

I. COUNTRY CONTEXT

1. ***The Maldives has made impressive development gains over the last three decades.*** In 1978, the World Bank Group's first year of engagement, it was one of the world's twenty poorest countries with a population of 156,000. Today, with a population of just over 300,000, it is on its way towards achieving middle-income status with a per capita GDP approaching \$2,800. Furthermore, economic upsurge has been achieved without compromising human development. On the contrary, the past decade has seen increased literacy, reduced maternal and child mortality, declining poverty levels, and improvements in access to basic services.
2. ***The sustained growth and rising prosperity of the last three decades was founded on sound fiscal policies, political stability and a highly successful tourist industry, based upon the country's extraordinary natural assets.*** The Maldives is endowed with 1,192 small tropical islands that cross strategic shipping routes and has a marine environment rich in diversity. The coral reefs are the seventh largest in the world and cover an area of 8,920 square kilometers. There are now 89 tourist resorts in operation, up from 64 in 1990 and with another 45-50 planned; over the last ten years tourist arrivals have increased at an average annual rate of 8 percent. Fish catch, the other main economic activity, has increased around 5 percent per year during the same period. The revenues achieved through these core economic activities are ploughed effectively into infrastructure and human development investments.
3. ***Nevertheless, like other small states, the Maldives faces high unit costs of infrastructure and other public service provision.*** Sovereignty imposes high indivisible fixed costs on small island economies including policy formulation, regulatory activities, education, social services, justice, security, and foreign affairs. The Maldives' economic base is narrow, and diversification is limited by the small size of the domestic market and distance to markets. The economy is therefore vulnerable to exogenous shocks in international markets as well as to natural disasters. Openness and international investment has brought development to the Maldives, but it also brings new challenges such as increased environmental susceptibilities, and rising concerns with respect to youth unemployment, security and crime.
4. ***The context has changed considerably since the last CAS was discussed by the Board in 2000.*** During this period the Maldives experienced economic and social rupture in the wake of the Indian Ocean tsunami of December 2004 which caused damage worth 62 percent of GDP. The government also initiated a wide-ranging reform program that is still ongoing, to modernize its governance institutions in line with its middle income status.² Demands on the government for better services are also rising with income levels.
5. ***This CAS comes at a time when the country faces new issues that could offset— or potentially roll back— some of the important development gains to date.*** Three key challenges are (a) the sustainability of fiscal policy; (b) the passage of ambitious governance reforms; and (c) adaptation to global climate change. In different ways, these challenges relate to the tsunami. The tsunami was a major natural disaster with national, large-scale impacts. Furthermore, the tsunami complicated and pressurized ongoing political reforms, ushered in successive expansionary budgets, and underlined institutional gaps in the country's response systems.

² Formally, within the UN system, the Maldives will lose its Least Developed Country status only in 2011 although its per capita GDP is already high enough for it to be classified as a middle income country, and is approaching upper-middle income status.

A. POLITICAL CONTEXT

6. *The current Head of State, President Maumoon Abdul Gayoom, has dominated politics in the Maldives since 1978, presiding over a period of sustained economic growth and stability.* In late 2003, President Gayoom embarked on wide-ranging reforms to the country's political and institutional framework. In March 2006 the government unveiled the "Roadmap for the Reform Agenda" which, among other things, envisaged the revision of the Constitution ahead of the country's first multi-party elections planned for June 2008.

7. *Constitutional reform has proved difficult and slow.* Despite extensive meetings of the special *Majlis* to prepare the new Constitution, progress has been slow and pressures are growing to ensure that the expectations for competitive and pluralistic politics are met. In August 2007, a referendum was held on the country's political system. Billed as a referendum on the president's own performance (in light of his announced intention to run again, for the last time, in the 2008 presidential elections), the vote resulted in strong support for the presidential, rather than parliamentary system.

