

# Chapter One

## MACRO-ECONOMIC OVERVIEW

*"Small states like the Maldives happen to be in the front line of most of the crises that afflict or threaten the world. From environmental degradation through international lawlessness to energy crises, it is the small states who are often the first victims."*

*His Excellency Mr. Maumoon Abdul Gayoom, President of the Republic of Maldives  
at the 2005 World Summit - United Nations*

### 1.1 What is the Investment Climate and Why does it Matter?

There is an increasing awareness of the need for a better investment climate in countries, in order to stimulate higher growth and reduce levels of poverty. The term investment climate broadly encompasses the policy, regulatory, institutional, and governance environment that supports entrepreneurship and efficient markets. A favorable investment climate creates opportunities for firms and entrepreneurs of all types. More governments are recognizing that their policies and behavior play a vital role in shaping the investment climates of their societies and they are consciously making changes. The most compelling examples are China and India. Many other governments are introducing reforms, but the progress is somewhat slow and uneven.

World Bank studies have been conducted in more than 53 countries surveying more than 30,000 firms in all parts of the world.<sup>2</sup> In South Asia, investment climate assessments have been conducted in all seven countries. The recent research has highlighted four main issues that need attention: (i) the investment climate should benefit the society as a whole, not just firms; (ii) efforts to improve the investment climate should go beyond reducing business costs; (iii) progress requires more than changes in formal policies; and finally, (iv) governments need to address major constraints to build up investor confidence and, most importantly, sustain the reform process in the long run.

### 1.2 Why Conduct an Investment Climate Assessment (ICA) in the Maldives?

The main objective of the investment climate study in the Maldives is to develop a better understanding of the constraints to support more rapid expansion and growth of investments in the formal enterprises in the Maldives, provide input to the Seventh National Development Plan, and identify priority areas for funding for the country's development partners, including the World Bank. Compared to the rest of the region, the Maldives has been able to provide a relatively better policy environment for investors. However, the results of the study will be useful for the government and the private sector in the Maldives and donor organizations for creating an even more conducive policy environment to further improve the investment climate over time.

---

2 World Development Report 2005-World Bank.

ICAs generally use a rigorous and a standardized approach to measure investment climate conditions in countries. These assessments also provide cross country-comparisons wherever possible while at the same time allowing the flexibility to address the specific needs of the country. ICAs cover factor markets, product markets, infrastructure services, and firm performance measures to the extent possible. In addition, they also use the available literature extensively to place the survey results in a broader macroeconomic context. The survey findings reflect the perceptions of investors in major sectors, which will be a useful input for the governments in their policy formulation process.

### 1.3 Facing the Special Challenges of being a Small Island Economy (SIE)

Small islands are defined as those with a total population below 1.5 million.<sup>3</sup> Since the 1940s, more than 80 small states have become independent or have secured increased autonomy from their former colonial rulers. Of these, a large number are dependent to some degree on tourism and have tropical or subtropical climates. SIEs are characterized by profound economic disadvantages, including restricted comparative advantages; diseconomies of scale; dysfunctional market structures; high transport costs; high levels of openness to international trade; tendencies to be price takers not price makers; limited natural resources; and small labor markets with deficiencies in professional and institutional knowledge and experience.

*Developing small states share a number of characteristics that pose special development challenges. They are especially vulnerable to external events, including natural disasters, which cause high volatility in national incomes; many of them are currently facing an uncertain and difficult economic transition to a changing world-trade regime; and they suffer from limited capacity in the public and private sectors. Box 1.1 reflects the special development challenges and vulnerabilities that many small states face.*

