post-tsunami reconstruction expenditures, combined with a dramatic fall in fiscal revenue since the latter part of 2008 driven by the global downturn and its negative impact on tourism, has led to very large budget deficits. The main source have been rapid increases in current expenditures, particularly in salaries and wage allowances—the wage bill rose from 13 percent of GDP in 2004 to 21 percent of GDP in 2008. As provided for by the Finance Act, the initial budget for 2009 had to be presented to Parliament by end-November, 2008, leaving no time for the new Government to reduce the unacceptably high budget deficit. In addition, the Government had to put in place in February 2009 a wage restructuring, including a significant rise, agreed to by the previous administration. As a result, the fiscal deficit in the first half of 2009 was running at an annual rate of over 30 percent of GDP.

4. **Moreover, greater recourse to monetization of the deficit has increased inflationary pressures and led to reserve losses .** Large and rapidly increasing fiscal deficits, combined with a rise in oil and food prices through mid-2008, and since late 2008 with a dramatic fall in external financing and foreign currency earnings associated with the global downturn, have caused the current account deficit to soar and led to a loss of usable foreign reserves down to below 1 month of imports. This forced the Maldives Monetary Authority (MMA) to limit the amount of foreign exchange sold weekly to commercial banks as a short-term measure to stem reserve losses and defend the fixed peg to the US dollar, which has served economy well as a nominal anchor since 2001.

5. **The domestic economic downturn has put significant stress on the domestic banking system.** With a high exposure to the tourism sector, some banks, including the Bank of Maldives (BML), have experienced a significant increase in non-performing

loans. Combined with a more difficult external financing environment, this has also provoked stress in the foreign-currency liquidity position of some banks.

6. **The near-term outlook remains challenging.** In 2009, tourism receipts are projected to decline by around 7 percent. We anticipate real GDP to fall by up to 4 percent in 2009, dragged down mainly by a decline in tourism and related activities. Budgetary revenues from the tourism tax and from customs duties are also expected to fall. Assuming that the global recession starts abating in late 2009, growth for 2010 should recover to about 3½ percent, leading to a pick up in fiscal revenue. Global economic conditions, however, are unusually uncertain, and could affect the strength and timing of domestic recovery as well as the availability of external financing and, through these, the health of the banking sector. Whereas lower commodity prices have reduced inflationary pressures and should help moderate the current account deficit, a sharp reduction in non-oil import demand would be necessary to stem reserve losses. Despite having received substantial financial support from the Indian Government, Maldives could have faced a severe fiscal and balance of payments crisis, unless a substantial policy adjustment was put in place.

7. **Against this background, the Government of Maldives is committed to implementing a policy strategy, under an IMF-supported arrangement, to restore domestic and external stability, while protecting the poor.** The key elements of the policy program are to: (i) bring public finances on a sustainable path, including through a continuous reduction in public debt from 2011; (ii) tighten monetary policy, including by halting deficit monetization and conducting open market operations to absorb excess liquidity; (iii) muster adequate multilateral and bilateral financing to smooth the path of internal and external adjustment; and (iv) strengthen the liquidity and capital position of the banking system. These policies to strengthen the macroeconomic position will be complemented by broader and deeper policy and institutional reforms to improve the microeconomic fundamentals and the investment environment by boosting productivity growth and addressing key bottlenecks to private economic activity.

II. FISCAL POLICY

8. **Fiscal policy will aim at bringing government finances back to a sustainable medium-term trajectory.** Without corrective action, the fiscal deficit would have soared to about 33 percent of GDP in 2009, reflecting a sharp fall in revenue and continued spending growth. Starting with the wage restructuring announced by President Nasheed on August 12, 2009, we have initiated a comprehensive package of reforms to not only improve the public finances but also achieve a leaner and more efficient public sector. These reforms aim to reduce the fiscal deficit to 29 percent of GDP in 2009, and to 18 percent of GDP in 2010. The 2010 Budget, submitted to Parliament in mid-November, reflects the proposed fiscal adjustment measures and is consistent with the achievement of the fiscal targets in the program.

9. **The adjustment focuses primarily on expenditure restraint.** A key part of our program, in line with the present government's Manifesto, is to reduce the size and revise the pay structure of the civil service. Savings will come from an ongoing restructuring of wages, allowances and overtime payments, implemented in a progressive manner such

that lower earners are proportionally less affected. Effective October 1, 2009, the Civil Service Commission (CSC) implemented a temporary reduction in civil service wages of between 10 and 20 percent, depending on rank. This adjustment will be reversed when central government's domestic revenue reaches Rf 7 billion. Equivalent cuts have been extended to non-civil service government employees. In April 2009, the Government instructed the CSC, the Maldives Police Services and the Maldives National Defence Force, to freeze the number of positions allowed in their institutions. In addition, we have announced and initiated the transfer of certain services (airports, public works, schools, hospitals) to the private sector, with the aim of improving efficiency and reducing costs. In the case of education, this process will be complemented by scholarships for poorer children. Transferred employees will have access to training to facilitate their incorporation into the private sector. These transfers, together with direct redundancies to begin this year, will significantly reduce the number of staff on government payroll by end-2010, compared to June 2009 staffing levels. Finally, we are introducing cuts in other operational expenses (mainly travel expenses and supplies), and postponing domestically-financed, non-priority capital projects. The expected full-year impact of the expenditure measures is Rf 2½ billion (14 percent of GDP), bringing overall central government spending down to just over Rf 10 billion (about 55 percent of GDP) by end-2010.

