

Discussion Paper

Achieving Debt Sustainability and the MDGs in Small Island Developing States: The Case of the Maldives

20 December 2010

United Nations Development Programme

POVERTY REDUCTION





Acknowledgements

This discussion paper was written by Gail Hurley, Poverty Group, Bureau for Development Policy, UNDP. Thanks to: Raniya Sobir (UNDP Maldives), Andrew Cox (UNDP Maldives), Aishath Esha (UNDP Maldives), Paul Ladd, (UNDP, Poverty Group), Mifzal Ahmed (former Advisor to the Maldivian Ministry of Economic Development), Paul Sutton (London Metropolitan University), Dev Kar (Global Financial Integrity) and Carly Curcio (Global Financial Integrity) for their feedback and inputs on earlier versions of the paper.

Cover photo acknowledgements: Author's own photograph of the capital island, Male' (July 2010)

Contact information

Poverty Group, Bureau for Development Policy, UNDP: poverty.reduction@undp.org

Disclaimer

The views expressed in this publication are those of the author and do not necessarily represent those of the institutions to which they are affiliated or the United Nations, including UNDP, or their Member States.

Copyright © December 2010

United Nations Development Programme

Bureau for Development Policy

Poverty Group

304 East 45th Street

New York, NY 11375

USA

Email: poverty.reduction@undp.org

Website: www.undp.org/poverty

Contents

Achieving Debt Sustainability and the MDGs in Small Island Developing States: The Case of the Maldives.....	1
Executive Summary	5
1. The Maldives: An Overview	8
1.1 The Maldives at a Glance	8
BOX: The Maldives and the MDGs: A Snapshot	9
2. Debt Accumulation in the Maldives: An Overview	11
2.1 The Maldives: Severe and Multiple Economic Shocks.....	11
2.2 The Maldives: Structural Weaknesses	14
3. Debt in the Maldives	16
3.1 Debt in the Maldives: An Overview	16
3.2 Domestic Debt	19
3.3 External Debt	21
3.4 SOEs and Private Sector Debt	25
4. Current Measures to Address the Fiscal Crisis	26
4.1 Expenditure Cuts.....	26
4.2 Domestic Resource Mobilisation	27
4.3 Poverty and Social Impact Considerations	28
5. Policy Avenues to Explore	29
5.1 Policy Measures to Explore at the National Level	29
5.2 Policy Measures to Explore at the International Level.....	31
6. Conclusion	34
7. References	36

Executive Summary

This UNDP Discussion Paper examines the public debt situation in the Maldives. It is one of four case studies on debt in small island developing states carried out by UNDP in 2010 in the framework of the project entitled: 'Achieving Debt Sustainability and the MDGs in Small Island Developing States.' The initiative looks at the problem of high levels of public debt in many small island developing states (SIDS) and the possible impacts on governments' efforts to reduce poverty and increase economic growth. The other countries covered by this initiative are: Grenada, St. Kitts and Nevis and Tonga. The case studies are accompanied by a further discussion paper which provides an overview of the problem of debt in many small island economies as well as presents a range of policy options to deal more effectively with the growing problem.

The Maldives has experienced rapid public and private debt accumulation over the last six years. As a percent of GDP, public debt levels have almost doubled from 55 percent in 2004 to approximately 97 percent in 2010. Public debt service as a percent of government revenues will more than double between 2006 and 2010 from under 15 percent to over 30 percent. The IMF recently classified the country as 'at high risk' of debt distress. From a human development perspective, the extent to which increased debt service obligations may put at risk key social and infrastructure expenditures give serious cause for concern.

The Maldives has made excellent progress towards many of the Millennium Development Goals and is South Asia's only MDG-plus country. Nevertheless, important challenges remain with respect to several MDGs which include gender empowerment and environmental sustainability.

Rapid debt accumulation in the Maldives is the result of short-term economic 'shocks' combined with longer-term 'structural' factors. Short-term causes include the Indian Ocean tsunami of December 2004, a large expansion in public expenditures between 2004 and 2008 and the recent concurrent food-fuel-financial crises. Long-term causes include structural weaknesses associated with the country's geographical characteristics and a narrow tax and revenue base. Arguably the country is about to experience its fourth economic 'shock' in the form of its imminent graduation from Least Developed Country (LDC) status in January 2011 which will entail the loss of several trade related concessions.

The sharp increase in debt can be attributed predominantly to the increase in domestic debt. Domestic debt as a percent of GDP has increased from just 15 percent in 2004 to an estimated 55 percent by 2010. Debt service on domestic debt has also increased significantly over the last couple of years and is expected to rise further still. The domestic debt market has developed quickly in the Maldives and the government is now issuing USD denominated bonds on the domestic financial market. One important consequence of the government's reliance on bond finance is that major national banks have shifted a large portion of their assets to government securities. Increased government borrowing is now crowding out bank credit to the private sector with implications, in turn, on output and employment.

External debt levels in the Maldives have remained relatively stable as a proportion of GDP since 2004 at around 40 percent. Multilateral lenders account for 59 percent of external debt, bilateral lenders for 23 percent and private lenders for 17 percent. Most official sector debt is on concessional terms due to the 'small island exception' extended by several multilateral financial institutions. However, overall the proportion of official debt on concessional terms has declined steadily over the last decade. In 2000, over 78 percent of the government's public external debt burden was on concessional terms.

This had declined to 59 percent by 2009. With the Maldives' graduation to middle-income country status, this trend looks set to continue. In addition, tsunami-related assistance from international donors is now coming to an end, with aid flows projected to decline from on average US\$700 million per year over the last five years to US\$200 million in 2010.


The country's extreme vulnerabilities to external shocks – and increasingly climate change – call into question the reliance on market-based finance to meet fiscal deficits and fund development. The Maldives is one of the most vulnerable countries in the world to climate change with many islands under threat of being totally wiped-out by rises in the sea level. This will require, in turn, the resettlement of thousands of people either within the Maldives, or elsewhere. The threat posed by climate change cannot be emphasised strongly enough; an inability to adapt to climate change could propel the country into a negative development cycle which would be extremely difficult to break. Moreover, the scale of capital investments required by the country to adapt to climate change are likely to be beyond the capacities of such a small country. Crucially, the ability of the country to adapt depends much more critically on broader global commitments to tackle climate change as well as the volume of, and access to, external finance.

In 2009, the government's fiscal deficit registered over 26 percent of GDP, one of the highest in the world. In order to address its large budget deficit and growing public debt burden, the government has developed a sizeable fiscal adjustment programme as part of its Stand By Arrangement (SBA) with the IMF. The scale of the planned adjustment is immense with plans to reduce the civil service work-force by one-third, reduce public servants' pay, develop a range of new taxes and privatise several state-owned enterprises. However, intense political difficulties within the country mean that many of these policies have not progressed as anticipated and are unlikely to be implemented before 2011 at the earliest. This will have severe implications on the country's fiscal deficit and public debt position.

The implementation of public sector pay-cuts on which a significant proportion of the population depends has proven especially difficult and has heavy up-front costs as well as a high social impact since the capacity of the private sector to absorb large numbers of redundant workers remains open to question. The implementation of income, corporate and value-added taxes will also take time to implement in a country with limited experience of direct taxation. The government must also ensure that the burden of taxation does not fall unduly on the poor in a country of rising inequalities. Moreover, the Maldives has a small population and much economic activity is conducted informally, especially in the atolls. These realities mean there are limitations as to the amount of additional resources which can be generated through new taxation measures.

The 2010 budget indicates that the government will reduce expenditures on some social sectors as a proportion of GDP when compared to 2008. Overall, government spending on social services will decline from 32 percent of GDP in 2008 to 24 percent in 2010. Total expenditures on education will decline from 10 percent of GDP in 2008 to 8 percent in 2010 while expenditures on health will decrease from 8 percent to 4 percent over the same period. Government spending on economic services, which include fisheries and agriculture, transport, industry, communications and electricity will decline from 8 percent of GDP in 2008 to 5 percent in 2010. It is essential that key social and infrastructure expenditures are not put at risk in order to ensure that the country's good progress on the MDGs and other human development goals is not jeopardised.

Other policy measures must be taken into consideration in parallel. These include measures by the government to curtail revenue leakages through the mispricing of goods and services, measures to strengthen institutional debt management capacities and improving citizens' access to financial services, including through the development of a specialised



development bank. The international community must also do more. It must continue to provide concessional resources to the country in recognition of the Maldives' numerous structural economic weaknesses, as well as support targeted debt conversions for climate change adaptation. The Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) have now closed to future entrants however debt relief for the Maldives cannot be entirely ruled-out. In the absence of an international insolvency regime, the international community must not close down possibilities for other countries – such as the Maldives – to gain access to comprehensive bilateral and multilateral debt relief should it be required. This should be based on the principles of fair burden-sharing between creditors and incorporate considerations as regards countries' vulnerabilities to external shocks and capacities to cope.

1. The Maldives: An Overview

1.1 The Maldives at a Glance

The Maldives is an archipelagic nation of approximately 1,190 low-lying coral islands which form a chain across around 90,000 square kilometers of the Indian Ocean. The total population stands at around 300,000 people. One third lives in the capital, Male', which has a land area of just 2 square kilometers.¹ Most of the country's other 200 or so inhabited islands have less than 1000 inhabitants each. This geographical fragmentation complicates – and makes more expensive – the provision of essential social services such as health and education. The concentration of the population on the capital island has also led to problems of overcrowding, the rising cost of living and other social problems such as narcotics abuse and gang violence.

The Maldives' economic base is extremely narrow and structured around two key industries: tourism and fisheries. In 2009, tourism represented approximately 27 percent of GDP and fisheries, 10 percent.² From one of the poorest countries in South Asia in the 1970s, the Maldives is now one of the wealthiest countries in the region in income per capita terms. Real per capita GDP stood at approximately US\$2,800 in 2009.³ The development of tourism in particular has contributed to the country's impressive growth record and the country has also made impressive progress towards the Millennium Development Goals and other human development objectives (see box on the MDGs for further details).

At the same time, the country's reliance on two sectors that depend heavily on external conditions leaves the country extremely vulnerable to fluctuations in the global economy. The fisheries sector in particular has declined over recent years due to a combination of factors such as an increase in fuel prices in 2007 and 2008, poor catch, illegal and unregulated fishing by foreign vessels and the failure to modernize fishing boats and other essential infrastructure. In December 2004, the tourism sector was heavily damaged by the Indian Ocean tsunami which led to substantial reconstruction costs; it has also been negatively impacted by the global financial and economic crisis which led to fewer tourists and reduced tax revenues to the government.

On account of its unique geography, the Maldives is extremely vulnerable to extreme weather events and climate change. The Indian Ocean tsunami of 24 December 2004 wiped-out much of the country's economic infrastructure and left thousands of people homeless. The loss in economic and social infrastructure was estimated at around 62 percent of GDP.⁴ While international donor support combined with increased government expenditures enabled the country to rebound quickly from the disaster, the likelihood of further natural disasters must be ruled-in, especially given the predicted impact of climate change. Indeed, the Maldives' ability to adapt to climate change will be central to not only the country's poverty reduction and development effort but also its very survival.