#### Box 1.1 : Special Development Challenges and Vulnerabilities for Small Island Economies

- o **Remoteness and isolation.** Of the developing small states, the majority are islands, some are widely dispersed multi-island states, and most are located far from major markets. High transport costs make it harder for them to turn to world markets to compensate for the drawbacks of the small size of their domestic markets. Small domestic markets, combined with greater distances from other markets, reduce competition and lessen opportunities to improve efficiency and innovation.
- o **Openness.** Usually a high degree of openness to the rest of the world brings benefits. But it also means that small economies are heavily exposed to events in global markets, and developments in the global trade regime, over which they have very little influence. They also tend to rely more heavily on taxing imports as a source of revenue, leading to difficulties when tariffs are reduced.
- o **Susceptibility to natural disasters and environmental change.** Most small states are in regions that are susceptible to natural disasters such as hurricanes, cyclones, drought, and volcanic eruptions, which typically affect the entire population and economy. Some are threatened by global environmental developments. Since most of such adverse events affect the entire population, risk pooling at the national level is not feasible.
- o **Limited diversification.** Because of their limited domestic markets, many small states are relatively undiversified in their production and exports. Where one dominant activity declines, it is replaced with another. This adds to vulnerability to changes in the external environment.
- o **Poverty.** There is some evidence that poverty levels tend to be higher, and income distribution more uneven, in smaller states than in larger ones. Where this is so, income volatility can create additional hardship as the poor are less able to weather negative shocks to their incomes.
- o **Limited capacity.** While weaknesses in both public and private sector capacity are a key problem for most developing countries, small size adds a further dimension to the challenge. This is further compounded in states, where the internal distances are large and the population is scattered. In the public sector, small states face diseconomies in providing public services and in carrying out the business of government, and tend to have relatively larger public sectors than other developing countries. As they face the challenges and opportunities of globalization, small states find that they do not have sufficient institutional capacity to participate fully in international finance and trade negotiations-the outcomes that can profoundly affect their economies. In the private sector, as already noted, the lack of diversification and domestic competition can hold back successful development.

Source: Small States Meeting Challenges in the Global Economy-Report of the Commonwealth Secretariat/World Bank Joint Taskforce on Small Economies-April 2000.

3 Commonwealth Secretariat, 1997.

Many of these factors combine to make small states' economies especially vulnerable, and in particular, they affect income volatility and access to external capital. The Maldives belongs to the category of highly vulnerable SIEs and therefore one needs to take this into consideration in the investment climate assessment. Compared to the other economies in the region, the Maldives' economy is small in size. For instance, Maldives is but a fraction of Sri Lanka, one of the smallest countries in the region. The Maldives' population is only 1.5 percent of the Sri Lankan population, the Gross National Income is only 3.6 percent, and exports are only 8.9 percent of exports in Sri Lanka.

## 1.4 Macroeconomic Environment

The Maldives, known as "Divehi Rajje," is a small island economy comprising a chain of Indian Ocean islands spread over a distance of 900 kilometers. The total land area is less than 300 square kilometers and covers about 26 geographic atolls. The estimated population in the Maldives is about 300,000 and the country has 1,190 islands, of which 198 are inhabited. Of these islands, only 33 have a land area greater than one square kilometer. One-third of the inhabited islands have a population of less than 500, and 70 percent of the inhabited islands have a population of less than 1,000.<sup>4</sup> However, the population density is 977 per square kilometer; one of the highest in the world.<sup>5</sup>

	1996	1997	2002	2003	2004 estimate	2005 estimate
GDP growth	9.10%	10.40%	6.50%	8.50%	8.80%	-5.50%
Inflation - CPI	6.20%	7.60%	0.90%	-2.90%	6.50%	8.00%
Employment - Government	15,862	18,022	26,363	28,651	-	-
Employment - Expatriate	21,169	16,744	30,664	33,765	-	-
Exchange Rate (Rf per US\$)	11.77	11.77	12.8	12.8	12.8	12.8
Total external debt (% GDP)	38.50%	35.60%	40.40%	40.70%	42.00%	48.90%

Source: Maldives - Ministry of Planning and National Development, Ministry of Education and World Development Indicators.

