Maldives: 2007 Article IV Consultation-Public Information Notice; Staff Report; and Statement by the Executive Director for Maldives

INTERNATIONAL MONETARY FUND

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MALDIVES

September 2019

2007 ARTICLE IV CONSULTATION—PUBLIC INFORMATION NOTICE; STAFF REPORT; 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 2007 Article IV consultation with Maldives, the following documents have been released and are included in this package:

- A **Public Information Notice** summarizing the views of the Executive Board as expressed during its July 30, 2007 consideration of the staff report that concluded the Article IV consultation with Maldives.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 30, 2007, following discussions that ended on April 30, 2007, 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 June 12, 2007.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Maldives.

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IMF Concludes 2007 Article IV Consultation with Maldives

On July 30, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Maldives.[1]

Background

The Maldives economy has recovered strongly from the 2004 tsunami. In 2005, the decline in tourism weighed heavily on the economy, which contracted by 4.5 percent. However, strong recovery in tourism arrivals underpinned growth in 2006, and the economy grew by an estimated 19 percent.

Meanwhile, fiscal expenditures in Maldives have increased sharply in the years following the natural disaster, and, correspondingly, the fiscal deficit has deteriorated, from 1.9 percent of GDP in 2004 to 11 and 7 percent of GDP in 2005 and 2006, respectively.

The 2007 budget confirms this trend by including a further rise in planned expenditures. Overall expenditure is projected to rise by 45 percent, while the domestically financed portion of the budget—excluding development grants and loans—would increase by 31 percent, and the domestic expenditures-to-GDP ratio would rise from 46 percent in 2006 to 54 percent in 2007. The 2007 budget carries risks of a significant deficit as the large spending program is based on optimistic revenue assumptions.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the July 30, 2007 Executive Board discussion based on the staff report.

Price pressures resulting from higher fiscal deficits remained limited due to the openness of the economy. Inflation has remained relatively subdued—although rising—at 3.3 percent in 2005 and 3.7 percent in 2006 against a pre-tsunami average of 2.5 percent.

Higher fiscal deficits have, however, resulted in sizable external current account deficits. The current account deficit widened from 36 percent of GDP in 2005 to 41 percent in 2006. External debt has risen from 43 percent of GDP in 2004 to about 65 percent in 2006, while the debt service ratio has increased from 5.1 percent to 8.8 percent.

Progress has been made recently with the implementation of the first T-bill issue, and the government commenced weekly issuance in September 2006. The authorities have also embarked on several structural reform initiatives—fiscal, legal, and state-owned enterprises—to create a business environment conducive to private investment and to support growth.

Executive Board Assessment

Executive Directors noted that GDP growth in Maldives has rebounded strongly from the devastating Indian Ocean tsunami of 2004, underpinned by booming tourism and construction sectors. Per capita income has doubled over the last decade. Inflation remains low—albeit rising, anchored by the pegged exchange rate regime, which has served the country well. At the same time, large fiscal deficits and an ambitious foreign borrowing program, as well as an acceleration in private sector credit, have led to a substantial current account deficit and pressures on the balance of payments.

Against this background, Directors agreed that the main challenge for Maldives will be to ensure that the broadly favorable growth prospects are supported by a prudent fiscal policy and a viable macroeconomic framework. They stressed the need to keep expenditures in line with a realistic resource envelope, in order to contain inflation, strengthen private investment and growth, and safeguard the external position.

Directors expressed concern that the 2007 budget accommodates a substantial increase in domestically financed expenditures—mostly unrelated to post-tsunami rehabilitation. Moreover, a number of new revenue measures depend on an overly ambitious resort development schedule, and the expected revenues may fail to materialize. Directors therefore encouraged the authorities to prioritize expenditures and bring them in line with realistic revenue estimates, so as to achieve the stated objective of zero domestic financing of the budget. They recommended developing a medium-term expenditure framework to help accommodate the desired level of development spending within the available resource envelope.

Directors supported revenue-enhancing reforms to ensure fiscal sustainability over the medium term. These include the introduction of corporate taxation, a broad-based sales tax, and replacing the current “per head” tourism tax with an ad valorem tax.

Directors agreed that external vulnerabilities need to be monitored carefully, given the recent rise in external debt and debt service. They cautioned that in a small, open economy like that of Maldives, fiscal slippages tend to magnify external vulnerabilities and could cause the already low level of international reserves to fall rapidly.

Directors acknowledged that Maldives’ U.S. dollar peg exchange rate regime, and the current level of the exchange rate, seem appropriate, as long as fiscal policy is tightened. The dollar’s decline against the euro has enhanced the country’s competitiveness in recent years, and downside risks to competitiveness seem unlikely. They were concerned, however, that with unchanged fiscal policies, the resulting sharp fall in reserves would undermine the dollar peg. Against this background, many Directors noted that adequate information was not available to make a determination whether or not the Maldives’ exchange rate is in fundamental misalignment. However, some Directors concurred with the staff’s assessment that Maldives is in a situation of fundamental misalignment.

Directors welcomed the passage of the Maldives Monetary Authority Act as an important step in establishing an independent central bank. They observed that the recent introduction of treasury bills would help eliminate the practice of automatic central bank financing of fiscal deficits, and that further incremental steps to develop this market should be pursued. Directors encouraged the authorities to accept the obligations of Article VIII of the Articles of Agreement.

Directors pointed to the need for further structural reforms, including privatization, with the objective to improve competitiveness and the climate for private investment. They commended the authorities for identifying several state-owned enterprises for divestment of shares, and for the recent passage of the Audit Act and the Civil Services Act.

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

Maldives: Selected Economic Indicators, 2003–07

	2003	2004	2005	Est. 2006	Proj. 2007
	(Annual percentage change)				
Growth and prices					
Real GDP	8.5	9.5	-4.5	19.1	5.5
Inflation (period average)	-2.8	6.3	3.3	3.7	7.0
	(Percent of GDP)				
Central government					
Revenue and grants	34.8	34.2	48.0	62.9	55.8
Of which: Grants	1.4	0.7	8.6	18.1	10.7
Expenditure and net lending	38.2	36.0	58.9	70.2	79.6
Of which: Domestic spending	34.0	33.2	46.8	47.4	54.6
Overall balance	-3.4	-1.9	-10.9	-7.3	-23.9
Overall balance, excluding grants	-4.8	-2.6	-19.5	-25.3	-34.6
Financing					
Domestic	-1.3	-2.2	8.4	1.9	9.0
Foreign	4.7	4.1	2.4	5.4	14.9
	(In millions of U.S. dollars)				
Balance of payments					
Exports, including re-exports	152.0	181.0	161.6	225.2	237.5
Imports	-414.3	-567.3	-655.5	-815.3	-921.8
Nonfactor services (net)	311.1	352.4	118.8	240.0	292.9
Current account balance	-31.8	-128.4	-268.8	-369.2	-414.8
(In percent of GDP)	-4.6	-16.5	-35.8	-40.7	-40.5
Official capital (net)	29.9	25.0	18.6	38.4	152.3
Private capital (net)	70.3	140.1	145.8	237.5	163.3
Errors and omissions (net)	5.3	16.2	-11.3	27.2	0.0
Overall balance	26.5	44.2	-17.3	45.1	-24.2
Gross official reserves (year-end)	160.3	204.4	187.1	232.2	208.0
(In months of imports of GNFS) 1/	2.7	2.9	2.1	2.4	2.1
External Debt	289.5	331.8	429.1	592.3	819.6
(In percent of GDP)	41.8	42.7	57.2	65.3	80.1
Public External Debt	272.9	311.6	309.9	361.8	514.1
(In percent of GDP)	39.4	40.1	44.0	40.7	50.9
Debt service	22.0	32.3	43.0	53.7	80.3
(In percent of domestic exports of GNFS) 2/	4.0	5.1	10.1	8.8	11.9
Exchange rate					
Rufiyaa per U.S. dollar (period average)	12.8	12.8	12.8	12.8	12.8
Memorandum item:					
Nominal GDP (in millions of rufiyaa)	8,863.2	9,939.2	9,607.7	11,608.3	13,104.1

Sources: Data provided by the Maldivian authorities; and IMF staff estimates and projections.
1/ GNFS = Goods and nonfactor services.
2/ Domestic exports are defined as merchandise exports net of re-exports.

INTERNATIONAL MONETARY FUND

MALDIVES

Staff Report for the 2007 Article IV Consultation

Prepared by Staff Representatives for the 2007 Consultation with Maldives

Approved by Daniel Citrin and Michael Hadjimichael

June 12, 2007

- **Consultation:** Held in Male during April 18–30, 2007 with President Gayoom, Finance Minister Ibrahim, Maldives Monetary Authority Managing Director Hassan, other economic ministers and senior officials, and market participants.

- **Team:** Messrs. Weerasinghe (Head), Aiyar, Tchakarov, and Nakabayashi (all APD).

- **Previous Article IV consultation:** The 2005 consultation was concluded by the Executive Board on February 22, 2006. Directors expressed deep sympathy for the losses suffered due to the 2004 tsunami, and commended donor-supported reconstruction activities. They urged a return to the prudent fiscal policies in place before the tsunami, and recommended revenue reforms, expenditure management, and moving toward central bank independence.

- **Exchange rate system:** Maldives' exchange rate regime comprises a conventional fixed peg against the U.S. dollar. Maldives continues to avail itself of the transitional arrangements under Article XIV of the Fund's Articles of Agreement, but no longer maintains Article XIV restrictions. Maldives is yet to accept the obligations of Article VIII Sections 2, 3, and 4, but maintains no restrictions on the making of payments and transfers for current international transactions.

- **Economic statistics:** Maldives' statistical base is adequate to conduct effective surveillance. Technical assistance is being provided to improve coverage in certain areas.

- **Publication:** No staff report has been published thus far, although PINs have been. The authorities have not yet indicated their consent to the publication of this year's documents.

Contents Page

EXECUTIVE SUMMARY

Maldives has rebounded strongly from the tsunami of late 2004. GDP has grown rapidly, underpinned by a robust increase in tourist arrivals, and by construction activity pertaining to the development of new resorts. Inflation remains low although it is on a rising trend. The exchange rate peg continues to serve the country well.

The main challenge for Maldives is to ensure that favorable growth prospects are not undermined by fiscal excesses and consequent macroeconomic instability. Recently, domestic expenditures have increased sharply, and further increases are planned. If expenditures are not kept in line with a realistic resource envelope, financing the fiscal deficit will pose a major challenge for the country, with repercussions for inflation, private investment, growth, and external vulnerabilities.

Key issues discussed during the consultation were:

- **The 2007 budget.** A substantial planned increase in domestically financed expenditures is accommodated by several new revenue measures. However, these revenue measures are premised on a resort-development schedule that is broadly recognized as overambitious. Staff estimates that revenue shortfalls could lead to a large domestic financing need, which would undermine macroeconomic stability. Staff urged the authorities to prioritize expenditures in line with more realistic revenue estimates, so as to achieve the stated objective of zero domestic financing of the budget.

- **Fiscal reforms.** Going forward, a medium-term expenditure framework (MTEF) should be developed, to accommodate ambitious development spending within the available resource envelope. Revenue reforms are also needed, including the introduction of corporate taxation, a broad-based sales tax and replacing the current "per head" tourism tax with an ad valorem tax.

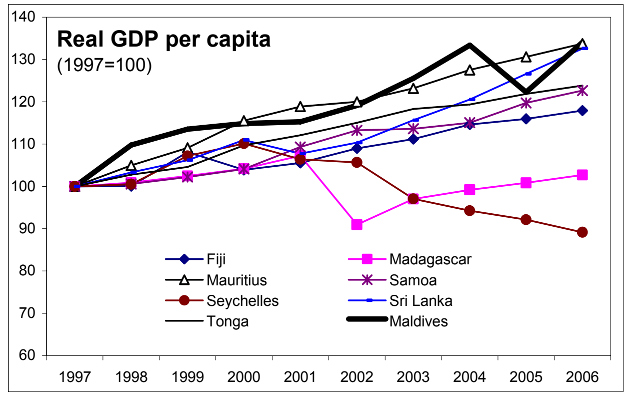
- **External vulnerabilities**. There has been a recent increase in debt ratios due to construction of new resorts and the government's ambitious infrastructure program. In the absence of policy reforms, fiscal slippages could lead to deterioration in the macroeconomic environment, thereby increasing external vulnerabilities and causing international reserves to fall to very low levels.

- **Central bank independence.** The new central bank act has separated the positions of finance minister and governor of the central bank, and reorganized the governing body of the central bank. Going forward it will be important to entrench central bank independence.

I. Introduction and Background

1. **While Maldives has achieved solid economic growth in the last decade, it faces challenges arising from its small size, dispersed population, and dependence on tourism and fishing.**

- Per capita income stands at $2,800 or double the level 10 years ago, while real GDP per capita has also risen substantially over the last decade, and social indicators have improved. Macroeconomic stability has been anchored by an exchange rate peg to the U.S. dollar.



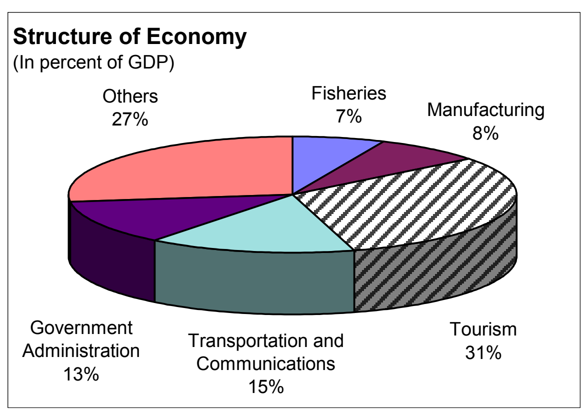
- The small and dispersed population presents serious challenges for transportation and provision of public services, and makes it difficult for Maldives to develop economic activities other than tourism and fisheries. Tourism is the mainstay of the economy, impacting many other sectors such as construction, wholesale and retail trade, transportation, and communication, but it is subject to external shocks. In addition, the authorities face several environmental challenges, including rising sea levels due to global warming, limited supplies of fresh water, and scarce arable land.

GDP Per Capita and Human Development Index in Maldives and Comparator Countries

	HDI Rank 1/	GDP per capita in US$ (2006)	Real GDP Per Capita Annual Growth Average 1995–2006
Fiji	90	3,514	1.7
Madagascar	143	294	0.1
Maldives	98	2,757	4.1
Mauritius	63	5,085	3.4
Samoa	75	1,933	2.8
Seychelles	47	8,246	0.6
Sri Lanka	93	1,324	3.4
Tonga	55	2,193	1.8
Vanuatu	119	1,530	-0.6

Sources: UN, *Human Development Report* (2006); and IMF, WEO database.
1/ Rank out of 177 countries.

2. **Maldives' vulnerability to external shocks was exposed in 2005 by the devastating Indian Ocean tsunami, but the economy recovered strongly in 2006.** Although human casualties were limited, damage to infrastructure was extensive, with the cost of reconstruction estimated at nearly half the GDP. The associated collapse in



tourism led to output contraction in 2005, but GDP rebounded in 2006 with a revival in tourism.[1]

3. **Given the country's small size and vulnerability, it is crucial to maintain macroeconomic stability, including, most importantly, through prudent fiscal policies.** Broadly favorable short- and medium-run prospects, based on the development of tourism, may be threatened by fiscal slippages. Domestic expenditures—mainly unrelated to tsunami reconstruction—have recently expanded at a rapid rate, and another large expansion is incorporated in the current budget.

4. **With recent reforms to introduce multiparty democracy, the country is preparing for elections in late 2008.** Important further reforms are being discussed by parliament, including limiting the term of the presidency and revising the constitution to appoint a prime minister.

II. Recent Developments

5. **The tsunami inflicted considerable damage on the economy, although strong tourist arrivals in 2006 helped overcome the sharp contraction of 2005.**[2] The decline in tourism weighed heavily on the economy, which contracted by 4.5 percent in 2005. However, major tourism indicators showed significant improvement in 2006 and the economy grew by an estimated 19 percent.

Maldives : Developments in 1995-2004

	1995-2004 Average
GDP growth	7.4
Tourism growth	7.9
Fiscal revenue/ GDP	36.4
Current expenditure/ GDP	28.1
Fiscal Balance/ GDP	-3.7

Source: Maldives authorities.