¹ Government of Maldives, Department of National Planning, Ministry of Finance and Treasury, Millennium Development Goals, Maldives Country Report 2010

² UNDP, Assessment of Socio-Economic Impact of Food, Fuel and Financial Crises on Maldives, 31 July 2009

³ Government of Maldives, Department of National Planning, Ministry of Finance and Treasury, Millennium Development Goals, Maldives Country Report 2010

⁴ UNDP Regional Centre in Colombo, Rapid Economic/Poverty Assessment of the Maldives, Technical Report, Millennium Development Goals Initiative, January 2009

BOX: The Maldives and the MDGs: A Snapshot

The Maldives has made considerable progress towards achievement of the Millennium Development Goals. The country has already achieved five out of the eight MDGs, five years ahead of schedule. It is South Asia's only 'MDG-plus' country (i.e. the country has expanded towards more challenging development targets). By 2007, it had achieved universal primary education and eliminated gender disparities in primary education (although net primary enrolment ratios declined from 99 percent in 2007 to 92 percent in 2009 which warrants careful attention). Extreme poverty in the Maldives has been eradicated (defined as the number of people who survive on less than US\$1 per day).

Since 1990, infant mortality rates have fallen significantly and the country has maintained almost universal coverage for all vaccines for preventable childhood diseases for over two decades. Government expenditures on health and education have increased significantly over the last two decades. Education expenditures increased from US\$42million in 2000 to almost US\$170 million by 2009. Health expenditures increased from US\$24 million in 2000 to almost US\$70 million by 2009.

Nevertheless, considerable challenges remain. Despite the Maldives' status as an 'MDG-plus' country, aggregate figures hide the extent to which there are increasing disparities between rich and poor, and between the capital island, Male', and the atolls. Poverty rates are heavily concentrated in the atolls, which contain more than 60 percent of the country's poor. Inequalities between the atolls are also on the increase.

While access to education has increased, an urgent need now exists to improve the *quality* of both primary and secondary education. Net enrolment ratios in secondary and tertiary education need to be improved. Attention needs to be paid to persistent child malnutrition rates, especially in the atolls. The government's latest data puts the prevalence of underweight children under five at 17.3 percent. Delivering essential social services to remote islands remains a challenge and the costs extremely high.

The labour market in the Maldives is heavily concentrated in and around the capital, Male', and unemployment and underemployment represent serious challenges, especially in the context of current demographic changes; the Maldives' population is very young with 62 percent of the population under 25 years of age. In 2006, the latest year for which data is available, the national unemployment rate was estimated at 14.4 percent, although the figure is much higher for women and in the atolls. In the atolls, almost 50 percent of young women and 25 percent of young men are unemployed. Drug abuse and gang violence have increased in and around the capital and now represent a serious social problem. The lack of affordable homes also means that overcrowding is an important issue.

The Maldivian authorities have indicated that progress must be accelerated towards the three MDGs which have not yet been achieved, namely: MDG3 on the promotion of gender equality and the empowerment of women; MDG7 on ensuring environmental sustainability, and; MDG8 on developing a global partnership for development.

In comparison to its impressive performance in many other areas, the Maldives continues to face a number of challenges with regard to gender inequalities, and important gaps between women and men persist in several key development areas. On current trajectories, progress is insufficient to meet MDG3 by 2015. Women in the Maldives continue to be disadvantaged by a lack of socioeconomic opportunities arising from unemployment, shifting roles within the family and violence against women. Significantly, increased Islamic conservatism within the country and varied interpretations of shariah law could have a bearing on women and girls' access to education, health, justice and other services. Women are also under-represented in local and national government.

Not surprisingly, environmental sustainability (MDG7) represents one of the most fundamental challenges to the Maldives. The Maldives is one of the most vulnerable countries on the planet to extreme weather events and climate change. More than 80 percent of its land lies less than 1.5 metres above the sea level. The Maldives must urgently take numerous initiatives on a number of environmental fronts to achieve MDG7, for instance to allocate a larger share of public expenditures to conservation. Over the last five years, the government has allocated less than one percent of the public sector budget to environmental protection. Although the government has solicited international support for investments in renewable energies, the extent to which this request will be met remains open to question.

An additional problem for the country is that sustained progress in environmental sustainability depends not simply on the positive actions of the Maldivian authorities but more critically on broader global commitments to tackle climate change, as well as the volume and availability of external finance for climate adaptation and environmental protection. As such, exogenous factors could limit the country's progress in this area regardless of the government's commitments to environmental sustainability. The threat represented by climate change to the country cannot be emphasised strongly enough; an inability to mitigate or adapt to climate change could propel the country into a negative development cycle which would be extremely difficult to break.

Source: Most data in this box from Government of Maldives, Department of National Planning, Ministry of Finance and Treasury, Millennium Development Goals, Maldives Country Report 2010

2. Debt Accumulation in the Maldives: An Overview

The Maldives has experienced rapid public and private debt accumulation over the last six years. As a percent of GDP, public debt levels have almost doubled from 55 percent in 2004 to an estimated 97 percent in 2010.⁵ Public debt service as a percent of government revenues are projected to more than double between 2006 and 2010 from under 15 percent to over 30 percent.⁶ The IMF recently classified the country as 'at high risk' of debt distress.⁷ From a human development perspective, the extent to which increased debt service obligations may put at risk key social and infrastructure expenditures give serious cause for concern.

The country's rapid increase in public debt over the last few years has both short-term and long-term causes. Short-term contributory factors include:

- a) The Indian Ocean tsunami of December 2004;
- b) The democratization process which took place between 2004 and 2008;
- c) The recent food-fuel-financial crises which ran concurrently between 2007 and 2010;
- d) Imminent graduation from Least Developed Country (LDC) status.

Long-term causes include:

- a) Structural characteristics which are particular to many small island developing states (such as geographical isolation, small population, limited natural resource endowment, narrow economic base, high unit cost of service provision, vulnerability to external shocks etc.);
- b) Narrow tax and revenue base.

2.1 The Maldives: Severe and Multiple Economic Shocks

Between 2004 and 2008, the Maldives was hit by a series of severe economic shocks. The first occurred with the Indian Ocean tsunami which hit the archipelago in December 2004. This unimaginable disaster, which was the worst ever recorded in the country's history, devastated the nation's social and economic infrastructure and brought the country to a virtual standstill. In the year that followed the disaster, the economy contracted by 5.5 percent of GDP.⁸ The tsunami entailed not only high capital costs to rebuild damaged infrastructure but also necessitated high current expenditures because of the need to provide income support and other financial aid to large sections of the affected population.

⁵ IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010 and IMF Maldives 2009 Article IV Consultation

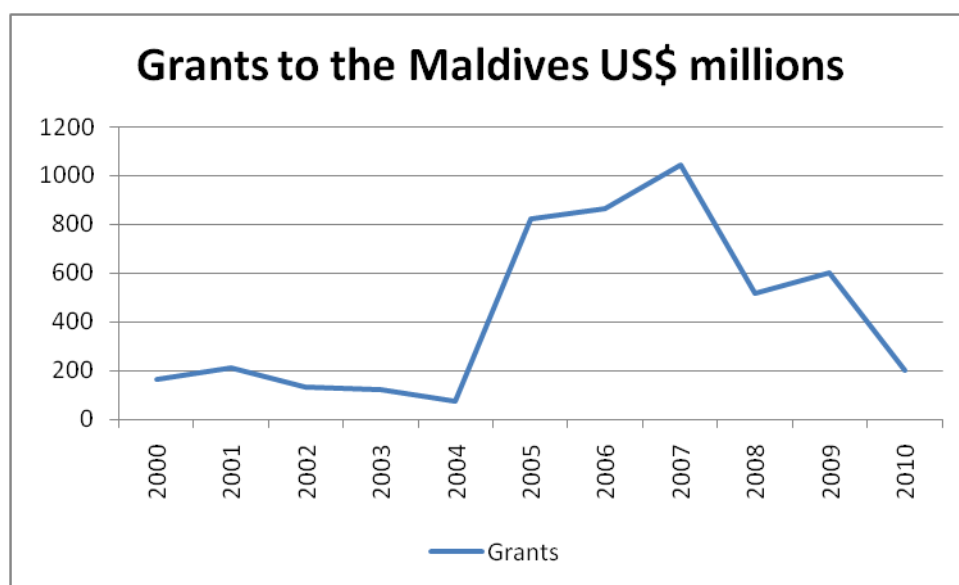
⁶ UNDP calculations based on: IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

⁷ IMF, Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis, April 1 2010

⁸ UNDP Regional Centre in Colombo, Rapid Economic/Poverty Assessment of the Maldives, Technical Report, Millennium Development Goals Initiative, January 2009

The reconstruction effort was financed largely by international donors. Prior to the disaster, Official Development Assistance (ODA) from OECD-DAC members had been on the decline, as shown by the table. Following the tsunami, ODA increased sharply from US\$72 million in 2004 to US\$824 million in 2005. ODA levels remained above US\$500 million annually for the next four years.⁹

Figure 1: Grant Aid to the Maldives 2000-2010



Source: Maldives Monetary Authority, Monthly Statistics, June 2010, Table 7: Summary of Central Government Finance 2000-2010

The tsunami reconstruction effort – although financed mostly through international donor assistance – had a number of other important effects on the economy. Firstly, the reconstruction effort was immense. This led to a construction boom and inflation. Second, the construction boom occurred at precisely the same time as a large increase in international commodity prices around the world, especially oil and natural resources. By mid-2008, energy prices were 320 percent higher than in January 2003 and the prices of metals and minerals had increased by 296 percent.¹⁰

Given the Maldives' limited natural resource endowment and high degree of import dependency, the reconstruction effort had to be financed at a time of rising international commodity prices. This further exacerbated inflation. Finally, the huge rush in international donor assistance led to a demand for local expertise to manage and implement large-scale reconstruction projects. This meant that talented civil servants were in demand by the major bilateral and multilateral agencies. As a consequence, increases in public sector salaries were implemented in order to retain qualified personnel with the government. Between 2004 and 2009, the average monthly salary of a government sector worker increased from MRF 3,223 (US\$250) to MRF 11, 136 (US\$866).¹¹

⁹ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 7: Summary of Central Government Finance 2000-2010

¹⁰ World Bank, Global Economic Prospects 2009

¹¹ Mifzal Ahmed, Presentation on the Maldivian economy

The second recent ‘shock’ to the economy emerged in the form of a political challenge to the 30 year autocratic rule of former-President Gayoom. Between 2004 and 2008, the regime came under increased pressure from a more politically aware public which demanded political change. The regime responded to this challenge with a substantial fiscal stimulus programme which saw large increases in public sector spending and investment, much of which was not related to post-tsunami reconstruction efforts. This strategy led to a large increase in the number of civil servants from around 26,000 in 2004 to around 34,000 by 2008 or 11 percent of the total population.¹² Thus the government simultaneously increased the number of public sector workers *as well as* their salaries. Between 2004 and 2008, government spending rose from 35% of GDP to over 64% of GDP.¹³ This strategy also meant that a larger and larger share of government expenditures went towards civil service salaries, i.e. *recurrent* expenditures rather than *capital* investments. Indeed by 2010, current expenditures are projected to exceed 82 percent of total expenditures while capital expenditures will amount to just 18 percent in the same year.¹⁴

The former government’s fiscal stimulus programme had to be financed, and it sought to do this through three major sources: external grants, new loans, and revenues from leasing out new tourist resorts. Between 2005 and 2008, the global financial markets were awash with liquidity and interest rates were low. In this context, the development of new tourist resorts seemed highly attractive and profitable and the government sought to lease up to 60 new resorts when capacity stood at around 80 in 2004.¹⁵

This increased the domestic money supply and led to inflationary pressures; in 2007 and 2008, average inflation rates on food and beverage items registered almost 16 and 18 percent respectively. In the capital, Male’, inflation was even more severe.¹⁶ This helped put in place a traditional vicious cycle whereby increases in inflation led to calls for increases in income. The government responded with increases in public sector salaries. In a context where more than one third of the population relies on government salaries for their income, the overall impact of this wage increase on inflation was considerable, especially in the capital. This led, in turn, to even higher government expenditures. By 2008, the fiscal deficit had climbed to 16.9 percent of GDP.¹⁷ Despite the increases in salaries, however real incomes continued to decline, given inflation.¹⁸ This intensified the political challenge to the former-regime.

