EXECUTIVE BOARD MEETING

SM/17/267
Correction 1

October 19, 2017

To: Members of the Executive Board

From: The Secretary

Subject: **Maldives—Staff Report for the 2017 Article IV Consultation**

Board Action:	The attached corrections to SM/17/267 (10/6/17) have been provided by the staff:
Mischaracterizations of the Views of the Authorities	**Page 14**
Evident Ambiguity	**Pages 5, 6, 7, 24**
Questions:	Mr. Karam, APD (ext. 35900) Mr. De, APD (ext. 34869)

2016 to 0.8 percent. The temporary lift to inflation from the food and electricity subsidy reforms (October 2016) and the increase in import duties on cigarettes, soft and energy drinks (March 2017) is expected to fade this year and next. More broadly, administered subsidized prices for key staple items, falling international commodities prices and an appreciating U.S. dollar (to which the currency is pegged) have maintained low and stable prices.

6. **The fiscal deficit widened in 2016 driven by lower than expected revenue and large arrears clearance despite unchanged current spending.** Both staff and the authorities estimate a significantly higher overall fiscal deficit in 2016 (10.3 percent of GDP) compared to the 2016 Budget (5.2 percent of GDP). Lower Tourism-GST (T-GST), non-tax revenues, sales of assets, grants, and large arrear payments largely account for the deviation. Current spending is close to the Budget as a decline in subsidies, transfers and interest payments were offset by higher social welfare contributions. Capital spending is lower than the Budget but remained high. Public debt rose in 2016 up nearly 11.5 percentage points over the past two years. In response, the 2017 Budget aimed to reduce the deficit in line with the Fiscal Responsibility Act (FRA) that came into effect in 2014 and with the fiscal rules of the Fiscal Responsibility Law (FRL) under the Act, in 2017. The Budget includes a continuation of the wage and hiring freeze since 2015, significant cost rationalization following the electricity and food subsidy reforms of 2016, and revenue measures including a new Airport Development Charge (ADC), land sales to the public, and higher import duties on cigarettes and drink items.

7. **Monetary policy remains accommodative.** The MMA has kept the minimum reserve requirement (MRR) rate at 10 percent and administered yields on Treasury bills and bonds below those of neighboring countries. The parallel market premium increased fourfold during 2015–16, reflecting monetary easing in 2015, moderating tourism receipts and a sharp decline in FX reserves from a large one-off external payment. To restore confidence, the MMA ~~supplied~~ increased FX sales ~~directly~~ to the banks and sold directly to the public in late 2016. This helped bring down and stabilize the premium at around 4 percent above the upper official rate. Starting in 2017, the MMA increased both its allocation to commercial banks and U.S. dollar sales to SOEs (Annex II).

8. **The overall external position has worsened and is assessed to be substantially weaker than implied by fundamentals and desirable policy settings.** The current account deficit widened sharply from 7.3 to 19.6 percent of GDP between 2015 and 2016, due to increased infrastructure-related imports, moderating tourism receipts, higher remittance outflows, and reclassification of a large one-off court mandated payment made later in the year (Table 4).[1] Fisheries, the largest source for goods export, has fallen in value terms driven by a large decline in global prices. Net FDI inflow, new debt and reserve drawdown have financed the deficit. The real exchange rate (RER) is assessed to be well above the norm at end-2016, while the current account (CA) is assessed to be well below. Reserve coverage declined from 2.4 to 1.8 months of imports between 2015 and 2016 (Annex IV).

[1] The MMA has benefitted from recent TA in external sector statistics. The TA concluded that travel receipts were underestimated because of a problem in the main data source and missing components.

9. To boost reserves, the MMA entered into two swap arrangements totaling US$200 million.[2] These swaps with the Reserve Bank of India and the State Bank of India have since been settled. More recently, reserves have also benefitted from the first ever sovereign bond issuance (US$200 million)[3] and timely repayments by MACL, on the bond held by MMA. By end-July 2017, gross reserves stood at US$571 million (1.9 months of imports) while usable reserves were US$208 million (0.7 month of imports).