Tourism Indicators
(In thousands)

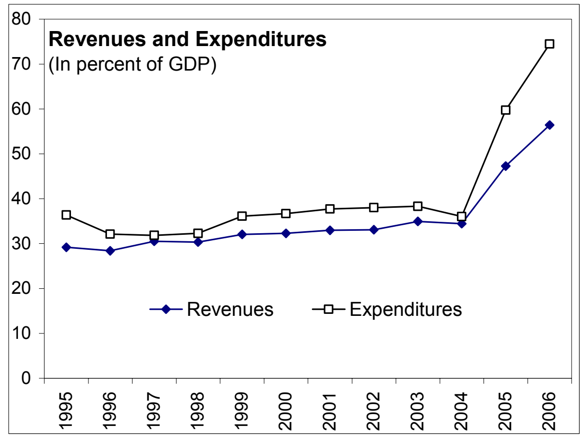
	2004	2005	2006	2005				2006			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Tourist arrivals	617	395	602	84	78	102	132	168	130	137	167
Bed capacity	17	14	16	13	14	14	15	16	16	16	17
Bed nights	5,111	3,300	4,822	680	667	884	1,069	1,372	1,047	1,127	1,276
Bed capacity utilization (in percent)	84	64	82	57	54	69	78	96	72	77	83

Source: Ministry of Tourism and Civil Aviation.

[1] More recently, during May 2007, Maldives has been subject to recurrent wave swells, which have caused considerable flooding and some property damage, but thankfully no loss to human life. Preliminary indications are that this event—which occurred after the Article IV mission—is unlikely to affect the policy stances discussed.

[2] The international community has been actively involved in helping Maldives. The World Bank and Asian Development Bank have taken the lead in multilateral efforts on post-tsunami reconstructuring.

6. **Macroeconomic and fiscal management have weakened sharply following the tsunami.** Domestic expenditures in Maldives were comparable with that of broadly similar island economies before the tsunami in 2004, but they have reached new highs in the years following the natural disaster. While tsunami-related spending justifiably rose in the immediate aftermath of the tsunami,[3] the continuous uptrend in domestically financed expenditures—mostly on non-tsunami-related spending on new recruits in police, national security, education, and health—has become a major concern. Correspondingly, the fiscal deficit has deteriorated significantly, from 1.9 percent of GDP in 2004 to 11 and 7 percent of GDP in 2005 and 2006, respectively.

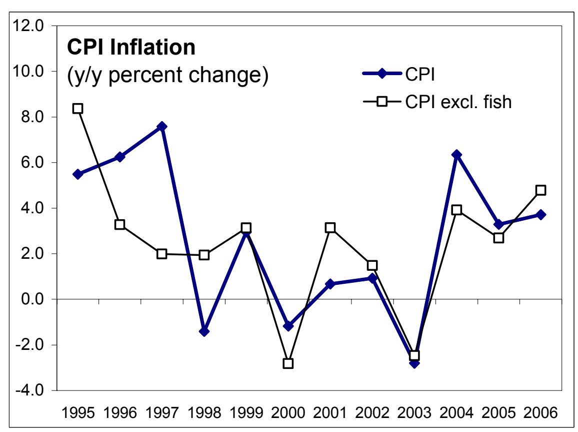


Expenditure as a Share of GDP

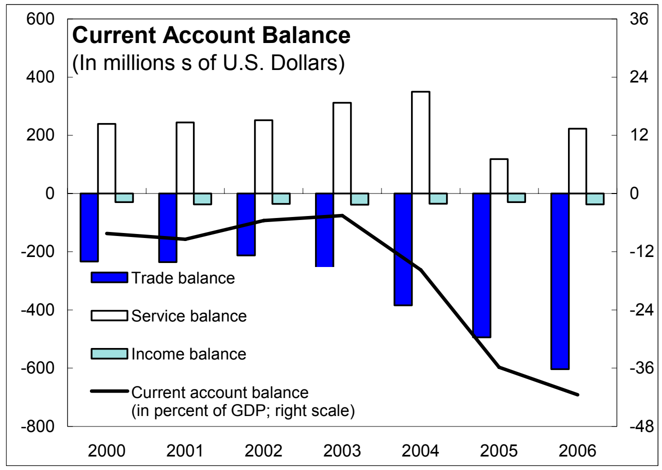
	2000	2002	2004	2005	2006 1/
Barbados	34.5	40.5	35.6	35.7	35.3
Fiji	26.3	28.6	28.4	27.5	27.5
Maldives	**36.7**	**38.0**	**36.0**	**58.9**	**70.2**
Mauritius	22.5	23.1	23.8	23.1	24.5
Samoa	34.3	33.4	47.6	33.4	38.3
Tonga	27.1	27.8	25.0	25.1	25.1
Vanuatu	29.0	25.6	20.2	19.8	23.1

1/ Estimates.

7. **Price pressures resulting from higher deficits and domestic financing have intensified, but remained limited due to the openness of the economy**. Inflation has remained relatively subdued—although rising—at 3.3 percent in 2005 and 3.7 percent in 2006 against a pre-tsunami average of 2.5 percent. Higher deficits and domestic financing have, however, resulted in sizable current account deficits.



[3] Domestic spending on tsunami reconstruction by the National Disaster Management Center was 1.6 percent of GDP in 2005 and 0.7 percent in 2006.



8. **The external current account deficit has widened, although reserves have not declined due to foreign grants and increased foreign borrowing by commercial banks.** Lower tourism arrivals led to a current account deficit of 36 percent of GDP in 2005, while higher reconstruction-related and petroleum imports—notwithstanding the recovery in tourism receipts—increased the current account deficit to 41 percent of GDP in 2006. However, tsunami-related foreign grants and increased foreign borrowing by commercial banks have helped buoy foreign reserves to US$232 million at end-December—about 2.4 months of imports.

9. **The banking sector—comprising one local and four international banks—has presided over a recent boom in private sector credit, while NPLs have fallen**. Private sector lending increased by 50 percent in 2006, continuing the robust trend seen since 2004, when the government commenced an ambitious program for leasing new islands. Most of the lending is to the tourism and tourism-related sectors of trade and construction. Much of this expansion was financed by foreign-owned banks borrowing from their head office and on-lending locally, with risks contained through the country risk exposure limits of the banks, and through collateralizing the property in the case of loans for resort development. On-site bank examinations are being conducted with MCM technical assistance (TA). NPLs as a share of total loans decreased to 2.4 percent at end-2006 from 6.7 percent in September 2005, mainly due to the recovery of the tourism sector and improved banking supervision.

III. Key Policy Discussions

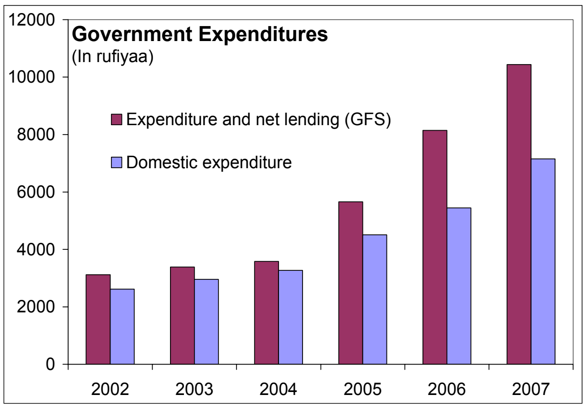
Discussions focused on the following issues:

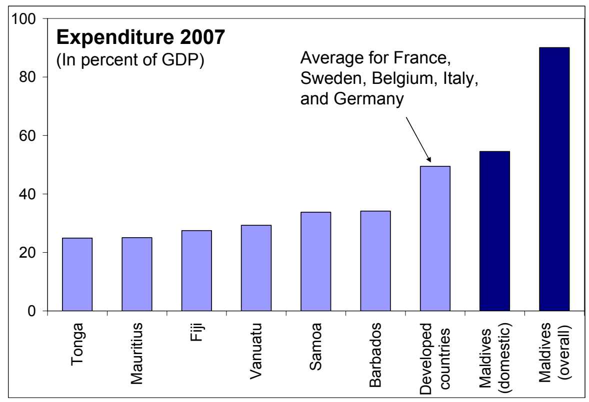
- *Fiscal policy, including the 2007 budget and medium-term fiscal outlook.*
- *Fiscal reforms, particularly revenue-enhancing measures and the creation of a medium-term expenditure framework.*
- *External sector vulnerabilities arising from possible fiscal slippages.*
- *Recent monetary policy reforms.*
- *Structural reforms including the privatization agenda and key legislation.*

A. Re-establishing a Prudent Fiscal Stance

10. **The 2007 budget incorporates a continued rapid rise in planned expenditures.** Overall expenditure is projected to rise by 45 percent, and is very high by international

standards. The domestically financed portion of the budget—excluding development grants and loans—would increase by 31 percent, and the domestic expenditures-to-GDP ratio would rise from 46 percent in 2006 to 54 percent in 2007. This is driven mainly by increased spending on community development, planned increases in the capital base of state-owned enterprises (SOEs), subsidies and welfare payments, and the opening of a number of new embassies.



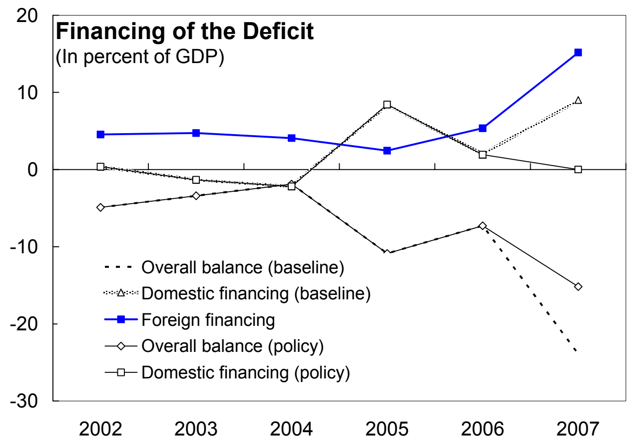


11. **The budget is balanced—in terms of domestic financing—by the introduction of several new revenue measures, but staff noted that some of these revenues may fail to materialize (Annex I).** New revenue measures—mainly related to lease payments from resorts, city hotels, and airports—are forecast to yield about 11 percent of GDP. However, the development of 46 island resorts and 2 city hotels by 2009—a planned expansion of capacity of 55 percent—would seriously test the supply constraints of the economy. Already construction is lagging behind schedule, the price of construction materials is rising rapidly, and several government ministries and private sector agents are cautioning that the timetable for development of the new islands is unrealistic.

Island Resort Capacity
(Government plans)

	Number of Island Resorts	Increase in Capacity (In percent)
1995	73	
2006	87	20
2009	135	55

12. **In the absence of scaled-back expenditures, staff estimates a requirement for domestic financing of about 9 percent of GDP.** This rests on the following assumptions on revenue shortfalls: (i) a slower pace of imports related to the construction of new island resorts due to implementation constraints. This would lead to a shortfall of about Rf 490 million in import duties (3.7 percent of GDP); (ii) dividend payments from SOEs rise with nominal GDP instead of the budget forecast of a 30 percent increase. This would cause a shortfall of Rf 120 million (0.9 percent of GDP); (iii) a conservative estimate of the planned new revenue measures leading to a further shortfall of Rf 600 million (4.5 percent of GDP).



13. **Such a large domestically financed deficit would present serious challenges for macroeconomic stability.** Deficits have traditionally been financed by the Maldives Monetary Authority (MMA), which would lead to rapid expansion of the monetary base, and some combination of inflation and depletion of foreign reserves. This, in turn, would put pressure on the Maldives' exchange rate peg, which has been the country's nominal anchor for many years. The government now also has the option of issuing treasury bills, but the market is too thin to accommodate such a large financing need and a substantial crowding out of private credit would be necessary.

14. **With the 2007 budget failing to adjust the fiscal stance, the mission stressed that expenditure restraint is imperative to forestall a potential fiscal crisis.** The mission presented an alternative scenario, which envisions a spending trajectory governed by a realistic resource envelope. The mission advised that domestic expenditures be curtailed to a realistic projection of domestic revenue, without resort to domestic financing, reflecting the government's own stated objective. This will imply that domestic expenditures are trimmed[4] to about 47 percent of GDP—7 percent of GDP lower than the 2007 budget, and broadly at the level of the 2005 budget. These cuts are feasible without affecting tsunami-related expenditures, for example, by scaling back on planned increases in non-tsunami-related grants and subsidies and on plans to expand the equity base of SOEs.

15. **Over the medium term, staff argued that expenditures should be further reduced, while still allowing for higher spending relative to pre-tsunami levels.** The medium-term alternative scenario projects that domestic expenditures continue to evolve in line with realistic revenue projections. While by 2012, domestic expenditures are further brought down to 42 percent of GDP—a significant adjustment relative to the 2007 budget—they remain materially higher than their pre-tsunami levels.[5] By preserving macroeconomic stability, the alternative scenario envisages a better investment climate and thus more rapid expansion of GDP in the medium term. GDP grows by 6.5–7.5 percent per annum, about 3 percent higher than in the baseline, underpinned by robust private investment in tourism,

[4] Foreign financing and the expenditure associated with it does not affect the regular (domestic) budget, and correspondingly, the required policy effort described in this paragraph, since it is tied to specific projects.

[5] The introduction of the BPT in 2008, and additional lease payments related to the development of the tourism industry create the necessary fiscal space, allowing for the rise in spending in the medium term.

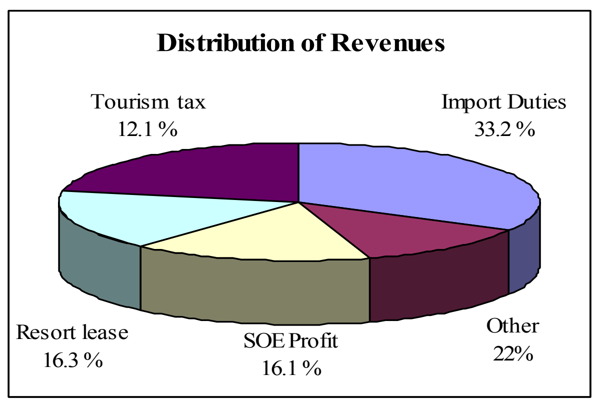
fisheries, and related construction activities, and by quicker structural reforms, including SOE restructuring. Prudent fiscal policies lower the need for central bank financing of the deficit, and lead to low and stable inflation of 2.5–3 percent per annum.

16. **While the authorities acknowledged the presence of downside risks on the revenue side, they stressed that the political environment may limit their ability to undertake corrective actions.** The authorities shared the mission's concerns on the risks of the budget, and proposed to prioritize expenditures in line with actual revenue performance. They announced that a Macroeconomic Coordination Committee will convene every three months in order to produce realistic updates of the budget situation with a view to recommending adjustments as needed.

B. Expediting Fiscal Reforms

17. **Staff noted that the country's fiscal structure was relatively inflexible, and that it would be necessary to pursue several reforms to enhance revenues over the medium term.** Currently there is no income or sales tax, and government's main sources of revenue derive from nontax revenues, import tariffs, and a specific tourism tax. Staff encouraged the authorities to expedite several planned tax reforms. TA is being provided by FAD in this regard.

- *Business profit tax.* The preparation of legislation to introduce a business profit tax has been underway for a number of years. The mission underscored that the estimated annual revenue of about 2–3 percent of GDP, which is factored in both government and staff fiscal projections from 2008 onwards, is an indispensable element of a strategy to boost revenues in the medium term.



- *Broad-based sales tax*. Staff encouraged the authorities to announce a clear timetable for their plan to substitute a broad-based sales tax for a large portion of the import duties.

- *Ad valorem tourism tax.* The specific tourism tax, which is levied uniformly "per head," is inefficient, and the mission recommended that it be replaced by an ad valorem tax to take advantage of the heavier distribution of high-price tourism resorts at the upper end of the spectrum.

18. **The authorities reaffirmed their intention to improve tax management, but noted that careful preparation was needed.** The authorities committed to submitting the Business Profit Tax Bill to parliament by the end of the year. They confirmed that the sales tax is an important element of their fiscal reform strategy, but did not commit to accelerated implementation, stressing the need for careful implementation. The authorities in principle concurred with the need to convert the "bed" tax into an ad valorem tax, but pointed to collection difficulties.