These large economic imbalances were exacerbated even further when the economy was hit by its third shock, namely the global financial and economic crisis. By September 2008, when the crisis began to take hold, the Maldivian economy was already in the middle of a severe economic crisis with substantial fiscal and current account deficits, high liquidity growth, double digit inflation, pressure on the fixed exchange rate, increases in public and private sector debt, rising inequalities

¹² Ibid.

¹³ Ibid.

¹⁴ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 7: Summary of Central Government Finances, 2000-2010

¹⁵ Mifzal Ahmed, Presentation on the Maldivian economy

¹⁶ Maldives Monetary Authority, Monthly Statistics, June 2010, Tables 6a and 6b: Consumer Price Index, 2000-2010 (National and Male’)

¹⁷ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 1, Economic Indicators 2000-2010

¹⁸ The large increase in domestic money supply also placed the country’s fixed exchange rate regime under enormous pressure. Since 2001, the Maldivian Rufiyaa has been pegged to the US\$ at a rate of MRF 12.85 per 1 USD. With increased domestic currency in circulation, the demand for US\$ increased, but this was not accompanied by a real increase in supply of foreign reserves. This caused the ‘real’ exchange rate to shoot above MRF 12.85 and led to even worse inflation.

between the capital and the atolls, and a costly civil service. The crisis exacerbated these weaknesses even further as tourist arrivals declined by approximately 10.5 percent in 2009 when compared to the previous year.¹⁹

The country's first multi-party presidential elections took place in October 2008 as the international economic crisis began to take hold. The elections ushered in a new government led by opposition candidate Mohamed Nasheed whose party was elected on a democratic manifesto that set out an ambitious development plan for the country. The '*Strategic Action Plan: National Framework for Development 2009-2013 (SAP)*' set out five key pledges: to reduce the cost of living; link all islands through a comprehensive transportation network; establish a national health insurance scheme; provide affordable housing; and prevent narcotics abuse.²⁰ Citizens' expectations for the new government are high. At the same time, the severe fiscal situation inherited by the present government mean that pressures to reduce the large fiscal deficit – which reached an estimated 26.1 percent of GDP in 2009 – are considerable.²¹ The central question has thus become how to finance the government's social programme under the Strategic Action Plan in an era of exceedingly tight resources, with success necessary to demonstrate that democratic governance delivers a better standard of living.

Arguably, the country is about to experience its fourth 'shock' at one of the most critical periods in its recent history. Following several years of delay, due mainly to the devastation caused by the Indian Ocean tsunami of December 2004, the Maldives will finally graduate from Least Developed Country (LDC) status in January 2011.²² This means that the country will lose some trade benefits it has enjoyed under World Trade Organisation (WTO) and UN rules for the LDCs. This transition is happening at a time when the government faces a severe economic crisis and has pledged an ambitious social programme designed to improve the lives of ordinary citizens. The Maldives' graduation from LDC to MIC may also open up more avenues for commercial sources of finance in the future which, if used extensively, will have implications on the country's already fragile economic situation.

2.2 The Maldives: Structural Weaknesses

Long-term factors have also played an important role in the country's present economic difficulties. As a small island developing state, the country is characterised by a number of structural weaknesses or vulnerabilities. These include: geographical isolation and distance from markets, small and dispersed population (which results in a high unit cost of service provision), narrow economic base and reliance on a couple of key 'industries' or exports (tourism and fisheries), limited economies of scale, and a high degree of systemic vulnerability to external shocks, including extreme weather events and climate change. These characteristics mean that the Maldives lacks economic resilience and also help to explain, in part, the government's failure to generate sufficient revenues to meet public expenditures.

The Maldives' revenue base is extremely narrow and while public administration and social sector expenditures have increased markedly over the last decade, tax and non-tax revenues have not kept pace with expenditures. The country's fiscal

¹⁹ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 4, Tourism Statistics, 2000-2010

²⁰ Strategic Action Plan (SAP) 2009-2013

²¹ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 1, Economic Indicators 2000-2010

²² The UN General Assembly formally recognised the severe disruption caused by the December 2004 tsunami and recommended that the Maldives graduate from LDC status on 1 January 2008, with a three year transition period to end on 1 January 2011. See UNCTAD, Towards a Smooth Transition strategy in anticipation of Maldives' loss of LDC status, Advisory Note to the Government of Maldives by UNCTAD and UNESCAP, December 2009

accounts are dominated by tax revenues limited to import duties, tourism taxes (the so-called ‘bed tax’ at US\$8 per bed per night), and a bank profits tax. Customs duties are the single most important source of government tax revenues. In 2010, an estimated 28 percent of government revenues will be generated via import duties (almost US\$2 billion). Just 5 percent of government revenues will be generated through the tourism tax, down from 8 percent one year earlier.²³

Currently, the government does not impose income, corporate or value-added taxes on the population. Non-tax revenues are dominated by land lease rentals associated with tourism resorts and profit transfers from state-owned enterprises. Expansion and diversification of the government’s revenue base will therefore be essential in order to resolve the current economic crisis over the longer-term, however such measures also take time to implement fully and have important social consequences which must be carefully evaluated (as discussed in more detail in section 4 to this paper).

Figure 2: Maldives’ Central Government Finance 2010

Maldives Central Government Finance 2010 (US\$ millions)²⁴	
	2010 (proj.)
Import duties	1,897
Tourism tax (US\$8 per night bed tax)	570
Other	891
- of which new measures	622
Total tax revenues	3,358
SOE profit transfers	762
Royalties, land and resort rent	1,863
Other	894
Total non-tax revenues	3,297
Grants	201
TOTAL REVENUES AND GRANTS	7,095
TOTAL EXPENDITURE	10,907
OVERALL DEFICIT (% GDP)	-18.7

Source: Maldives Monetary Authority, Monthly Statistics, June 2010, Table 1: Economic Indicators, 2000-2010

²³ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 1: Economic Indicators, 2000-2010

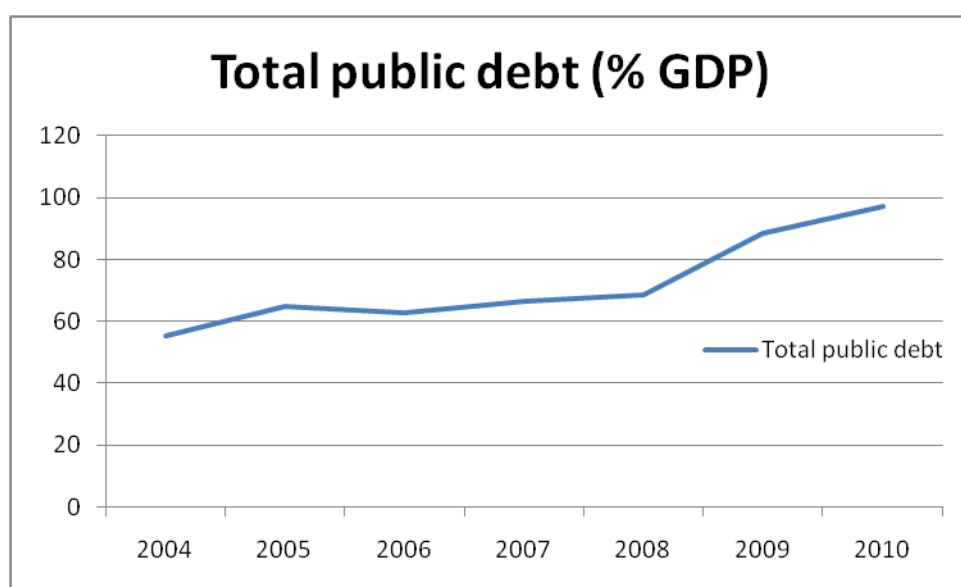
²⁴ IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

3. Debt in the Maldives

3.1 Debt in the Maldives: An Overview

Public sector debt levels in the Maldives have increased markedly over the past decade. Levels of private non-guaranteed commercial bank debt have also increased considerably. The Asian Development Bank has described debt sustainability in the Maldives as, ‘at a critical juncture’. Total public debt (domestic and external) has almost doubled over the last six years from 55 percent in 2004 to an estimated 97 percent of GDP in 2010.²⁵ As a benchmark, the IMF suggests that annual increases in public debt of more than 5-7 percent of GDP per year give cause for concern.²⁶

Figure 3: Maldives Total Public Debt 2004-2010



Source: Maldives Monetary Authority and IMF, 2009 and 2010

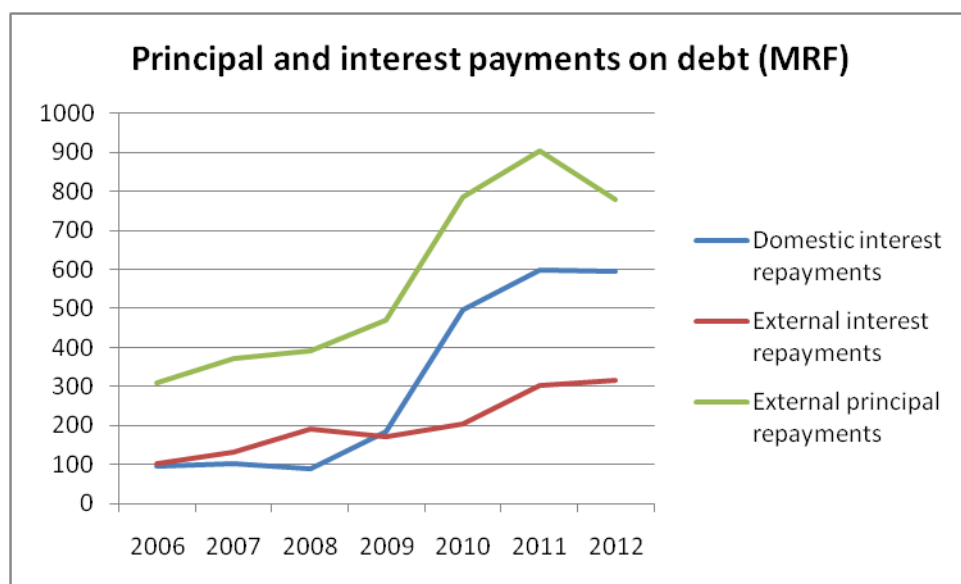
Debt service ratios have also increased albeit at a slower rate due to the concessional nature of much of the country's external debt portfolio. Repayments on external debt (principal and interest) have climbed from MRF 410 million in 2006 (US\$32 million) to MRF 989 million (US\$77 million) in 2010. Interest repayments on domestic debt rose from MRF 97 million in 2006 (US\$7.5 million) to almost MRF 500 million by 2010 (US\$39 million). These ratios are projected to rise further still in 2011 and 2012 to approximately MRF 600 million (US\$47 million) each year.²⁷

