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The Acting Chair's Summing Up
Maldives—2007 Article IV Consultation
Executive Board Meeting 07/67
July 30, 2007

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, some Directors concurred with the staff's assessment that Maldives is in a situation of fundamental misalignment. However, many other Directors noted that adequate information was not available to make a determination in this case.

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.

It is expected that the next Article IV consultation with Maldives will be held on the standard 12-month cycle.