19. **The South Asian Free Trade Agreement (SAFTA) came into force in January 2006, and requires all signatories to reduce tariff rates to 0–5 percent within 10 years.** The authorities could consider reducing tariffs ahead of schedule, consistent with FAD advice, provided that they receive the full compensation guaranteed by the agreement over the transition period. Other reforms should include broadening the tax base by eliminating tariff exemptions, rationalizing the tariff structure, and improving revenue administration.

20. **The mission emphasized the need to expedite the introduction of a medium-term expenditure framework (MTEF) as an integral part in developing a sustainable fiscal strategy.** The framework should consist of integrated macroeconomic and revenue projections, and a policy commitment to a set of strategic fiscal policy goals that govern expenditures. The authorities reaffirmed their commitment to the MTEF, and agreed that projects should be prioritized according to agreed criteria such as cost-based calculations.

C. Limiting External Vulnerabilities

21. **The current account deficit widened from 36 percent of GDP in 2005 to 41 percent in 2006.** Although exports grew rapidly, supported by growth in tourism of over 50 percent, imports also surged, mainly due to construction activities and high oil prices. External debt has risen from 43 percent in 2004 to about 65 percent of GDP in 2006, while the debt service ratio has increased from 5.1 percent to 8.8 percent.

22. **The 2007 budget incorporates a marked increase in foreign debt financing, with additional borrowing projected for the next few years.** These are mainly for infrastructure projects such as harbor and atoll development, land reclamation, and electricity plants. Staff noted that such government borrowing, in conjunction with projected borrowing by the private sector for resort construction, would increase overall external debt ratios significantly. While the need to expand the country's infrastructure is pressing, prudent fiscal policies would be required to keep external vulnerabilities in check.

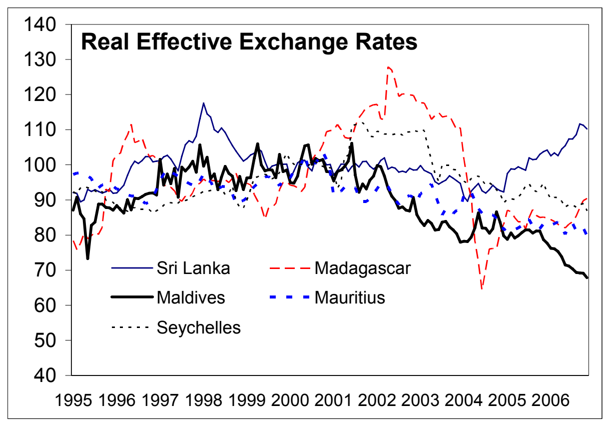
23. **In the baseline scenario with unchanged policies, international reserves are projected to fall to 1.5 months of imports by 2010, representing a significant increase in external vulnerabilities (see Annex II).** External public debt would rise to above 50 percent of GDP by the end of 2007, while total external debt would approach 90 percent. While both external public debt and total external debt would subsequently decline as a percentage of GDP, due to a reduction in borrowing and projected growth, the country would be vulnerable

to external shocks or further fiscal slippages. Moreover, with international reserves falling to precarious levels, additional private sector borrowing may be required to finance imports.

24. **The mission noted that in the alternative scenario, with more prudent fiscal policies, international reserves increase over the projection period to about three months of imports.** The more stable macroeconomic environment allows construction of new resorts to proceed apace, and allows higher growth underpinned by a better performance in the tourism sector. Higher export revenues allow a larger reserves cushion, despite an identical profile of public sector borrowing. With more comfortable reserves, less external borrowing by the private sector is required to finance imports in the later years of the projection period, and overall debt ratios are better than in the baseline.

25. **The authorities agreed that rising external vulnerabilities were an area of concern.** They acknowledged that broadly favorable current account prospects based on a dynamic performance in the tourism and fisheries sectors could be undermined by deterioration in the macroeconomic environment caused by fiscal slippages.

26. **Staff agreed with the authorities that the dollar peg continues to be an appropriate exchange arrangement.** The current arrangement has served Maldives well by reducing transaction costs and foreign exchange risks, providing an effective nominal anchor, and limiting inflation. The arrangement is also consistent with limited institutional capacity to manage a foreign exchange market. However, staff stressed that the peg needed to be supported by sustainable macroeconomic policies, particularly on the fiscal front.



27. **The level of the exchange rate appears appropriate.** Most of Maldives' exports are to euro-denominated areas—with 80 percent of tourists' arrivals coming from the EU—while the bulk of imports are dollar-denominated. Thus, the depreciation of the dollar against the euro in recent years has helped the country's competitive position. With WEO forecasts indicating continued dollar depreciation over the medium term, downside risks to competitiveness would appear unlikely.

D. Strengthening Monetary Management

28. **Traditionally, monetary policy in Maldives has been passive, with the MMA automatically monetizing any outstanding fiscal deficit, although some progress has been made recently with the implementation of the first T-bill issue.** Until recently, the automatic monetization of deficits, combined with undeveloped financial markets, has led to a primary reliance on administrative instruments to implement monetary policy.

Consequently, this has led the MMA to keep the minimum reserve requirement (MRR) at an elevated level—despite a 5 point reduction in June 2006, the MRR remains high at 25 percent—and to absorb excess liquidity through the issue of certificates of deposits via fixed rate auctions. Following the recommendations of a number of MCM TA missions, the government commenced weekly auctions of treasury bills in September 2006—a move that would allow the government scope to finance its deficits without resort to the MMA.

29. **Staff commended the authorities on recent moves toward establishing central bank independence.** Amendments to the MMA Act were passed in April 2007, enshrining the separation of the positions of finance minister and central bank governor and reorganizing the board of the MMA. A new governor is expected to be appointed soon. A recent inter-agency agreement between the MMA and the Ministry of Finance empowers the central bank to set interest rates, and puts a ceiling on the amount that the government can borrow through its Ways and Means Account at the MMA.

30. **Staff noted that going forward, it will be important to entrench the MMA's independence and ease the burden on monetary policy through a more prudent fiscal path.** Although the government is now limited in the amount it can borrow from the MMA's Ways and Means Account, the option to monetize the deficit still exists through the sale of T-bills to the MMA. The authorities agreed that entrenching central bank independence is an important goal, and that preventing fiscal slippages would help in this regard.

31. **The mission recommended further incremental steps to develop the new market for T-bills.** Creating a secondary market would allow participants to manage more actively their risks. Furthermore, moving to a variable rate auction would allow market participants to determine interest rates in a competitive manner. However, a variable rate auction would require a good liquidity forecasting framework, and while progress had been made in creating such a framework, the unpredictability of government finances still impeded the effort. The authorities agreed with these goals, aiming to implement them in gradual steps as they build up experience with market operations.

E. Progress on Structural Reforms

32. **Staff recommended that the SOEs be encouraged to operate on commercial terms with a view towards privatization.** No firm has been privatized since 2001, and even though the majority of SOEs have been corporatized (out of 23 SOEs, 9 are still 100 percent government-owned); the public sector continues to be a dominant force in many areas of economic activity. The authorities noted that shares in several SOEs will be sold in the near future, including the Allied Insurance Company of Maldives, Housing Development and Finance Corporation, Maldives Industrial Fishing Company, Maldives National Shipping Limited, and Nasandra Palace Hotel.

33. **The authorities agreed with staff on the need to expedite several key pieces of legislation, and pointed to the passage of some recent significant bills by parliament.**

The Civil Service Act (setting up an independent commission to oversee appointments, promotions, and evaluations of civil servants) and the Audit Act (establishing an independent Auditor General's Office) have been recently passed by parliament. The Banking Bill—to codify prudential regulations in the banking sector—and the Public Enterprise Bill—to introduce standards of corporate governance in SOEs—are being finalized.

34. **Staff proposed that the authorities consider acceptance of the obligations of Article VIII, Sections 2, 3, and 4, since Maldives maintains an exchange system free of restrictions on payments and transfers for current international transactions.** MMA staff will prepare a note on this issue and present it to its board for discussion once the new board members are appointed. AML/CFT legislation has been drafted with Fund assistance and a bill is expected to be submitted to parliament by end-2007.

IV. Staff Appraisal

35. **The economy has rebounded strongly from the devastating impact of the tsunami.** A strong recovery in tourist arrivals in 2006—which continued in the first quarter of 2007—underpinned growth of 19 percent. Construction is also booming, partly due to investment in several new resorts. Inflation remains low but is on a rising trend. Post-tsunami reconstruction activities continue, with the assistance of external bilateral and multilateral donors.

36. **The main policy challenge for the Maldives will be to contain domestic expenditures in line with revenues, and ensure macroeconomic stability.** The fiscal position has deteriorated recently, with large increases in domestic expenditures and the fiscal deficit. Most of the incremental spending is unrelated to alleviating social needs in the wake of the tsunami.

37. **The 2007 government budget envisages a substantial increase in expenditures, which would require significant domestic financing if an unprecedented level of increased revenues were not realized.** New revenue measures are forecast to yield about 11 percent of GDP, but much of this may fail to materialize. Staff estimates that with unchanged expenditure policies, there may be need for large domestic financing of the budget, which would present serious threats to macroeconomic stability. Therefore, prioritizing expenditures and curtailing budgeted expenditure in line with actual revenues would be crucial.

38. **To enhance medium-term fiscal sustainability, revenue-enhancing reforms should be expedited.** These reforms include the introduction of corporate taxation, a broad-based sales tax, and replacing the current "per head" tourism tax with an ad valorem tax. Moreover, a medium-term expenditure framework should be developed.

39. **External vulnerabilities should be carefully monitored.** The current account deficit has widened further, with construction imports and high oil prices outweighing booming

tourism exports. External debt and debt service have continued to rise. In the absence of prudent fiscal policies, external vulnerabilities would increase over the medium term.

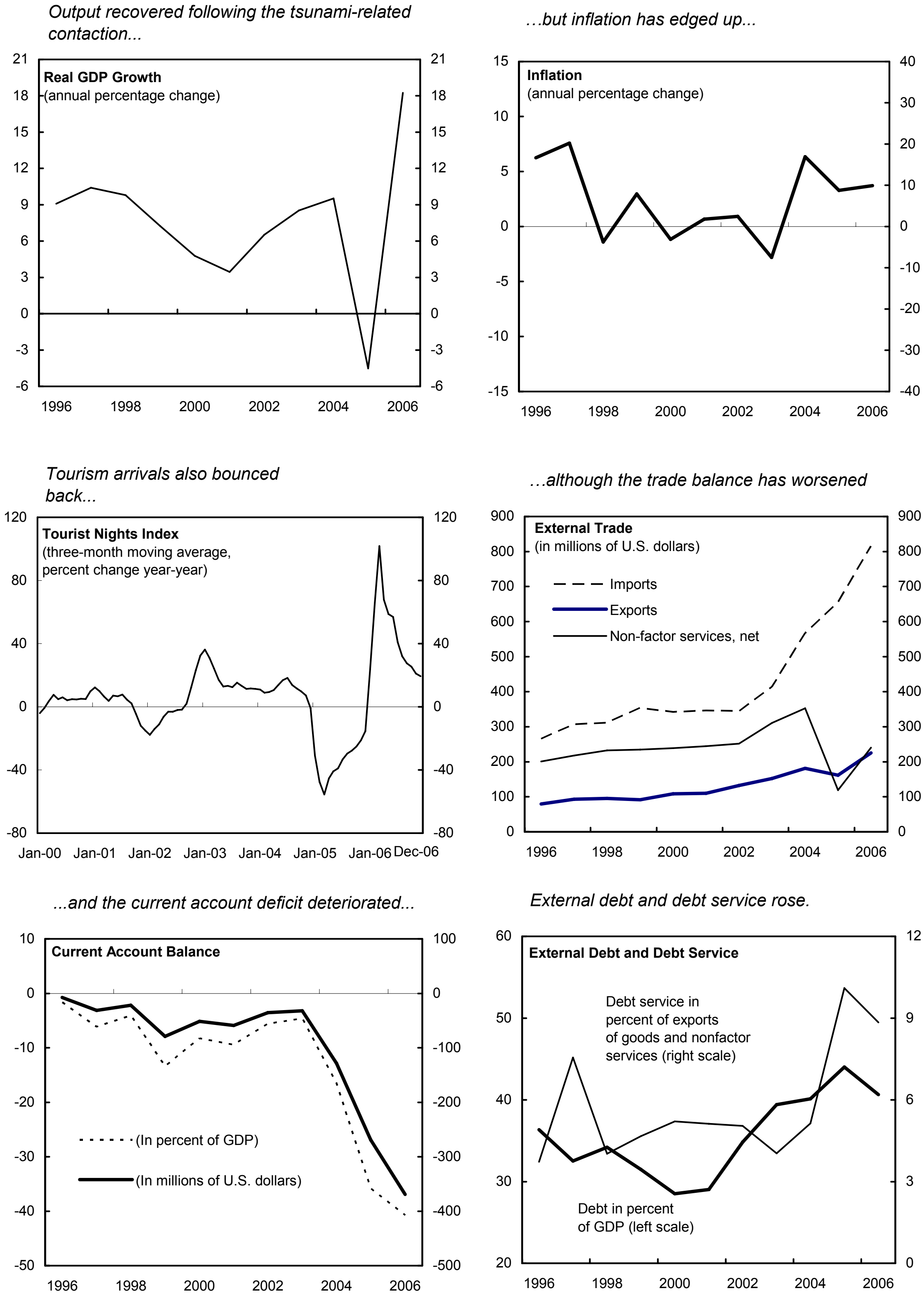
40. **The level of the exchange rate appears appropriate, as does the peg against the dollar.** The dollar's decline against the euro has enhanced the country's competitiveness in recent years, and downside risks to competitiveness would seem unlikely.

41. **The new MMA Act and the Inter-Agency Agreement are welcome steps in establishing central bank independence.** A new governor is expected to be appointed soon. The recent introduction of treasury bills is an important step toward eliminating the practice of automatic central bank financing of fiscal deficits, and further incremental steps to develop this market should be pursued.

42. **Structural reforms, including selling shares in several SOEs, and passing important legislation, should be expedited.** The identification of several SOEs for divestment of shares, and the recent passage of the Audit Act and the Civil Service Act are encouraging developments.

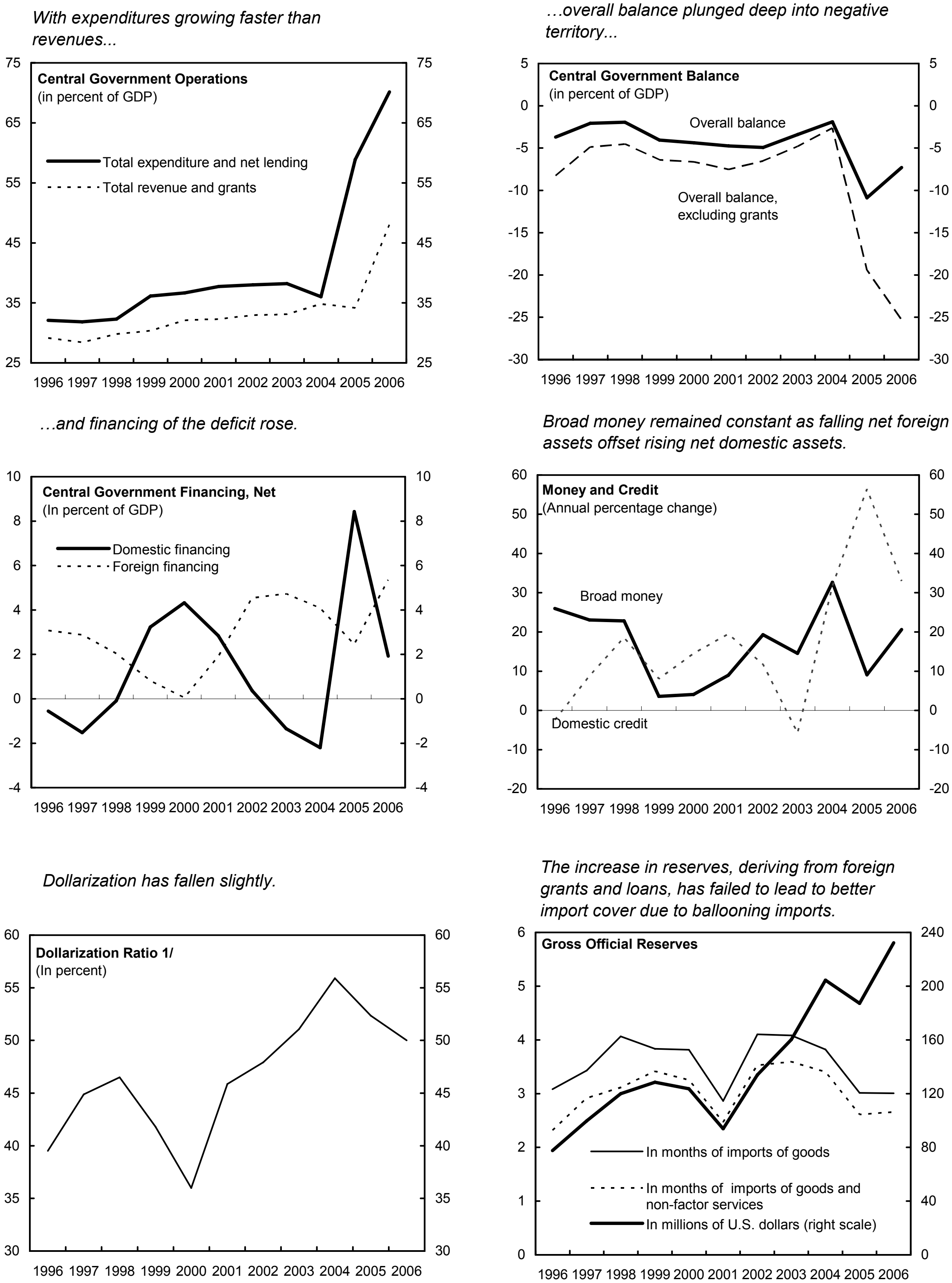
43. **It is recommended that the next consultation with Maldives take place within the standard 12-month cycle.**

Figure 1. Maldives: Real and External Sector Developments, 1996–2006



Sources: Maldivian authorities; and IMF staff estimates.