²⁵ IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010 and IMF Maldives 2009 Article IV Consultation

²⁶ IMF and World Bank, Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief, 2006

²⁷ IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010 and IMF Maldives 2009 Article IV Consultation

Figure 4: Debt Service Repayments 2006-2012



Source: IMF, Maldives, First Review Under the Stand-By Arrangement, June 2010

When measured as a proportion of government revenues, the increase in public debt service over the last few years is considerable. Public debt service as a percent of government revenues has increased sharply from 14.4 percent in 2006 to an estimated 35 percent by 2010.²⁸ This ratio is important because the burden of the debt is borne by governments' budgets, which in turn means that fewer resources are available to governments to spend in other areas including the MDGs. International benchmarks suggest that low-income countries should not spend more than 15 percent of government revenues on public debt service.²⁹

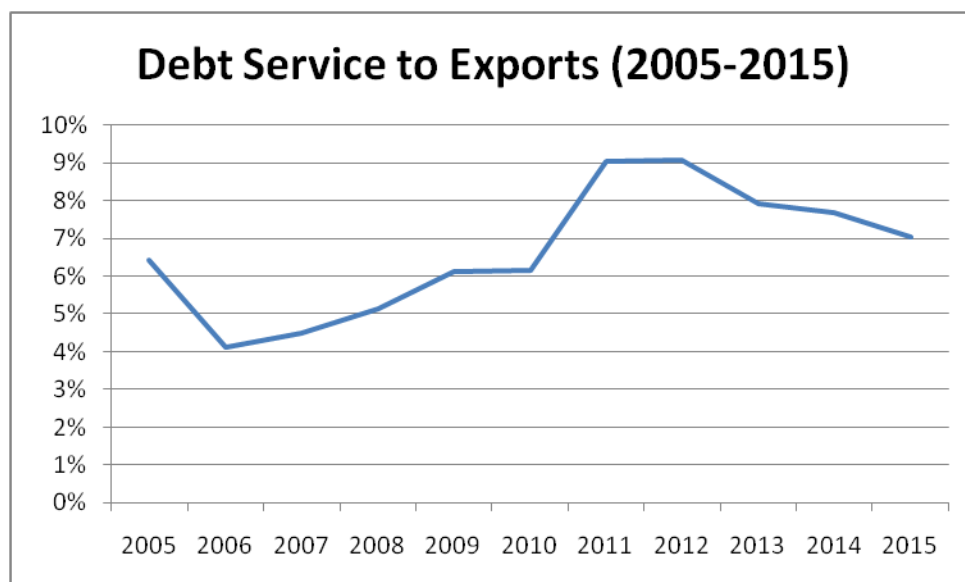
In relation to the Maldives' external position, external debt service ratios as a proportion of exports has also increased from on average 4 percent over the last decade to an estimated 6.2 percent in 2010. External debt service as a proportion of exports will increase to over 9 percent in 2011 and 2012.³⁰ This indicator is important since the higher a country's external debt service burden (typically denominated in hard currencies) the more it must earn via exports (including tourism) to meet those debt repayments.

²⁸ UNDP calculations based on: IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

²⁹ IMF and World Bank, Debt Sustainability Framework for Low-Income Countries, 2006

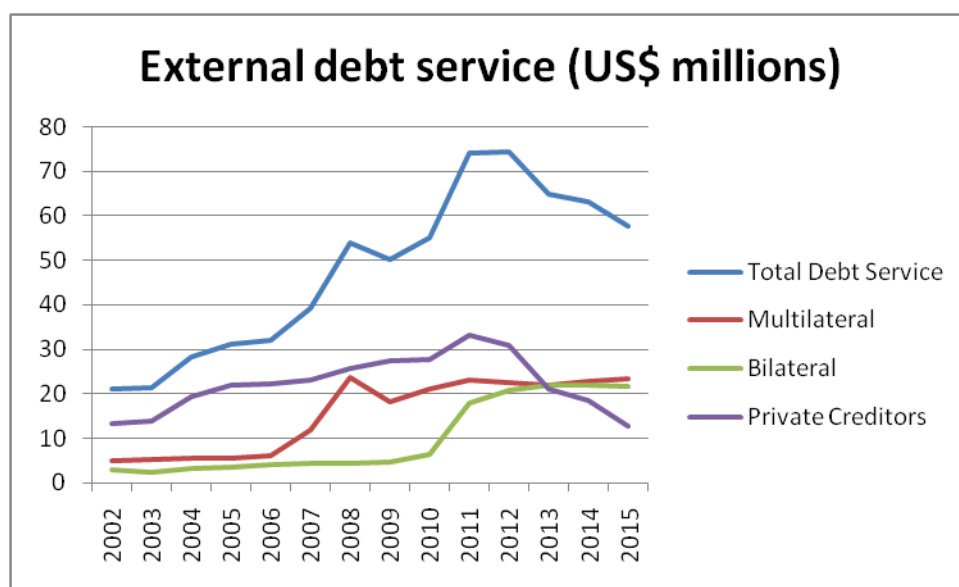
³⁰ All debt service data from: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010. These figures relate to debt service on the *current* external debt portfolio, and do not include probable new borrowings over the next few years.

Figure 5: Debt Service as a Percent of Exports 2005-2015



Source: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

Figure 6: External Debt Service 2002-2015



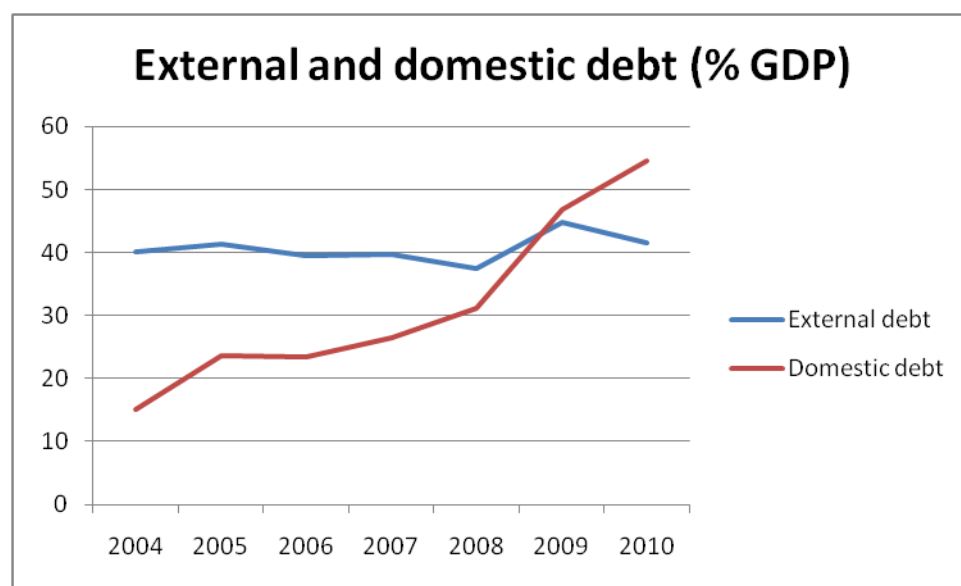
Source: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

3.2 Domestic Debt

The increase in total public sector debt can be attributed predominantly to the sharp rise in domestic debt; domestic debt as a percent of GDP has increased from just 15 percent in 2004 to an estimated 55 percent by 2010.³¹ Debt service on domestic debt has also increased significantly over the last couple of years, and is expected to increase further still. In 2009, interest payments on the domestic debt amounted to US\$14 million. This will climb to an estimated US\$38 million in 2010 and around US\$47million in 2011 and 2012.³²

In the past, the former government covered fiscal deficits through direct monetisation of the public debt. This strategy however, contributed to a vicious cycle of inflation, excess rufiyaa liquidity and considerable pressures on the exchange rate peg. It was ended by the current government which, in September 2009, converted its entire debt stock with the Maldives Monetary Authority into tradable securities, and introduced open market operations to absorb excess liquidity in rufiyaa. The new bonds carried maturities of between 1–15 years and fixed interest rates of between 6–9 percent, payable semi-annually.³³

Figure 7: External and Domestic Debt as a Percent of GDP 2004-2010



Source: IMF Article IV Consultations (multi-year)

The first Treasury Bill and bond sales began in December 2009. The domestic debt market has since expanded quickly in the country and there are plans to develop it further still. By July 2010, the face value of Maldivian Treasury Bills totaled more than MRF 3.3 billion.³⁴ Most are owned by commercial banks (MRF 2.7 billion) and only a small proportion by state-owned

³¹ IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010 and IMF Maldives 2009 Article IV Consultation

³² IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

³³ IMF, Maldives Article IV Consultation 2009

³⁴ Maldives Monetary Authority

enterprises. Maldivian Rufiyaa denominated Treasury Bills are divided into three separate instruments: coupons that mature in 28 days, 91 days and 182 days. Interest rates on Treasury Bills have averaged between 4.5 to 6.1 percent (depending on the type of instrument held) since December 2009.³⁵

US dollar denominated bonds have also been introduced. In July 2010, the Maldives Monetary Authority reported a total of US\$100 million in US dollar denominated debt on the domestic market.³⁶ This represents two separate purchases by the State Bank of India's Male' branch – in December 2009 and February 2010 – for a total of US\$100 million in dollar-denominated T-Bills. However this needs to be carefully managed since it means that the country must earn sufficient foreign currency to pay the interest on, or redeem, the bonds.

One important consequence of the government's reliance on bond finance is that major national banks (such as Bank of the Maldives which is partly public owned) have shifted a significant portion of their assets to government securities. For instance in 2009, the Bank of the Maldives held more than MRF 1.47 billion in Treasury Bills compared to MRF 289 million in 2007.³⁷ This reflects on the one hand a deterioration in conditions in the market for local lending even though private sector demand for credit remains high. Several banks in the country report that default rates have increased over the last two years, especially on loans extended to the fisheries and construction sectors and confidence in borrowers is low. On the other, it reflects market perceptions of the sovereign state as a less risky borrower. There are indications that increased government borrowing is now crowding out bank credit to the private business community in the country. This in turn has implications for the amount of credit available to the private sector which has implications on output and employment.