10. **We will also take decisive action on the revenue side, and have already announced important tax reforms.** The aim is to broaden the overall tax base and reduce reliance on import taxes. The airport tax has been transferred to the central government, effective November 2009, and Parliament recently passed an amendment to the airport tax law raising its rate by about 29 percent. We plan to introduce by end-2009 a business profit tax on all enterprises earning above a certain threshold (structural benchmark). Also, by end-September 2010, a new *ad valorem*-based tourism tax to substitute for the existing $8/per night/per person tax will be introduced (structural benchmark). For 2011, we plan to put in place a goods and services tax (GST) (structural benchmark). On a conservative basis, these revenue measures are expected to yield 3½ percent of GDP in 2010, with a much larger impact in later years (over 15 percent of 2009 GDP), when the full-year impact of the ad-valorem tax is felt, and the other revenue measures come on stream.

11. **The Government is determined to support the most vulnerable sectors of the population.** Our program will protect spending on tsunami relief and social welfare contributions, while broadening the coverage of the pension system. We are also enhancing the targeting of food, medicine and other subsidies to the poor, including through cuts in non-targeted transfers. In particular, starting from November 2009, electricity subsidies have been restructured from a universal-based system to a targeted approach. The electricity tariff has been raised and based on a cost-linked formula, but the pricing scheme provides relief on the cost of electricity to the most vulnerable. This will eliminate the need for central government transfers to STELCO and enable the company to repay loans on-lent to it by the government.

12. **In line with the main tenets of its Manifesto, the Government has put in place a privatization program, which will continue to reduce the direct involvement of the state in production activities that can be more efficiently carried out by the private sector.** This includes the transfer of services referred to above, as well as the privatization

of state-owned enterprises and other assets. In particular, we have already sold a stake of the telecommunications company for US$40 million, and plan to sell a majority of the shares of the Maldives Airports Company, with substantial proceeds to be received over three years. The President's Office also set up a Privatization Committee to program the privatization of other state-owned enterprises. Privatization receipts will provide a short-term source of financing the deficit, while the public finances are put back on a sustainable footing.

13. **We acknowledge that financing the large fiscal deficit, even with a significant adjustment and with the privatization proceeds, will be challenging.** However, we have already halted the monetization of the deficit, and switched to other sources of financing, including through t-bill and bond sales. We intend to initiate auctions of t-bills in the primary market by the end of 2009 (structural benchmark). Additionally, we are seeking budget support from multilateral and bilateral sources. The IMF-supported arrangement will be complemented by direct budget support loans from the World Bank (about US$24 million) and the Asian Development Bank (about US$35 million). We have also secured additional external financial support, in particular further funds from India. A donors meeting is being organized by the World Bank to secure further pledges.

14. **The fiscal adjustment measures will be complemented by actions to improve public financial management over the medium term.** We are committed to adopting the recommendations of the recent IMF/World Bank Public Expenditure and Financial Accountability (PEFA) assessment. A single treasury account at the MMA has been introduced. We are completing the transition to a new Public Accounting System (PAS) that will enhance budget execution, internal control, cash management, accounting and fiscal reporting. We are in the process of establishing effective debt management units, accompanied by transparent procedures on borrowing, on-lending, and the provision of government guarantees.

III. Exchange Rate Regime and Monetary Policy

15. **Since 2001, the exchange rate has been pegged to the US dollar at Rf 12.8 per dollar.** In a small, highly open economy with very limited instruments for the independent conduct of monetary policy, the peg has provided a strong and credible nominal anchor, while reducing transaction costs and uncertainty. The Government is committed to reducing the pressures on the currency through a combination of strong fiscal adjustment and monetary tightening, thus supporting the exchange rate peg at its current level. Should usable reserves fall at any time during a given quarter by more than a predefined amount relative to the performance criterion of the previous quarter, we will consult with the IMF staff.

16. **We will gradually ease the rationing of foreign exchange as conditions improve.** At present, the MMA is rationing the amounts of foreign exchange it supplies to commercial banks on a weekly basis. This practice has given rise to a multiple currency practice and an exchange restriction subject to International Monetary Fund's jurisdiction. We hereby request approval by the IMF of the maintenance of the exchange restriction and multiple currency practice under the program. We undertake not to intensify the restriction nor modify the multiple currency practice during the length of the Fund arrangement. As the foreign currency market stabilizes, the MMA will phase out the

current rationing of foreign exchange by gradually increasing the maximum amount supplied to banks, thereby re-channeling transactions back to the formal foreign exchange market.

17. **To support the external and internal adjustment, the MMA is focusing on tightening monetary policy.** A key step has been the halting of deficit monetization starting in September 2009. Also, the totality of the stock of government debt with the MMA was converted into negotiable securities with varying maturities. This has allowed the MMA to begin conducting open market operations to reabsorb the excess liquidity generated by years of monetizing the deficit. These operations, as well as the auctions of government securities, will yield market interest rates. The increased volumes of government securities should eventually facilitate the emergence of secondary markets, including a money market, that would provide a source of liquidity for banks and the non-financial private sector.

18. **The Government is committed to seeking passage, by end-2010, of a set of reforms to the MMA Act** (structural benchmark)**.** Among other things, these reforms will strengthen the autonomy of the MMA, define its relations with the Government (including by limiting its financing of the fiscal deficit), improve its governance and accountability, and provide it with instruments to conduct an independent monetary policy.

IV. Financial Sector Policy

19. **The banking system is well capitalized and has long net open positions in foreign exchange, but some of the banks are facing an increase in non-performing loans associated with the downturn in the tourism sector.** The global crisis has also impacted banks through a reduced access to external financing. This is particularly relevant in the case of the Bank of Maldives (BML), which, unlike the rest of the commercial banks, is not a branch of a foreign bank and hence lacks access to the credit lifelines that parent banks can extend.

20. **The Government of Maldives is determined to maintaining the health of the banking system, including by strengthening BML.** The MMA, together with the Ministry of Finance and Treasury, is implementing a clear plan to address BML's problems. As a first step, the management of the bank has been replaced. Going forward, the intention is to restructure its portfolio and, as required, secure a capital infusion, possibly by attracting a strategic partner.