Figure 2. Maldives: Fiscal and Monetary Sector Developments, 1996–2006



Sources: Maldivian authorities; and IMF staff estimates.

1/ Foreign currency deposits as a percentage of broad money.

Table 1. Maldives: Selected Economic Indicators, 2003–07

	2003	2004	2005	Est. 2006	Proj. 2007
			(Annual percentage change)		
Growth and prices					
Real GDP	8.5	9.5	-4.5	19.1	5.5
Inflation (period average)	-2.8	6.3	3.3	3.7	7.0
			(Percent of GDP)		
Central government					
Revenue and grants	34.8	34.2	48.0	62.9	55.8
Of which: Grants	1.4	0.7	8.6	18.1	10.7
Expenditure and net lending	38.2	36.0	58.9	70.2	79.6
Of which: Domestic spending	34.0	33.2	46.8	47.4	54.6
Overall balance	-3.4	-1.9	-10.9	-7.3	-23.9
Overall balance, excluding grants	-4.8	-2.6	-19.5	-25.3	-34.6
Financing					
Domestic	-1.3	-2.2	8.4	1.9	9.0
Foreign	4.7	4.1	2.4	5.4	14.9
			(In millions of U.S. dollars)		
Balance of payments					
Exports, including re-exports	152.0	181.0	161.6	225.2	237.5
Imports	-414.3	-567.3	-655.5	-815.3	-921.8
Nonfactor services (net)	311.1	352.4	118.8	240.0	292.9
Current account balance	-31.8	-128.4	-268.8	-369.2	-414.8
(In percent of GDP)	-4.6	-16.5	-35.8	-40.7	-40.5
Official capital (net)	29.9	25.0	18.6	38.4	152.3
Private capital (net)	70.3	140.1	145.8	237.5	163.3
Errors and omissions (net)	5.3	16.2	-11.3	27.2	0.0
Overall balance	26.5	44.2	-17.3	45.1	-24.2
Gross official reserves (year-end)	160.3	204.4	187.1	232.2	208.0
(In months of imports of GNFS) 1/	2.7	2.9	2.1	2.4	2.1
External Debt	289.5	331.8	429.1	592.3	819.6
(In percent of GDP)	41.8	42.7	57.2	65.3	80.1
Public External Debt	272.9	311.6	309.9	361.8	514.1
(In percent of GDP)	39.4	40.1	44.0	40.7	50.9
Debt service	22.0	32.3	43.0	53.7	80.3
(In percent of domestic exports of GNFS) 2/	4.0	5.1	10.1	8.8	11.9
Exchange rate					
Rufiyaa per U.S. dollar (period average)	12.8	12.8	12.8	12.8	12.8
Memorandum item:					
Nominal GDP (in millions of rufiyaa)	8,863.2	9,939.2	9,607.7	11,608.3	13,104.1

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

1/ GNFS = Goods and nonfactor services.
2/ Domestic exports are defined as merchandise exports net of re-exports.

Table 2. Maldives: Balance of Payments, 2003–07

	2003	2004	2005	2006	2007
	(In millions of U.S. dollars)				
Current account balance	-31.8	-128.4	-268.8	-369.2	-414.8
Trade balance	-262.3	-386.4	-493.8	-590.1	-684.3
Exports, f.o.b. (including re-exports)	152.0	181.0	161.6	225.2	237.5
Imports, f.o.b.	-414.3	-567.3	-655.5	-815.3	-921.8
Services (net)	272.7	311.6	88.8	198.8	251.0
Balance on nonfactor services	311.1	352.4	118.8	240.0	292.9
Receipts	432.1	505.2	322.9	473.1	526.0
Of which: Tourism receipts	401.6	470.9	284.2	433.7	482.2
Payments	-121.0	-152.9	-204.1	-233.1	-233.1
Balance on factor services	-38.4	-40.8	-30.0	-41.2	-41.9
Receipts	6.2	10.3	11.8	15.1	16.1
Payments	-44.6	-51.1	-41.8	-56.3	-58.0
Unrequited transfers (net)	-42.3	-53.6	136.2	22.1	18.5
Official	12.7	7.6	205.7	105.3	110.0
Private	-54.9	-61.1	-69.5	-83.2	-91.5
Nonmonetary capital (net)	52.4	150.3	263.5	387.1	390.6
Official medium- and long-term	29.9	25.0	18.6	38.4	152.3
Disbursements	46.6	46.5	42.5	61.8	184.4
Amortization	-16.7	-21.6	-23.9	-23.4	-32.1
Private capital	70.3	140.1	145.8	237.5	163.3
Commercial banks	-47.8	-14.8	99.0	111.2	75.0
Net errors and omissions	5.3	16.2	-11.3	27.2	0.0
Overall balance	26.5	44.2	-17.3	45.1	-24.2
Monetary movements	-26.5	-44.2	17.3	-45.1	24.2
Memorandum items:					
Domestic export growth (value, in percent) 1/	24.5	8.7	-15.4	30.5	9.4
Import growth (value, in percent)	20.2	36.9	15.5	24.4	13.1
Current account balance (in percent of GDP)	-4.6	-16.5	-35.8	-40.7	-40.5
Gross official reserves (in millions of U.S. dollars)	160.3	204.4	187.1	232.2	208.0
(In months of imports of GNFS) 2/	3.6	3.4	2.6	2.7	2.2
External debt (in millions of U.S. dollars)	289.5	331.8	429.1	592.3	819.6
External debt (in percent of GDP)	41.8	42.7	57.2	65.3	80.1
Debt service (in millions of U.S. dollars)	22.0	32.3	43.0	53.7	80.3
Debt service (in percent of domestic exports of GNFS) 1/	4.0	5.1	10.1	8.8	11.9
Exchange rate (rufiyaa per U.S. dollar, average)	12.8	12.8	12.8	12.8	12.8
GDP (in millions of U.S. dollars)	692.4	776.5	750.6	906.9	1023.8

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

1/ Domestic exports are defined as merchandise exports net of re-exports.
2/ GNFS = Goods and nonfactor services.

Table 3. Maldives: Central Government Finance, 2003–07

	2003	2004	2005	2006	2007	
				Est.	Budget	Staff
	(In millions of rufiyaa)					
Total revenue and grants	3,087.9	3,395.2	4,612.8	7,298.7	8,097.5	7,305.7
Total revenue	2,964.3	3,320.7	3,788.3	5,203.3	7,138.6	5,897.7
Current revenue	2,936.8	3,302.4	3,753.3	5,171.6	7,106.2	5,865.3
Tax revenue	1,268.7	1,638.1	1,722.9	2,382.8	3,193.9	2,702.5
Import duties	817.1	1,126.7	1,245.8	1,712.9	2,424.1	1,935.5
Tourism	359.8	412.2	345.0	506.6	534.3	531.2
Other	91.8	99.2	132.1	163.3	235.5	235.9
Nontax revenue	1,668.1	1,664.3	2,030.4	2,788.8	3,912.3	3,162.8
SOE profit transfers	570.6	545.1	608.6	712.1	927.3	803.8
Resort lease payments	575.7	553.6	599.6	1,408.2	2,108.1	1,482.0
Other	521.8	565.6	822.3	668.5	876.9	876.9
Capital revenue	27.5	18.3	35.0	31.7	32.4	32.4
Grants	123.6	74.5	824.5	2,095.4	958.9	1408.0
Expenditure and net lending	3,388.2	3,582.6	5,657.6	8,144.4	11,801.6	10,436.6
Current expenditure	2,345.7	2,788.1	4,643.3	6,584.0	6,797.2	6,797.2
Capital expenditure	1,206.2	991.0	1,132.1	1,631.2	5,078.5	3,713.5
Domestic expenditure	3,009.1	3,299.2	4,500.0	5,497.8	7,153.3	7,153.3
Net lending	-163.7	-196.5	-117.8	-70.8	-74.1	-74.1
Overall balance	-300.3	-187.4	-1,044.8	-845.7	-3,704.1	-3,131.0
Overall balance, excluding grants	-423.9	-261.9	-1,869.3	-2,941.1	-4,663.0	-4,539.0
Current balance	591.1	514.3	-890.0	-1,412.4	309.0	-931.9
Domestic financing	-118.9	-218.0	809.8	223.7	15.0	1,181.5
Foreign financing	419.2	405.4	235.0	622.0	3,689.1	1,949.4
Government debt (end of period)	4,087.6	4,282.8	5,052.1	6,002.8	9,706.9	9,133.8
Of which: Foreign	2,622.9	3,026.6	3,261.6	3,883.6	7,572.7	5,833.0
	(In percent of GDP)					
Total revenue and grants	34.8	34.2	48.0	62.9	61.8	55.8
Current revenue	33.1	33.2	39.1	44.6	54.2	44.8
Tax revenue	14.3	16.5	17.9	20.5	24.4	20.6
Import duties	9.2	11.3	13.0	14.8	18.5	14.8
Tourism	4.1	4.1	3.6	4.4	4.1	4.1
Other	1.0	1.0	1.4	1.4	1.8	1.8
Nontax revenue	18.8	16.7	21.1	24.0	29.9	24.1
SOE profit transfers	6.4	5.5	6.3	6.1	7.1	6.1
Resort lease payments	6.5	5.6	6.2	12.1	15.8	11.3
Other	5.9	5.7	8.6	5.8	6.7	6.7
Capital revenue	0.3	0.2	0.4	0.3	0.2	0.2
Grants	1.4	0.7	8.6	18.1	7.3	10.7
Expenditure and net lending	38.2	36.0	58.9	70.2	90.1	79.6
Current expenditure	26.5	28.1	48.3	56.7	51.9	51.9
Capital expenditure	13.6	10.0	11.8	14.1	38.8	28.3
Domestic expenditure	34.0	33.2	46.8	47.4	54.6	54.6
Net lending	-1.8	-2.0	-1.2	-0.6	-0.6	-0.6
Overall balance	-3.4	-1.9	-10.9	-7.3	-28.3	-23.9
Overall balance, excluding grants	-4.8	-2.6	-19.5	-25.3	-35.6	-34.6
Current balance	6.7	5.2	-9.3	-12.2	2.4	-7.1
Domestic financing	-1.3	-2.2	8.4	1.9	0.1	9.0
Foreign financing	4.7	4.1	2.4	5.4	28.2	14.9
Government debt (end of period)	46.1	43.1	52.6	51.7	74.1	69.7
Of which: Foreign	29.6	30.5	33.9	33.5	57.8	44.5
Of which: Domestic	16.5	12.6	18.6	18.3	16.3	25.2
Memorandum items:						
Exchange rate (rufiyaa per U.S. dollar, average)	12.8	12.8	12.8	12.8	12.80	12.80
Nominal GDP (in millions of rufiyaa)	8,863.2	9,939.2	9,607.7	11,608.3	13,104.1	13,104.1

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

Table 4. Maldives: Summary of Monetary Accounts and MMA Balance Sheet, 2002–07

	Dec.					Proj.
	2002	2003	2004	2005	2006	2007
	(In millions of rufiyaa)					
Monetary survey						
Broad money	3,936.0	4,543.7	5,983.7	6,685.0	8,063.3	9102.3
Net foreign assets	1,676.6	2,613.4	3,357.1	1,787.7	941.6	-328.0
Monetary authorities (net)	1,704.9	2,050.3	2,605.1	2,303.5	2,490.7	2571.4
Foreign assets	1,715.1	2,060.5	2,616.1	2,394.9	2,972.3	2662.8
Foreign liabilities	-10.2	-10.2	-11.0	-91.4	-91.4	-91.4
Commercial banks (net)	-28.3	563.1	752.0	-515.8	-1,939.4	-2899.4
Net domestic assets	2,259.4	1,930.4	2626.6	4897.2	7121.8	9430.3
Domestic credit	3,421.7	3,246.6	4,239.6	6,904.9	9,180.8	11489.4
Public sector	1,314.5	1,002.2	698.3	1,430.9	995.6	2245.8
Central government (net)	1,103.5	911.8	456.3	953.0	423.1	1604.6
Other	2,318.2	2,334.8	3,783.3	5,952.0	8,757.7	9884.7
Public enterprises	211.0	90.4	242.0	477.9	572.5	641.2
Private sector	2,107.2	2,244.4	3,541.3	5,474.1	8,185.2	9243.5
Other items (net)	-1,162.3	-1,316.3	-1,613.0	-2,007.7	-2,059.1	-2059.1
	(Annual percentage change)					
Broad money	19.5	15.4	31.7	11.7	20.6	12.9
Net foreign assets	43.0	55.9	28.5	-46.7	-47.3	-134.8
Domestic credit	11.9	-5.1	30.6	62.9	33.0	25.1
Public sector	6.8	-23.8	-30.3	104.9	-30.4	125.6
Central government (net)	5.4	-17.4	-50.0	108.9	-55.6	279.2
Other	15.3	0.7	62.0	57.3	47.1	12.9
Public enterprises	14.7	-57.2	167.8	97.5	19.8	12.0
Private sector	15.3	6.5	57.8	54.6	49.5	12.9
Memorandum items:						
GDP (in millions of rufiyaa)	8,201.0	8,863.2	9,939.2	9,607.7	11,608.3	13,104.1
Rufiyaa per U.S. dollar	12.8	12.8	12.8	12.8	12.8	12.8
Velocity	2.2	2.1	1.9	1.5	1.5	1.5
Official reserves (US$ million)	134.0	160.3	199.6	187.1	232.2	208.0
Commercial banks' NFA (US$ million)	-2.2	44.0	58.8	-40.3	-151.5	-226.5