It is also important to note that most domestic debt is in the form of short-term securities (over 85 percent), which adds significantly to the fiscal pressures currently facing the government.³⁸

³⁵ Maldives Monetary Authority

³⁶ Maldives Monetary Authority

³⁷ Bank of the Maldives Annual Reports, 2009 and 2007

³⁸ World Bank, Debt Management Performance Assessment (DeMPA), October 2009

3.3 External Debt

External debt levels in the Maldives have remained relatively stable as a proportion of GDP since 2004 at around 40 percent. In nominal terms, external debt has risen from US\$223 million in 2002 to US\$545 million in 2010.³⁹

Most external debt is owed to the multilateral financial institutions. The major multilateral creditors include the International Development Association, IDA (US\$95 million in 2010), Asian Development Bank (US\$73 million), European Investment Bank (US\$62.6 million), and Islamic Development Bank (US\$37 million in 2010).⁴⁰ The Maldives also recently turned to the IMF for a total of US\$94.5 million in new credits due to the crisis.⁴¹ In total, the multilateral lenders account for US\$324 million (or 59 percent) of publicly guaranteed external debt.⁴²

Bilateral lenders hold US\$ 127.2 million (23 percent) of the country's public external debt burden.⁴³ The principal creditors are the so-called 'emerging' lenders, namely the government of India (US\$78.8 million in 2010), the Saudi Fund for Development (US\$23.4 million), and the Kuwait Fund for Arab Economic Development (US\$21.7 million). 'Traditional' bilateral lenders are much less present in the Maldives; combined so-called 'traditional' lenders hold just under US\$25 million in claims. Japan accounts for more than half this amount in turn.⁴⁴

In 2009, the Government of India committed US\$100 million in financial support to the Maldives. Exactly half of this amount (US\$50 million) was in balance of payments support while the other half was directed towards the private sector for the financing of imports from India. The trade credit component has been granted interest free, while the remainder of the loan intended to bolster international reserves carries an interest rate of 1.5 percent; it is thus highly concessional. The loan was initially due to mature in two years but has now been rolled over from two to ten years in recognition of the intense fiscal pressures the government currently faces.

The Maldives also owes substantial amounts to private creditors such as commercial banks and suppliers. For instance, the Bank of Ceylon Colombo held approximately US\$12.3 million in 2010 and HSBC Bank, US\$25 million. In terms of buyers credit (i.e. private sector debt which carries a sovereign guarantee), the Export-Import Bank of Thailand, ING Bank, Rabo Bank and Fortis Bank are the main creditors.⁴⁵ In total, private creditors accounted for US\$94.6 million in credits in 2010 (17 percent of public external debt).⁴⁶

³⁹ IMF Maldives Article IV Consultations (multi-year)

⁴⁰ Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

⁴¹ US\$79.3 million was agreed under a Stand-By Arrangement and US\$13.2 million under the Fund's Exogenous Shocks Facility. See: IMF Executive Board Approves US\$79.3 Million Stand-By Arrangement and US\$13.2 Million Arrangement Under the Exogenous Shocks Facility for Maldives, Press Release No. 09/444, December 4, 2009: <http://www.imf.org/external/np/sec/pr/2009/pr09444.htm>

⁴² Maldives Monetary Authority, Monthly Statistics, July 2010, Table 22: External Debt and Debt Service

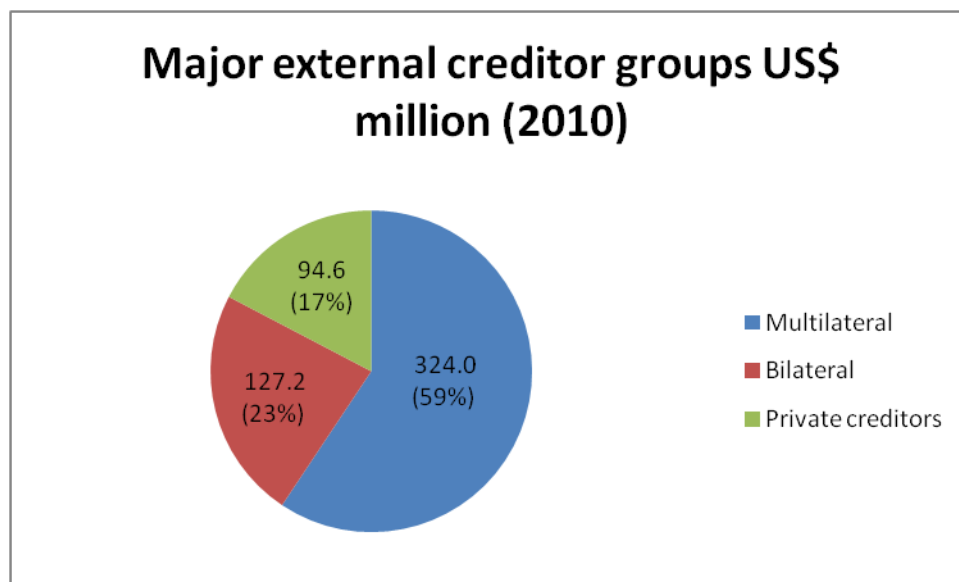
⁴³ Maldives Monetary Authority, Monthly Statistics, July 2010, Table 22: External Debt and Debt Service

⁴⁴ The other bilateral lenders are the Agence Francaise de Developpement, Government of Belgium and USAID.

⁴⁵ Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

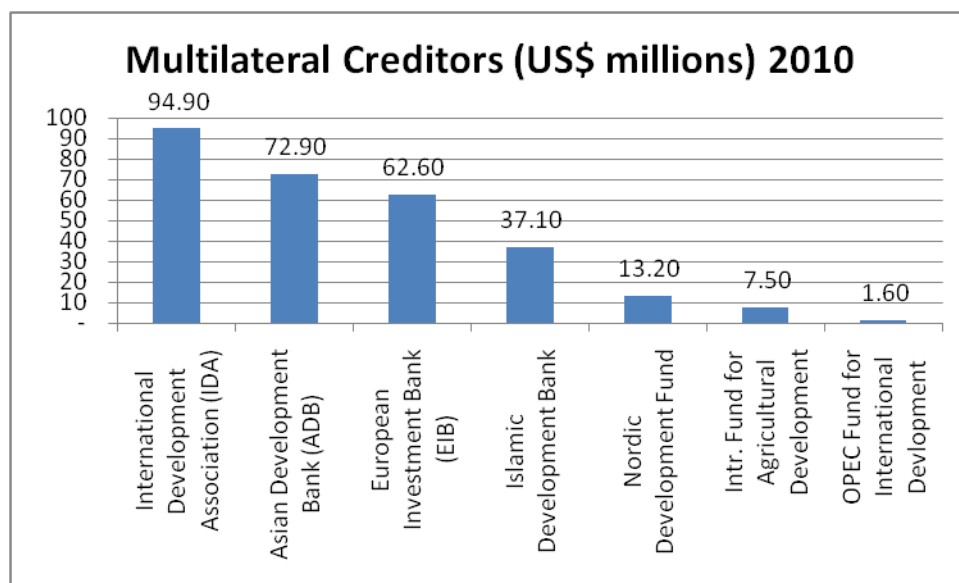
⁴⁶ Maldives Monetary Authority, Monthly Statistics, July 2010, Table 22: External Debt and Debt Service

Figure 8: The Maldives' major external creditor categories (2010)



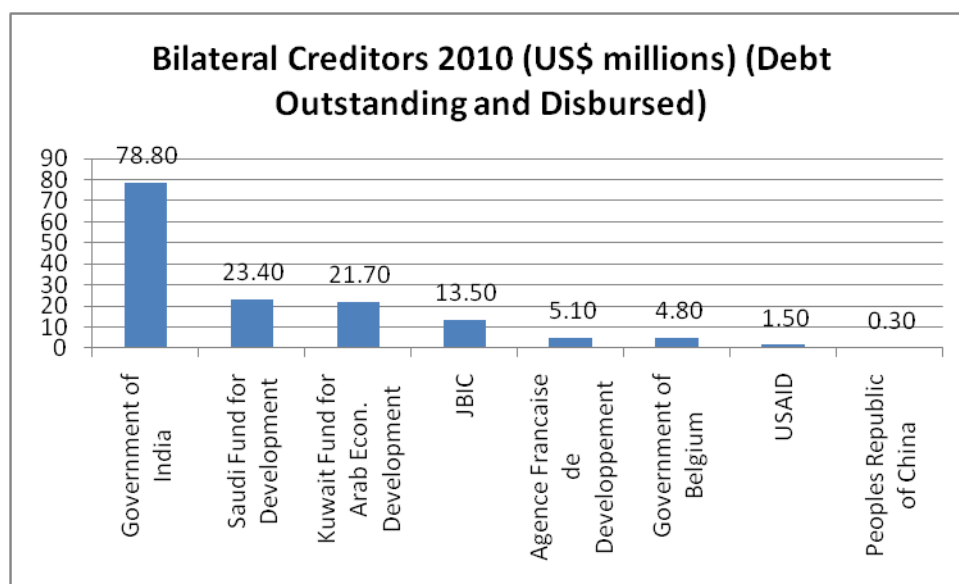
Source: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

Figure 9: Major Multilateral Lenders to the Maldives (2010)



Source: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

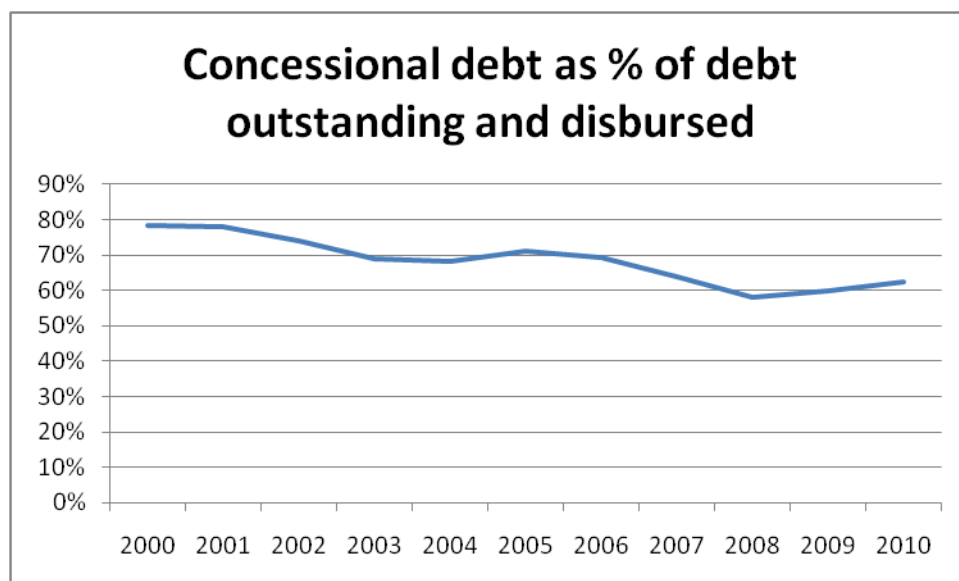
Figure 10: Major Bilateral Lenders to the Maldives (2010)



Source: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

Most official sector debt is on concessional terms due to the ‘small island exception’ extended by several multilateral institutions such as the World Bank.⁴⁷ However, overall – as in many other small island developing states – the proportion of official debt on concessional terms has declined steadily over the last decade. In 2000, over 78 percent of the government’s public external debt burden was on concessional terms. This had declined to 59 percent by 2009.⁴⁸

Figure 11: Concessional debt as a percent of total debt



Source: Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

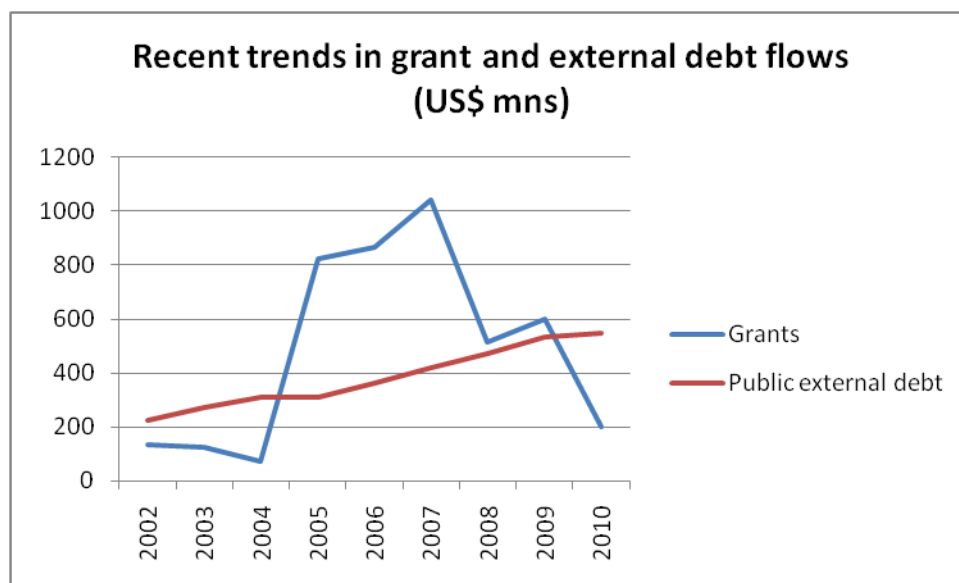
⁴⁷ The ‘small island exception’ allows several small island developing states to retain access to concessional resources despite relatively higher income per capita levels in recognition of the structural development challenges faced by these countries.

