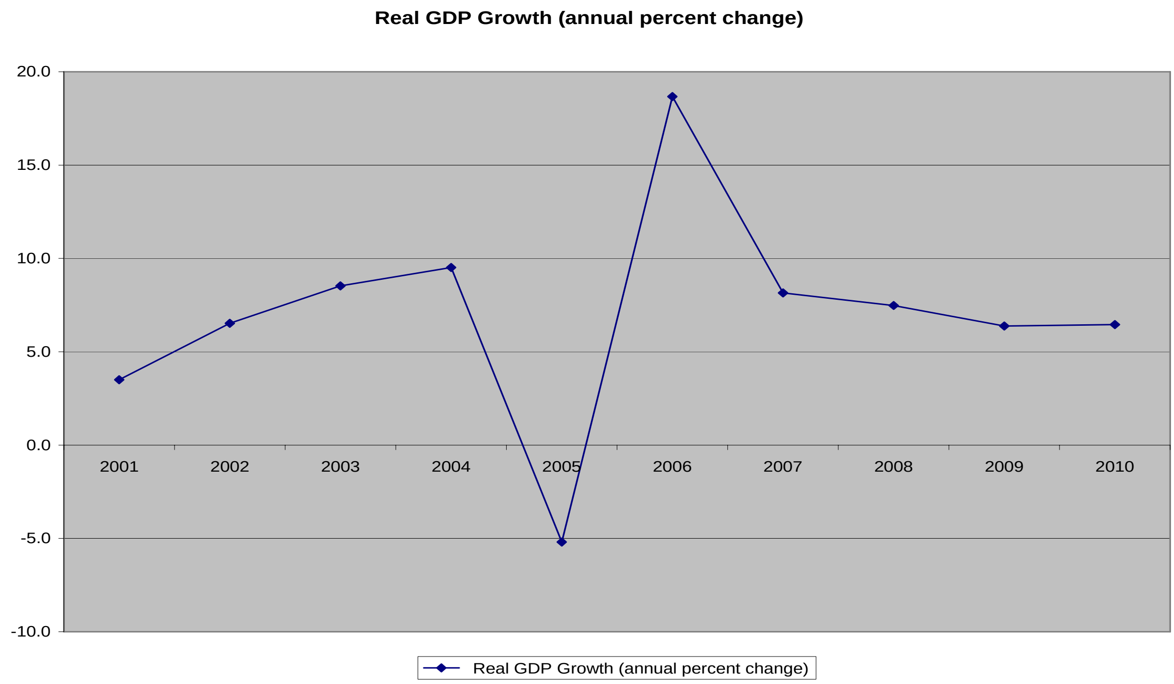
Maldives Macroeconomic Perspectives for the Medium Term

A background paper prepared by the Ministry of Finance and Treasury of the Maldives for the Maldives Partnership Forum to be held in the Maldives on 26 June 2006

The Maldives achieved remarkable economic growth over the past two decades, with a sustained average Gross Domestic Product (GDP) growth rate of approximately 8 percent over the last fifteen years. Per capita income rose from US$ 192 in 1974 to US$ 2,514 in 2004. Poverty levels declined from 23 percent in 1997 to 8 percent in 2004. These outstanding economic and social advances were achieved with a narrow resource base, relying heavily on exports, primarily tourism, making the Maldivian economy highly vulnerable to external shocks.