21. **We will expedite passage of the Banking Law** (structural benchmark)**.** In conjunction with reforms to the MMA Act, this legislation will provide an enhanced legal framework for the operation, supervision, regulation, intervention, and resolution of commercial banks.

V. Safeguards Assessment

22. **We welcome the safeguards assessment currently in progress.** Following on the recommendations of a mission conducted by the IMF in October 2009, the MMA has already taken steps to appoint an international audit firm to conduct the audit of the

MMA's financial statements in accordance with international standards. The MMA is committed to implementing the other priority recommendations of the safeguards assessment.

VI. Program Monitoring

23. **The program will be monitored on the basis of quarterly reviews, with quantitative performance criteria, indicative targets, and structural benchmarks.** Completion of the first and second reviews, scheduled for March 2010 and June 2010, will require observance of the quantitative performance criteria for end-December 2009 and end-March 2010, respectively. These performance criteria are specified in Table 1. The first review will also assess progress towards observance of the structural benchmarks specified in Table 2. Program conditionality is further specified in the accompanying Technical Memorandum of Understanding (TMU).

24. **The Government authorizes the IMF to publish this Letter of Intent and its attachments, Tables 1 and 2.**

Table 1. Maldives: Quantitative Performance Criteria and Indicative Targets

	2009				2010			
	Mar. Act.	Jun. Act.	Sep. Proj.	Dec. PC	Mar. PC	Jun. IT	Sep. IT	Dec. IT
I. Performance criteria 1/								
Usable reserves of MMA (floor on stock, in million $)	128	87	64	100	120	120	120	127
Reserve money (ceiling on stock, in million MRF)	5,669	5,974	5,948	6,050	5,950	5,900	5,750	5,750
Total financing of the central government's budget deficit (ceiling on cumulative flow from beginning of FY, in million MRF)	1,335	2,888	4,061	4,970	1,170	2,200	2,865	3,320
Net credit of MMA to central government (ceiling on cumulative flow from beginning of FY, in million MRF)	340	568	1,143	750	100	100	100	100
Contracting or guaranteeing of new nonconcessional external debt 2/ (ceiling on stock, in million $)	…	…	…	70	120	120	120	120
Accumulation of external payments arrears 3/ (ceiling on stock, in million $)	0	0	0	0	0	0	0	0
II. Indicative target								
Domestically financed expenditure by government (ceiling on cumulative flow from beginning of FY, in million MRF)	2,248	4,958	7,265	8,800	2,500	5,000	7,500	10,000
III. Adjusters								
External financial support to the government and MMA (grants and loans), excl. IMF 4/ (cumulative flow from beginning of FY, in million $)	121	138	196	287	37	112	147	168
Central government revenue (cumulative flow from beginning of FY, in million $)	1,157	2,561	4,022	5,410	1,374	2,817	4,664	6,628
IV. Memorandum items								
Program exchange rates								
MRF/$	12.80	12.80	12.80	12.80	12.80	12.80	12.80	12.80
$/SDR	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
V. Consultation clause								

If the level of usable reserves falls at any time during a given quarter by more than a predefined amount below the performance criterion for the previous quarter, the authorities will consult with the IMF staff.

1/ Evaluated at the programmed exchange rate.
2/ The ceiling is set on the stock of new debt contracted or guaranteed at any time after the approval of the program.
3/ This performance criterion is assessed on a continuous basis.
4/ Includes $100 million in dollar-denominated bonds to be purchased by the Male branch of the State Bank of India; excludes swap arrangement with Sri Lanka.

Table 2. Maldives: Prior Actions (PA) and Structural Benchmarks (SB)

Actions	Type	Test date
Conversion of the government's outstanding debt with the MMA into negotiable securities.	PA	Implemented
Directives from the relevant authorities mandating adjustments in wages, allowances and staffing levels to achieve a reduction in the central government's wage bill in line with the program.	PA	Implemented
Transfer of revenue from airport tax to the central government.	PA	Implemented
Introduction of a cost-based formula to govern electricity tariff adjustments; approval by the Maldives Energy Authority of an electricity tariff increase in line with that formula; and introduction of an electricity subsidy scheme targeted to the poor.	PA	Implemented
Submission to Parliament of 2010 Budget in line with the program	PA	Implemented
Launch of t-bill auctions	SB	December, 2009
Passage by Parliament and entry into effect of business profit tax	SB	December, 2009
Passage by Parliament and entry into effect of ad valorem tax on tourism industry	SB	September, 2010
Passage by Parliament of revised Banking Bill and MMA act	SB	December, 2010
Passage by Parliament and entry into effect of goods and services tax (GST)	SB	January, 2011

ATTACHMENT II

Technical Memorandum of Understanding

1. **This Technical Memorandum of Understanding sets out a framework for monitoring the performance of Maldives under the program, supported by a Stand-by Arrangement (SBA) and an arrangement under the Exogenous Shock Facility (ESF).** It specifies the definitions for quantitative performance criteria and indicative targets, on the basis of which Maldives's performance under the program will be assessed through quarterly reviews. Monitoring procedures and reporting requirements are also specified. The first review will take place in or after March 2010 and the second review in or after June 2010.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

2. Performance criteria for end-December 2009 and end-March 2010 have been established. The targets in Table 2 for end-June 2010, end-September 2010, and end-December 2010 are indicative and will be converted to performance criteria at the time of the reviews. Targets have been set with respect to:

- Floor on the level of usable reserves of the MMA;
- Ceiling on the level of reserve money of the MMA;
- Ceiling on the level of total financing of the central government's deficit;
- Ceiling on the level of net credit of MMA to central government;
- Ceiling on the contracting and guaranteeing by the central government or the MMA of new nonconcessional external debt.
- Ceiling on the accumulation of new external payment arrears of the central government and the MMA. This performance criterion is applicable on a continuous basis.

3. Indicative targets for end-December 2009, end-March 2010, end-June 2010, end-September 2010 and end-December 2010 have been established with respect to a ceiling on the overall domestically financed expenditure by the government, excluding debt amortization payments.