10. Banks' capital position remains strong and asset quality has improved. NPLs in absolute terms have fallen by 36 percent and as a share of total loans have declined, from 21 percent in 2012 to 11 percent in 2016. Profitability remains high with return on equity close to 15 percent. Credit to the tourism industry constitutes the largest share to private sector (40 percent), but has fallen as construction activity has risen sharply in recent years driven by the residential and commercial construction boom. Banks' linkages to public infrastructure projects are limited as the projects are mainly financed externally (Table 5 and Figure 6).

Authorities' Views

11. On inflation, the main drivers are food and oil prices. Food price increases were primarily attributed to the subsidy cut on staples during the latter part of 2016, partly offset by a fall in vegetable prices. Oil price changes on the other hand are not believed to have affected inflation, with less than a clear link between currency movements and inflation.

12. The authorities do not see that the accommodating monetary policy has contributed to BOP pressures. They stressed that the CA deterioration during 2016 is due to the one-off external payment and to the increase in public infrastructure-related imports. Slowdown in tourism receipts and increased infrastructure spending have not added pressure on the availability of U.S. dollars because the MMA increased its intervention in the FX market, evident in the gradual decline in the parallel market premium in the first half of 2017. On reserves, they explained that using months of imports may not be an appropriate measure in assessing reserve adequacy. This is considering the significantly large capital imports related to infrastructure and the high structural nature of the import bill reflecting large demands from tourism.

13. Authorities also pointed to lower than expected revenues and high infrastructure spending resulting in the larger than budgeted fiscal deficits in 2016. Based on outturns so far this year, they however remain confident that overall expenditure will be contained at budgeted levels for 2017.

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[2] In late 2016, gross reserves declined significantly to US$468 million of which US$200 million are usable reflecting an MMA purchase of a US$140 million bond from the SOE, the Maldives Airports Company Limited (MACL), as well as FX withdrawals from local banks.

[3] The first international sovereign bond (US$200 million, at 7 percent with a 5-year maturity) was oversubscribed. Investors were from Asia (83 percent) and Europe. As a pre-requisite, two credit ratings were obtained from Moody's (B2 rating, which is speculative and subject to high credit risk) and Fitch (B+ rating which falls between a BB Speculative and a B Highly Speculative rating).

OUTLOOK AND RISKS

A. Outlook

14. The baseline outlook is for a modest recovery in the near term, with low inflation, loose financial conditions, but with significant downside risks from a fragile fiscal and external position.

- **GDP growth is projected to recover to 4.6 percent in 2017 and stabilize at close to 5 percent over the medium term.** The Maldives is expected to benefit from stronger economic growth in Russia, India and China and continued recovery in Europe. Further ahead, capacity in the tourism sector is set to expand following the infrastructure scale up, and the baseline assumes favorable long-term tourism forecasts in the South Asia region. Under such forecasts (Annex III), medium-term growth could rise to 5 percent (consistent with MMA projections) but still remain below the annual average of 6 to 7 percent over the last 15 years. Construction is set to continue to grow strongly buoyed by major infrastructure projects. Non-tourism exports are expected to rise gradually as the agriculture and fisheries sectors diversify into new value-added products, and strong growth in Asian and European markets (Maldives' export market destinations) continues.

International Tourism by Region of Destination
(average a year (%))

	2010-'30	2010-'20	2020-'30
World	3.3	3.8	2.9
Asia and Pacific	4.9	5.7	4.2
South Asia	6.0	6.8	5.3

Source: UNWTO tourism towards 2030

- **Following the infrastructure surge, the fiscal deficit is projected to widen significantly before gradually declining over the medium term (Table A).** After reaching a peak of 10.3 percent of GDP in 2016, the headline fiscal deficit is projected to decline gradually to 6.5 percent in 2019 as infrastructure spending winds down. Staff's deficit projection in 2017 is significantly higher than the authorities' Budget which aims to keep the deficit below 3.5 percent of GDP and a primary surplus. Staff projects lower revenues than the Budget factoring in large uncertainties surrounding non-tax measures and grants and the absence of tax revenue measures to cover the large scale up costs. On spending, staff factors in the effect of subsidy reforms, a slower pace of wage and welfare rationalization, higher current spending in support of the major infrastructure scale-up, and still relatively high but more realistic capital spending with due attention to challenges in implementation capacity.