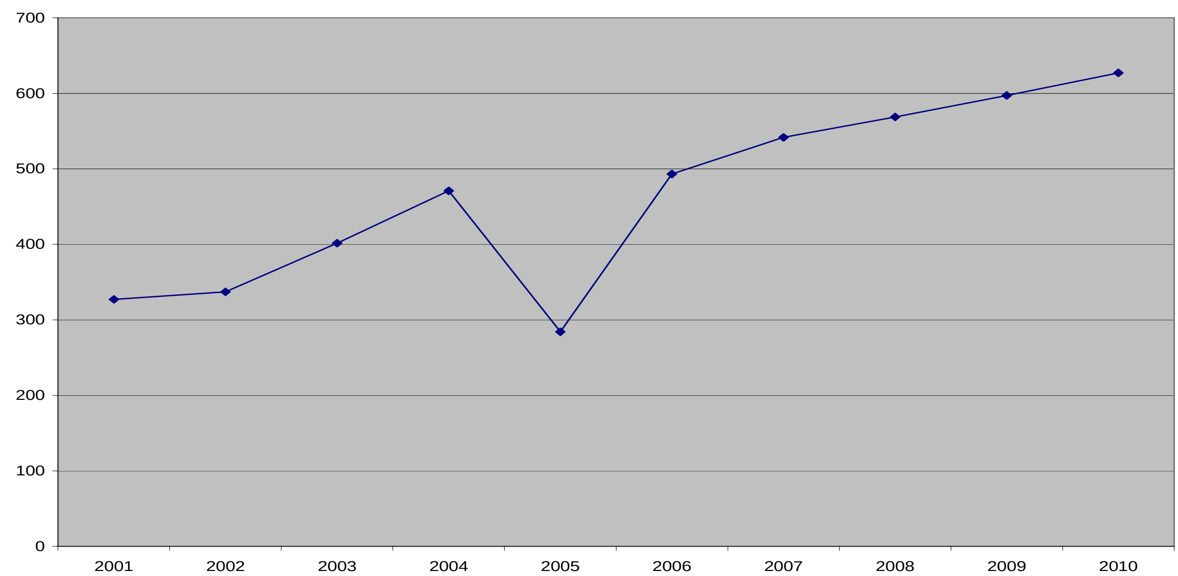
The Asian tsunami of December 2004 has been estimated to have destroyed 62 percent of the country's GDP, making the Maldives the most affected county in relative terms by far. In 2005 the country recorded negative economic growth of 5.2 percent, the first negative growth in recent history. Output from the tourism sector, which accounts for about a third of the nation's GDP, contracted by 33 percent in the same year.

Fuelled by reconstruction activities and the strong pick up in tourist arrivals in late 2005, the country's growth performance looks robust in the medium term, with the GDP projected to grow by close to 19 percent in 2006 and to stabilize to more normal levels of around 7 percent in the years 2007-2010. These very positive growth rates are based on growth estimates in the tourism, construction, and fisheries sectors of 50.7 percent, 22.4 percent, and 6.1 percent respectively.

The current account deficit is likely to remain high at about 40 percent of the GDP in 2006 and is expected to widen further in 2007. This is largely attributable to the significant increase in imports projected for both years due to post-tsunami construction and the development of 46 new resorts as well as record high fuel costs. However, a substantial part of the current account deficit will be financed by private capital flows and concessional loans; and only about 5 percent of GDP is expected to be financed from the net foreign assets of the banking system, more specifically by the commercial banks. Hence, it is expected that the gross international reserves will increase slightly in 2006 and 2007 to cover around 2.5 months of imports of goods.