II. INSTITUTIONAL DEFINITIONS

4. The central government includes all units of budgetary central government.

5. The domestic banking system is defined as the MMA, the existing and any newly licensed commercial banks incorporated in Maldives, and their branches.

6. The domestic non-bank sector is defined as comprising private individuals as well as any business or institution, private or public, that is not classified as part of the domestic banking system.

III. Monetary Aggregates

7. **Valuation**. Foreign currency-denominated accounts will be valued in rufiyaa at the program exchange rate between the rufiyaa and the U.S. dollar of Rf 12.80 per U.S. dollar. Foreign currency accounts denominated in currencies other than the U.S. dollar, excluding SDRs, will first be valued in U.S. dollars at actual end-of-period exchange rates used by the MMA to calculate the official exchange rates. SDR-denominated accounts will be valued at the program exchange rate of U.S. dollar 1.50 per SDR. Monetary gold will be valued at US$950 per ounce.

A. Usable Reserves of the MMA

8. A floor applies to the level of usable reserves of the MMA. The floor on usable reserves will be adjusted upward (downward) by the amount of external support (loans and grants) to the government and MMA (excluding from the IMF) in excess (short) of the programmed level.

9. Usable reserves will be calculated as gross international reserves less international reserve liabilities less foreign currency deposits at the MMA. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the MMA shall be valued at program exchange rates and gold price as described in paragraph 7 above.

10. **Gross international reserves** of the MMA are defined as the sum of

- Monetary gold holdings of the MMA;
- Holdings of SDRs;
- Maldives's reserve position in the IMF;
- Cash in foreign currencies
- Foreign currency assets held abroad that are under the direct and effective control of the MMA and readily available for intervention in the foreign exchange market or the direct financing of balance of payments imbalances and are of investment grade or held with an investment-grade institution.

11. **International reserve liabilities** of the MMA are defined as the sum of

- All outstanding liabilities of Maldives to the IMF[1]; and
- Any foreign convertible currency liabilities of the MMA to nonresidents with an original maturity of up to and including one year.

12. **Foreign currency deposits** at the MMA include foreign currency deposits of comme rcial banks, state-owned enterprises and the government held with the MMA.

B. Reserve Money of the MMA

13. A ceiling applies to the level of reserve money of the MMA.

14. Reserve money consists of currency issued by the MMA (excluding MMA holdings of currency), commercial banks' deposits held with the MMA and public enterprises' deposits held with the MMA.

C. Net Credit of the MMA to the Central Government

15. A ceiling applies to the net credit of MMA to the central government measured cumulatively from the beginning of the year.

16. Net credit of the MMA to the central government is defined as the net borrowing of the central government from the MMA (ways and means advances, loans, overdrafts, holdings of restructuring bonds, holdings of treasury bills or other government bonds, and all other accounts on account of the government, minus central government deposits at the MMA).

IV. Fiscal Aggregates

A. Total Financing of the Central Government's Deficit

17. A ceiling applies to the total financing of the deficit of the central government, measured cumulatively from the beginning of the year. The ceiling on the total financing of the central government's deficit will be adjusted downward by eighty percent of the amount of total central government's revenue in excess of the programmed levels.

18. For the purpose of program monitoring, total financing of the central government's deficit is defined as the sum of (i) net domestic financing; (ii) net external financing and (iii) privatization receipts.

[1] Allocations of special drawing rights (for a total of 7,691,108 SDRs) are reflected in the capital accounts of the MMA. The asset counterpart of these allocations (holdings of SDRs) is reflected in the gross international reserves of the MMA. Therefore, the recent general and special SDR allocations, for a total of 7,408, 708 SDRs, resulted in an increase in the gross international reserves and the net usable reserves of the MMA.

- Net domestic financing is the sum of net domestic bank financing and net nonbank domestic financing.

- Net domestic bank financing is defined as the sum of: (i) net MMA credit to the central government (defined above), and (ii) the change in the commercial banks' claims on the central government in domestic and foreign currency, including the change in the holdings of government securities by the commercial banks; minus the balances of the central government held in the commercial banks.

- Net nonbank domestic financing is defined as the sum of: (i) the change in the holdings of government securities by the domestic non-bank sector, calculated as the difference between the change in the stock or net issuance of government securities and the change in the holdings of government securities by the banking system; and (ii) the net change in the float. The float consists of the value of checks issued and not yet cashed by the beneficiaries.

- Net external financing is the sum, in national currency valued at program exchange rates, of (i) the disbursements of external loans to the central government; (ii) exceptional financing (rescheduled principal plus interest); (iii) proceeds from bonds issued abroad; less (iv) amortization due; (v) net reduction in external arrears; and (vi) changes in cash, deposits, and securities held for liquidity purposes outside the domestic banking system.

- Privatization proceeds are defined as the cash receipts from asset sales by the government from abroad or domestically.

19. For the purposes of program monitoring, total central government revenue is defined as the sum of tax revenue and non-tax revenue, and excludes (i) subsidiary loan repayments; (ii) government loan account repayments; (iii) the MMA revaluation account; and (iv) any receipts from privatization.

B. Domestically Financed Expenditure by Government

20. An indicative ceiling target applies to the central government domestically financed expenditure, measured cumulatively from the beginning of the year.

21. The central government domestically financed expenditure, excluding amortization payments, is defined as actual domestically financed central government expenditure on a cash basis, excluding amortization payments, calculated on the basis of expenditure reports submitted by Accountable Government Agencies.

V. Public Debt

A. External Debt

22. A ceiling applies to the contracting and guaranteeing by the central government, the MMA, or other agencies on behalf of the central government, that takes place after the approval of the program, of new non-concessional debt of any maturity with nonresidents. The ceiling applies to the total amounts of the debt and commitments contracted or guaranteed after program approval, regardless of when the corresponding disbursements are made.