*The Maldives has recorded remarkable economic growth over the past two decades, especially compared with the rest of the South Asian countries, and is on the threshold of graduating from Less Developing Country (LDC) status to the middle-income group (Table 1.1). In 2004, it reached an impressive per capita income of \$2,514, up from \$771 in 1984; this reflects more than a threefold increase during the past two*

decades. The Maldives has enjoyed strong economic performance over a sustained period of time, with real GDP growth averaging more than 7.9 percent in the past 15 years.<sup>6</sup> A country that was not even on the economic radar in the 1980s has become a phenomenal success due to continued stable political environment and strong leadership and commitment to liberalization policies, all of which have attracted foreign direct investments.

4 Maldives Tsunami: Impact and Recovery. Joint Needs Assessment by World Bank-ADB-UN Systems, February 2005.

5 World Development Report, 2006.

6 World Bank-Maldives Economic Update- December 15, 2004.

*Ironically, the Maldives lacks the resource endowments, the scale of economies, and the geographical diversity enjoyed by its South Asian neighbors, but it has surpassed all of them to achieve the highest per capita GDP levels in the region.* What is more remarkable in this island state is the achievement of economic upsurge without compromising human development. The economic achievements were complemented by high literacy, low maternal and child mortality, declining poverty levels, and improvement in service delivery during the past decade, as shown in table 1.2.

	1996	1997	2002	2003	2004 estimate
Infant Mortality (per 1000 live births - under 1 year)	28	27	18	14	-
Child Mortality (per 1000 live births - under 5 years)	39	39	23	18	-
Life expectancy	-	70	73	70	-
Adult Literacy Rate (% of people ages 15 and over)	96.1	96.4	97.2	-	-
Public Education Expenditure (% GDP)	4.6	5.4	7.8	8.1	-
Poverty - Male (% below Rf 10)	-	8	-	-	0
Poverty - Atolls (% below Rf 10)	-	28	-	-	11
Source: Maldives - Ministry of Planning and National Development, Ministry of Education and World Development Indicators.					

*However, despite the Maldives' phenomenal achievements in the economic and social spheres, the Tsunami tidal waves also washed ashore the message of the country's high vulnerability to natural disasters.* The high level of global integration brings with it the vulnerability to external shocks such as the downturn in tourism after the terrorist attack on the World Trade Center in 2001, the outbreak of SARS in East Asia in 2003, and the escalating fuel prices since 2004. The combined impact of these international incidents has temporarily forestalled the upward economic trends enjoyed by the country that, for the first time in its recent history, had a negative growth rate of 5.5 percent in 2005.

*In addition, the Maldives is facing the challenges of increasing unemployment and underemployment of the educated Maldivian youth and increasing inflationary trends.* Continuation of such adverse trends could bring in social unrest, as demonstrated by the recent incidents in *Male*, which will have social and economic implications in the long run. The loss of assets due to the Tsunami has been estimated at 62 percent of the Maldives' GDP and the government is expected to face budgetary constraints requiring significant levels of budgetary support from foreign sources. This might result in severe pressure on the exchange rates.

## **1.5 Economic Upsurge in the Region with a Trickle-down Effect on Social Development**

*Economic growth in the Maldives has been spectacular from an Asian context, with per capita income escalating from \$192 in 1975 to \$2,514 in 2004; this reflects a 13-fold growth compared to other South Asian countries, who have recorded only marginal growth ranging from 2 times in Bangladesh to 4 times in India during the same time period.* As can be seen in figure 1.1, Maldivian per capita growth had even exceeded the East Asian countries: Malaysia (6 times), Thailand (7 times), and Singapore (10 times). Some of the comparable smaller island economies, who were at a higher base than the Maldives even in 1975, have also grown at a lower pace, as is the case for Seychelles (10 times), Fiji (3 times), and Mauritius (8 times). However, the Maldives' economic growth had a setback in 2005 and more prudent government expenditure policies will be required to ensure that this is a temporary phenomenon.

The increase in per capita has been coupled with great strides in human indicators, with Maldivians achieving a life expectancy of 70 years, infant mortality dipping down to 14 per thousand live births, maternal mortality declining to 1 in one thousand live births, the adult literacy rate reaching 97 percent, and the poverty levels declining to 8 percent.

