

## CHAPTER- II

### AN OUTLINE OF MALDIVIAN ECONOMIC ENVIRONMENT

#### 2.1 Introduction

The Maldivian archipelago, located 300 miles south west of the southern tip of India and 450 miles west of Sri Lanka, is a beautiful string of 1,192 coral islands scattered across the equator in vast expanse of the Indian Ocean. Few of the islands have a land area in excess of 1 sq km and only 199 are inhabited.

The country was never colonized, though the Portuguese sought to impose their sovereignty on Maldives in the 16<sup>th</sup> century. From 1887 to 1965, Maldives was a British protectorate but there was no interference in the internal affairs of the country. Maldives gained independence and became a **Republic** on November 11, 1968.

The main economic and social indicators of Maldives in year 2000 are shown below.

Table<sup>1</sup> 2.1

Land area	300 q. km
Population	270101
Annual population growth	1.9 %
Life expectancy at birth	71 years
Infant mortality rate per '000	21
Adult literacy rate	99 %
Urban share of population	27%
<b>Sectoral Composition of GDP</b>	
Primary	9 %
Manufacturing	9 %
Services	82 %
<b>Enrolment Ratio in Education</b>	
Pre-school	85 %
Primary	99 %
Secondary	36 %
<b>UN Human Development Index (1999)</b>	
Overall ranking	77 <sup>th</sup>
Within category	Medium human development

<b>UN Human Poverty Index in Developing Countries (1999)</b>	
Overall ranking	25 <sup>th</sup>
Within category	22 <sup>nd</sup>

1. Source: UNDP (2001), Human Development Report 2001: World Bank (2001), World Development Indicators, 2001, Report of Maldives Monetary Authority.

Despite the number and severity of constraints, the economic performance of Maldives has been impressive in recent years. Only a few developing countries are able to report the progress recorded by Maldives in the past two decades. Gross domestic product (GDP) growth exceeded 10 % p.a. through most of the 1980s, averaging 8.77 % p.a. during 1986-96 and moderating to a more sustainable 6.2 % in 1996-97. The GDP per capita increased in real terms from \$ 470 in 1985 to \$ 837 in 1997. The rate of increase was more than twice that of the population growth. This progress recorded by Maldives has been considered the highest among the countries of the South Asian Association for Regional Co-operation (SAARC).

High priority accorded to social development and a high proportion of government spending allocated to social sectors brought about a rapid transformation in several aspects of the quality of life to the entire population. Crude birth rate, crude death rate and infant mortality rate have halved.

With a global Human Development Index (HDI) of 0.739, Maldives ranks 77<sup>th</sup> out of 162 countries. The country's impressive economic progress has largely been attributed to the judicious exploitation of its marine resources and potentials, with fisheries and tourism having established as the dominant sectors of the economy. Though the tsunami on December 26, 2004 inflicted severe damage with an estimated loss of at \$450 million (approximately 60% of GDP). As a result of interrupted tourist inflows and livelihoods, Maldives' economy fell by about 5% in 2005. However the World Bank predicts positive growth should resume relatively quickly, as the tourist trade picks up.

## **2.2 Important Sectors of The Economy of Maldives:**

Some important sectors of the economy of Maldives are being briefly described below.

### **2.2.1 Tourism**

In recent years, Maldives has successfully marketed its natural assets for tourism--beautiful, unpolluted beaches on small coral islands, diving in blue waters abundant with tropical fish, and glorious sunsets. Tourism now brings in about \$210 million a year.

### **2.2.2 Fishing**

This sector employs about 11% of the labor force and contributes 6% of GDP, including fish preparation. The use of nets is illegal. So all fishing is done by line. Production was about 158,000 metric tons in 2004, most of which was *skipjack tuna*. About 50% of the harvest is exported, largely to Sri Lanka, Japan, Hong Kong, Thailand, and the European Union. Fresh, chilled, frozen, dried, salted, and canned tuna exports accounted for 94% of all marine product exports. Total export proceeds from fish were about \$85 million in 2004.