23. The definition of debt, for the purposes of the program, is set out in Executive Board Decision No. 12274, Point 9, as revised on August 24, 2000 (see Annex I).

24. Excluded from the ceiling are (i) the use of Fund resources; (ii) lending from the World Bank, the Asian Development Bank, and the International Fund for Agricultural Development; (iii) debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt; (iv) concessional debts; (v) any rufiyaa-denominated treasury bills and government bonds, and MMA bills held by nonresidents; (vi) debts classified as international reserve liabilities of the MMA; (vii) debts to restructure, refinance, or prepay existing debts; and (viii) normal import financing. A financing arrangement for imports is considered to be "normal" when the credit is self-liquidating.

25. For program purposes, the guarantee of a debt arises from any explicit legal obligation of the central government, the MMA, or other agencies on behalf of the central government to service a loan in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the central government, the MMA, or other agencies on behalf of the central government to finance a shortfall incurred by the loan recipient.

26. For program purposes, a debt is concessional if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The NPV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the NPV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD would continue to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to

19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more). Loans provided by a private entity will not be considered concessional unless accompanied by a grant or grant element provided by a foreign official entity, such as both components constitute an integrated financing package with a combined grant element equal to at least 35 percent.

VI. External Payment Arrears

27. A continuous performance criterion applies to the nonaccumulation of external payments arrears on external debt contracted or guaranteed by the central government or the MMA. External payments arrears consist of external debt-service obligations (principal and interest) that have not been paid at the time they are due, as specified in the contractual agreements. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring.

VII. Data Provision

28. The authorities have committed to using the best available data, so that any subsequent data revisions will not lead to a breach of a performance criterion. All revisions to data will be promptly reported to the Fund's Asia and Pacific Department. The likelihood of significant data changes, including definitional changes, will be communicated to Fund staff as soon as the risk becomes apparent to the authorities.

29. Data required to monitor performance under the program, including those related to performance criteria and indicative targets, will be provided electronically or in hard copy to the Fund. The data to be reported are listed below, and the reporting responsibilities are indicated in parentheses.

A. Monetary Data (MMA)

- The monetary survey, the balance sheet of the MMA, and the consolidated balance sheets of the commercial banks. Data will be provided on a monthly basis, with the exception of the balance sheet of the MMA and the consolidated balance sheets of the commercial banks, which will be provided on a weekly basis within ten working days of the end of the respective week and on a monthly basis within fifteen working days of the end of the respective month.

- Interest rates and volume on standing facilities and market operations, to be provided on a weekly basis within ten working days of the end of the respective week, and on a monthly basis within fifteen working days of the end of the respective month.

- A detailed breakdown of net credit to the central government from the MMA, the commercial banks and the nonbank sector, to be provided on a weekly basis withing

ten working days of the end of the respective week and on a monthly basis within fifteen working days of the end of the respective month.

- Results of reverse repurchase operations by the MMA, to be provided within five working days of each operation, including total bids received, accepted amount, and average interest rate.

B. Fiscal Data (Ministry of Finance and Treasury—MOFT)

- Domestically financed central government expenditure on a cash basis, excluding amortization payments, calculated on the basis of expenditure reports submitted by Accountable Government Agencies to be provided on a monthly basis within four weeks of the end of the respective month.

- Net domestic bank financing to the central government (as defined above), to be provided on a monthly basis within four weeks of the end of the respective month.

- Net nonbank domestic financing to the central government (as defined above), to be provided on a monthly basis within four weeks of the end of the respective month.

- Net external financing to the central government (as defined above), to be provided on a monthly basis within four weeks of the end of the respective month.

- Privatization receipts from asset sales by the government on a cash basis, to be provided on a monthly basis within 4 weeks of the end of the respective month.

- Results of outright sales and auctions of treasury bills, to be provided within five working days of each operation, including total amounts sold to banks and the non-bank sector, and the average yield.

C. External Sector Data (MMA and MOFT)

- Outstanding stock, disbursements, amortization, and interest payments of short-term external debt contracted or guaranteed by the government or the MMA by creditor in original currency and U.S. dollars, to be provided on a quarterly basis within four weeks of the end of the respective quarter.

- Outstanding stock, disbursements, amortization, and interest payments of medium- and long-term external debt contracted or guaranteed by the government or the MMA by creditor in original currency and U.S. dollars, to be provided on a quarterly basis within four weeks of the end of the respective quarter.

- External debt newly contracted or guaranteed by the government or the MMA, including terms (interest rate and grace and repayment periods), to be provided on a quarterly basis within 4 weeks of the end of the respective quarter.

- Arrears on the external debt contracted or guaranteed by the government or the MMA by creditor in original currency and U.S. dollars, to be provided on a quarterly basis within four weeks of the end of the respective quarter.

- Exports and imports in value terms, to be provided by the MMA on a monthly basis within four weeks of the end of the respective month.

D. Other Data (Department of National Planning)

- Consumer price index data, including a detailed breakdown by major categories of goods and services, to be provided on a monthly basis within four weeks of the end of the respective month.