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

Table 5. Maldives: Base Case Medium-Term Scenario, 2005–12

			Proj.					
	2005	2006	2007	2008	2009	2010	2011	2012
			(Annual percentage change)					
Output and prices								
Real GDP growth	-4.5	19.1	5.5	4.5	4.0	4.0	3.5	3.5
Consumer prices (period average)	3.3	3.7	7.0	6.0	6.0	6.0	6.0	6.0
			(In percent of GDP)					
Central government								
Revenue and grants	48.0	62.9	55.8	52.7	47.5	44.5	43.0	41.7
Tax revenue	17.9	20.5	20.6	22.7	20.2	18.8	18.0	17.4
Nontax revenue	21.1	24.0	24.1	23.6	23.1	22.6	22.2	21.8
Grants	8.6	18.1	10.7	6.2	4.0	2.9	2.6	2.4
Expenditure and net lending	58.9	70.2	79.6	68.1	54.6	45.5	43.6	41.7
Current expenditure	48.3	56.7	51.9	47.3	41.1	38.0	36.0	34.0
Capital expenditure	11.8	14.1	28.3	21.3	14.0	8.0	8.0	8.0
Domestic expenditure	46.8	47.4	54.6	51.6	47.2	44.8	43.0	41.2
Overall balance	-10.9	-7.3	-23.9	-15.4	-7.1	-1.0	-0.6	0.0
Overall balance, excluding grants	-19.5	-25.3	-34.6	-21.6	-11.1	-3.9	-3.2	-2.4
Financing								
Domestic	8.4	1.9	9.0	4.5	3.2	2.8	2.3	1.5
Foreign	2.4	5.4	14.9	3.6	3.9	-1.7	-1.7	-1.5
Total public sector debt	52.6	51.7	69.7	78.3	78.1	71.9	66.1	60.2
Of which: Foreign debt	44.0	40.7	50.9	56.8	55.5	48.6	42.6	37.3
			(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments								
Domestic exports (in percent change) 1/	-15.4	30.5	9.4	8.0	8.1	8.0	8.0	8.1
Merchandise imports (in percent change)	15.5	24.4	13.1	7.2	-7.6	-1.1	2.7	5.2
Tourism receipts (in percent change)	-36.1	46.5	11.2	8.1	8.1	8.2	8.0	8.0
Trade balance	-493.8	-590.1	-684.3	-727.7	-635.3	-606.3	-610.5	-635.3
Nonfactor services (net)	118.8	240.0	292.9	381.9	446.6	490.1	536.5	579.4
Current account balance	-268.8	-369.2	-414.8	-411.6	-244.1	-172.7	-125.0	-105.4
(In percent of GDP)	-35.8	-40.7	-40.5	-36.3	-19.5	-12.5	-8.3	-6.4
Overall balance	-17.3	45.1	-24.2	-43.2	-11.7	-9.9	-0.5	12.4
Memorandum items:								
Gross official reserves (year-end)	187.1	232.2	208.0	164.8	153.1	143.2	142.7	155.2
(In months of imports of GNFS) 2/	2.1	2.4	2.1	1.8	1.7	1.5	1.5	1.5
External debt (year-end)	429.1	592.3	819.6	1,007.6	1,123.8	1,183.7	1,213.6	1,133.7
(In percent of GDP)	57.2	65.3	80.1	88.8	89.9	85.9	80.3	68.3
Public External debt (year-end)	309.9	361.8	514.1	637.1	693.3	673.2	653.1	523.3
(In percent of GDP)	44.0	40.7	50.9	56.8	55.5	48.6	42.6	37.3
Debt service	43.0	53.7	80.3	98.4	106.3	118.7	121.4	124.1
(In percent of exports of GNFS)	10.1	8.8	11.9	13.5	13.5	13.9	13.2	12.5

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

1/ Domestic exports are defined as merchandise exports net of re-exports.
2/ GNFS = Goods and nonfactor services.

Table 6. Maldives: Alternative Policy Medium-Term Scenario, 2005–12

	2005	2006	Proj. 2007	2008	2009	2010	2011	2012
			(Annual percentage change)					
Output and prices								
Real GDP growth	-4.5	19.1	7.5	7.0	7.0	7.0	6.5	6.5
Consumer prices (period average)	3.3	3.7	3.0	3.0	2.5	2.5	2.5	2.5
			(In percent of GDP)					
Central government								
Revenue and grants	48.0	62.9	57.9	54.3	49.5	46.6	45.2	44.6
Tax revenue	17.9	20.5	22.0	24.7	22.3	20.8	19.8	19.6
Nontax revenue	21.1	24.0	24.7	23.1	22.9	22.6	22.5	22.3
Grants	8.6	18.1	11.0	6.3	4.1	3.0	2.8	2.5
Expenditure and net lending	58.9	70.2	73.1	65.5	53.6	44.8	43.4	42.9
Current expenditure	48.3	56.7	49.2	45.4	40.1	37.8	36.4	35.8
Capital expenditure	11.8	14.1	24.5	20.7	14.0	7.5	7.5	7.5
Domestic Expenditure	46.8	47.4	47.5	48.6	46.0	44.1	42.9	42.4
Overall balance	-10.9	-7.3	-15.2	-11.2	-4.0	1.8	1.8	1.6
Overall balance, excluding grants	-19.5	-25.3	-26.1	-17.5	-8.2	-1.2	-1.0	-0.9
Financing								
Domestic	8.4	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	2.4	5.4	15.2	3.6	4.0	-1.8	-1.8	-1.6
Total public sector debt	52.6	51.7	61.9	67.3	65.4	57.8	51.2	45.3
Of which: Foreign debt	44.0	40.7	51.9	58.2	57.1	50.3	44.3	39.0
			(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments								
Domestic exports (in percent change) 1/	-15.4	30.5	11.5	10.6	11.2	11.1	11.1	11.2
Merchandise imports (in percent change)	15.5	24.4	19.5	10.1	-5.7	-2.3	1.1	7.9
Tourism receipts (in percent change)	-36.1	46.5	13.6	12.2	10.4	10.5	10.6	10.4
Trade balance	-493.8	-590.1	-732.4	-800.2	-712.8	-660.9	-639.9	-682.1
Nonfactor services (net)	118.8	240.0	304.3	416.3	497.8	560.9	632.2	702.0
Current account balance	-268.8	-369.2	-451.5	-449.7	-270.4	-156.5	-58.7	-29.6
(In percent of GDP)	-35.8	-40.7	-45.0	-40.6	-22.3	-11.8	-4.0	-1.9
Overall balance	-17.3	45.1	32.5	-23.0	15.3	-3.7	25.8	44.9
Memorandum items:								
Gross official reserves (year-end)	187.1	232.2	264.7	241.7	257.0	253.3	279.1	324.0
(In months of imports of GNFS)	2.1	2.3	2.5	2.5	2.7	2.6	2.6	3.0
External debt (year-end)	429.1	592.3	819.6	972.6	1,068.8	1,088.7	1,108.6	1,018.7
(In percent of GDP)	57.2	65.3	81.6	87.9	88.1	81.8	76.3	64.2
Public External debt (year-end)	309.9	361.8	514.1	637.1	693.3	673.2	653.1	523.3
(In percent of GDP)	44.0	40.7	51.9	58.2	57.1	50.3	44.3	39.0
Debt service	43.0	53.7	80.3	96.5	103.4	113.5	115.7	117.9
(In percent of exports of GNFS) 2/	10.1	8.8	11.7	12.5	12.2	12.1	11.1	10.2

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

1/ Domestic exports are defined as merchandise exports net of re-exports.
2/ GNFS = Goods and nonfactor services.

Table 7. Maldives: Indicators of External Vulnerability, 2003–06

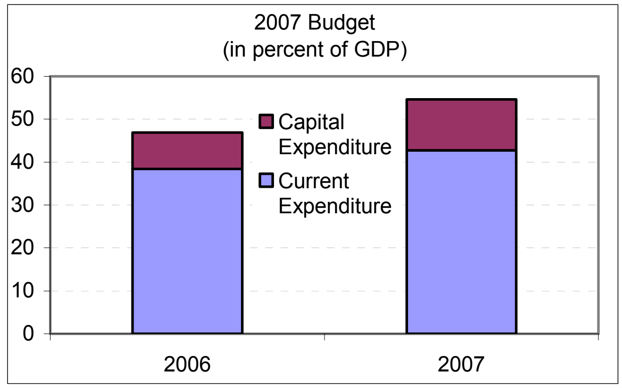
	2003	2004	2005	Est. 2006
	(In percent of GDP, unless otherwise indicated)			
Financial indicators				
Government debt 1/	46.1	43.1	52.6	51.7
Broad money (annual percent change) 2/	15.4	31.7	11.7	20.6
Private sector credit (annual percent change) 2/	6.5	57.8	54.6	49.5
External indicators				
Domestic exports (annual percent change, in U.S. dollars)	24.5	8.7	-15.4	30.5
Imports (annual percent change, in U.S. dollars)	20.2	36.9	15.5	24.4
Current account balance 1/	-4.6	-16.5	-35.8	-40.7
Capital and financial account balance	7.6	19.4	35.1	42.7
Of which: Official medium- and long-term loans (net)	4.3	3.2	2.5	4.2
Other	3.2	16.1	32.6	38.5
Gross official reserves (in millions of U.S. dollars)	160.3	204.4	187.1	232.2
Central bank short-term foreign liabilities (in millions of U.S. dollars)	0.8	0.9	7.1	7.1
Short-term foreign assets of the banking sector (in millions of U.S. dollars)	60.6	79.0	47.1	61.1
Short-term foreign liabilities of the banking sector (in millions of U.S. dollars)	16.6	20.2	87.4	212.6
Official reserves in months of following year's imports GNFS 3/	2.7	2.9	2.1	2.4
Broad money to reserves	2.2	2.3	2.8	2.7
Total reserves to short-term external debt (residual maturity)	419.7	463.9	131.2	88.4
Total external debt	41.8	42.7	57.2	65.3
Of which: Government debt	29.6	30.5	33.9	33.5
Total external debt to domestic exports of GNFS 4/	53.2	52.9	100.6	97.4
Debt service to domestic exports of GNFS	4.0	5.1	10.1	8.8
Exchange rate (rufiyaa/U.S. dollar, end-period)	12.8	12.8	12.8	12.8

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

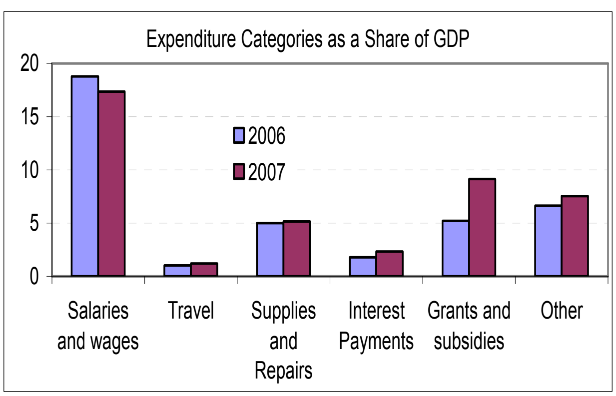
1/ The first entry is the average for 1995–96.
2/ Adjusted for the exchange rate change in 2001.
3/ GNFS = Goods and nonfactor services.
4/ Domestic exports are defined as merchandise exports net of re-exports.

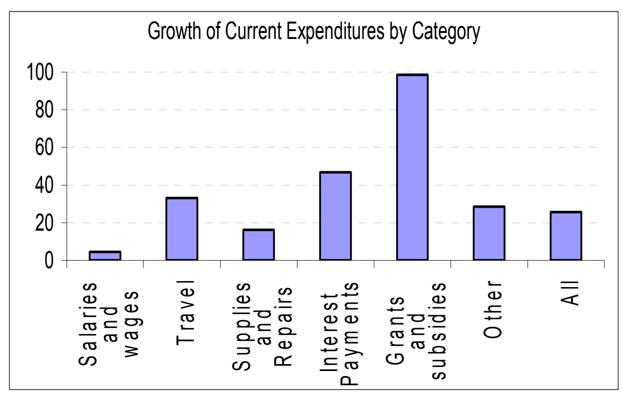
ANNEX I. MALDIVES: DETAILS OF THE 2007 DOMESTIC BUDGET

The domestic budget—excluding foreign-financed spending—provides for significant increases in both current and capital expenditures. Overall expenditures rise by 31 percent relative to the 2006 budget, with current and capital expenditures increasing by 26 and 58 percent, respectively. As a share of GDP, current and capital expenditures grow by 4.4 and 3.7 percentage points, respectively.

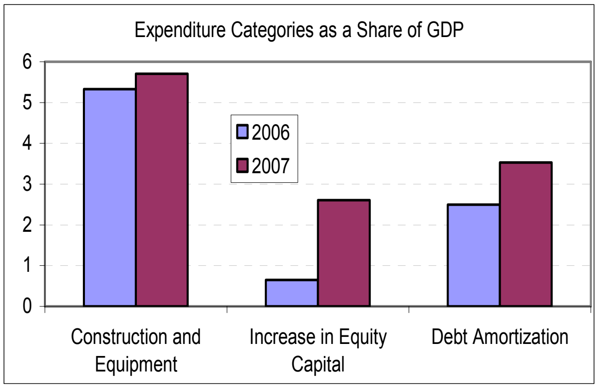


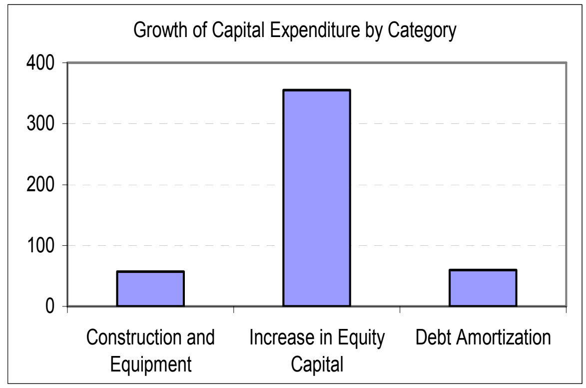
The increase in current expenditures is dominated by government grants and subsidies. They double in the 2007 budget, and almost fully account for the overall rise of the share of current expenditure in GDP. Only about a third of the increase in the grant and subsidies category can be attributed to domestic spending on tsunami reconstruction by the National Disaster Management Center, while the rest reflects elevated spending on food subsidies, welfare payments, fellowship assistance for overseas studies, and contributions to local associations. While budgeted spending on salaries and wages declines as a share of GDP, it is offset by increases in interest payment on rising domestic debt, travel expenses, and supplies and repairs, including related to the construction of a new penitentiary.





The rise in capital expenditures reflects mainly an increase in government paid-up capital in state-owned enterprises (SOEs). This accounts for almost 60 percent of the overall increase in capital spending, and—according to the government—was necessitated by the limited capital base of a number of SOEs, which impaired their ability to raise debt capital. Increased debt amortization and elevated spending on construction and equipment also contributed significantly to the overall rise in capital expenditure.





The budget is balanced by the introduction of many new revenue measures. The budget envisages Rf 1.4 million (about 11 percent of GDP) in new revenue measures. About 80 percent of these new measures are related to tourism, including the extension of resort lease periods from 25 to 50 years, collection of advance lease payments from 14 new islands and 10 new airports, and from the establishment of new hotels in 3 regional airports. The remaining new measures pertain to raising work permit fees for foreign workers, and introducing new import duties on vehicles, tobacco, and cigarettes.

New Revenue Measures
(in mn Rf.)

Tourism-related	**1198.8**
Extension of resort lease period	239.7
Development of airports in 10 islands	191.3
Advance lease rent from MTDC (9 islands)	191.3
Lease of Gulhifalhu land	127.5
Development of additional resorts (5 islands)	127.5
New hotels in the existing regional airports	95.63
Lease rent arrears	67.8
Other	158.2
Other	**228.5**
Work permit fee	100
New import duties on tobacco and cigarettes	62.5
Increase in customs surcharge	36
New import duties on vehicles	14
Other	16.0

ANNEX II. MALDIVES: PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

Debt sustainability analysis indicates a rise in external and public sector vulnerabilities—underlined by falling international reserves—in the absence of fiscal reforms. The baseline scenario assumes GDP growth of 3.5–5.5 percent per annum. The alternative scenario, predicated on fiscal and structural reforms leading to a better investment climate, assumes growth of 6.5–7.5 percent per annum. While the profile of public sector external debt is identical in nominal terms in the two scenarios[6], the unstable macroeconomic environment and lower export growth of the baseline scenario leads to international reserves falling to 1.5 months of imports in the baseline, while external vulnerabilities are tempered by a buildup of reserves in the alternative scenario.

Public debt sustainability

In the baseline scenario, the public debt-to-GDP ratio continues to accelerate until 2009, although it declines later into the projection period. Driven mainly by sharp increases in foreign public debt, overall public debt rises from 51.7 percent in 2006 to 78.3 percent of GDP by 2008. Domestic fiscal deficits, deriving from the deteriorating fiscal position in 2007 and beyond also contribute to the rising public debt-to-GDP ratio. While the share of foreign public debt in GDP reverts to pre-tsunami levels by 2012 in line with official repayment schedules for foreign public debt, the lingering fiscal deficits over the medium term maintain the level of domestic public debt relatively constant over the medium term, leading to a public debt-to-GDP ratio of 60 percent in 2012—lower than its peak in 2008–09, but substantially higher than its pre-tsunami levels.