### **2.2.3 Agriculture**

Poor soil and scarce arable land have historically limited agriculture to a few subsistence crops, such as coconut, banana, papayas, mangoes, taro, betel, chilies, sweet potatoes, and onions. Almost all the food, including staples, has to be imported. The December 2004 tsunami inundated several agricultural islands, and it could take a significant amount of time for the recovery. Agriculture provides about 2.5% of GDP.

### **2.2.4 Industry and Manufacturing.**

The industrial sector provides only about 8% of GDP. Traditional industry consists of boat building and Handicrafts, while modern industry is limited to a few tuna canneries, a bottling plant, and a few enterprises in the capital producing PVC pipe, soap, furniture, and food products. Five garment factories which had mainly exported to the United States closed in 2005, following the expiration of the Multi-Fiber Agreement (MFA) that had set quotas on developing country garment exports to developed countries.

### **2.2.5 Production, Prices and Employment**

It is, therefore, clear that the Maldivian economy is heavily dependent on fisheries and tourism, which are the major sources of foreign exchange earnings and government revenue, and which together account for about 40 % of gross domestic product. The economy prospered in the 1990s with the rapid expansion of tourism and the modernization of the fishery sector together with the expansion of basic economic and social infrastructure to more inhabited islands. As a result, annual GDP growth averaged around 8% during the decade. Due to heavy reliance on imports for most economic activities and daily needs, coupled with the dependence on tourism, Maldives is very vulnerable to external shocks.

Inflation has remained low in recent years and in past, reflecting the appreciation of the nominal exchange rate against major trading partners since 1995. In 2000, deflation was recorded, with prices of imported food and beverages and clothing and footwear declining sharply.

In terms of employment, the fisheries and tourism sector alone account for more than a third of total employment. The total labor force of the country is estimated at around 50% of the working age population, which, coupled with the low level of educated labor, has led to a high proportion of expatriate workforce in the country. Categories in which expatriate labor has been employed mostly include teachers, medical personnel and other professional categories, as well as semi skilled and unskilled workers such as domestic helpers and construction workers.

### **2.2.6 Fiscal Policy**

The public sector consists of the government and public enterprises. Fiscal policy of the country aims at sustainable growth without undermining macro economic stability. Tax revenues account for around 45% of the total revenue (excluding grant) and the balance consists of profit transfers from public enterprises and resort lease rent. The bulk of tax revenue comprises of import duties (63%) and tourism tax (28%), while there are no taxes on personal income, capital gains, business profits, wealth or real estate. Non-tax revenues come from public enterprise profit (31%), lease rent on resort islands (35%), royalties and charges. Grants have been the other source of inflows and have averaged around 10% of total revenue between 1995 and 2001. External donor assistance has also played an important role in the development projects. Although in recent years this has had a fluctuating trend. Yet on average, external funding accounts for around 28% of development expenditure.

On the expenditure side, social services and public services make up the major areas of expenditure reflecting around 40% and 42% respectively of expenditure and net lending. Payments on economic services account for roughly 15% of expenditure and net lending. On the social sector, education and health take up the major portion of expenditures and account for around 46% and 26% respectively of the expenditure on social services. The government also invests heavily in the development of infrastructure of the country.

The record of fiscal performance of the country has been one of mixed achievements. While fiscal performance was relatively well kept in the mid 1990s with considerable fiscal restraint and sizeable repayments of the debt taken from the central bank, the late 1990s experienced a somewhat expansionary trend in the public enterprises with expenditure outstripping the growth in government revenue. During this period since 1998, sizeable resource mobilization of the deficit through the central bank financing took place, adding to the government debt.

Keeping in mind the importance of fiscal sustainability and efficient expenditure management for the sustainable growth and development of the economy, the government is currently pursuing a number of efforts to address these issues. '*The Public Expenditure Review*', a joint

exercise by the World Bank, International Monetary Fund, Asian development bank, and the Government of Maldives which was initiated in 2001. It will recommend ways to better prioritize and rationalize expenditure programs. The '*Public Accounting Systems Project*', coming into effect in 2003, will overhaul the current single entry accounting system to introduce a centralized double entry based computerized public accounting system. In addition to this effort to rationalize and more efficiently manage the public expenditures and improve the transparency of the public sector, the government also recognizes the need to diversify and broaden the revenue base. In this context, the government plans to introduce a business profit tax to be levied on business activities and a property rental value system to rationalize fees and administrative charges.