ANNEX I. GUIDELINES ON PERFORMANCE CRITERIA WITH RESPECT TO FOREIGN DEBT

Excerpt from Executive Board Decision No. 12274, as revised on August 24, 2000

9. (a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

MALDIVES

Joint IMF/World Bank Debt Sustainability Analysis under the Debt Sustainability Framework for Low Income Countries[1]

Prepared by the staffs of the International Monetary Fund and
the International Development Association

Approved by Kalpana Kochhar and Aasim Husain (IMF)
and Carlos Braga and Ernesto May (IDA)

November 25, 2009

Based on the low-income country debt sustainability analysis (LIC DSA), Maldives' is rated to be at a moderate risk of debt distress. Vulnerabilities for total public debt are higher, and addressing them will require timely implementation of the authorities' strong fiscal adjustment program. The borrowing space in the short and medium terms has shrunk after the recent accumulation of large fiscal and external deficits. The build-up of private external debt prior to the onset of the global financial crisis and of public domestic debt (mainly owed to the Maldives Monetary Authority, MMA) in the last two years has intensified the debt burden. Key risks for debt sustainability are large future shocks to exports or fiscal policy slippages. Satisfactory implementation of the fiscal adjustment proposed under the program would lead to a sustained downward path in the public and external debt stocks.[2]

I. THE DEBT PORTFOLIO

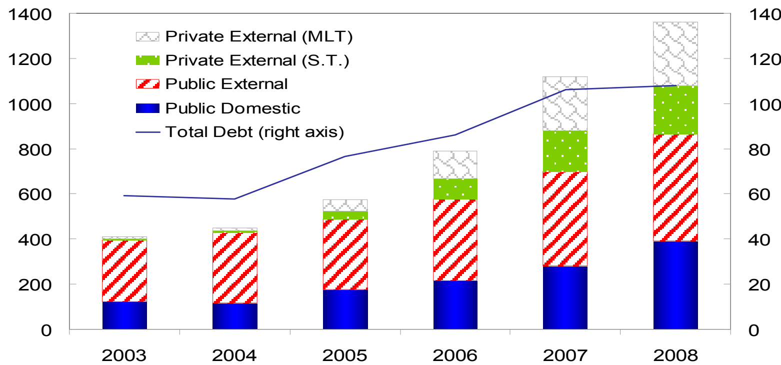
1. **The total debt to GDP ratio has increased fast since 2004, and reached almost 110 percent of GDP in 2008[3].** Each major category of debt has shown strong growth rates following the 2004 tsunami. Growth in private external debt, used to finance a rapidly expanding

[1] This DSA was prepared jointly by the staffs of the IMF and the World Bank. The staffs also consulted with the Asian Development Bank. The debt data underlying this exercise were provided by the Maldivian authorities. The fiscal year for Maldives is January-December.

[2] Maldives' policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA), averaged 3.53 over the past three years (2006-2008), placing it as a "medium performer." The relevant indicative thresholds for this category are: 40 percent for the NPV of debt-to-GDP ratio, 150 percent for the NPV of debt-to-exports ratio, 250 percent for the NPV of debt-to-revenue ratio, 20 percent for the debt service-to-exports ratio, and 30 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed (PPG) external debt.

[3] In this section, total debt refers to total PPG debt (external and domestic) and private external debt.

tourism sector, has been particularly fast. An increasing fiscal deficit in the last two years has also led to a build up of public debt, much of it domestic. With external financing sources limited for much of 2009 and a fiscal deficit running close to 30 percent of GDP, a further build-up of domestic debt has been observed so far this year, which largely explains the projected increase in the total debt-to-GDP ratio to about 129 percent in 2009.



2. **Public external debt rose rapidly after the 2004 tsunami**, as donor funds flowed into the country for reconstruction needs. It reached US$472 million (37½ percent of GDP) in 2008. About 70 percent (or one third of the total debt stock) is from multilateral and bilateral creditors. This fact, and the assumption that new borrowing is expected to be contracted from multilateral and bilateral creditors throughout the projection period, motivates the use of the low-income country (LIC) framework for the DSA.[4]

II. Macroeconomic Assumptions

3. **Maldives is facing severe fiscal and external imbalances.** For the first three years after the 2004 tsunami disaster, the authorities pursued a growth strategy based on infrastructure spending and expansion of tourism, financed by both official grants and loans and private sector foreign borrowing. However, the global economic downturn has had a significant negative impact on export and tourism receipts, as well as government revenue. Moreover, private sector financing has contracted sharply. Combined with excessive government spending, this has led to a growing fiscal deficit, much of which has been monetized by the central bank. To address these challenges, the Government of Maldives has adopted a package of economic policy measures as described in their Memorandum of Economic and Financial Policies (MEFP). The DSA that follows builds on the program baseline scenario (Box 1).

---

[4] This is the first DSA for Maldives that uses the LIC framework. Previous DSAs were conducted using the template designed for Middle-Income Countries (MICs). Thus, no debt distress rating was previously assigned. Although a comparison of ratings is therefore not possible, a qualitative comparison with the last DSA (IMF Country Report No. 09/97) suggests that the risk of debt distress has increased.

Box 1: Main Assumptions for the Debt Sustainability Analysis (2009-2029)

- **Real GDP growth** in 2009-14 is projected to average 2½ percent a year compared with an average of 7¼ percent over the previous five years. Negative growth in 2009, projected at -4 percent, is mainly due to reduced activity in the tourism sector, which has been adversely affected by global economic downturn. Growth is expected to recover thereafter to around 4½ percent, as global and domestic conditions improve, but to remain below the recent historical average. This assumes that resort development takes place at a more sustainable pace than that observed since the tsunami, and that supply constraints will hold back the fisheries sector.

- **Inflation** (which drives the GDP deflator) is projected to average 4¼ percent a year in 2009-14, compared with an average of 6½ percent over the previous five years, thanks to a moderation of global prices and the fiscal adjustment effort. Inflation is expected to stay at 3 percent thereafter, in line with trading partners' rates, reflecting continued fiscal consolidation and a tighter monetary policy.

- **Interest rates** on public debt are assumed to increase to 4½ percent by 2011 (compared with an average of 3¼ percent over the previous five years), reflecting a tighter domestic liquidity. They are assumed to decline thereafter.

- **The external current account deficit** (including grants) in 2009-14 is projected to average 15½ percent of GDP a year and decline to 5 percent by 2019 reflecting a significant fiscal retrenchment, compared to 51½ percent in 2008. Thereafter, it would remain at below its pre-tsunami level (2003).