These changes were mainly due to the government's policy of improving access to health and education not only in *Male* but also addressing these issues in the outer Atolls. However, regional disparities still exist and the government's policy on regional development is expected to ameliorate these disparities. Though regional development was a priority area identified in the Sixth National Development Plan, progress seems to have been rather slow. The development of Hulhumale Island adjacent to the main island of *Male* to address emerging issues of high urbanization, increasing unemployment in *Male*, the inward migration to *Male*, and the lack of land for expansion need to be resolved when the fiscal pressure on the government budget eases off. In addition, the government needs to increase public-private partnerships in development work, as in the case of *Male* water treatment project.

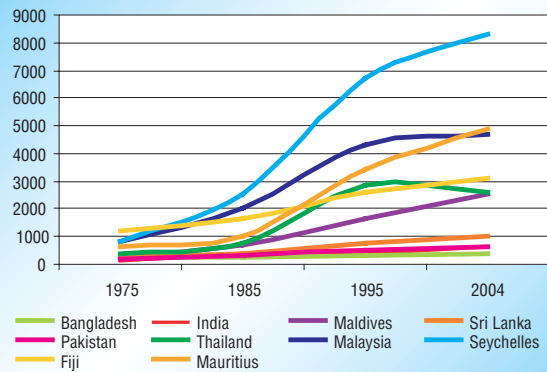
Though regional development was a priority area identified in the Sixth National Development Plan, progress seems to have been rather slow. The development of Hulhumale Island adjacent to the main island of *Male* to address emerging issues of high urbanization, increasing unemployment in *Male*, the inward migration to *Male*, and the lack of land for expansion need to be resolved when the fiscal pressure on the government budget eases off. In addition, the government needs to increase public-private partnerships in development work, as in the case of *Male* water treatment project.

## 1.6 Continued Narrow Economic Base

Over the past two decades, the structural change in the economy is only marginally visible as experienced in many a small island economies. The agricultural sector, including fishing, accounted for 18.6 percent of the GDP in 1984 but declined to 9.4 percent in 2003, while the industrial sector accounted for 12.3 percent in 1984, increasing to 14.9 percent in 2003 (figure 1.2). The decline in agriculture was offset by the services sector, which accounted for 69.1 percent in 1984, expanding to 75.7 percent in 2003. Within the agricultural sector, the decline mainly came from fishing, which accounted for 11.8 percent in 1984, dipping down to 6.6 percent by 2003.

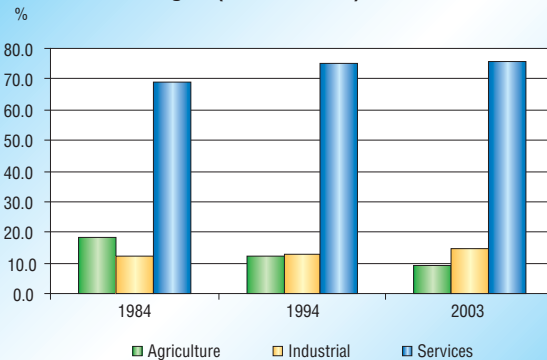
The industry sector that includes the construction industry increased its contribution to GDP from 2.7 percent to 3.6 percent between 1984 and 2003. In the services sector, tourism accounted for 32.7 percent, transport and communication 14.2 percent. In the recent past, the transport and construction sub-sectors have shown significant growth potential. With the increase in tourism, development projects such as Hulhumale, and reconstruction efforts in Tsunami-affected areas, the construction sector would have further enhanced its potential for growth. However, in 2005

Figure 1.1  
GDP per capita (current US\$)



Source: WDI and UN statistics

Figure 1.2  
Structural Changes (1984 - 2003)



Source: Maldives - Ministry of Planning and National Development

the manufacturing industries recorded much less growth since the garment factories in the Maldives closed down after the phasing out of the Multi Fibre Agreement (MFA). The narrow economic base poses a major threat to the country and demonstrates the need for further diversification to the extent possible, given the limited resource base.

