SM/08/261
Correction 2

March 3, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Maldives—Staff Report for the 2008 Article IV Consultation**

The attached corrections to SM/08/261 (7/31/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 26, para. 1, line 9: for "Public" read "Government"
line 10: for "45 percent" read "39 percent"
line 11: for "26 percent" read "23 percent"
line 12: for "13 percent in 2008 to 15 percent"
read "12 percent in 2008 to 14½ percent"
line 13: for "12.6 percent" read "about 13 percent"

para. 2, line 3: for "121 percent" read "over 120 percent"
line 4: for "89 percent" read "90 percent"
line 5: for "decline over" read "decline appreciably over"
line 6: for "122 percent" read "about 144 percent"

Questions may be referred to Mr. Weerasinghe (ext. 38780), Mr. Aiyar (ext. 38638), and Ms. Oura (ext. 38166) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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APPENDIX I. MALDIVES: PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

Debt sustainability analysis (DSA) indicates a considerable rise in the external debt-to-GDP ratio over the next few years—driven primarily by private sector activity—while public sector debt ratios are forecast to decline from next year onwards. The baseline scenario is premised on GDP growth of about 6 percent per annum over the medium term, consistent with a cautiously optimistic forecast for expansion in the tourism and fisheries sectors.[7] The fiscal assumptions incorporate a substantial scaling down of current expenditure over the medium term, in conjunction with revenue reforms described in the main text of the staff report.

A. Public Debt Sustainability

The Maldives' public sector debt has increased rapidly owing to fiscal expansion following the tsunami. The primary deficit has jumped from an average of 2¼ percent of GDP during 2000–04 period to an average of 6⅔ percent of GDP during the 2005–07 period. Both domestic and foreign resources have been mobilized to finance the deficit, pushing up the overall debt ratio by over 13 percentage points of GDP between 2004 and 2007.

In the baseline DSA, the public debt ratio declines steadily over the medium term, reflecting the fiscal prudence embedded in the staff projection. The projection builds on zero or small positive domestic balances, by restraining expenditures within a realistic resource envelope (which builds in various revenue reforms). The zero or negative usage of domestic financing and the start of the net repayment of the government external debt as per the amortization schedule implies a sharp turnaround of the primary balance into positive territory starting in 2010. As a result, both domestic and foreign public debt ratios decline appreciably, achieving a level well below the pre-tsunami average over the medium term.

The major risks to the baseline are on the fiscal stance, indicating the significance of fiscal prudence for achieving macroeconomic stability. The historical scenario would imply an increasing trajectory for public debt, rather than the forecast decline. The major driver of this result is the historically high primary deficits, with a 10-year average of 3.4 percent of GDP. If the primary balance remains fixed at the elevated level of 7.4 percent of GDP (as budgeted in 2008), the debt ratio would continue to expand to and reach 75 percent of GDP by 2013. Sensitivity tests also show that the public debt path is susceptible to shocks to real GDP growth, with a one-fourth standard deviation shock to growth leading to a public debt ratio of 55 percent in 2013 (instead of the baseline forecast of

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[7] The forecast assumes that roughly half of the resorts planned by the authorities will be constructed by 2013, which still comprises an ambitious schedule. In line with government plans, construction activity is expected to be particularly concentrated in the period 2008–10, after which it diminishes as some resorts are completed along with the transshipment port and various infrastructure projects.

30). However, the impact of a GDP shock may be overstated by the standardized sensitivity test, because in the Maldives' case the tsunami and the sharp recovery thereof accentuate the volatility of GDP growth. Excluding the year of the tsunami and the following year, the growth rate shock scenario generates a falling path for public debt, which reaches about 40 percent of GDP by 2013.

B. External Debt Sustainability

The external debt-to-GDP ratio is forecast to climb sharply until 2010, before attaining a downward trajectory later in the projection period. Over the next three years, several new resorts will begin construction, while work continues on island resorts leased previously. The financing for these resorts is mainly expected to be channeled through commercial banks borrowing from their head offices and on-lending domestically, as in the past. In addition, work will commence on a transshipment port, while various other infrastructure projects continue. The external debt-to-GDP ratio is forecast to climb to about 95 percent in 2010, after which it will diminish as several projects are completed. Notably, this path is driven by private sector activity and borrowing. ~~Public~~ Government external debt, in contrast is forecast to decline from next year onwards—falling gradually from 39~~45~~ percent of GDP in 2008 to about 23~~6~~ percent by 2013—as amortization on existing loans comes due and loans for tsunami reconstruction activities winds down. Debt service follows a similar profile, rising as a percentage of domestic exports from 12~~3~~ percent in 2008 to 14½ ~~5~~ percent in 2010, before declining to ~~12.6~~about 13 percent by 2013.

The stress tests illustrate that the debt path is particularly vulnerable to shocks to the current account and the exchange rate. A real depreciation of 30 percent would cause the ratio to rise sharply to over 120~~121~~ percent in the year that the depreciation occurred, before falling to about 90~~89~~ percent in 2013. A large current account shock is potentially more worrying because the trajectory of the external debt ratio does not decline appreciably over the projection period, rising steadily to about 144~~122~~ percent by 2013. 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 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.