⁴⁸ Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

The decline in concessional resources is likely to continue given the country's imminent transition to middle-income status and the dissipation in tsunami-related grants, combined with current strains on OECD-DAC members' aid budgets. Indeed aid flows are projected to decline from on average US\$771 million annually between 2005 and 2009 to US\$200 million in 2010 and demonstrate a high degree of volatility over the last decade (see Figure 12).⁴⁹ Combined, these factors mean it is highly likely that private capital flows will gradually replace official capital flows as the principal source of external finance in the future. Because private external finance is typically provided on market terms – and carries shorter maturities – this will have important cost implications for the government. However given the country's extreme vulnerabilities to external shocks and climate change, the ability of market-based finance to support development and meet fiscal deficits is highly open to question.

It can be observed that the decline in concessional finance has been accompanied by an increase in the proportion of debt contracted on a short-term basis. In 2000, only 10.4 percent of external debt was short-term debt. This increased to 14.5 percent by 2005 then jumped to 49 percent by 2008.⁵⁰ In nominal terms, the Maldives' short-term debt stock has increased sharply from US\$38 million in 2006 to US\$178 million by 2010.⁵¹ Most short-term debt is owed to commercial banks. The increase in short-term debt contracted on commercial terms had added to – and will further intensify – already severe fiscal pressures.

Figure 12: Recent trends in grant and external debt flows



Source: Maldives Monetary Authority, Monthly Statistics, June 2010

⁴⁹ Maldives Monetary Authority, Monthly Statistics, June 2010, Table 7: Summary of Central Government Finances, 2000-2010

⁵⁰ World Bank Global Development Finance 2010

⁵¹ IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

3.4 SOEs and Private Sector Debt

The levels of debt owed by state-owned enterprises (SOEs) and the private sector are also important measures of the country's vulnerabilities to potential debt difficulties. SOEs' liabilities carry a sovereign guarantee and in the event of the enterprise's failure become a public liability. Although most private sector debt is non-guaranteed by the government, the external liabilities of commercial banks (and other major enterprises) can become public liabilities in the event of a domestic banking crisis, as seen in several other countries (e.g. Jamaica in the 1990s, Ecuador in 2000 and the Dominican Republic in 2004).

In relation to state-owned enterprises, there is currently a large government involvement in the economy and SOEs have traditionally played a key role in the economy. In 2010, 15 SOEs were registered in the country which operate across a wide range of sectors including banking, postal services, tourism, water and sanitation, public works, housing, fisheries and transportation. Currently, when a state-owned enterprise needs a sovereign guarantee to borrow, a request is submitted to the Ministry of Finance and Treasury, which includes documentation relating to the soundness of the SOE. Domestic and externally-financed guarantees are managed by separate government entities. Where loans are financed externally, it is the government which receives the loan funds in foreign currency and then on-lends to the enterprise in domestic currency at the same maturity. This current practice however exposes the government to exchange rate risk because the Maldivian rufiyaa while pegged to the US dollar floats against the EURO and SDR.¹

Private commercial bank debt (which is not guaranteed by the state but can become public liabilities in the event of a domestic banking crisis.) has also experienced a rapid expansion over the last decade driven by demand in the tourism, construction and fisheries sectors. In 2001, commercial bank debt as a percent of GDP amounted to just 3.4 percent; by 2010 it had increased to 30.6 percent of GDP (although it had reached as much as 38.7 percent of GDP in 2007 at the height of global boom in international private capital flows). In total, commercial banks in the Maldives owe over US\$400 million to external creditors in 2009; this includes the Bank of the Maldives which is 51 percent state-owned. Given the dearth of investment finance in the Maldives, commercial banks have generally borrowed from their head offices or from elsewhere abroad to finance lending to the domestic private sector. If public and publicly guaranteed external debt is added to private external debt liabilities, total external debt in the Maldives amounted to over 71 percent of GDP in 2009, up from 32 percent in 2001 and 50.6 percent in 2005.

Sources: Maldives Monetary Authority and Ministry of Finance and Treasury, Republic of Maldives, Government Budget in Statistics 2010

4. Current Measures to Address the Fiscal Crisis

The Maldivian authorities have devised an extensive fiscal adjustment programme to tackle the country's large fiscal deficit estimated at over 26 percent of GDP in 2009. This adjustment programme is an integral part of the government's Stand-By Arrangement (SBA) with the International Monetary Fund (IMF). The strategy focuses on a sharp reduction in government expenditures coupled with an increase in – and the development of new – domestic taxes. The IMF has described the magnitude of the planned fiscal adjustment in the Maldives as 'massive by international standards'.⁵²

The proposed fiscal contraction is estimated at approximately 17.5 percent between 2009 and 2011.⁵³ This is an enormous undertaking especially for a nascent democracy. It will involve sharp reductions in current expenditures *as well as* capital investment with implications for future resource allocations and output and employment in the short-run.

4.1 Expenditure Cuts

By far the largest component of the national effort to cut costs is the plan to dramatically downsize the civil service (which employs a third of the country's total work force). The government plans to restructure the civil service and reduce the number of civil servants from 30,000 to 21,000 by the end of 2010. These measures are expected to reduce the public service wage bill by 28 percent by the end of 2010 (or 35 percent of domestic recurrent revenues).⁵⁴ At the same time, civil servants' salaries will be reduced.

In October and November 2009, salary reductions of between 10 to 20 percent were implemented across the civil service but a severe political backlash from the parliament (Majlis) meant the government was unable to maintain these wage cuts.⁵⁵ In March 2010, the parliament passed a 2010 budget with amendments which increased the government's proposed budget by 7 percent (or 4.5 percent of GDP). Three quarters of this increase funded a reversal in civil service wage cuts implemented the previous year. Progress on redundancies has also been slower than expected and reforms in this area are unlikely to be completed until the end of 2011 at the earliest. This will have important fiscal consequences.

In parallel, the promotion of public-private partnerships is under development. This is viewed as another way in which the government can reduce its expenditures in the provision of essential services such as education and health. The new government has ambitious plans to substantially re-define the role of the state in the provision of essential services, transferring this function to corporate entities while government ministries perform a regulatory and monitoring function.⁵⁶ Education, healthcare, housing, transportation and utilities have all been flagged as areas the government wishes to open up for private sector investment. However given the country's geographical fragmentation, high unit cost of service provision and the vulnerability of infrastructure to extreme weather events and climate change, the extent to which the government

⁵² IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

⁵³ IMF, Maldives 2009 Article IV Consultation

⁵⁴ Maldives Donor Forum 2010

⁵⁵ Maldives Donor Forum 2010

⁵⁶ Corporatization through Public-Private Partnerships: The new strategic direction of the Maldivian Government, A background paper prepared by the President's Office for the Maldives Partnership Forum (MPF), Maldives, 23-24 March 2009

will be able to open more remote parts of the country to private investment remains open to question. It will also be vital for the government to ensure equitable access to quality service provision regardless of where people live in order not to exacerbate inequalities between the atolls.

The Government of the Maldives' 2010 budget also indicates reductions in expenditures in some social areas. Overall, government spending on social services will decline from 32 percent of GDP in 2008 to 24 percent in 2010. Total expenditures on education will decline from 10 percent of GDP in 2008 to 8 percent in 2010 while expenditures on health will decrease from 8 percent to 4 percent over the same period. Government spending on economic services, which include fisheries and agriculture, transport, industry, communications and electricity will decline from 8 percent of GDP in 2008 to 5 percent in 2010. Environmental protection will be allocated just 0.6 percent of GDP in 2010 compared to 1 percent in 2007. Given that MDG7 is already off-track in the Maldives, such a small budgetary allocation gives serious cause for concern. Importantly, capital investments in key social sectors will experience a decline between 2008 and 2010. Capital investment in education will decline from 1 percent to 0.3 percent over this period and capital investments in health from 1.8 percent to 0.2 percent.⁵⁷ Although the Maldives' is an MDG-plus country and has made impressive progress across most of the MDGs, important challenges still remain in relation to the provision of essential services across more remote areas of the country and there is a need to improve the *quality* of education and health services. In this context, reductions in government spending in these areas – including capital investment – give cause for concern.

4.2 Domestic Resource Mobilisation

The difficulties experienced so far with attempts to downsize the civil service have led to increased efforts in the area of domestic resource mobilisation. This has focused on the development of new taxes, reform of land lease arrangements and the privatisation of some state-owned enterprises.

In November 2009, a 29 percent increase in the airport tax was approved by the Majlis. The government has also tabled amendments to the US\$8 per night tourist bed tax. From January 2011, this will become a new ad valorem tourism tax of 6 percent and is projected to increase government revenues by approximately 8 percent of GDP in 2011.⁵⁸ A business profits tax (BPT) on all enterprises earning above a certain income threshold has also been proposed. This is projected to generate an extra 2.9 percent of GDP.⁵⁹ The implementation of a goods and services tax (GST) has also been tabled. The government estimates that combined these revenue measures will yield an increase in revenue of about 15 percent of GDP once their full impact is felt.⁶⁰

The implementation of taxation reform has however experienced severe delays. Passage of the BPT was initially scheduled for December 2009 but by November 2010, the bill still had not passed. Moreover estimates of the amounts of revenues which could be generated via this channel have been revised (downwards) due to the controversial exemption of foreign

⁵⁷ All data from Ministry of Finance and Treasury, Republic of Maldives, Government Budget in Statistics 2010

⁵⁸ The government's draft bill to parliament for reform of tourism taxes proposed a phased approach with an ad valorem tax on tourism of 4 percent to co-exist with the existing tourist bed tax of US\$8 per night until end-2010. The new 6 percent ad valorem tourism tax would replace this in January 2011. IMF, Maldives Article IV Consultation 2009

⁵⁹ Ibid.