- **The overall fiscal deficit** (including grants) is projected at 28¾ percent of GDP in 2009, as the full impact of the adjustment effort will only be felt in 2010. The deficit is expected to decline to an average of 5¾ percent of GDP in 2010-14, owing to a strong fiscal consolidation. The budget is expected to remain in balance thereafter. As a result, the volume of domestic borrowing will decline, although its cost may rise somewhat as the stock of outstanding obligations from the government to the MMA are securitized at a slightly higher average market rate than the penal rate charged by the MMA on the government's overdraft account. Public external debt is assumed to be contracted mainly on concessional terms until the end of the projection period.

- **Government expenditures** are expected to decline from 63 percent of GDP in 2008 to 45 percent by 2014, mainly reflecting civil service reforms. The **government's revenue** measures—airport tax, ad valorem bed tax, business profits tax, and the general sales tax—are expected to yield about 15 percent of 2009 GDP once their full impact is felt. These new taxes will partly offset steep falls in import duties, lease payments, and profits transfers from SOEs, stemming, respectively, from the fall in public expenditure, a moderation in future lease payments from resorts, and privatization.

III. External Debt Sustainability[5]

Baseline Scenario

4. **Maldives' external debt has increased rapidly since the Tsunami,** reflecting an increase in both public external financing and private foreign-financed investment. As of end-2008, PPG debt represented 49 percent of total external debt. The external debt path is expected to worsen in the near term, as the Maldivian authorities seek external assistance to tide over the difficult economic situation. In particular, this includes financial assistance from the Indian government totaling US$200 million,[6] and borrowing from IFIs (IMF, World Bank, and Asian Development Bank) projected at US$146 million. The authorities are also expecting additional nonconcessional external borrowing through end-2010.[7] This borrowing explains the hump in the path of external debt service in 2010–11. The external-debt-to-GDP ratio, however, is projected to decline from 2010 onwards.

5. **With one minor and temporary exception, all external debt indicators remain below the debt burden thresholds under the baseline scenario.** The PV of external public debt-to-GDP ratio is projected to be slightly above the 40 percent threshold this year, but trend down thereafter as expected program implementation helps reduce the current account deficit to sustainable levels. This marginal and temporary breach of the threshold is due in large part to the extraordinary fiscal and current account imbalances of the past two years, which the Fund-supported program aims to address. The program also places a ceiling on non-concessional public external borrowing going forward. All other public external debt burden indicators remain well below thresholds throughout the projection period. While there is a hump in debt service payments over the next two years as a result of a repayment of a large loan from the Indian government, both debt service ratios remain well within the thresholds.

---

[5] External debt sustainability analysis is focused on PPG external debt, to which thresholds are applicable. Private external debt is not considered for the purpose of IDA grant allocations.

[6] A credit of US$100 million was made available to the government of Maldives by the government of India in early 2009, and repayments in the tune of US$50 million in two tranches are expected to be made in 2010 and 2011, respectively. Also, the Male branch of the State Bank of India (SBI) is expecting to contract a US$100 million two-year non-concessional loan (subject to fifty percent rollover) from its parent by end 2009 and early 2010, and on-lend it to the government of Maldives in exchange for foreign currency-denominated domestic bonds.

[7] Such borrowing includes a foreign exchange swap with the Central Bank of Sri Lanka for at least US$25 million to boost international reserves, as well as the following infrastructure and development projects: (i) the construction of ten harbors, which has been favorably assessed by the Board of the Islamic Development Bank (IDB) and is being financed as follows—Saudi Fund ($15 million), the IDB ($15 million), and OFID ($10 million); (ii) an infrastructure development project (housing, sewerage, electricity, and desalination) in tsunami affected areas funded by Abu Dhabi ($15 million); and (iii) reclamation projects and supply of equipment to be financed by loans under negotiation. The terms of such financing vary, but are generally very favorable in relation to terms that Maldives may have received had it sought to borrow on international or domestic financial markets.

Stress Tests and Alternative Scenarios

6. **Stress tests indicate vulnerability to exogenous export shocks.** The PV of debt-to-GDP ratio, debt-to-exports ratio and debt service-to-exports ratios breach the thresholds under the most extreme standard stress test. For the former, the most extreme stress test is the combination shock—a one standard deviation shock to growth, exports, GDP deflator and non-debt flows—while in the latter two cases the most extreme shock is the export shock—an export value growth at historical average minus one standard deviation in 2010–11 relative to the 2008 baseline. This highlights the vulnerability of the economy to the variability of tourism receipts.

7. **The historical scenario indicates unsustainable debt dynamics.** When key macroeconomic variables are set to their historical averages all stock debt burden indicators breach respective thresholds, while the debt service burden indicators show an increasing trend after 2014. The key factor driving this scenario is the non-interest current account deficit, which averaged 20 percent of GDP over the 10-year period to 2008. This 10-year average contains three rather extreme events that drove the current account deficit to unprecedented highs: the 2004 tsunami, the extraordinary run-up in food and fuel prices in 2007 and 2008, and the rising fiscal deficit of the past few years. To the extent that the magnitudes of these events can be considered unique, the historical scenario may overestimate potential risks of debt distress. Nevertheless, the simulations illustrate that without significant fiscal consolidation the debt path would become unsustainable.

8. **Private external debt may increase the risks to debt sustainability.** Private external debt accounts for over one half of the external debt-to-GDP ratio. Much of this debt is at maturities of less than 10 years, at market interest rates, and denominated in U.S. dollars. To the extent that private external debt may increase liquidity and re-financing risks for the country as a whole, or entail contingent liabilities for the sovereign, the risks to debt sustainability could be higher than an analysis of external PPG data alone may suggest. Moreover, private external debt may be underestimated in Maldives: non-FDI external inflows to the non-financial private sector—which comprise mainly financing for privatization and tourism projects, and which sum to about 60 percent of GDP over 2009–2012—are treated as non-debt creating in both observed data and projections. Part of these flows, however, could be debt creating. [8]

9. **In the staff's view, the risk of public external debt distress for Maldives is moderate.** With one exception, no external debt burden indicator breaches the thresholds in the baseline scenario. Staff judges the marginal and temporary breach in the external debt-to-GDP ratio to be a function of the severe fiscal and current account imbalances over the past two years that the

---

[8] The authorities do not have adequate information to disaggregate these flows into FDI and arm's length borrowing. Accordingly, the FDI account in the balance of payments may also be underestimated.

program aims to address.[9] The steady decline in external debt burden indicators under the program indicates that the risk of debt distress declines significantly with the proposed fiscal adjustment. However, stress tests illustrate that the debt path is particularly vulnerable to export shocks and decline in non-debt creating inflows, while the historical scenario shows unsustainable debt dynamics.

