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## **Maldives Donor Conference**

*Maldives*

*March 28-29, 2010*

*World Bank Background Note*

### **Creating Opportunities for Sustained Economic Growth and Poverty Reduction**



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#### **Introduction**

The Maldives Donor Forum is a timely opportunity for Development Partners and the Government of Maldives to jointly commit to support implementation of a program to accelerate economic growth and realize the development objectives of the Government's Strategic Action Plan. The Forum offers the Government a platform to describe to Development Partners the challenges it is facing and the impressive measures it has taken in recent months to lay the foundations for an economic turnaround. It also provides an opportunity for the Government to present its five priority development areas to realize its broader goals as set out in its Strategic Action Plan. Successful implementation of these policy measures would require external financing from Development Partners.

#### **External Financing in support of Government Policy Action**

The new Government of Maldives faced two daunting macroeconomic challenges upon assuming office after the first ever multi-party democratic elections in late 2008. The first was an unsustainable and growing level of government expenditures as the wage bill of public servants grew to almost 80 percent of domestic revenues. The second was the early impacts of the global financial crisis, which led to declining tourism receipts and opened up a yawning fiscal deficit that was on pace to reach 34 percent of GDP by end-2009 without corrective measures. Such macroeconomic imbalances threatened not only macroeconomic stability, but the stability of the newly elected Government.

The Government has been decisive in the last few months, implementing a coherent stabilization program. To date, the main element of the Government's program has been expenditure reduction. The Government implemented wage cuts for the public service in October 2009 and has cut domestically financed capital expenditures. The government has also increased the electricity tariff charged by state-owned electricity company (STELCO) by 40-60 percent (for Male' residents, rest of country planned for early 2010). Revenue measures also figure prominently in the government's program. Plans are underway to introduce a goods and services tax on the tourism sector, which will be additional to the existing flat-rate bed tax, and to accelerate implementation of the business profits tax. The austerity measures are being complemented with social support measures, social sector spending is being protected and for the poor and vulnerable who will be most affected by the increase in electricity tariffs the government will introduce targeted consumer subsidies.

Supporting policy and institutional changes have also been implemented to ensure that the austerity measures are sustainable. The World Bank has in particular focused on support to three areas: (a) *public financial management*, specifically budget preparation, implementation and monitoring, (b) *public enterprise reform*, specifically measures to help ensure that the Government planned Public-Private Partnerships appropriately minimize future fiscal risks to the Government, and (c) *social protection*, specifically efforts to lay the foundations for a harmonized national social protection system. These actions and the austerity measures have taken place in an extremely challenging environment, particularly considering the lack of a parliamentary majority for the Government.

Donors have supported the Government's actions by providing external financing. The IMF approved a blended Stand-By Arrangement and arrangement under the Exogenous Shocks Facility for a combined amount of about US\$92.5 million (or 700 percent of quota) on December 4, 2009. The Bank has approved a \$13.7 million budget support operation that was processed under IDA's Fast Track Facility and is proposing a second operation of similar value for later this year. The ADB has approved a US\$35 million budget support operation with half being disbursed in 2010 and the other half planned for mid-2011. The Government of India and the State Bank of India have also provided significant financing.

The combination of policy measures and external financing is starting to yield results. The fiscal deficit is now estimated to have ended 2009 at 26.3 percent of GDP compared to projections of 30 percent without corrective action and is expected to further decline to 18 percent in 2010. Foreign exchange reserves have risen from lows reached in August 2009 to more than three months of imports in February. The Maldives Monetary Authority (MMA) has stopped providing credit to the Government, which has helped to reduce inflationary pressures. The global economic recovery has also helped to reduce macroeconomic imbalances through a rebound in tourist arrivals.

Real GDP growth is expected to reach 3-4 percent this year, up from a decline of 3 percent in 2009.