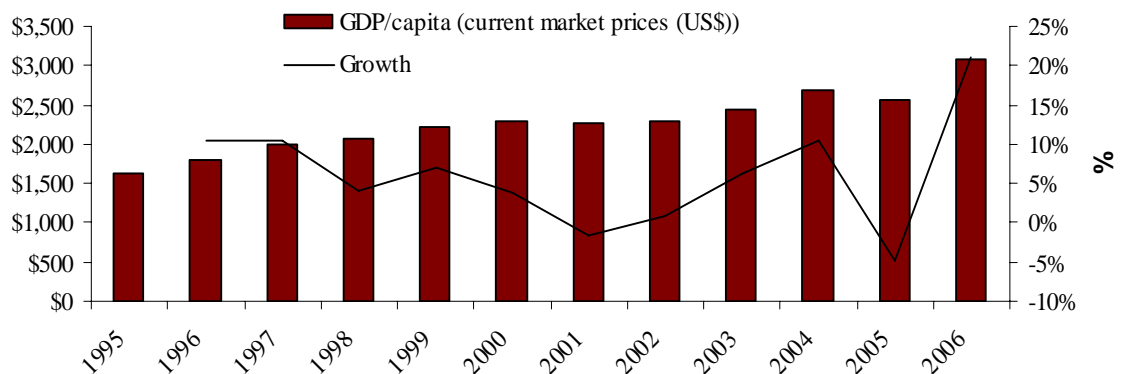
8. *An ambitious program of constitutional change is currently making its way through the Special Majlis.* In the political sphere, this includes a wider choice for electing a president; a limit on the number of times one person may be elected to the office of president; removing the gender bar on standing for the presidency; greater decentralization of executive authority by separating the functions of the head of state from those of the head of government, including the creation of the office of prime minister; abolition of the category of appointed members to the *Majlis* (the parliament); proportionate representation in the *Majlis*; independence of the *Majlis* from the executive, with the speaker and the deputy speaker becoming elected positions.

9. *The reforms reflect rising expectations amongst a polity that has new economic power.* Expectations of government among the people of the Maldives remain high. These span the range of public services, including health and education, as well as addressing felt needs for protected harbors and adequate fish processing capacity. There continue to be protests on the atolls related to the post-tsunami reconstruction efforts which have neither moved quickly nor met community expectations. The government faces the difficult task of managing expectations, and meeting core needs, while returning to a sound macroeconomic and fiscal path.

B. RECENT ECONOMIC AND SOCIAL DEVELOPMENTS

10. *The Maldivian economy has performed strongly over the last 25 years, with real GDP growth averaging over 7 percent a year.* Following the tsunami, the economy contracted by 4.5 percent, but rebounded by 19.1 percent in 2006, and has remained strong in 2007. Rapid growth in the last two years stems from the recovery in tourism and the high fish catch, boosted by accelerating

Figure 1: GDP/ capita 1995 - 2006



Source: Government of Maldives

tsunami reconstruction activity and the development of new resorts.

11. ***The tsunami highlighted vulnerability, but also resilience.*** The tsunami hit during the peak tourist season, closing 21 of the country's 87 resorts and totally destroying six. It displaced 29,000 people from their homes and caused damage equivalent to 62 percent of GDP. Nevertheless, by mid 2005 many of the closed resorts had re-opened and tourist flows were on their way to pre-tsunami levels, reflecting the attractive tourism product and the strengthening of the euro against the rufiyaa. In addition, the fish catch in 2005 reached record levels and off-set some of the weakening in other sectors.

12. ***The mainstay of the economy – the tourism sector – has continued to perform well.*** Tourist arrivals so far in 2007 have exceeded the levels reached before the tsunami, and the government expects arrivals growth of around 6-9 percent this year, as the sector looks to increase capacity in line with rising demand. Leases for 11 new resorts were awarded in 2004, and a further 35 were awarded in 2006. Although there have been delays in bringing the new resorts online (mainly due to implementation and financing constraints), strong investor interest attests to the bright prospects of the sector.