## 1.7 A High Level of Global Integration and Excessive Reliance on Imports

*The Maldives has a very low level of natural resources other than "sun and sand," which the country has exploited to a great extent through tourism. However, all food products, fuel, raw material, and intermediate goods need to be imported.* Unlike all of the other countries in South Asia, the Maldives does not have any hydro potential for electricity and also needs to desalinate sea water for consumption and other uses. The export base is very narrow, with only fish products accounting for 16 percent of the GDP. Since 2004, with the exit of garment exporters, fish has become the only export product. Conversely, all of the essential food products, such as rice, flour, and vegetables, are imported, bringing the share of imports as a percentage of GDP up to 68 percent in 2003. The flourishing tourism industry is highly reliant on imports, with all food products, fruits, and vegetables being imported from neighboring countries. Thus, the tourism industry has not created adequate direct linkages with the rest of the economy; however, it has provided an indirect impetus to other sectors such as transport, construction, and import trade.

The openness indicator<sup>7</sup> in the Maldives has increased from 64 percent in 1984 to 85 percent in 2003, reflecting a high level of integration with the international economy. While this is a barometer of the country's open economic policies, it also demonstrates the nation's vulnerability to changes in the external environment.

The Maldives follows a more *laissez faire* trade policy<sup>8</sup> than other countries in the region: the average tariff is about 23 percent and some quotas are in effect. Duty exemptions amounted to 36 percent of the total import duty collected and loss of revenue had been \$32.0 million in 2004, of which 50 percent was in lieu of foreign investments.<sup>9</sup> Taxes on imports are relatively nondiscriminatory. Since there are virtually no import-competing domestic industries other than handicrafts, differences in tariff rates are commonly imposed on certain goods or activities for the same reasons as is the case in the rest of the world. Tariffs are in place mainly in order to raise revenue at low administrative cost compared to implementing a sales tax or Value Added Tax accounting, and account for more than 60 percent of the tax revenue and almost 25 percent of the total revenues and grants. Except for few exceptions,<sup>10</sup> no duties are levied on exports or re-exports. However, the government needs to consider reviewing trade policy, eliminating quotas to further induce the private sector, and developing alternate sources of revenue. The government also plans to develop technology-intensive, knowledge-based, and environmentally sustainable light industries while some of the import-substituting heavy industries such as cement, gas, and

---

7 Openness indicator = exports of goods and services)/GDP.

8 Trade Policy Review-World Trade Organization, 2002 and World Bank, Maldives: Country Economic Update, December 2004.

9 Maldives Customs-2004 (internal data base).

10 Refer to chapter 4 for details.

boat building are based in the reclaimed island of Thilafushi (which is only assigned for industrial use). In addition, the Laamu Gan and Seenu Gan islands have been declared industrial zones due to the availability of physical infrastructure and large populations, but are yet to take off as main growth centers.

While the legal and regulatory environment for foreign direct investment (FDI) in the Maldives is very liberal, the leasing of resort islands still has a differential for local and foreign investors. This has been further liberalized by issuing new FDI guidelines. However, more discretionary powers still seem to be vested with institutions and the selection criteria need to be made more transparent in order to improve the credibility of the policy makers and the overall governance structure.

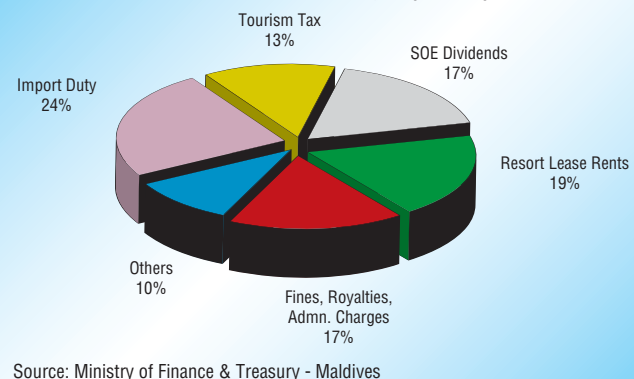
## 1.8 Need to Sustain Prudent Macroeconomic Policies