Under the IMF's program financing from the IMF, the Bank, and the ADB are assumed to cover the financing gap over the life of the program consistent with the program's international reserve targets. However, there are several reasons why additional budget financing from Development Partners could still be helpful to support implementation of the Government's macroeconomic program. The first is to reduce private sector crowding out from government borrowing in domestic financial markets, and therefore enhance private sector investment and growth. Despite the Government's significant efforts, the fiscal deficit is still expected to be close to 18 percent and 4 percent in 2010 and 2011 respectively. According to IMF estimates, these deficits would require domestic financing of about 8 percent of GDP over the two years. The second reason is that donor funding provides a stable source of public financing, which helps protect critical areas of spending. In addition, donor funding can help improve the structure of debt and improve Maldives' reserve position, which would provide the country with a better buffer against future unexpected exogenous shocks.

### **The Strategic Action Plan**

Returning to positive rates of economic growth is a pre-requisite for sustaining Maldives' impressive progress in improving human development outcomes. Despite the challenges of a dispersed population, the Maldives has achieved notable development progress in recent decades through a combination of private sector-led tourism development and improving public service provision. Annual real GDP growth has averaged over seven percent in the last 25 years contributing to a sharp reduction in poverty. Poverty rates, as measured by the headcount ratio at 15 Rufiyaa per person per day, have fallen steeply, from 40 percent in 1997, to 28 percent in 2004. Other human development indicators - infant mortality, maternal mortality, or educational attainment - have registered similar improvements. The country has achieved 5 of 8 Millennium Development Goals (MDGs) and is on track to meet most of the goals by 2015. While poverty has declined sharply overall in recent years, vulnerability and inequality are a concern, as a significant number of people fell back into poverty during the recent crisis, and the disparities between remote islands with small populations and the capital Male region remain substantial.

The Government is seeking to consolidate human development gains while also responding to the current challenges, increasing the quality of service provision and decreasing inequalities. For the Donor Forum, the Government has identified five priority areas as necessary for a stable framework to develop all other sectors, but is currently lacking adequate resources to ensure meaningful outcomes. These priority areas are closely linked to the SAP's key themes of good governance, social justice and economic development and must be supported together. The five priorities are:

- i) **Macroeconomic Reform** to support private sector-led economic growth: Reducing the role of the state in the economy is a core component of the SAP as is facilitating conditions for growth in the tourism and fisheries sectors.
- ii) **Public sector reform:** A major plank of the structural adjustment program is public sector reform. The public sector is being streamlined to efficient and effective delivery of quality government services.
- iii) **Good governance initiatives:** Strengthening democratic institutions and processes is a priority to ensure that the new democracy is entrenched.
- iv) **Social development:** Investment in human resources development of the country is an immediate step required to deliver on all social development pledges.
- v) **Climate change and adaptation:** Climate change poses an existential threat to the Maldives. The Government is proposing a series of mitigation and adaptation measures that require funding.

The Government has costed the five priority areas; the total estimated costs amount to approximately US\$402 million over 4 years, in addition to US\$45 million in general budget support that the Government is seeking from Development Partners. These costs represent the amount of financing that is needed to scale up already ongoing activities or carry out new activities necessary to achieve the Government's desired development outcomes. Spending in these activities is expected to enhance economic growth and revenue generation over the medium-term and it would be expected they leave the fiscal deficit unchanged from current projections. When the medium-term budget framework is updated next year these activities will, unless grant financed by Development Partners, substitute as appropriate for current items.

The form and type of Development Partner finances that flow to Government matters in the current context. Concessional financing is preferred to non-concessional funds given the fiscal situation and for debt sustainability concerns. Indeed, there is a non-concessional funding ceiling of about US\$50 million remaining for 2010 under the IMF program. In order to strengthen aid-effectiveness, the Government plans to operationalize an international cooperation strategy and put in place mechanisms to enhance monitoring and evaluation and reporting of external assistance within the overall framework of Managing for Development Results (MfDR) for the SAP. There are many ways to deliver financing effectively to the Government in a harmonized way, but two options that the Bank has experience with are Multi-Donor Trust Funds and co-financing of budget support operations. We stand ready to discuss these possibilities with the participants at the Forum.