As the stress tests illustrate, the profile of public debt deteriorates further in the face of shocks to the baseline. The worst public debt-to-GDP ratio of 85 percent is projected under the growth shock scenario, which envisions a permanent one-half standard deviation shock to the assumed growth path in the baseline. The rest of the shock scenarios, which include shocks to the interest rate, contingent liabilities, exchange rate, and a combination of the above, also generate significant deterioration in the public debt-to-GDP ratio.

In the alternative scenario prepared by staff, prudent fiscal policy helps bring public debt-to-GDP ratio to pre-tsunami levels. The alternative scenario is built on the assumption that the domestic financing requirement is kept at zero over the medium term. This implies that domestic public debt is kept constant in nominal terms during 2006–12. While the profile of foreign public debt is still governed—as in the baseline scenario—by the official repayment schedules for foreign public debt, the level of domestic public debt is significantly lower than in the baseline. Consequently, by the end of the projection period,

[6] Debt ratios differ across the two scenarios due to differences in nominal GDP. Note that nominal GDP is higher in the baseline scenario, due to higher inflation.

the public debt-to-GDP ratio declines to 45.3 percent—close to its pre-tsunami level of 43.1 percent.

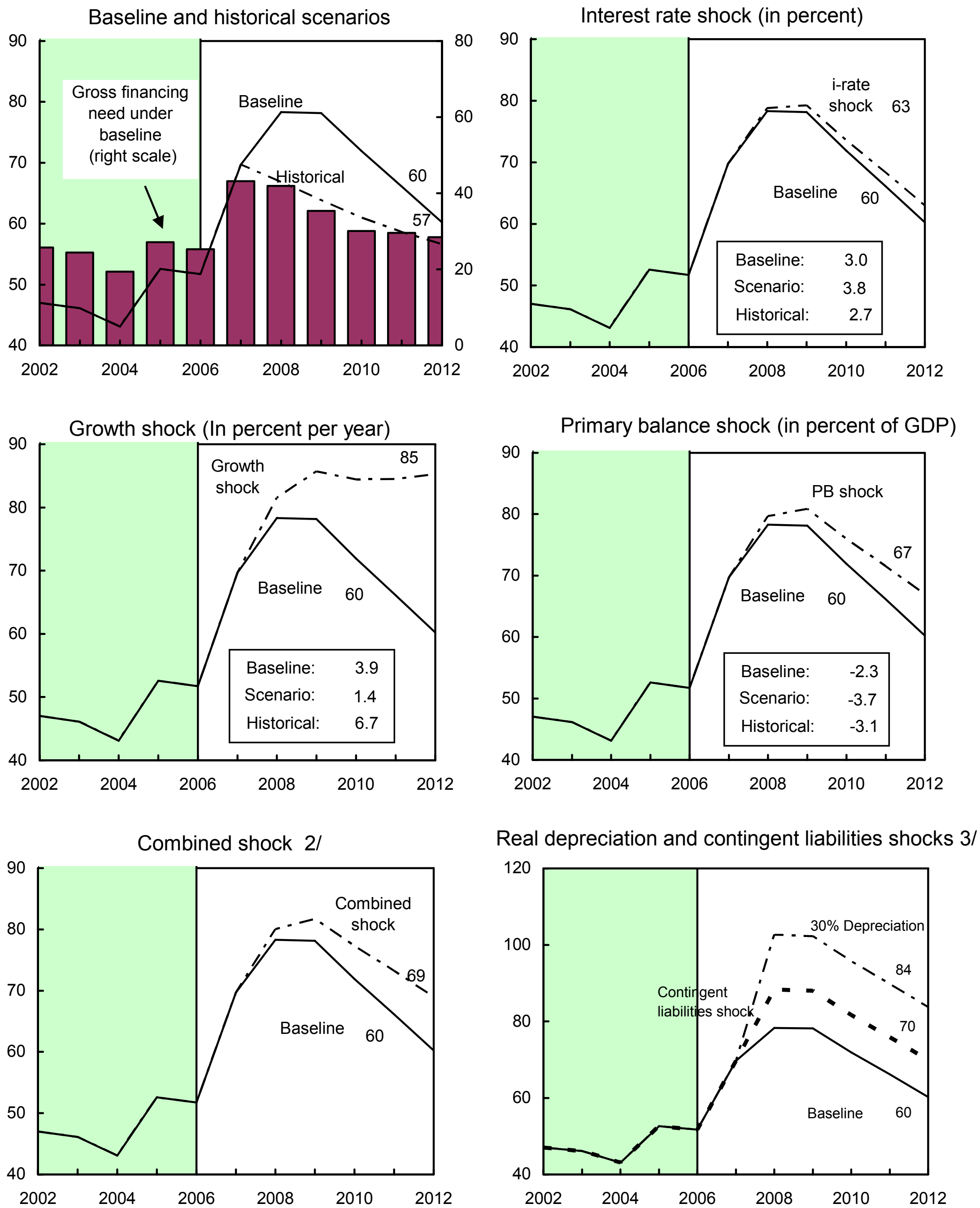
External debt sustainability

With unchanged fiscal policies, international reserves fall to very low levels, and the external debt-to-GDP ratio is projected to climb until 2009. In 2007 and 2008, there is a substantial planned increase in government borrowing from multilateral and bilateral sources, mainly for infrastructure projects, including the development of atolls and harbors, electricity generation, airports and sewage and waste collection systems. In addition to government borrowing, the private sector is assumed to borrow to finance ambitious resort-development plans. The external debt-to-GDP ratio accordingly peaks in 2009. After 2009, the pace of resort-building activity is assumed to slow, and with amortization and a planned reduction in government borrowing, the ratio falls to 68.3 percent in 2012, slightly above the end-2006 level. However, despite the fall in debt ratios by the end of the projection period, external vulnerabilities remain high, as evinced by the fall in international reserves to 1.5 months of imports.

The stress tests illustrate that the debt path is particularly vulnerable to shocks to the current account and the exchange rate. While in both shock scenarios the debt-to-GDP ratio eventually declines, a current account shock would cause the ratio to climb above 100 percent from 2008 through 2011, and a real depreciation of 30 percent would cause the ratio to rise sharply to 120 percent in the year that the depreciation occurred. While both scenarios are unlikely, neither can be ruled out entirely. A current account shock could occur due to Maldives' large exposure to tourism patterns and world commodity prices. A real depreciation could occur if further fiscal slippages and attendant deficit monetization led to high inflation or if a surge in import demand—generated by excessive public expenditure—put the peg under pressure.

In the alternative scenario, with domestic expenditures kept in line with a realistic revenue forecast, international reserves rise to three months of imports. The stable macroeconomic environment permits more rapid expansion of tourism and fisheries, the mainstay both of exports and of real GDP. Despite an identical profile for external public debt, the lower current account deficits permit a rise in international reserves, thereby limiting external vulnerabilities relative to the baseline.

Figure II-1. Maldives: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table II-1. Maldives: Public Sector Debt Sustainability Framework, 2002–12

(In percent: of GDP, unless otherwise indicated)

		Actual					Projections						
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing primary balance** 9/
1	**Baseline: Public sector debt** 1/	47.0	46.1	43.1	52.6	51.7	**69.7**	**78.3**	**78.1**	**71.9**	**66.1**	**60.2**	**-0.4**
	Of which : foreign-currency denominated	26.9	29.6	30.5	33.9	33.5	44.5	51.1	50.3	43.8	38.3	33.4	
2	Change in public sector debt	3.6	-0.9	-3.0	9.5	-0.9	18.0	8.6	-0.2	-6.2	-5.8	-5.9	
3	Identified debt-creating flows (4+7+12)	2.0	-0.1	-3.1	12.4	-1.8	20.4	11.9	3.5	-2.5	-2.4	-2.8	
4	Primary deficit	3.2	1.9	0.5	9.4	5.6	22.2	13.0	4.4	-1.7	-1.9	-2.3	
5	Revenue and grants	33.1	34.8	34.2	48.0	62.9	55.8	52.7	47.5	44.5	43.0	41.7	
6	Primary (noninterest) expenditure	36.3	36.7	34.7	57.4	68.5	77.9	65.7	51.9	42.8	41.1	39.4	
7	Automatic debt dynamics 2/	-1.3	-2.0	-3.6	2.9	-7.4	-1.8	-1.1	-0.9	-0.9	-0.5	-0.4	
8	Contribution from interest rate/growth differential 3/	-1.3	-2.0	-3.6	2.9	-7.4	-1.8	-1.1	-0.9	-0.9	-0.5	-0.4	
9	*Of which:* contribution from real interest rate	0.4	1.7	0.3	0.9	-1.6	0.7	1.7	2.0	2.0	1.8	1.7	
10	*Of which* : contribution from real GDP growth	-1.7	-3.7	-3.9	2.0	-5.8	-2.5	-2.8	-2.8	-2.8	-2.3	-2.1	
11	Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	1.6	-0.8	0.1	-2.9	0.9	-2.4	-3.3	-3.7	-3.7	-3.4	-3.1	
	Public sector debt-to-revenue ratio 1/	142.1	132.4	126.1	109.5	82.2	125.0	148.7	164.5	161.5	153.8	144.3	
	Gross financing need 6/	25.8	24.4	19.4	27.1	25.3	43.2	41.9	35.4	30.1	29.6	28.5	
	In billions of U.S. dollars	165.0	169.3	150.6	203.6	229.4	442.3	475.2	442.3	414.6	447.3	472.1	
	Scenario with key variables at their historical averages 7/						**69.7**	**66.9**	**63.8**	**61.0**	**58.6**	**56.7**	**-2.2**
	Key macroeconomic and fiscal assumptions underlying baseline												
	Real GDP growth (in percent)	4.1	8.5	9.5	-4.5	13.4	5.5	4.5	4.0	4.0	3.5	3.5	
	Average nominal interest rate on public debt (in percent) 8/	4.1	3.5	3.3	3.2	3.8	9.0	9.0	9.0	9.0	9.0	9.0	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.1	3.9	0.9	2.1	2.7	2.0	3.0	3.0	3.0	3.0	3.0	
	Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	3.0	-0.4	2.4	1.2	6.5	7.0	6.0	6.0	6.0	6.0	6.0	
	Growth of real primary spending (deflated by GDP deflator, in percent)	4.5	9.6	3.5	58.2	35.2	20.0	-11.9	-17.8	-14.2	-0.8	-0.7	
	Primary deficit	3.2	1.9	0.5	9.4	5.6	22.2	13.0	4.4	-1.7	-1.9	-2.3	

1/ Includes central government debt.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

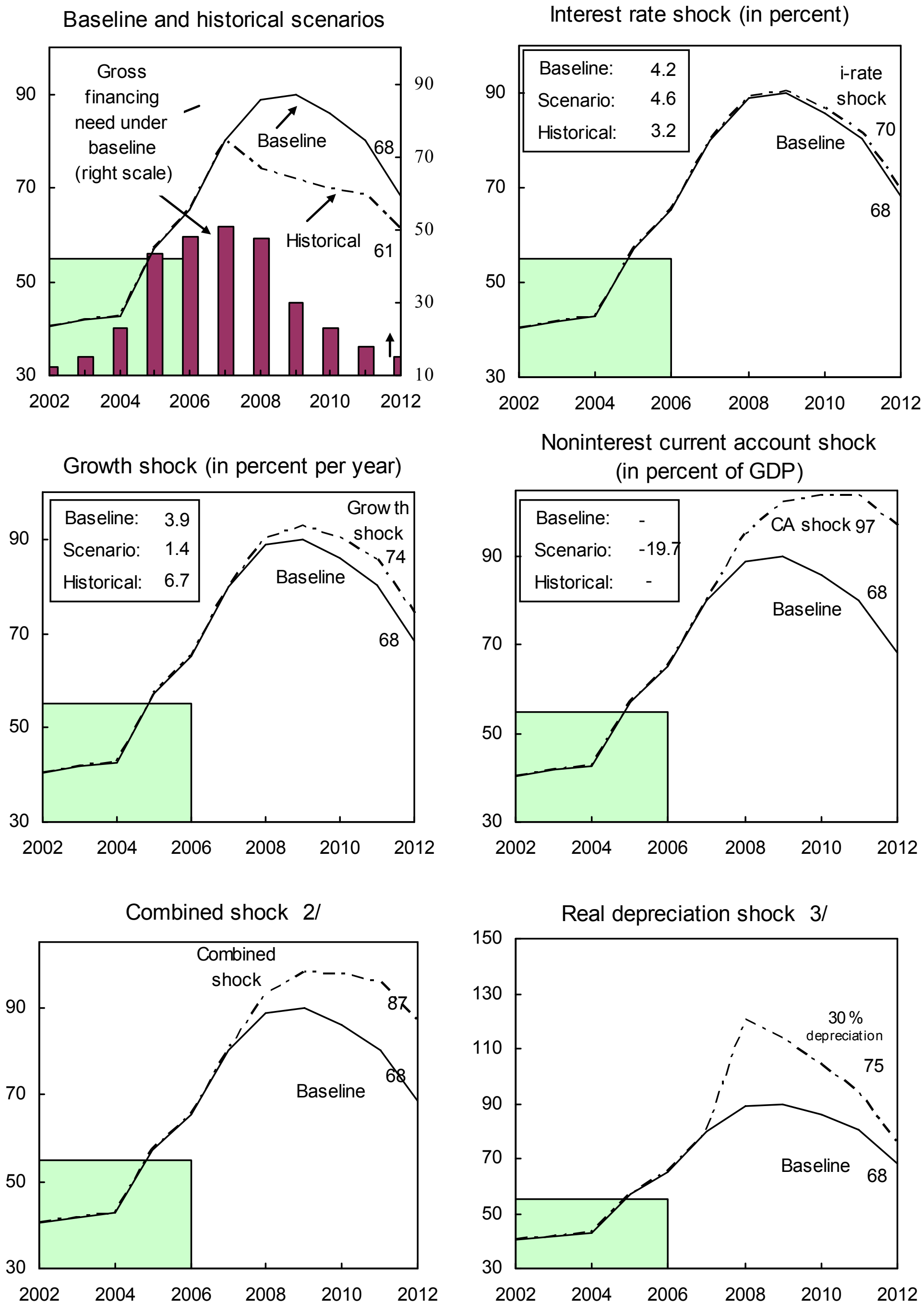
6/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure II-2. Maldives: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data; and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

Table II-2. Maldives: External Debt Sustainability Framework, 2002-12
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing noninterest current account 6/**
1 **Baseline: External debt**	40.4	41.8	42.7	57.2	65.3	**80.1**	**88.8**	**89.9**	**85.9**	**80.3**	**68.3**	**-9.0**
2 Change in external debt	6.9	1.4	0.9	14.4	8.1	14.7	8.8	1.0	-4.0	-5.6	-11.9	
3 Identified external debt-creating flows (4+8+9)	-2.5	-8.6	-6.0	17.9	4.7	21.4	17.2	6.4	1.5	-1.1	-1.8	
4 Current account deficit, excluding interest payments	4.6	3.8	15.5	33.9	38.5	37.8	33.2	16.2	9.1	5.0	3.2	
5 Deficit in balance of goods and services	-6.1	-7.0	4.4	50.0	38.6	38.2	30.5	15.1	8.4	4.9	3.4	
6 Exports	77.3	84.3	88.4	64.6	77.0	74.6	73.1	71.4	69.8	68.5	67.3	
7 Imports	71.2	77.3	92.8	114.5	115.6	112.8	103.6	86.5	78.2	73.4	70.6	
8 Net nondebt creating capital inflows (negative)	-7.2	-10.2	-18.0	-19.4	-26.2	-16.0	-15.9	-9.9	-7.7	-6.6	-5.6	
9 Automatic debt dynamics 1/	0.1	-2.3	-3.5	3.4	-7.6	-0.4	-0.1	0.1	0.1	0.5	0.6	
10 Contribution from nominal interest rate	1.0	0.8	1.0	1.9	2.2	2.8	3.1	3.3	3.4	3.3	3.2	
11 Contribution from real GDP growth	-1.3	-3.2	-3.5	2.0	-6.3	-3.2	-3.3	-3.2	-3.3	-2.7	-2.6	
12 Contribution from price and exchange rate changes 2/	0.5	0.2	-1.0	-0.5	-3.5	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	9.3	10.0	7.0	-3.4	3.5	-6.6	-8.4	-5.4	-5.5	-4.5	-10.1	
External debt-to-exports ratio (in percent)	52.3	49.6	48.4	88.6	84.8	107.3	121.6	126.0	123.1	117.2	101.6	
Gross external financing need (in billions of U.S. dollars) 4/	79.2	105.2	177.5	326.5	436.0	519.0	537.4	373.1	316.3	268.6	249.0	
in percent of GDP	12.4	15.2	22.9	43.5	48.1	50.7	47.4	29.8	22.9	17.8	15.0	
Scenario with key variables at their historical averages 5/						**80.1**	**74.1**	**72.0**	**69.9**	**68.7**	**60.9**	**-14.5**
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	4.1	8.5	9.5	-4.5	13.4	5.5	4.5	4.0	4.0	3.5	3.5	
GDP deflator in U.S. dollars (change in percent)	-1.5	-0.4	2.4	1.2	6.5	7.0	6.0	6.0	6.0	6.0	6.0	
Nominal external interest rate (in percent)	2.9	2.1	2.7	4.3	4.7	4.8	4.3	4.2	4.2	4.2	4.3	
Growth of exports (U.S. dollar terms, in percent)	6.7	17.9	17.5	-29.4	44.1	9.3	8.5	7.7	7.8	7.7	7.8	
Growth of imports (U.S. dollar terms, in percent)	0.0	17.4	34.6	19.3	22.0	10.2	1.7	-8.0	-0.3	2.9	5.6	
Current account balance, excluding interest payments	-4.6	-3.8	-15.5	-33.9	-38.5	-37.8	-33.2	-16.2	-9.1	-5.0	-3.2	
Net nondebt creating capital inflows	7.2	10.2	18.0	19.4	26.2	16.0	15.9	9.9	7.7	6.6	5.6	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