Fiscal Projections 2016-19: Authorities and Staff
(In percent of GDP)

	2016		2017		2018		2019	
	Auth	Staff	Auth	Staff	Auth	Staff	Auth	Staff
Total Revenue incl grants	28.4	28.4	31.3	28.7	29.7	28.6	29.2	28.3
Tax Revenue	20.2	20.2	20.5	20.9	20.1	20.8	20.0	20.4
Non-tax Revenue	7.9	7.8	9.5	7.4	8.4	7.5	8.0	7.6
Total Expenditure & net lending	38.6	38.7	33.5	36.6	32.3	35.8	28.7	34.7
Current Expenditure	24.9	24.9	19.5	24.3	19.0	25.1	18.1	26.5
Wages Costs	10.6	10.7	9.8	10.3	9.2	10.0	8.6	9.6
Interest Costs	1.8	2.0	2.0	2.2	2.2	2.5	2.1	3.0
Social Welfare Contributions	3.5	3.3	1.5	3.1	1.4	3.2	1.3	3.2
Subsidies & Transfers	2.5	2.5	1.7	2.0	1.9	1.9	1.9	1.8
Capital Expenditure 1/	13.2	13.2	14.1	12.4	13.4	10.7	10.7	8.3
Primary Balance	(8.5)	(8.3)	(0.3)	(5.8)	(0.4)	(4.7)	2.6	(3.5)
Overall Balance	(10.3)	(10.3)	(2.3)	(8.0)	(2.5)	(7.2)	0.5	(6.5)
Public Debt 2/	63.6	65.7	65.5	69.4	63.9	72.2	61.5	74.0

1/ Capital expenditures are inclusive of contributions to the sovereign development fund (SDF)
2/ Based on Authorities' preliminary estimates and own nominal GDP (Macroeconomics Outlook, Spring 2017).

Supportive Exchange Rate, Monetary and Financial Policies

27. Considering Maldives' small scale, high openness, dollarized nature, and volatile export revenue, a stabilized arrangement remains appropriate. The stabilized arrangement has helped anchor inflation and provided a natural hedge for the tourism sector, where income and imports are received and paid in U.S. dollars. The peg so far has been shored up by sustained exchange rate restrictions, but low reserve coverage and rising public debt have undermined its stability and raised the risk of a disorderly exchange rate correction. Strong and durable fiscal adjustment, combined with a tighter monetary stance (see below), can better support the peg going forward and help build foreign reserves. Within the peg arrangement, the authorities could consider a gradual move in the future from the historically-backed link to the U.S. dollar towards an import-weighted currency composite to support the buildup of reserves and price stability.[7]

28. Monetary policy should be tightened to mitigate pressures on the peg from government finances and the infrastructure surge. Moderate FX receipts combined with loose macro policies will continue to push up the CA deficit and external debt, undermining the credibility of the pegged regime. Furthermore, the subsidy phase out could push up inflation through pass-through of higher international prices. To safeguard the peg, the monetary stance should be tightened gradually through an increase in the MRR and in the remuneration rates on rufiyaa-deposits while replenishing FX reserves through sustained net inflows of foreign currency receipts. Reserve coverage should return to three months of imports at a minimum. Tightening should be paced so it does not impede credit in support of economic growth. In the event of building pressures on the peg, a stronger policy mix will be needed including more fiscal and monetary tightening rather than further FX sales or external commercial borrowing.

29. Market-based auctioning of liquidity should be restarted. Renewing open market operations to absorb excess liquidity and gradually expanding the Treasury bond profile into longer maturity to develop a yield curve would enhance financial efficiency. This needs to be well-designed and weighed against a sudden risk of higher debt service under the likelihood of rising external interest rates and fiscal imbalances.

Authorities' Views

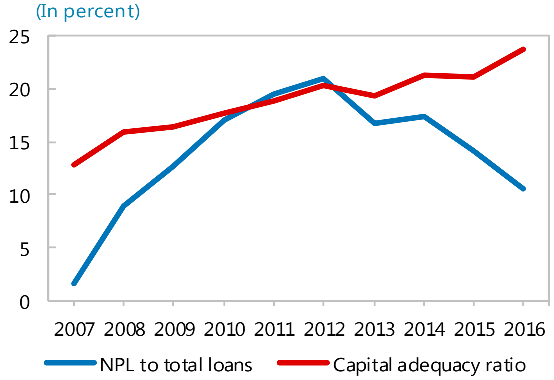
30. The MMA did not see the need for monetary policy tightening to support the peg in the absence of inflation and FX market pressures. They noted that the parallel market premium had narrowed considerably from the increased FX intervention ~~following the sovereign bond issuance~~. Moving to a more market-based auctioning and developing the domestic bond market would be challenging under the current financial infrastructure which needs to be overhauled. In the event of pressure on the peg, the MMA indicated its ability and readiness to activate alternative monetary instruments based on open market operations, if needed. They saw moving from a dollar

[7] Given the high external debt burden, a composite with initially a heavy weight on the U.S. dollar should be introduced gradually to avoid increasing the MVR cost of debt repayment.