13. ***At the same time, the tsunami ushered in a period of expansionary budgets.*** The fiscal deficit, which was at 10.9 percent of GDP in 2005 and narrowed to 7.3 percent in 2006, was budgeted to widen to 28.3 percent in 2007. While partial year data suggest that the outturns for 2007 are likely to be much less expansionary than budgeted, this is largely the result of implementation capacity constraints, rather than a reflection of explicit policy. A key challenge for the government over the next 1-2 years is to constrain spending from the high levels that followed the 2004 tsunami and coincided with gathering political reforms, in order to ensure that the impressive socioeconomic gains of the past two decades are not undermined. This will be especially difficult in 2008, when the first multi-party elections are planned. Much of the initial spike in expenditures in 2005 was driven by the tsunami, but subsequent elevated spending has been mainly unrelated to the tsunami. In addition, most of the tsunami-related spending has been externally financed. Hence, rising domestic financing needs since 2005 are mostly unrelated to the tsunami, as well as being a key source of macroeconomic risk.

14. ***The current account deficit widened to US\$369 million in 2006, equivalent to 41 percent of GDP, and is expected to widen further in 2007.*** This is largely the result of the decline in the trade account, where strong receipts from tourism are outweighed by faster increases in merchandise imports. With the rufiyaa tied to the weakening US dollar, the exchange rate has depreciated substantially over the past two years in relation to the main European and East Asian tourist markets, helping maintain competitiveness. Import demand is fueled by the building of resorts and other construction activities. The deficit is being financed by large private capital inflows, as well as official creditors. As a result, reserves have remained resilient at US\$248 million at the end of September 2007, covering around three months of imports of goods and non-factor services.

Debt Sustainability

15. ***Debt sustainability analysis (DSA) suggests that debt service burdens are manageable if new borrowing slows, but points to elevated vulnerability.***³ Total external debt rose to US\$592 million in 2006, including US\$362 million in public debt and US\$230 million in borrowing by commercial

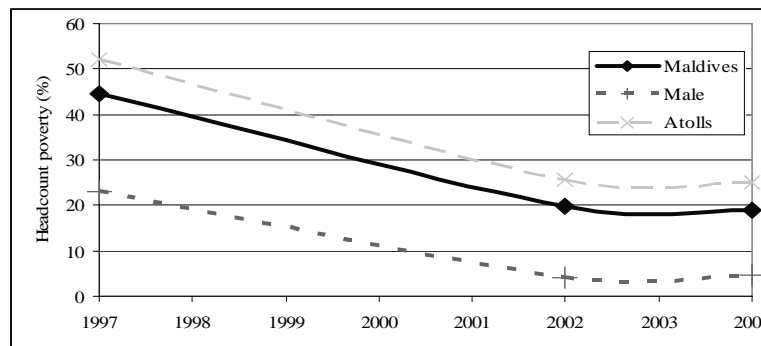
³ The DSA undertaken by the IMF as part of the Article IV consultations concluded in mid-2007 is attached as Annex VI. A more detailed joint IMF-World Bank DSA is planned in the first half of 2008, when more information on the fiscal outturns for 2007, as well as the budget for 2008, will be available.

banks. This raises public external debt to the equivalent of over 34 percent of GDP, which is expected to rise further to about 45 percent by the end of 2007. Domestic borrowing adds about 18 percent of GDP, and debt service is absorbing an increasing, though as yet manageable, share of the budget. The public sector external debt service ratio has doubled in recent years, increasing from around 5 percent to over 10 percent of domestic exports of goods and non-factor services. Commercial banks have borrowed heavily to finance resort construction, and official creditors have also made substantial disbursements, especially the European Investment Bank financing for the reconstruction of tsunami damaged resorts. Debt sustainability analyses suggest that the debt burden is manageable if new borrowing moderates. The current fiscal path points to a continued increase in public sector borrowing, however, raising risks and increasing vulnerability to external shocks and fiscal slippages.⁴

Poverty Assessment and Human Development Trends

16. **Poverty in the Maldives fell by more than half from 1997 to 2004.** Based on a poverty line of Rf.15 (US\$1.17) per person per day, the headcount index of poverty (the share of the population consuming below the poverty line) declined from about 45 percent to less than 19 percent before the tsunami (see Figure 2). Poverty fell most in Male': from 23 percent to less than 5 percent, and less sharply, but still significantly, in the atolls: from 52 percent to 25 percent. As a result, even more than before, income poverty is now concentrated in the atolls. The northern region appears to have seen only a modest decrease in poverty and has now emerged as Maldives' poorest region, followed by the north-central region.⁵

Figure 2: Headcount poverty, 1997-2004



Source: Preliminary Staff estimates based on VPA-1 and VPA-2.