MALDIVES

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by Staff Representatives for the 2007 Consultation with Maldives

(In consultation with Other Departments)

June 12, 2007

Contents Page

APPENDIX I
MALDIVES: FUND RELATIONS
(As of April 30, 2007)

I. **Membership Status:** Joined 1/13/78; Article XIV

II. **General Resources Account:**

	SDR Million	Percent Quota
Quota	8.20	100.00
Fund holdings of currency	10.75	131.05
Reserve position in Fund	1.55	18.95

III. **SDR Department:**

	SDR Million	Percent Quota
Net cumulative allocation	0.28	100.00
Holdings	0.34	121.11

IV. **Outstanding Purchases and Loans:**

	SDR Million	Percent Quota
Emergency assistance	4.10	50.00

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:**
(SDR million; based on existing use of resources and present holdings of SDR):

	Forthcoming				
	2007	2008	2009	2010	2011
Principal		1.54	2.05	0.51	
Charges/interest	0.17	0.21	0.11	0.01	0.00
Total	0.17	1.75	2.16	0.53	0.00

VII. **Exchange Arrangements**

From March 1, 1982 to June 30, 1985, the Maldivian rufiyaa was pegged to the U.S. dollar. Beginning in July 1985, the exchange rate of the rufiyaa was linked to a trade-weighted basket of currencies, but the exchange rate vis-à-vis the U.S. dollar remained relatively stable until February 1987. On March 1, 1987, the rufiyaa was devalued by 29 percent vis-à-vis the U.S. dollar. From 1987 to 1994, the exchange rate of the rufiyaa was adjusted periodically. Since October 1994, the exchange rate of the rufiyaa remained unchanged at Rf 11.77 per U.S. dollar, until July 25, 2001, when the rufiyaa was devalued to Rf 12.80 per U.S. dollar.

Maldives continues to avail itself of the transitional arrangements under the provisions of Article XIV, but no longer maintains restrictions under Article XIV. Under these circumstances, any exchange rate restriction that arises is subject to approval under Article VIII.

VIII. **Last Article IV Consultation**

The 2005 Article IV consultation (SM/06/47, February 8, 2006) was concluded by the Executive Board on February 22, 2006 (EBM/06/17-3).

IX. **Technical Assistance**

FAD: In April 1994, Mr. Potter and Ms. Bédague visited Male to advise on budget management. This was followed by periodic assistance from Mr. Webber (consultant) over the period November 1994 to December 1995. In July 1994, Mr. Faria and Mr. Kambil (consultant) assisted in formulating a strategy for revenue reform. This was followed by a visit by Mr. Kambil in August/September 1995 to draft tax legislation. In October 1996, a tax administration mission visited Male to develop a strategy to establish an Inland Revenue Department and a follow-up mission by a consultant took place in June 1997.

LEG: In October 2003, Mr. Head provided assistance on the revision of the Maldives Monetary Authority Act (MMA Act).

MCM: In March 1993, a consultant provided assistance on the introduction of treasury bills. In November 1994, a mission headed by Mr. Taniguchi provided assistance on monetary management, foreign exchange operations, and bank supervision. In February/June 1995, a consultant provided assistance for the development of a treasury bill and MMA certificate market. In February/March 1996, a mission headed by Mr. Swinburne provided advice on the reform of monetary operations and exchange system. This was followed by a visit of a foreign exchange advisor in May 1997. In early 2001, two consultants provided assistance on foreign exchange and monetary management, of two missions each. In July 2001, a consultant provided assistance on monetary management following the lifting of credit ceilings and further impending changes in the monetary framework. In October 2002, a multi-purpose mission took stock of developments and provided recommendations in the areas of banking, foreign exchange operations, and foreign exchange reserves management. In October 2003, in cooperation with the legal consultant, Mr. Dornseif (Deutsche Bundesbank) provided assistance on the drafting of the amended MMA Act. In October 2006, MCM provided advice on monetary operations, financial market development, and banking issues. In

January 2007, MCM provided assistance on developing a licensing regime for securities dealers.

STA: In June 1993 and February 1994, assistance was provided on monetary and balance of payments statistics, respectively. In May 1995, a STA consultant provided assistance on the compilation of a new consumer price index, which was followed by further assistance in August 1996. In November 2005, TA was given on monetary and banking issues. In June 2006, STA provided advice government finance statistics. In January 2007, STA provided advice on balance of payments statistics.

APPENDIX II
MALDIVES: RELATIONS WITH THE WORLD BANK GROUP[1]
(As of March 2007)

IBRD/IDA Lending Operations

	Net Commitments	Disbursements 1/	Undisbursed
CURRENT PORTFOLIO (IDA)			
Integrated human development	16.4 2/	3.7	8.6
Emergency recovery credit and grant	13.9 3/	11.1	2.9
Sub-total	30.3	14.8	11.5
Closed projects (IDA)			
Fisheries I	3.2	1.6	...
Fisheries II	5.0	5.0	...
Fisheries III	10.7	9.4	...
Male airport upgrading	7.5	7.5	...
Education and training	8.2	7.3	...
Education and training II	13.4	12.9...	
Education and training III	18.6 4/	16.8	...
Sub-total	66.6	61.0	...
Total	96.9	75.7	11.5

1/ Note: Disbursement figures subject to SDR/USD exchange rate fluctuations. Source: WB Operations Portal and Client Connection.
2/ US$10 million were cancelled to make IDA resources available under the Maldives Post-Tsunami Emergency Recovery Credit and Grant. Original commitment was US$21.3 million. US$5.7 million were then regranted as additional financing in 2006.
3/ Of this total, $8.4 million provided as credit and $5.6 million (40 percent of total financing) as grant.
4/ US$2 million cancelled to make IDA resources available under the Maldives Post-Tsunami Emergency Recovery Credit and Grant. US$1.4 million in additional financing was contributed to the project in 2006.

The World Bank's Country Assistance Strategy

The Country Assistance Strategy (CAS), discussed by the Board in FY2000, emphasized increasing the frequency and scope of nonlending activities, and gradually shifting from sector-specific project lending to a more multisectoral and programmatic approach. The overarching ***objective*** of the previous CAS for the Maldives was:

[1] Prepared by World Bank staff.

> "*The reduction of poverty and regional disparities in access to social and infrastructure services.* To advance this objective, the strategy, in partnership with other donors, aims at supporting: (i) sustainable economic growth; (ii) improvements in public sector management, including institutional capacity; and (iii) human development."

This CAS was originally intended to cover the period up to the end of 2004. However, end-December 2004, the country was struck by a devastating tsunami, which caused damage equivalent to more than 60 percent of the country's GDP. As a result, the Bank agreed to extend its previously agreed assistance program so as to include emergency reconstruction activities.

The Bank will prepare its new CAS during 2007. AsDB and the Bank have informally agreed to make available to each other their respective thematic assessments with the objective that Part I of both strategies would by and large have a similar—though not necessarily common—assessment of government's development priorities, issues, and challenges including the macroeconomic outlook. The CAS will be based on the government's Seventh National Development Plan (7NDP) that now awaits adoption by the Cabinet. During the Fund's upcoming Article IV consultations, the Bank and Fund aim to discuss the preparation of a Joint Staff Advisory Note on the 7NDP, providing constructive comments to the government as they move forward with the implementation of their poverty reduction strategy.

Lending program

Historically, the Bank group has focused its assistance, totaling over US$96 million in net IDA commitments to date, on fisheries, tourism, human development, particularly education, and recently, emergency recovery. The first, second, and third fisheries projects helped boost production and exports, increasing the incomes of fishermen in the outer atolls. IDA promoted the development of tourism through the Male Airport Upgrading project, which closed in 1994. IDA has also supported human resource development in the Maldives, by widening access to secondary education, improving the planning and management capacity of the Ministry of Education, providing overseas scholarships for critical skills acquisition, and training teachers in country. In line with the 2000 CAS, before the Tsunami disaster, the Bank had increased its nonlending services and initiated a shift from sector-specific lending to a more multisectoral and programmatic approach (reflected in the Integrated Human Development Project approved in early FY05).

In close coordination with other development partners, the Bank Group is concentrated presently in helping the government implement its post-tsunami recovery program. The Bank approved the Maldives Post-Tsunami Emergency Recovery Credit /Grant (US$14 million) soon after the disaster, including US$12 million from funds reallocated from existing credits, and US$2 million from additional IDA resources. Furthermore, 40 percent (US$5.6 million) of the emergency operation was provided as grant, and the rest as credit. The operation has helped finance cash grants to affected persons, plus assistance for the reconstruction of schools and some technical assistance. The grant portion was fully disbursed as of beginning of October 2006. The EU subsequently added additional funds equivalent to $17 million to this project to finance an improved public accounting system, to be used initially to manage the tsunami reconstruction funds, school reconstruction activities, health facilities, and a solid waste management component. To facilitate coordination and provide advice to the government, the Bank has set up a temporary office in the Maldives managed by an experienced Special Representative. The Bank administers a Japan Social Development Trust Fund and the EU Trust Fund (mentioned above) under the same program of activities for post-Tsunami recovery.

Implementation of the Integrated Human Development Project continues, although the project was restructured after US$10 million of credit funds were cancelled to make room for post-tsunami support (see above). This project has an inter-sectoral focus, encompassing education, health, social protection, and improved development management at the atoll and island level. The development objective of the project is to improve social service provision and economic opportunities in selected ecologically viable focus islands, helping to provide an alternative to Male and the capital region. In the second half of 2006, the Bank restored US$5.7 million in financing to the project, to help ensure that the objectives originally established for this project can be met.

Advisory and analytical support

The Bank Group has promoted a better understanding of poverty and vulnerability in Maldives and completed a country economic update; provided technical advice and training on public expenditure management and pension reform; and supported the development of a strategy and action plan in critical areas such as urban development, land management, land administration, and housing markets/finance. Following the December 2004 tsunami disaster, the Bank, in partnership with AsDB and the UN agencies, and in coordination with the IMF, prepared an assessment of damage and needs that helped guide the government's reconstruction efforts, as well as international support.

Much effort, in close coordination with other development partners, has been devoted to helping the government manage large fiscal and balance of payment imbalances that have emerged in the years since the tsunami. In part, these imbalances are the direct result of the tsunami, which impinged on revenues (mainly due to a sharp drop in tourism in 2005), while raising expenditure requirements. To a large extent, however, spending also increased sharply for other reasons, as the government seeks to meet high expectations for a range of public services and investment projects. The development partners providing technical assistance have sought to help the government manage associated risks.

During FY06, the Bank helped the government develop a Fisheries Sector Development Strategy, conduct an investment climate assessment (ICA), and prepare a pension and social security study, while continuing to build capacity in public expenditure management through an Institutional Development Fund grant. The pension and social security study explored various options and provided input into the national debate on social security reform. The ICA was completed in 2005 and provides a good platform for understanding the environment for private sector growth.

Another key priority of the government is strengthening and deepening the financial sector, and the authorities have sought legal and technical assistance from the Bank in this area. Efforts in the near future will focus on reforming the provident fund and spurring the development of housing finance (contributing to improved land management). The IFC has begun providing assistance with insurance and leasing, and help is needed to introduce anti-money laundering legislation.

APPENDIX III

MALDIVES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[2]

(As of March 2007)

Loans

- Since 1981, Asian Development Bank (AsDB) has provided 15 loans with total approved amount of $91.5 million.
- In terms of value, the energy sector is the largest recipient of AsDB assistance comprising 33 percent of total lending to Maldives, followed by transport and communications at 28 percent, education at 13 percent, multisector at 13 percent, water supply and sanitation at 7 percent, law, economic management and public policy at 6 percent.
- As of end-January 2007, seven loans were active with a net loan amount of $47.2 million comprising two projects in urban development amounting to $12.6 million (27 percent), followed by two projects in education amounting to $12.3 million (26 percent), two for energy for $11.2 million (24 percent), and one for transport and communications for $11.1 million (23 percent).
- In 2006, contract awards totaled $7.65 million, bringing the cumulative figure to $73.79 million. Of the total contract awards, $4.55 million (59 percent) went for two energy projects, followed by $1.66 million (22 percent) for two education projects, and $1.44 million (19 percent) for two urban development projects. The contract award ratio was 40.92 percent.
- In 2006, disbursements totaled $4.93 million, bringing cumulative disbursements to $62.18 million. The disbursement ratio was 16.84 percent, significantly lower than the AsDB-wide average of 23.42 percent.

Technical assistance

- As of end-January 2007, AsDB had approved 56 technical assistance (TA) projects for a total amount of $19.5 million of which 16 had been project preparatory and 40 had been advisory TAs addressing institutional strengthening and capacity development.
- In terms of TA amount, assistance is largest for law, economic management and public policy at 47 percent for 22 projects, followed by transport and communications at 15 percent for 11 projects, education at 10 percent for 6 projects, energy at 7 percent for 6 projects, industry and trade at 7 percent for 2 projects, agriculture at 6 percent for 3 projects, finance at 5 percent for 4 projects, urban development and multisector at 3 percent for 2 projects.
- As of end-January 2007, there are 10 TAs in the active portfolio with a total amount of $3.6 million. Of these, 2 are project preparatory and 8 are advisory.

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[2] Prepared by Asian Development Bank Staff staff.

APPENDIX IV
MALDIVES: SOCIAL AND DEMOGRAPHIC INDICATORS

	Latest single year	
	1980–85	1996–2005
GDP per capita (U.S. dollars)	469	2,482
Land area (square kilometers)	300.0	300.0
Population		
Total population	180,088	329,198
Rate of growth (percent per annum)	2.8	2.5
Density (persons per square kilometer)	839	1,097
Population characteristics		
Infant mortality at birth (per 1,000)	115.0	35.4
Crude birth rate (per 1,000)	41.6	30.8
Crude death rate (per 1,000)	11.8	6.0
Life expectancy at birth (years)	57.1	67.2
Labor force (in percent of working-age population)		
Labor force participation rate	52.1	54.8
Male	77.7	61.1
Female	23.8	38.9
Unemployment rate (2000)	...	2.0
Health care		
Access to safe water	17	84
Immunization (DPT, percent of children under age one)	28	96
Physicians (per 1,000 people)	0.07	0.92
Population per nurse	10,080	651
Population per hospital bed	1,500	503
Education		
School enrollment, primary (gross)	…	103.5
School enrollment, secondary (gross)	…	72.8
Adult illiteracy rate (percent, ages 15 and above)	…	96.3

Sources: Data provided by the Maldivian authorities; *Statistical Yearbook of Maldives*, various years; *World Development Indicators 2006*; and IMF staff estimates and projections.