Figure 6. Maldives: Financial System and Business Environment

System wide NPLs and capital adequacy have significantly improved….

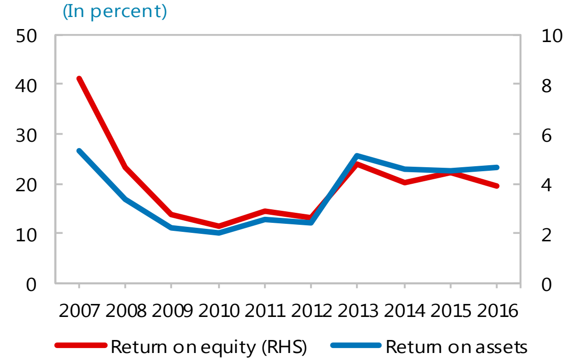
Commercial Banks' Capital and Credit Quality Indicators
(In percent)



Source: Maldivian authorities.

Banks maintain high level of profitability…

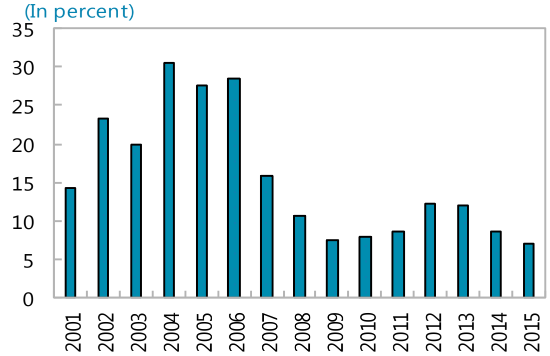
Commercial Banks' Profitability Indicators
(In percent)



Source: Maldivian authorities.

~~Storyline goes here~~ Ratio of offshore banks deposits to domestic bank deposits remains below long-term average….

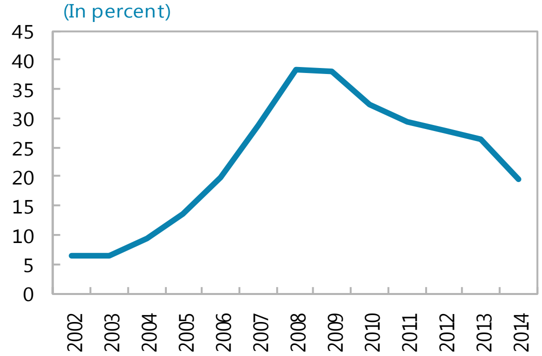
Offshore Bank Deposits to Domestic Bank Deposits
(In percent)



Source: World Bank Financial Structure Database.

Loans from non-resident banks in relative to GDP continue to decline~~Storyline goes here~~….

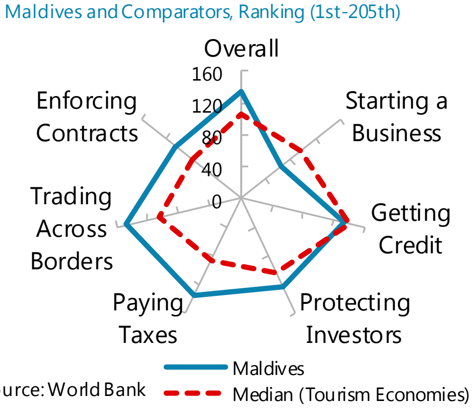
Loans from Non-Resident Banks to GDP*
(In percent)



Source: World Bank Financial Structure Database, * = does not reflect impact of recent revisions to nominal GDP (fig. 7).

Doing Business indicators remain weak…

2016 Doing Business Ranking
Maldives and Comparators, Ranking (1st-205th)



Source: World Bank