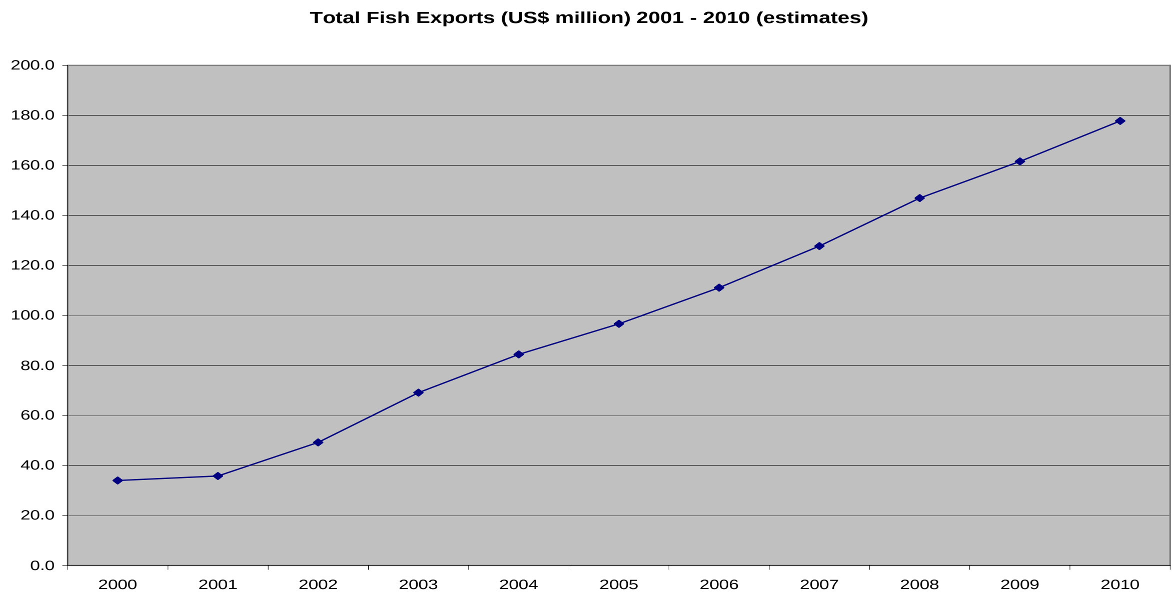
The fiscal outcome of the first five months of 2006 was actually better than the initial budget forecasts. This was mainly on account of additional revenue generated from higher tourism tax receipts and import duty with the better than anticipated tourist arrivals and higher imports into the country. At the same time, expenditure was less than forecasts, mainly due to lower than expected expenditures in all recurrent categories as well as in capital spending. In addition, the rapid increase in tourism development planned for the immediate and medium term, including a vast expansion of the number of tourist resorts from the current 87 to an expected 133 by the end of 2008, is expected to generate considerably higher revenue both in 2006 and the following years. Similarly, the economy is expected to benefit from a broadening of fishery activities with greater participation of the private sector.

Tourism receipts (US$ millions) 2001 - 2010 (estimates)



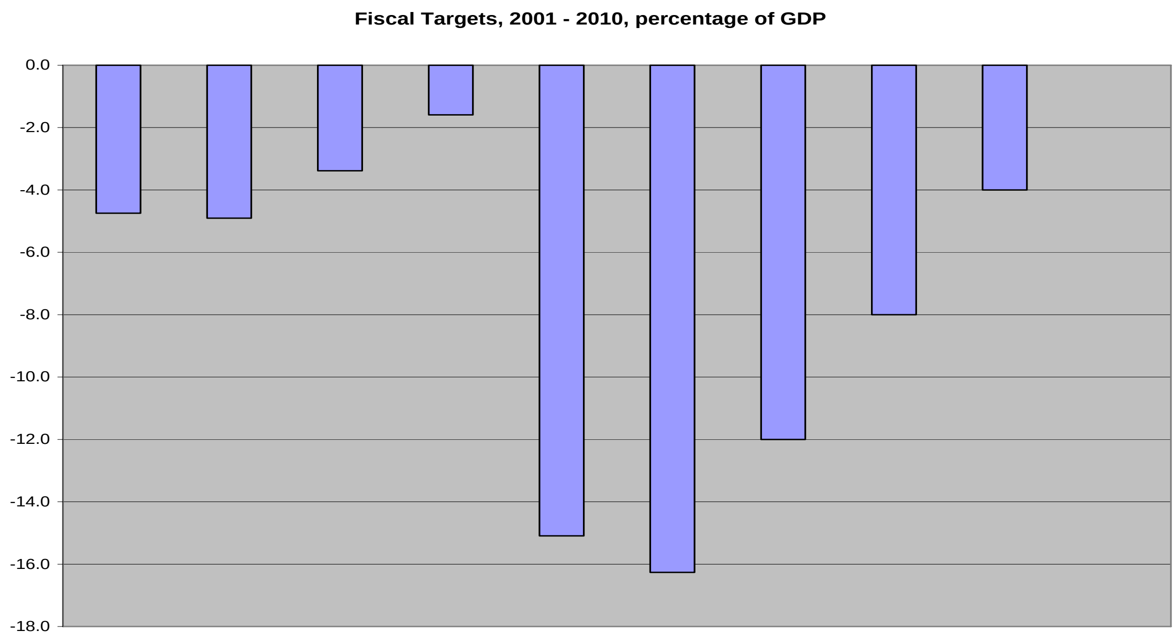
Revenue from the tourism sector for 2006 is estimated at slightly less than US$ 50 million and this is projected to increase to almost US$ 75 million by 2010. Given these developments and the strong commitment of the government to work towards a more prudent and sustainable fiscal policy, the fiscal deficit—which is expected to be about 16 percent of GDP in 2006—is targeted to decrease considerably during the next few years, with a zero balance target for 2010. In close consultation with the World Bank, the Asian

