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**Statement by Ms. Lundsager and Mr. Kushlis on Maldives
(Preliminary)
Executive Board Meeting 07/57
July 2, 2007**

While the recovery from the tsunami is clearly underway, as manifest by rebounding growth and tourism, macroeconomic policies appear to be on an unsustainable trajectory. As such, we urge the authorities to reconsider the course of fiscal and monetary policy. We note that external vulnerabilities and indebtedness are rising at an alarming rate and that recent spending plans are not geared toward productivity-enhancing activities and are based on unrealistic revenue targets. While in principle we see value in maintaining the exchange rate peg as a nominal anchor for a small, open economy, in this case underlying macroeconomic policies need to be made consistent with the peg. Monetary financing of the deficit clearly poses significant dangers under such a regime and a disorderly collapse of the peg would pose significant economic costs.

Since 2005, domestic expenditures have increased markedly, outpacing revenue growth, which has led to large fiscal deficits. While tsunami-related grants and loans provided a cushion to the budget in 2006, this support will taper off this year, even as the authorities continue to grow expenditures on items unrelated to tsunami recovery. Staff projections that revenue is likely to fall significantly short of 2007 budget estimates are alarming, especially if the resulting deficits are monetized. In this context, we note the establishment of a Macroeconomic Coordination Committee and would be interested in an update from the staff as to how revenues are coming in to date and whether the authorities have taken any steps to adjust the budget. Have any decisions been taken which would affect staff's baseline scenario? Legally separating the positions of Central Bank Governor and Finance Minister, as well as ending the automatic monetization of fiscal deficits, are steps in the right direction, and we urge the authorities to take further steps to bolster the Central Bank's independence, as noted in Mr. Shaalan's statement.

Large fiscal deficits and foreign borrowing plans, as well as an acceleration in private sector borrowing, have led to a significant jump in imports and the current account deficit. Reserves remain at low levels, leaving the economy exposed to shocks. Further stoking domestic demand by monetizing budget deficits would only put further pressure on the

balance of payments. Moreover, external indebtedness (which has increased from 43 percent of GDP in 2004 to 65 percent of GDP in 2006 and a projected 80 percent of GDP in 2007) is clearly on an unsustainable path. While the authorities appear to have plans to scale back external public borrowing starting next year, such consolidation will depend critically on the fiscal program (including tax reform) holding together. Even under the assumed baseline, however, the external situation will remain precarious, and we urge the authorities to take more ambitious. With respect to the increase in private sector external indebtedness, we would be interested to know whether it is expected to be in projects that generate sufficient foreign exchange to be sustainable.

Staff's assessment of the exchange rate level appears to be relatively limited, not delving beyond a cross-country comparison of the real exchange rate evolution over the past ten years. While we would not expect a full CGER estimate in the case of the Maldives, we would expect the staff to present a broader range of estimates for comparison, such as a PPP price level comparison. To the extent that the staff may have caveats and reservations about using other methods, we would expect them to be discussed in the staff report.

We encourage the authorities to move to full compliance with Article VIII. We welcome the draft AML/CFT legislation and urge its prompt passage. We encourage the authorities to move ahead with a broader range of competitiveness enhancing structural reforms, particularly divesting SOEs, which are becoming a drain on the budget, as well as the Banking Bill and key tax reform bills.