⁶⁰ Maldives Donor Forum 2010

owned companies from the tax. Indeed, most new taxation measures are unlikely to be approved and implemented until at least 2011. In November 2010, the third payment under the Maldives' IMF programme was suspended due to the government's inability to make progress on the proposed expenditure cuts.

The privatisation of several key state-owned enterprises, such as Male' international airport and a stake in the nationally owned water company were also tabled as a means to generate extraordinary revenues. However this too has not progressed as anticipated, and also represent one-off revenue streams. The airport's sale was expected to generate approximately US\$233 million in extraordinary revenues but proved highly controversial. In the end, the government decided to lease the airport to GMR Malaysian Airports consortium rather than sell it outright; an approach which also attracted criticism.⁶¹ Privatisation of a stake in the water company – which took place in January 2010 – yielded only US\$16 million compared to a projected US\$30 million, in part due to unfavourable external economic conditions.⁶²

4.3 Poverty and Social Impact Considerations

A fiscal adjustment of the magnitude and speed envisioned by the Maldivian authorities will have important social consequences. For instance, the ability of the private sector to absorb around 9,000 redundant civil service workers – with redundancies initially planned for end-2010 – is extremely unlikely especially in a small country and one with already high unemployment levels. Additionally, public sector retrenchment programmes are typically extremely costly upfront, with the costs of mitigation measures per worker estimated at around US\$40,000. The government estimates that compensation measures combined (which include provisions for re-training for example) will amount to US\$42 million in 2010 while the savings on the wage bill will amount to just US\$13 million over the same period.⁶³ Thus significant savings will emerge over the longer term only. While the Maldivian authorities have sought donor funds to support these costs, at the time of writing this had not been forthcoming. In the case of the Maldives, there are strong arguments that the civil service reform programme be implemented in a gradual and phased manner over a longer period of time.

There are also a number of open questions as regards the ability of the government to radically broaden and strengthen its tax base. In a country with no real experience of direct taxation, it will take time to introduce both income and corporate taxes. The internal revenue collection service will need to be developed from scratch, agency personnel trained and business accounting standards developed and implemented. If efforts centre instead around the introduction of some form of value added tax (goods and services tax – GST) this will impact the poorer sections of society more severely since they spend a greater proportion of their incomes on food, energy and other essential items. At the same time, the Maldives has a small population and much economic activity is conducted informally, especially in the atolls. The country is also geographically highly fragmented which further complicates – and makes more expensive – effective revenue collection. These realities mean there are limitations as to the amount of additional resources which can be generated through new taxation measures. This is not to say that serious efforts to enhance revenue generation via tax reform should not be undertaken; merely that these will take time and should be implemented in a phased manner with an eye on the impact of new taxes on the poorest.

⁶¹ Minivan News, Government signs Male International Airport to GMR-Malaysia Airports consortium, June 29 2010:

<http://minivannews.com/politics/government-signs-male-international-airport-to-gmr-malaysia-airports-consortium-8720>

⁶² IMF, Maldives, First Review Under the Stand-By Arrangement and the 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

⁶³ Maldives Donor Forum 2010

5. Policy Avenues to Explore

These considerations raise important questions as to other policy measures which could be explored – at both the country level and internationally – to support the Maldives to address its current fiscal crisis and growing debt burden. In particular, new policy measures must help the government to protect and strengthen social expenditures as we approach the MDG target year of 2015. Some policy measures are ‘quick fixes’; others are longer-term solutions to address issues of poor revenue collection, weak debt management capacities and access to appropriate forms of external finance.

5.1 Policy Measures to Explore at the National Level

1. Improve revenue generation and curtail trade mispricing

As with many small island economies, the single most important source of tax revenues is import duties (at almost US\$1.9 billion in 2010). The Maldives is an import dependent country; it imports approximately 90 percent of domestic consumption. As such, efforts to curtail practices such as trade mispricing (whereby imported and exported goods are assigned different

values to their market price in order to avoid import and export duties or to earn subsidies) could yield substantial results.¹ Trade mispricing is a form of tax evasion and results in the direct loss of tax revenues to governments. This area has thus far received too little attention from policymakers and one suggestion would be for the authorities to undertake further work as to the magnitude of the problem in the country and possible remedies.

Indicative research in the area of trade mispricing has revealed that over the nine year period from 2000-2008, there was a cumulative outflow of resources from the Maldives to the magnitude of US\$4.7 billion, mainly through export under-invoicing. This issue was most problematic between 2000 and 2004 under the former-regime which saw annual average outflows of over US\$900 million due to trade mispricing. By 2008, this figure had declined significantly to around US\$8 million in lost revenues through trade mispricing activities, however it should be noted that this figure undoubtedly underestimates the real magnitude of the problem since the methodology cannot capture possible mispricing in the services trade (such as tourism for instance which plays a major role in the economy).¹

Given the Maldives’ high degree of dependence on customs duties and the importance of the services sector to the economy, efforts should be undertaken to gain a better understanding of where trade and services mispricing may be occurring. The government’s recent efforts to introduce a customs bill to the parliament to address mispricing and trade valuation are an important step forwards. In November 2010, the bill was pending parliamentary approval. This should be combined with efforts to increase the capacities of customs officials and the development of legislation to curtail trade mispricing activities and sanction those who engage in the practice.

Maldives Illicit Financial Flows, 2000-2008 (US\$ millions)	
Year	Total GER Outflows
	Export Under + Import Over
2000	835.09
2001	919.39
2002	1,072.48
2003	886.63
2004	935.08
2005	35.87
2006	6.46
2007	7.87
2008	7.98
Totals	4,706.87
Outflow Totals	4,706.87

2. Improve institutional debt management capacities

The Maldives has not currently developed a coherent medium term debt sustainability strategy, but urgently needs to. The World Bank's 2009 'Debt Management Performance Assessment' (DeMPA) assigned the Maldives a low score on multiple dimensions of public debt management, which included: failure to develop a debt management strategy, existence of multiple debt management entities and lack of coordination between them, lack of focus on total central government debt, high staff turnover and multiple vacant positions.⁶⁴

There is no single unit that oversees both the domestic and external debt portfolios. And while domestic debt has increased markedly over the last few years, there is no stated strategy for developing the domestic debt market. Issuance of Treasury Bills has taken place on a needs basis once income and expenditure are reconciled at the end of the month, and no borrowing plan is prepared for the forthcoming month.⁶⁵

It is vital for the government to develop a coherent medium-term debt sustainability strategy especially given the recent rise in domestic debt and the issuance of US dollar denominated bonds on the domestic debt market. The on-going process of decentralisation within the country will also – over the long-term – give local authorities the powers to borrow domestically and although this process will take some time, this will add to the contingent liabilities on the central government and needs to be carefully managed and monitored.

In relation to *external* debt, while the IMF has clear guidelines as to what constitutes a concessional loan, these guidelines are not followed by the Maldives and the government has not established any target in relation to the minimum grant element to be achieved in new official sector borrowing.⁶⁶ The country's imminent transition to middle-income country status may open new avenues for commercial borrowing and thus it will be vital for the government to develop a clear and transparent strategy with respect to the volume of concessional and non-concessional resources the country is able to bear in order to safeguard medium-term debt sustainability

The government reports that it has plans to develop a fiscal responsibility law. Over the last few years, fiscal responsibility legislation has become increasingly popular and more and more countries – developed and developing alike – have introduced some form of legislation in this area. Some of these laws focus on a concrete set of numerical fiscal policy rules, i.e. a maximum budget deficit, debt or expenditure growth rule, others are more focused on improving fiscal transparency and accountability. While the jury remains divided as to the effectiveness of such measures, in the specific case of the Maldives, such legislation could create a more convincing environment for donors to upscale aid, as well as support the government to develop more credible budgetary and expenditure processes, develop a coherent medium-term debt strategy, strengthen audit processes and improve public accountability. Such measures therefore warrant further consideration.

⁶⁴ World Bank, Debt Management Performance Assessment (DeMPA), October 2009

⁶⁵ Ibid.

⁶⁶ Ibid.

3. Expansion of financial services to the wider economy

Although the Maldives has one of the highest per capita incomes in the South Asia region (at over US\$4000 in 2008 in current prices), it has one of the lowest domestic savings rates. Measures are needed to support citizens to save and invest locally. These savings in turn need to be channeled into productive investments which generate economic growth, poverty reduction and additional tax revenues, as well as reduce the government's over-reliance on debt.

One of the most effective ways to achieve this is through improved access to financial services for both potential savers and potential borrowers. Greater focus on financial products and instruments that respond to the needs of poorer and more isolated households (especially in the atolls), are easily accessible, affordable and do not require prohibitive levels of collateral are needed.

A specialised development bank in the country is desirable and the government should provide seed capital for such an institution, possibly in partnership with the private sector. The Maldives' has only commercial banks at present whose lending activities have concentrated around tourism and the construction sectors which are perceived as more creditworthy and able to borrow at commercial interest rates. Commercial banks in the Maldives demand among the highest levels of collateral in the world, with property taken as security up to 150 to 200 percent of the loan.⁶⁷ This has led to the exclusion of financial services such as bank credit to small and medium sized enterprises (SME).

A development bank facility should aim to eliminate the exclusion of the majority from financial services, especially in the outer regions/atolls and enable people to engage in productive and gainful economic activities. This calls for the development of a new infrastructure specifically designed to support the development of – and provide finance to – the SME sector.⁶⁸ Microfinance and microcredit have already proven effective in the generation of productive employment, particularly in more isolated areas and for women. Making better use of new technologies such as telephone and internet banking would also contribute to increased access to the formal financial sector. This would help to encourage households to shift to the formal system and make these assets available for productive investment.

5.2 Policy Measures to Explore at the International Level

Measures taken by the national authorities must be combined with a supportive international policy environment. This includes explicit recognition of the country's particular structural vulnerabilities, the provision of appropriate finance and other support measures as appropriate.

1. Continued access to concessional finance required

The Maldives will graduate from Least Developed Country status on January 2011. The country was granted an exception three year moratorium on graduation in 2005 by the UN General Assembly to enable the country to cope with post-tsunami

⁶⁷ UNDP, SME Bank, An Analysis of Credit Infrastructure, Financial Issues and Strategy, Volume 1, 2009

⁶⁸ For an expanded analysis on proposed institutional set-up, see: UNDP, SME Bank, An Analysis of Credit Infrastructure, Financial Issues and Strategy, Volume I and II, 2009

reconstruction. In 2008, the country entered its three year ‘transition’ phase which was intended to support the country negotiate a ‘smooth transition’ with its development partners.⁶⁹

Graduation will entail the loss of certain trade related concessions and may expand the country’s access to commercial sources of credit. However, the case for continued concessional financial support for the Maldives is compelling. Maldives is recognised by the UN as one of the most vulnerable countries in the world as measured by the UN’s Economic Vulnerability (EVI) Index. This is due to a high degree of instability in exports of goods and services coupled with the country’s large exposure to extreme weather events and climate change.

The Maldives is extremely illustrative of the so-called ‘island-paradox’; while countries may appear relatively prosperous on the surface, their unique vulnerabilities are a constant challenge to their economic sustainability. These vulnerabilities result from factors beyond a government’s control and are therefore not dependent on governments’ domestic policy choices.