Generally, the Maldives has followed a prudent macroeconomic policy, which resulted in the spectacular growth recorded in the past. However, the government has been following a more expansionary fiscal policy regime, and since 1999 the overall deficit, including grants, had been between 4 and 5 percent of the GDP,<sup>11</sup> increasing up to 11 percent in 2005, mainly due to the Tsunami. Despite the strong revenue growth recorded until 2004, the government had not been able to bring additional revenue measures to offset the increasing government expenditure due to public investment programs for Tsunami reconstruction. Given that the major growth sectors—the tourism and fisheries sectors—are vulnerable to external shocks, maintaining a low level of government deficit is essential, as was seen with the downturn in the economic environment after the Tsunami.

However, according to the 2006 budget, the overall fiscal deficit, including grants, is expected to increase up to \$165 million, of which more than 50 percent is expected to be financed by foreign loans. At present, the ability of the government to raise domestic debt is highly constrained, which raises concerns about the feasibility of any proposed higher public expenditure.

The main sources of revenue are import duties, tourism taxes, resort lease rents, dividends from state-owned enterprises and royalties, fines, and other administrative charges, accounting for 91 percent of the total revenue in 2004 (figure 1.3). In 2005, the revenue sources were affected mainly by the contraction in the tourism industry. This would have been slightly offset by an increase in imports of construction material for reconstruction in Tsunami-affected areas but would not have been adequate to compensate for the revenue losses. The revenue flows were less

Figure 1.3  
Government Revenue - 2004 budget (Rf mn)



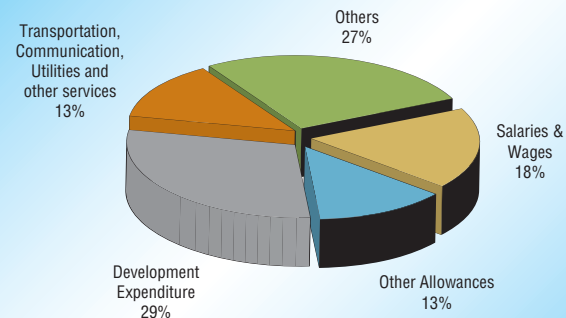
11 World Bank, Maldives: Country Economic Update, December 2004.

than budgeted, since the implementation of Tsunami activities was slow. The 2006 budget has proposed the removal of waivers for Tsunami-related imports. Higher revenue is also expected from lease rent and land rent from proposed new resorts, cost recovery from health and education services, and Tsunami-related grants.

On the expenditure side, the main areas of expenditure are government salaries and allowances (31 percent); transport, communications, and other utilities (13 percent); and development expenditure (29 percent) (figure 1.4). Escalating fuel prices, which have not been adequately adjusted, would put further pressure on government expenditures since they would require either direct subsidies from the budget or lower dividends from the state-owned enterprises such as State Trading Organization and State Telecom Company. Higher-

expenditure measures have been proposed in the 2006 budget in the form of additional hiring and promotion in the public sector, an increase in public investment programs, and higher expenditure for public health and educational services. Some of these public investment programs may need further prioritization, given the emerging fiscal constraints.

Figure 1.4  
Government Expenditure - 2004 budget (Rf mn)



Source: Ministry of Finance & Treasury - Maldives

## 1.9 High Reliance on Foreign Labor and Maintaining a Large Public Sector

The Maldives has been following a liberal labor policy, unlike in the rest of South Asia. According to the 2000 census, the total labor force<sup>12</sup> (economically active over 15 years) and the total employed were estimated to be about 87,442 and 85,722, respectively. Of the total employed, about 33 percent were women. Of the labor force, foreign labor accounted for more than 30 percent. The total employment in the government sector (government and public enterprises) was about 28,651, of which 37 percent were females. In terms of the industry origin, the tourism, manufacturing, and fisheries sectors accounted for about 16, 13, and 11 percent, respectively. Within the tourism sector, about 47 percent were foreign workers. The estimated unemployed were about 1,720, of whom about 68 percent were in the age group of 15-29.