17. **Poverty has continued to fall following the tsunami – but sections of the population are still vulnerable.** According to the government's impact assessment⁶ the tsunami had limited impact on social indicators such as poverty, health and education. While the people of the Maldives suffered serious loss of property and income as a result of the disaster, generous assistance from foreign and domestic sources, along with good economic performance, has helped lessen its effects on the economy in the short term and on average poverty decreased. Income levels only declined in Male (30 percent) and for islanders relocated to other islands (2 percent). Indeed, between June 2004 and June

⁴Debt indicators are approaching the indicative thresholds for classification as moderate or high risk of debt distress, which would affect the terms and volumes of IDA's assistance, as long as the Maldives remains IDA only.

⁵ Vulnerability and Poverty Assessments (VPA) were undertaken in 1997, 2004 (pre-tsunami) and 2005 (post-tsunami). All were prepared by consultants for the Ministry of Planning and National Development, the second was partially supported by the World Bank. The third in the series is known as the Tsunami Impact Assessment Study (TIAS)

⁶ "Tsunami Impact Assessment 2005: A socio-economic countrywide assessment at household level, six months after the tsunami", Republic of Maldives, June 2005.

2005, the proportion of the island population with income less than Rf.15 per day fell from over 30 percent to around 20 percent. Nevertheless, the same analysis reveals that of the 21 percent living in poverty in the atolls in 2005, only 7 percent has been consistently poor, while the rest are newly poor.

Table 1: Cross-country comparison of poverty and inequality in South Asia

	Gini index of inequality of expenditures	Poverty headcount ratio at national poverty line (% of population)	Year
India	33	29	2000
Pakistan	33	33	1999
Nepal	37	42	1996
Bangladesh	32	50	2000
Sri Lanka	47	23	2002
Maldives	43	19	2004

Source: World Development Indicators (except for Maldives, where Bank staff estimates are used)

18. ***Maldives has lower poverty but high inequality relative to South Asia.*** Unlike other countries in the region, Maldives experienced a spectacular growth performance and was therefore able to reduce poverty despite increasing inequality. Nonetheless, high inequality in the atolls remains a source of concern.

19. ***Finally, with two exceptions, Maldives has achieved all of its MDG target indicators.*** The gender gap in school enrollment and literacy among those aged 15 years to 24 years is virtually non-existent.⁷ The proportion of births not attended by skilled health personnel has been reduced by three-quarters.⁸ The two exceptions are for gender equality and management of the environment. Given the nation's social, economic and cultural traditions, women are at a disadvantage to men, even if as a group they are more equal than in other countries in the region. Current efforts to achieve the environmental goal are inadequate and under-funded, as discussed in a later section of this strategy.

II. KEY DEVELOPMENT CHALLENGES AND MEDIUM TERM PROSPECTS

20. The recently finalized 7NDP covers a broad range of the development needs and goals through 2010. This section attempts to highlight a critical subset that targets the strategic challenges facing the country over the short to medium-term, in particular: restoring macroeconomic and fiscal balance, improving the investment climate, consolidating human and social development, building institutional capacity, and sustaining the natural resource base.

A. RESTORING MACROECONOMIC AND FISCAL BALANCE

21. ***Overshadowing the strong economic performance is the substantial weakening of fiscal policy over the past three years, which is the main policy lever for affecting outcomes in the Maldives.*** This is the key source of risk facing the Maldives in the short-term. The fiscal outturns for 2006 showed an overall deficit exceeding 7 percent of GDP, mostly for non-tsunami related spending (Table 2). Although the 2007 budget anticipated a deficit equivalent to 28 percent of GDP, driven by

⁷ VPA-2

⁸ Annual Reports of Ministry of Health.