Maldives—Assessment Letter for the Asian Development Bank and World Bank

November 24, 2009

The global crisis has hit the Maldivian economy hard; combined with an unsustainable fiscal expansion, it has led to a large fiscal deficit and severe balance of payments pressures. The authorities are committed to a strong policy adjustment program, and have requested IMF financial support for their program.

Recent Economic Developments and Near-Term Outlook

Maldives is facing large external and fiscal imbalances. Following a period of dramatic fiscal expansion, the economy was severely hit by the global financial crisis, which has pushed the economy into recession, caused a significant fall in fiscal revenue, and led to a sharp deterioration in the external position.

- After growth of 5¾ percent in 2008, real GDP is expected to shrink by about 4 percent in 2009, driven by the decline in tourism and a retrenchment of the construction sector. Inflation has been falling on the back of lower import prices, but as commodity prices recover, it is expected to bounce back in the second half of this year to reach about 6¾ percent year-on-year by end-2009.

- Government expenditure almost doubled as a share of GDP between 2004 and 2008, and, without adjustment, would reach 69 percent of GDP by end-2009. A key driver has been the wage bill. The global crisis has intensified the fiscal imbalances: revenue has been shrinking on account of slower imports and lower tourism inflows and tourism-related investment. As a result, the fiscal deficit rose to 13¾ percent of GDP in 2008 and, without corrective action, could reach 33 percent of GDP in 2009, while public debt is projected to rise to 92 percent of GDP this year.

- After widening to 51 percent of GDP in 2008, the current account deficit is expected to moderate to 30 percent of GDP in 2009 reflecting the economic slowdown, foreign exchange constraints, and lower import prices. However, the reduced availability of external financing has led to reserve losses—with the reserve cover down to about two months of imports at end-September 2009—and forced the Maldives Monetary Authority (MMA) to ration foreign exchange.

The global crisis and the domestic downturn have put significant stress on the banking sector. Access to external credit became more difficult and non-performing loans (NPLs) have increased due to banks' large exposure to tourism projects. The state-owned Bank of Maldives (BML), which accounts for about 45 percent of commercial bank assets, has been particularly affected.

Economic Policies

Going forward, the authorities are committed to a very significant adjustment program, aimed at reducing the fiscal deficit to stem aggregate demand pressures, restore stability and medium-term fiscal sustainability; absorbing excess rufiyaa liquidity and shoring up reserves to prudent levels; and strengthening the banking sector.

- **Fiscal policy.** The core of the program is a large fiscal adjustment to bring public debt back to sustainable levels. The adjustment comprises: (i) a significant reduction in the wage bill (to unwind part of the large recent increases) through cuts in remuneration and staffing levels; (ii) reductions in other operational expenses and non-priority capital expenditure; and (iii) revenue measures, including the introduction of an ad valorem tax on tourism, a business profits tax and a goods and services tax. As a result, the fiscal deficit is expected to decline to about 17¾ percent of GDP in 2010 and 4¼ percent of GDP in 2011. The authorities have already initiated steps towards fiscal adjustment.

- **Monetary policy.** Monetary tightening will complement fiscal adjustment and help reduce pressures on reserves. Key steps in this regard have been the cessation of deficit monetization, the conversion of the government's debt stock with the MMA into negotiable securities, and the recent introduction of open market operations.

- **Exchange rate policy.** The fixed exchange rate regime has served Maldives well by providing an effective nominal anchor. The current level of the peg is consistent with medium-term fundamentals if the policy adjustment is implemented as envisaged. The program aims to preserve the viability of the current exchange rate peg through a combination of fiscal adjustment, monetary tightening, and external financing.

- **Financial sector policies.** The authorities are committed to strengthening the financial regulation and supervision framework, including through passage of the Banking Law and the reforms to the MMA Act. They have also passed new regulations on adequate loan classification and provisioning, as well as on foreign currency position.

The policy program is ambitious, and subject to considerable risks. The key risk is delayed or insufficient implementation of the envisaged fiscal adjustment, which could entail significant revisions to the program. Also, the global economic environment entails upside and downside risks.

IMF Relations

The authorities and IMF staff have reached agreement, *ad referendum*, on the adjustment policies outlined above. The authorities have requested IMF financial support in the amount of 700 percent of quota (approx. US$91 million) over three years through a blend of a Stand-By Arrangement and arrangement under the Exogenous Shock Facility. Consideration of the request by the IMF's Executive Board is tentatively scheduled for December 4, 2009. The last Article IV Consultation was concluded on September 3, 2008.