The government controls majority shares of about 21 state enterprises covering transport, aviation, real estate, telecom, water supply, hospitality, and banking. During 2004, the net profits of these institutions amounted to \$144 million. However, given the emphasis on private sector development, the government should expedite the divestment process of some of the state enterprises where the private sector can provide services more efficiently. During 2004, the state owned enterprises' (SOEs) value-added contribution to the economy was 36 percent; SOEs are by far the largest employer, accounting for about 30 percent of the total employment. Given the size

12 Statistical Yearbook of the Maldives, 2004.

and the geophysical nature of the country, a relatively large public sector is unavoidable. However, investors have raised concerns about the public and private sector roles. There is an urgent need for an increase in public disclosure, transparency, and accountability to improve investor confidence.

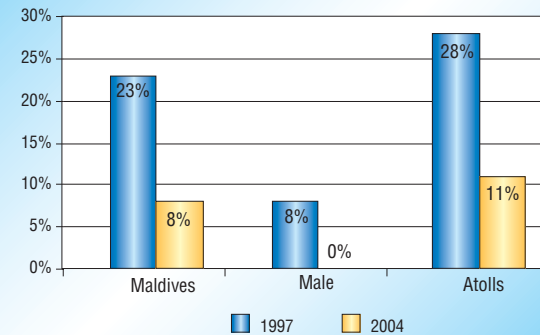
## 1.10 Declining Poverty and Increasing Regional Disparity

As is the case for most other countries in the region, the economic growth has resulted in a reduction of poverty in the country. The rate of growth in population has declined from 2.1 percent in 1997 to 1.6 percent in 2003. The geophysical nature of the country makes it difficult to have a trickle-down effect of the economic gains unless proper strategies are adopted by the government to ensure equity. Given the increasing economic opportunities in and around Male, there had been an increase in urbanization. It has increased from 25 percent in 1997 to 30 percent in 2004 (figure 1.5). The poverty levels have dramatically declined in the Maldives, from 23 percent to 8 percent between 1997 and 2004.

The poverty levels in Male have declined from 8 percent to zero, while in the Atolls it has declined from 28 to 11 percent. However, there is regional disparity, with the poverty levels ranging from 19 percent in the North to 3 percent in the South, according to the recent poverty assessment carried out by the government with assistance from the UNDP (United Nations Development Program) and the World Bank (2005) (figure 1.6).<sup>13</sup> It has also been revealed that income inequality has not undergone much change during the period 1997-2004, reflecting that the economic gains achieved during this period have been more for upper echelons of the population.

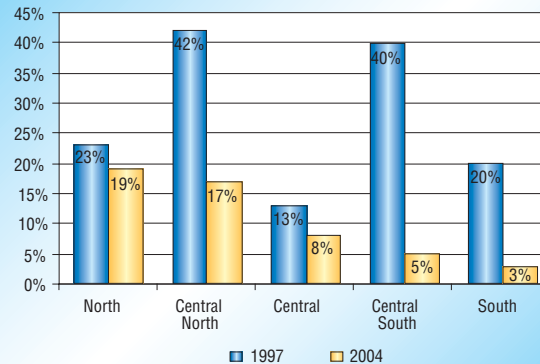
It has also been noted that the Gini Coefficient in the Maldives (0.41), which reflects the inequality, is much closer to the United States (0.41) and Singapore (0.43) than it is to its neighbors such as Sri Lanka (0.34), India (0.33), Pakistan (0.33), and Bangladesh (0.32).

Figure 1.5  
Headcount Ratios: Maldives, Male and the Atolls - 1997 & 2004



Source: Maldives - Vulnerability and Poverty Assessment, 2004

Figure 1.6  
Headcount Ratios by Region, 1997 & 2004



Source: Maldives - Vulnerability and Poverty Assessment, 2004

13 Vulnerability and Poverty Assessment-2004-Ministry of Planning and National Development in cooperation with the UNDP and World Bank