Development Bank, and the International Monetary Fund, and with the exercise of greater fiscal discipline, the Government of Maldives believes that the outlook is somewhat favourable and that these figures are achievable.



The government is conscious of the fact that such ambitious deficit reduction may not be attainable with fiscal adjustments alone. Proposed new revenue measures, such as the introduction of a business profit tax in 2008, the development of a trans-shipment port in the northern part of Maldives, restructuring or privatization of ailing state-owned enterprises, and the development of a banking sector, amongst others, need to be aggressively pursued.

As regards the total government debt, external borrowing is expected to decline in the next few years with some net repayments by 2010, while domestic debt is expected to subside considerably after peaking in 2008. The government is also currently setting the stage for the introduction of treasury bills, which will cease automatic financing of fiscal deficits by the Maldives Monetary Authority.



Although the government is putting in place several measures to increase the revenue side of the budget, it is also necessary to demonstrate tight fiscal discipline. Hence, the recurrent expenditure side of the budget must be reduced significantly by 2010 if the targeted deficit projections are to be met. Wages and salaries have to be rationalized; investment should target growth in exports and economic development; and public sector spending must be prioritized. The path of targeted deficits means significant declines in expenditure over the coming years with reduction of spending by 5 percent in 2007, over 10 percent in 2008 and 2009, and further reductions in 2010

Capital investments currently taking place or in the pipeline with secured financing, either via grants or loans, are included in the budget estimates and projections, but any new public capital expenditures must necessarily be subject to stringent prioritization. The overall resource envelope available for the implementation of the 7th National Development Plan will therefore have an impact on new development activities. The current short-term approach on financing the budget through borrowings from the central bank needs to be scaled back and discontinued. A continuation of the present approach – in effect a monetization of the economy – can in a worst case scenario lead to a potential devaluation of the Maldivian rufiyaa.

The government is working closely with the World Bank and the Asian Development Bank to monitor the macroeconomic developments in the country. On the recommendation of the World Bank and the macroeconomic team in the Maldives, a Macroeconomic Coordination Committee (MECC) was formed in February 2006, comprising the Ministry of Finance and Treasury, Ministry of Planning and National Development, and the Maldives Monetary Authority, to monitor macroeconomic and fiscal developments more closely as well as to develop and implement a Medium Term Fiscal Framework. The MECC convenes monthly to scrutinize the macroeconomic developments in the country and to recommend short, medium, and long-term policy changes, if warranted.

With enhanced revenues through a more market-based approach to national development, improved fiscal management and fiscal discipline, the firm commitment of the government to curbing expenditure growth, coupled with other structural reforms, the Maldives can return to the sound macroeconomic footing of the years preceding the tsunami. Well coordinated investment in close consultation with development partners will enable the Maldives to achieve the UN's Millennium Development Goals, to graduate from Lesser Developed Country status, and to become a middle-income country.

15 June 2006