APPENDIX V
MALDIVES: STATISTICAL ISSUES

While data provision for surveillance purposes is adequate overall, staff's analysis was affected by shortcomings in certain areas. The Maldives has improved the macroeconomic statistics in recent years, with technical assistance from STA and the Asian Development Bank (AsDB). However, remaining shortcomings affect the balance of payments, government finance, and national accounts statistics. The authorities have requested assistance from the Fund in the areas of balance of payments and government finance in addition to the ongoing assistance on monetary statistics. Also, the authorities are receiving assistance from other agencies to improve the national accounts. The main official statistical publication is the *Statistical Yearbook of Maldives*, which contains some data series up to 2004. APD also receives, albeit with a lag, the *Quarterly Economic Bulletin* and the *Annual Report* of the Maldives Monetary Authority (MMA).

Real sector

The national accounts are available only on an annual basis. There are inconsistencies between GDP data from the production and expenditure sides. The AsDB has been assisting the authorities in setting up a framework for compiling more comprehensive national accounts.

The CPI has been compiled since June 1995 based on the 1993 income and expenditure survey. As 1995 is still used as the base year, the CPI may not fully reflect current consumer spending patterns.

Fiscal sector

General government data are reported for publication in the *GFS Yearbook* and the latest published data are for 2006. Data on the operations of state enterprises are limited. A 2006 GFS mission recommended: (i) the immediate posting on the Ministry of Finance and Treasury's (MOFT) website of *Government Budget in Statistics FY 2006* and later issues as they become available, (ii) quarterly compilation of GFS for budgetary central government, and (iii) annual compilation of data for public enterprises through which quasi-fiscal activities are conducted. There are inconsistencies between fiscal and monetary data regarding the financing of the fiscal deficit, which involve issues of timing, and coverage.

Monetary sector

The timeliness of comprehensive data on the monetary sector published in the *Monthly Statistics*, *Quarterly Economic Bulletin*, and the *Annual Report* has improved recently. Data for the accounts of the MMA, commercial banks, and interest rates are reported to the Fund for publication in *IFS* on a regular and timely basis.

The STA monetary and financial statistics missions that visited Maldives in November 2005 and April 2007 introduced the standardized report forms (SRFs) for the central bank, other depository corporations, other financial corporations (OFCs) with coverage limited to the Maldives Financial Leasing Company, and monetary aggregates. The SRFs provide more detailed classification of certain accounts, fuller sectoral and instrument breakdown, and currency disaggregation. The missions developed an integrated monetary database which meets the monetary data needs of the MMA, STA, and APD. The IMD will become operational when the MMA submits historical data in the SRFs beginning in December 2001 by end-2007. It is expected that the SRF for the OFCs with full institutional coverage will be completed in a follow-up mission when data for the insurance companies become available.

External sector

Balance of payments data are compiled on an annual basis. There are problems of coverage and measurement in a range of areas. Travel receipts are still estimated based on a small and outdated survey of resorts/hotels to determine daily average expenditure by tourists. Estimates of profit remittances and reinvested earnings in the tourism sector are still unsatisfactory and information on private financial flows is incomplete. A technical assistance mission in January 2007 proposed steps to include data on direct investment, travel receipts, and coverage in a range of specific items.

Official reserves are reported monthly with a (variable) two-week lag. Predetermined outflows on foreign currency assets (mainly debt service payments) are reported at the time of the annual consultation missions, while other movements of foreign currency assets have not been identified. Quarterly data on external debt and debt service for the government and the monetary authority, and to some extent for the banking sector and state enterprises are provided at the time of the annual consultation missions, but no data are reported for the nonfinancial private sector.

Maldives: Table of Common Indicators Required for Surveillance
As of March 2007

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	4/07	5/8/07	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	1/31/07	2/21/07	M	M	M
Reserve/Base Money	4/07	5/10/07	M	M	M
Broad Money	3/07	4/26/07	M	M	M
Central Bank Balance Sheet	4/07	5/18/07	M	M	M
Consolidated Balance Sheet of the Banking System	3/07	4/26/07	M	M	M
Interest Rates[2]	3/07	4/26/07	M	M	M
Consumer Price Index	1/31/07	2/21/07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2006	2/21/07	A	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	2006	2/21/07	A	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2006	2/21/07	A	M	M
External Current Account Balance	2006	2/21/07	A	M	M
Exports and Imports of Goods and Services	1/31/07	2/21/07	M	M	M
GDP/GNP	2006	2/21/07	A	M	M
Gross External Debt	2006	2/21/07	A	M	M

[1] Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND

MALDIVES

Staff Report for the 2007 Article IV Consultation

Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with PDR)

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I. Introduction

1. In light of the recent Decision on Bilateral Surveillance, this supplement to the staff report (SM/07/207, 6/12/07) highlights staff views on the exchange rate level and external sustainability in the Maldives, as well as the authorities' views on the staff assessment. These views do not change the overall analysis and policy recommendations contained in the staff report, and paragraphs 5-7 below should be considered part of the staff appraisal.

II. Recent Developments

2. Fiscal developments in the first half of 2007 have been unfavorable. While domestically-financed expenditures are running at broadly the pace envisaged in the budget, revenues fell below budget estimates. Consequently, the domestic deficit in the first half of the year was almost 870 million rufiyaas, equivalent to about 6.6 percent of GDP. Hence a major effort is needed to cut back budgetary expenditures over the remainder of the year. However, the indications so far are that the cutbacks advocated by staff are unlikely to occur.

3. The authorities have conveyed to staff that based on the experience so far this year, it is likely that some of the new revenue sources assumed in the budget will not materialize. Hence the authorities intend to scale back budgetary expenditures, and cabinet guidance is being sought on the fiscal path for the remainder of the year.

4. International reserves have held up well this year, increasing from US$ 232 million at end-2006 to about US$ 250 million in June, and staying broadly unchanged in months of imports.

III. The 2007 Decision on Bilateral Surveillance: The Maldives

5. As explained in the Staff Report, Maldives has rebounded strongly from the tsunami of late 2004, with rapid GDP growth underpinned by a robust increase in tourist arrivals and construction activity pertaining to new resorts. However, fiscal expenditures have increased sharply, with a further large increase proposed in the 2007 budget, entailing a quadrupling of the overall budget deficit to 28 percent of GDP. Unless expenditures are kept in line with realistic revenue forecasts, financing the fiscal deficit could undermine macroeconomic management. Staff forecast that with unchanged fiscal policies there would be a sharp fall in reserves in months of import coverage, which could put pressure on the dollar peg. In other words, on unchanged fiscal policies, the exchange rate is fundamentally misaligned.

6. In this regard, the underlying concern is the current stance of fiscal policy, which has negative implications for external stability and the equilibrium REER, and not the nominal exchange rate per se. As detailed in the Staff Report, the current exchange rate regime (a peg against the U.S. dollar) and the current level of the exchange rate are appropriate and sustainable, as long as fiscal policy is tightened. The REER has depreciated substantially in recent years, and would depreciate further if, as expected, the U.S. dollar were to continue its decline against the euro.

7. Various available indicators suggest that the current level of competitiveness in the Maldives is appropriate. The cumulative real depreciation since 2001 has been greater than that of competitors like Seychelles, Mauritius, Madagascar, and Sri Lanka. In addition, the World Bank's report on "Doing Business in South Asia in 2007" ranks the Maldives as the best in the region in terms of ease of doing business, while ranking the country in the top third globally.

8. The authorities agree with the staff assessment in paragraphs 6-7, but do not concur with the concluding assessment in paragraph 5. They recognize that unchanged fiscal policies could lead to a loss of reserves and pressure on the dollar peg, and lead to a fundamental misalignment of the exchange rate. However, they do not think that based on the 2007 fiscal position the exchange rate is currently misaligned. They note that during the first six months of 2007 international reserves have increased slightly, and there has been no pressure on the dollar peg. Moreover, given the sensitivities associated with a pegged exchange rate regime, they are concerned that to say the level of the exchange rate is currently appropriate, and at the same time that the exchange rate is fundamentally misaligned, will be confusing to market participants and lead to unwarranted speculation. Staff clarified that, without a correction of the fiscal imbalance, the current exchange rate would not be sustainable.

Statement by Mr. Shaalan on Maldives
Executive Board Meeting 07/67
July 30, 2007

1. Following considerable damage inflicted by the December 2004 tsunami and the ensuing economic contraction, the Maldivian economy rebounded in 2006 with an unprecedented uptick in growth. Despite this strong growth rate, the country remains vulnerable to external shocks on account of its geography and high dependence on tourism and fishing. These vulnerabilities highlight the importance of a steady stream of concessional financing, which fortunately picked up to a generous level in 2006. Such financing helped support the authorities' continued reforms and sustain the gains made thus far in the country's economic performance.

2. In view of the recent recurrent wave swells, which caused considerable flooding and property damage, the authorities have contacted several multilateral agencies seeking assistance. These developments led the authorities to step up domestically financed community assistance. Thus, while overall projections for 2007 remain very tentative, the authorities wish to assure the Board that they remain committed to sound macroeconomic policies while addressing the challenges facing their economy. The Minister of Finance recently submitted to the Cabinet a paper on the fiscal outturn for the first five months of 2007 and projections for the full year. The aim of this paper was to seek Cabinet's guidance in view of lower revenue estimates and external loan financing. Furthermore, the paper submitted to Cabinet includes a medium-term fiscal scenario that progressively aims for smaller deficits of 14, 10 and 9 percent of GDP in 2008, 2009 and 2010, respectively. A decision by Cabinet on the fiscal outlook for the remainder of the year and the medium term is expected shortly, with due consideration to any further deterioration in the fiscal position and the risks this would pose for the sustainability of the pegged exchange rate regime.

3. In terms of the sustainability of the pegged exchange rate regime, staff has been in consultation with the authorities and has issued a supplement —in the context of the application of the transitional procedures of the 2007 Decision on Bilateral Surveillance. While the authorities agree with staff that the current fiscal position *could lead to* an exchange rate misalignment, they *do not agree* with the view that the currency *is presently* misaligned. Indeed, reserves have increased in the first half of this year to around US$250 million and there is no pressure on the exchange rate. Therefore, not only is the staff's supplement inconsistent with the staff report's assessment on competitiveness, but the authorities are concerned that the assessment of "fundamental misalignment based on a

forecast of unchanged fiscal policies" would confuse markets, potentially precipitating speculative pressures. Moreover, as mentioned above, such a forecast ignores the Cabinet's current deliberations on measures to rectify the course of fiscal policy.

Recent Developments and Outlook

4. The economy witnessed an unprecedented expansion in 2006. GDP growth accelerated to about 19 percent, inflation was moderately low, and foreign exchange reserves increased. The unprecedented growth rate was driven by tourism, construction, and government spending. Financial policies remained supportive of the fixed exchange rate regime. The government, supported by generous grants, continued to address the medium- and long-term challenges of developing the economy and improving the living standards by building a reliable infrastructure and investing in human capital and community development. The continued development of the tourism sector and export growth have contributed to increased current account receipts, which more than offset the slightly slower growth in imports. However, these increased receipts were not large enough to compensate for the substantial fall in net official transfers at a time of a significant expansion in GDP. The net effect was a widening of the already large current account deficit, which persisted due to intermediate and capital goods imports. These imports were in line with the reconstruction-induced acceleration of GDP growth and investment. This investment pickup was shared by both public and private sector participation, as manifested in the large private capital inflows and bank borrowing in 2006.

5. The outlook for GDP growth and the balance of payments is broadly favorable. The competitiveness of both the tourism and fishing sectors is adequate, benefiting from continued U.S. dollar depreciation considering that net foreign exchange receipts are Euro-denominated. While external debt increased to 65 percent of GDP in 2006, over two-thirds of the increase was driven by private sector borrowing. Given the large expansion in exports and GDP, the total debt-service ratio and the domestic debt stock as a share of GDP actually fell. The authorities, however, are cognizant of a pickup in banking sector vulnerability indicators owing to the booming private sector activity. They will remain vigilant in monitoring these developments. In terms of the fiscal outlook, and despite growing receipts, the continued exposure to natural devastation undermines the reliability of medium-term scenarios at this juncture. Nevertheless, the authorities wish to reassure Directors that their medium-term fiscal objectives will be balanced so as to ensure macroeconomic stability. In this context, their assessment is that the staff's base line scenario is unduly pessimistic.

Financial Policies

6. The fixed exchange rate regime has served the economy well by providing a simple and transparent nominal anchor while limiting inflationary pressures. External competitiveness strengthened over the recent past, with the real exchange rate depreciating in line with the U.S. dollar. The authorities are determined to continue to support the peg with appropriate fiscal and monetary policies. To this end, in April 2007 a new central bank act was passed, which separates the functions of the minister of finance from the governor of the

central bank. Furthermore, issuance of weekly treasury bills commenced last year with the aim of developing a treasury bill market and ceasing the automatic financing of the government deficit from the central bank. With technical assistance from the Fund's MCM department, a well-functioning liquidity-forecasting framework is also being developed to facilitate movement to an auction system for the issuance of treasury bills in the near future. This will modernize the central bank's toolkit away from administrative instruments, while providing the government with a credible instrument to finance its deficit. The government is working towards further gradual independence of the central bank and improving its monetary instruments. While the authorities will consider the staff's recommendation to reduce further the required reserves ratio, it is worth noting that this ratio has been reduced gradually since 2003, from 35 to 25 percent.

7. Progress continued to be made in improving central government finances. Tax revenues demonstrated a significant increase, from 18 to 21 percent of GDP between 2005 and 2006, while nontax revenues also rose from 21 to 24 percent. This improvement, along with a significant increase in grants amounting to 18 percent of GDP, allowed the authorities to scale up their expenditures considerably in 2006. This expenditure increase needs to be placed in context. It comes after wide spread tsunami-related devastation, on the back of an already weak and challenging infrastructural base. Moreover, as shown in the staff's statistical appendix, social services and capital spending accounted for the largest share of this increase, while the wage bill as a share of GDP did not increase. While the overall fiscal balance for 2006 actually *improved* year-on-year, from a deficit of about 11 percent of GDP to just over 7 percent, this reflected in large measure the increase in foreign financing.

8. In terms of the near to medium term, the authorities are fully cognizant that while grants are expected to remain high in 2007, any temporary or new expenditures should be fully financed before they are disbursed. Moreover, any permanency in future expenditures would be financed by domestic revenues. In this context, the Macroeconomic Coordination Committee will be convening to monitor the situation and the authorities are committed to prioritizing intended 2007 expenditures in line with revenue and grants receipts.

9. To support the authorities' difficult expenditure environment, the World Bank has been strengthening fiscal systems aimed at increasing the effectiveness of public spending, budget formulation, and expenditure management. Further capacity building by the World Bank in this important area is envisaged. In terms of domestic revenue reforms, the authorities are committed to gradually improving its performance, including through finalizing and tabling to parliament the Business Profit Tax Bill. They will proceed with this and other reforms as soon as feasible.

Other Structural Reforms

10. The banking sector has benefited from a booming economy with a strong pick up in private sector credit financing of the real economy. Concurrently, the public sector's share in credit diminished last year due to debt repayments from the government to the central bank. Non-performing loans have been falling, while risk exposure has been minimized through foreign-owned bank borrowing and collateralization of commercial domestic property.

11. The World Bank's report on "Doing Business in South Asia in 2007," released in the first quarter of 2007, ranks the Maldives as the best of the region in terms of business regulations, while ranking in the top third globally. Moreover, since the corporatization of state-owned enterprises, the authorities take note of staff's support for an expansion in the equity base of these enterprises and a limitation in their debt ratios. In this regard, they intend to privatize the number of firms through a public share issuance, while restructuring others. Recently, the Cabinet has approved the formation of a holding company for all such enterprises, to ensure an arms-length relationship with the government. This has now been submitted for the President's approval and, if approved, will be governed under the Companies Act of the Maldives. As such, the Public Enterprises Bill will no longer be implemented. Other reforms, such as the Banking Bill, are being finalized.

12. The authorities would like to express their appreciation for the staff's valuable analysis and policy advice and the Fund's technical assistance and training, which have been instrumental in the implementation of their reform and reconstruction efforts. Moreover, they wish to express their gratitude to the international community at large for their support through generous grant and project assistance. They look forward to continued close collaboration with the Fund and the international community in the years ahead.