Given the Maldives’ exceptional structural vulnerabilities, the suitability of market-based finance to meet fiscal deficits and fund economic development is highly open to question, and yet the proportion of debt owed on concessional terms as a proportion of total external debt is on the decline. It will be vital for the international donor community to provide continued financial support on a concessional basis. In addition, the international community should explore extending innovative financial instruments to the country in recognition of its explicit structural vulnerabilities.

These include for example instruments such ‘counter-cyclical’ loans which reduce the amount of debt service payable on a loan when a severe economic shock occurs. One option is to reduce the grace period on a typical concessional loan and to keep the remaining grace period as an asset on which the country can draw in the event of a severe exogenous shock. If no such shock occurs, this ‘floating grace’ period is redeemed to the country at the end of the repayment period as a prepayment in advance.⁷⁰ Other variations could also be explored. So far, such innovative instruments have been piloted in a very small number of Heavily Indebted Poor Countries, however the case for extending such financial instruments to the Maldives – and other small island developing states – in recognition of their economic vulnerabilities is compelling.

2. Debt swaps for climate change adaptation

The Maldives’ is one of the most vulnerable countries in the world to climate change and will need exceptional external support to help build resilience against it. The scale of the capital investments required to build this resilience is likely to be beyond the capacities of a small country such as the Maldives.

Over the next five years (the MDG window), the Maldives will see debt service to external creditors increase as the grace period on many official sector loans come to an end. Between 2011 and 2015 the Maldives is projected to make approximately US\$218.1 million in external debt repayments to official creditors.

⁶⁹ See UNCTAD, Towards a smooth transition strategy in anticipation of Maldives’ loss of least developed Country (LDC) status, December 2009

⁷⁰ For further elaboration on these proposals, see: Cohen Daniel, Lending to the Poorest Countries: A New Counter-Cyclical Debt Instrument, 2008 OECD

One way for external creditors to support the Maldives to simultaneously boost resources for climate change adaptation and relieve the fiscal burden of official sector debt is to support the creation of some form of 'mega debt conversion' for climate change adaptation. Under such a scheme, official sector debt repayments would be channeled into a single centralised trust account to be 'recycled' into initiatives that support climate adaptation measures. Such an initiative could generate an additional US\$220 million in additional resources between 2011 and 2015 (i.e. an 'extra' one year's aid at 2010 levels) if most official sector creditors participate simultaneously. If the initiative were extended by another five years, this would channel over US\$400 million in resources into a trust account in support of climate change adaptation.⁷¹ Debt swaps for climate change adaptation should of course be additional to donors' commitments to increase aid.

The World Bank, Asian Development Bank, European Investment Bank and Islamic Development Bank would be the multilateral creditors most impacted by such an initiative as the principal multilateral lenders to the nation. Meanwhile India, Saudi Arabia, Kuwait, Japan, Belgium, France and the United States are the major bilateral creditors.

While these sums do not substitute for continued efforts by donors to increase the quantity and quality of grant resources into the country, such an initiative would signal a clear recognition by the international community of the Maldives' extreme vulnerabilities to climate change while helping to support the country's adaptation efforts. Precise implementation mechanisms require further elaboration and discussion however there are many successful debt for nature and debt for health swaps which could be drawn on for best practice and lessons learned. This proposal is more ambitious in nature since it would involve the participation of several bilateral and multilateral creditors simultaneously.

3. Debt relief cannot be entirely ruled out

The need for more comprehensive debt relief for the Maldives cannot be entirely ruled out, especially in view of the country's extreme structural vulnerabilities. However, international schemes such as the HIPC Initiative and MDRI have now been closed to further entrants in the future regardless of indebtedness levels. A sovereign insolvency regime at the international level could facilitate the fair, orderly and efficient resolution of any eventual sovereign debt difficulties in the country. However in the absence of such a mechanism, the international community must not close down possibilities for other countries to gain access to comprehensive bilateral and multilateral debt relief should it be required. The eligibility criteria for future bilateral and multilateral debt relief initiatives requires further work but should operate on the basis of fair burden-sharing between creditors, as with previous initiatives. It should also incorporate considerations as regards countries' vulnerabilities to external shocks and capacities to cope.

⁷¹ Data on projected external debt repayments from Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

6. Conclusion

Public debt levels in the Maldives have increased markedly over the last decade and especially the last five years fuelled in part by the large increase in public expenditures post-tsunami. Total public debt levels are approaching 100 percent of GDP, mostly due to the marked increase in domestic debt.

The Maldives is a classic example of the ‘small island’ paradox; while it appears relatively prosperous, it is extremely vulnerable to external shocks such as natural disasters and fluctuations in international market conditions. As the lowest-lying country in the world, the predicted impacts of climate change will further exacerbate these vulnerabilities. These vulnerabilities constantly threaten the economic – and political – sustainability of the country.


Public debt levels are currently on an unsustainable trajectory. The government cannot even meet current expenditures with projected revenues plus external grants. Government borrowing to meet recurrent expenditures will propel the country into a debt trap since it will need to borrow even more in the future to meet day-to-day expenditures plus meet debt service repayments. It also leaves precious little for capital investment, essential to support economic growth and employment generation.

The political climate for public expenditure cuts remains extremely difficult. Moreover, a rush to implement large-scale redundancies in the civil service may have severe social consequences and must therefore be carefully managed and phased-in over an extended period. While important steps can be taken by the government to phase-in new taxes (such as corporate profit taxes, income taxes and goods and services taxes) as well as reform old ones (such as the tourist bed tax), care must be taken to ensure that tax reforms are equitable and do not unfairly impact the poorest people. Such a large-scale fiscal adjustment programme may also dampen output and employment in the short-run yet economic growth is one of the most important ways through which the public debt burden can be reduced over the medium-term.

The 2010 budget indicates that resource allocations to some social sectors will decline as a proportion of GDP when compared to 2008. Cuts in public investment must not put at risk social expenditures essential for maintaining and increasing progress towards the remaining MDGs and other human development goals.

Other policy avenues must be explored which include greater attention to institutional debt management capacities, efforts to understand and curtail the mispricing of goods and services, and increased access to financial services for the wider population with incentives to retain savings at home. In parallel, the international community must continue to provide concessional resources to the country in recognition of the numerous structural weaknesses, as well as support targeted debt conversions for climate change adaptation and debt relief for the country should it be required.

As with any country – developed and developing alike – the possibility of a future sovereign debt crisis can never entirely be ruled out. Sovereign debt defaults can be costly in human development terms since governments frequently delay entering into negotiations with creditors through fear of exclusion from international capital markets and reputational costs. This implies that prior to sovereign default, governments are already at crisis point.



Because sovereign debt crises occur so frequently, it is imperative that some form of sovereign insolvency procedure is developed at the international level to deal with them. Currently, no such mechanism exists and debt restructurings take place on a strictly ad-hoc basis. This imposes heavy transaction costs on sovereign debtors already under severe strain as they attempt to negotiate with individual creditors or creditor groups. It also leads to unpredictable outcomes and unfairness between creditors (some of which ‘take the hit’ and others which don’t).

A sovereign insolvency mechanism at the international level would institute a formal process for sovereign debt restructuring and would thus enhance predictability and efficiency. Under well-developed proposals for a sovereign debt work-out procedure, an independent expert panel – jointly appointed by debtor and creditors – would decide on appropriate measures to be taken with respect to the country’s debts on the basis of an independent, objective assessment of the measures needed to restore economic recovery and growth.⁷² Such a procedure would also help protect citizens and important development gains.

⁷² Raffer Kunibert, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, World Development 18(2), 1990 and IMF Sovereign Debt Restructuring Mechanism (SDRM), 2003

7. References

Bank of the Maldives, Annual Report 2009 and 2007

Cohen Daniel, Lending to the Poorest Countries: A New Counter-Cyclical Debt Instrument, 2008 OECD

Corporatization through Public-Private Partnerships: The new strategic direction of the Maldivian Government, A background paper prepared by the President's Office for the Maldives Partnership Forum (MPF), Maldives, 23-24 March 2009

IMF, Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis, April 1 2010

IMF and World Bank, Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief, 2006

IMF Executive Board Approves US\$79.3 Million Stand-By Arrangement and US\$13.2 Million Arrangement Under the Exogenous Shocks Facility for Maldives, Press Release No. 09/444, December 4, 2009: <http://www.imf.org/external/np/sec/pr/2009/pr09444.htm>

IMF, Maldives 2009 Article IV Consultation

IMF, Maldives, First Review Under Stand-By Arrangement and 24 Month Arrangement Under the Exogenous Shocks Facility, June 2010

IMF Sovereign Debt Restructuring Mechanism (SDRM), 2003

Global Financial Integrity: www.gfip.org

Government of Maldives, Department of National Planning, Ministry of Finance and Treasury, Millennium Development Goals, Maldives Country Report 2010

Maldives Donor Forum 2010

Maldives Ministry of Finance and Treasury, External Resources Management Division, July 2010

Maldives Monetary Authority, Monthly Statistics, June 2010

Maldives: Social Sector Overview, 2009

Ministry of Finance and Treasury, Republic of Maldives, Government Budget in Statistics 2010

Minivan News, Government signs Male International Airport to GMR-Malaysia Airports consortium, June 29 2010: <http://minivannews.com/politics/government-signs-male-international-airport-to-gmr-malaysia-airports-consortium-8720>

Minivan News, Comment: The Maldivian Economic Situation, March 30, 2010: <http://minivannews.com/politics/comment-the-maldivian-economic-situation-5297>

Raffer Kunibert, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, World Development 18(2), 1990

Strategic Action Plan (SAP) 2009-2013

UNCTAD, Towards a Smooth Transition strategy in anticipation of Maldives' loss of LDC status, Advisory Note to the Government of Maldives by UNCTAD and UNESCAP, December 2009

UNDP, Assessment of Socio-Economic Impact of Food, Fuel and Financial Crises on Maldives, 31 July 2009

UNDP, Jamaica's Debt Exchange Programme: A Case Study for Heavily Indebted Middle-Income Countries, May 2010

UNDP Regional Centre in Colombo, Rapid Economic/Poverty Assessment of the Maldives, Technical Report, Millennium Development Goals Initiative, January 2009

UNDP, Achieving Debt Sustainability and the MDGs in Small Island Developing States, October 2010

UNDP, SME Bank, An Analysis of Credit Infrastructure, Financial Issues and Strategy, Volume 1 and 2, 2009


World Bank, Debt Management Performance Assessment (DeMPA), October 2009

World Bank, Global Economic Prospects 2009

World Bank Global Development Finance 2010

Interviews:

- UNDP Maldives
- Ministry of Finance and Treasury (National Budget Section, External Resources Mobilisation Division, Department of National Planning)
- Ministry of Economic Development
- Maldives Monetary Authority (MMA)
- Bank of the Maldives
- State Bank of India
- Maldives Association of Tourism Operators
- Junior Commerce International
- Maldives National Chamber of Commerce International
- Maldives Institute for Economic Research
- Maldives Finance Leasing Company



Copyright © December 2010
United Nations Development Programme
Bureau for Development Policy
Poverty Group
304 East 45th Street
New York, NY 11375
USA
Email: poverty.reduction@undp.org
Website: www.undp.org/poverty