IV. PUBLIC DEBT SUSTAINABILITY

Baseline Scenario

10. **The stock of Maldives' nominal public debt has increased rapidly since the 2004 tsunami**, from 55 percent of GDP in 2004 to around 69 percent in 2008, and is expected to reach 94 percent of GDP (including IMF loans and some transactions of financial entities) in 2009.[10] This sharp increase has been driven by an expansionary fiscal policy combined with a dramatic shortfall in fiscal revenue. Much of the fiscal deficit over the next two years has been financed domestically, through MMA credit to the government (which in 2008 represented 75 percent of the central government's domestic debt and 55 percent of the total public domestic debt stock) and sales of t-bills, held mainly by commercial banks. Total public debt service cost has remained at an average of 7 percent of GDP a year in 2003–2008, and is expected to increase to 17.2 percent by 2010 before shifting to a downward trajectory later in the projection period.

[9] Recent experience has demonstrated flexibility in rating of external debt distress (SM/09/216), including in Mongolia (2009), Madagascar (2008), Mali (2008) and in Bhutan (2007). In the case of Bhutan, the incorporation of two new largely debt financed hydropower projects in the baseline scenario caused some external debt indicators to breach their thresholds in both the baseline and the alternative scenarios/stress tests. However, on account of several country-specific mitigating factors a moderate risk of debt distress rating was retained. Other recent cases of flexible treatment on ratings include Mongolia (2009).

[10] Public debt refers here to the debt of the non-financial public sector, comprising the central government and state-owned enterprises, as well as publicly guaranteed debt. In line with inclusion of IMF debt contracted by the central banks, it also includes a currency swap between the MMA and the central bank of Sri Lanka for $25 million currently being negotiated. The central government accounted in 2008 for 79 percent of the total public debt. The present value of total public debt in 2008 was 67 percent of GDP.

Maldives: Total Public and Publicly Guaranteed (PPG) Debt by Creditor
(In percent of GDP)

	2004	2005	2006	2007	2008	2009 Proj.	2010 Proj.
Total PPG debt	55.2	64.9	62.9	66.4	68.6	94.0	98.7
PPG external 1/	40.1	41.3	39.6	39.8	37.4	47.3	44.2
Multilateral	23.5	24.2	24.8	25.8	22.5	26.9	25.2
Bilateral	3.9	5.2	4.8	4.3	4.6	8.8	8.2
Private creditor	12.8	11.9	10.0	9.7	10.2	11.6	10.8
PPG domestic	15.1	23.6	23.4	26.5	31.2	46.8	54.5
MMA	8.7	15.0	9.4	8.1	17.0	20.1	19.3
Commercial banks	2.6	5.1	7.7	11.5	13.5	24.9	29.0
Others	3.8	3.5	6.3	6.9	0.7	1.8	6.2
Total PPG debt service	6.8	7.9	7.1	7.3	7.8	9.0	17.2

1/ Includes IMF and currency swaps by MMA, but excludes domestic foreign-currency denominated debt.

11. **The PV of the public debt-to-GDP ratio is projected to fall sharply under the baseline scenario**, from 91 percent in 2009 to 17 percent by 2029, owing to strong fiscal adjustment efforts on both the revenue and expenditure sides (Table 2a). The PV of the public debt-to-revenue (including grants) ratio would decline from a projected 252 percent in 2009 to 39 percent by 2029. The public debt service-to-revenue (including grants) ratio would increase to 28 percent by 2010 before shifting to a downward trajectory later in the projection period (Figure 2 and Table 2a). New public borrowing from all sources in the context of the program, including Fund financing, has been considered, and risks to debt sustainability appear manageable in the context of the programmed fiscal adjustment.

Stress Tests and Alternative Scenarios

12. **Maldives' high level of public debt makes its sustainability vulnerable to exogenous shocks or fiscal policy slippages.** The stress tests indicate that the debt path is particularly vulnerable to shocks to the primary balance and long term growth. If the primary deficit remains fixed at the elevated level of 26½ percent of GDP (as in 2009), the debt ratio would continue to expand and would reach 416 percent of GDP by 2029. This, of course, illustrates that the current fiscal stance is not sustainable. It also points to the risks arising from insufficient or delayed implementation of the fiscal adjustment measures envisaged in the program. Sensitivity tests also show that the public debt path is susceptible to shocks to long-term real GDP growth, with a one standard deviation permanent shock to growth leading to a PV public debt ratio of 124 percent of GDP in 2029, compared with a baseline projection of 17 percent.

V. Conclusion

13. **Maldives faces a moderate risk of external PPG debt distress.** With the exception of a one-time breach in the PV of debt-to-GDP threshold in 2009, no thresholds are breached under the baseline scenario, but the analysis indicates the country's vulnerability to shocks to the tourism sector (which are also shocks to growth), non-debt creating inflows and the primary

balance. This suggests the need to diversify, to the extent possible within the country's geographical constraints, the structure of the economy. Maldives also faces considerable risks to debt sustainability based on its overall public debt level. This underscores the need for strong fiscal adjustment: should the authorities fall short on their fiscal consolidation efforts, the risk of the public and external debt ratio moving on to an unsustainable trajectory would significantly increase.