### **2.2.7 Financial sector and Monetary developments**

The financial sector of Maldives is very narrow and dominated by the banking sector, which consists of one locally owned commercial bank, branches of three South Asian partly state owned commercial banks and a branch of a widely known international bank, HSBC. Non-bank financial institutions in the country consist of a provident fund, a finance leasing company, two insurance companies registered in the country, while Maldives Monetary Authority (MMA) is the primary source of domestic financing for the government's fiscal operation. At present the commercial banks are the principal institutions for mobilizing savings and for providing foreign exchange to the private sector.

All financial institutions currently operate under the supervision of the MMA, which has the mandate to function as a central banking authority. Monetary policy in Maldives has been targeted towards supporting growth and development with a stable macro-economic environment. In the past, MMA has mainly employed direct instruments of monetary policy to achieve this objective. However there has been a movement towards an indirect mechanism in the last few years. There is currently no organized capital market in Maldives. Government, through the capital market development section and the MMA, is working towards creating the institutional mechanism to facilitate a structured market for generating the capital required by the economy. There is some secondary market tradings of the limited number of shares in the bank of Maldives, and two other state owned public companies- the Maldives transport and contracting company and the state trading organization. This constitutes the only publicly available equity stock at present.

### **2.2.8 Balance of Payments and the External sector:**

As Maldives has a narrow export base but high dependence on imports, foreign merchandise trade normally records a large deficit. Imports have averaged around 61% of GDP in the last 7

years, while domestic exports, consisting primarily of fish and fish products, have ranged between 11-15 % of GDP. Services and transfers have shown a net surplus that has averaged around 34% of GDP in recent years, with service receipts being dominated by tourism and related activities. Nevertheless, there is also a significant outflow of transfers from the economy owing to the large expatriate work force that is resident in the country.

Official medium and long term debt flows of capital for direct investments dominate the capital accounts of the balance of payments as no portfolio investments flow into the Maldives yet, because of the lack of a formal capital market. Information on the country's external debt is limited to that of the public sector and commercial banks. In terms of the magnitude, external debt stock of the public sector and the banking system has averaged around 38% of GDP during 1995-2002, with a large portion of official debt being received on highly concessional terms.

There is no exchange control legislation in Maldives. Both residents and non residents may freely import and export capital through the foreign exchange market, and residents do not require permission to maintain foreign currency accounts either at home or abroad.

The Maldives has a pegged exchange rate system, whereby the rufiyaa is pegged to the US dollar at a market reflective rate.

#### **2.2.9 Trade and Economic Policy Objectives:**

Trade and economic liberalization are considered by the Maldivian authorities to be means of promoting private-sector investment and development. However, trade liberalization, such as tariff reductions, is not specifically included in the current development plan. Recently, high tariffs are maintained, mainly for revenue reasons. Nevertheless, the government is committed to further outward orientation of the economy to improve trade and economic performance, and to diversify the economy away from fishing and tourism. It maintains few non-tariff measures, and its industrial strategy is aimed at removing bottlenecks to private sector growth. This strategy entails reducing the heavy role of SOEs in the commercial sector and fisheries. Greater competition in the provision of key services, such as telecommunications is also envisaged. The government is committed to greater regional integration, including with its SAARC neighbors.

Economic growth is seen as an important means of alleviating poverty and improving living standards for Maldivians. The government is committed to fostering private-sector development by liberalizing trade and investment and strengthening the country's economic, legal social, administrative and physical infrastructure. Private, including foreign, direct investment and international trade are seen as important catalysts for growth. Economic

development is to be based on sustainable management of key natural resources, such as fisheries and those related to tourism.

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Development is guided by rolling government plans. The sixth national development plan, the first plan that extends for five years instead of three (2001-05), embodies the long-term vision of the Maldives becoming a top ranking middle income nation by 2020 (*Vision 2020*). It aims at achieving conducive conditions for brisk commerce and economic activity and for the country to become a '*hub for regional free trade*' as well as a '*more diversified economy with export oriented services trade.*' National prosperity is to be equitably distributed and *environmental friendly policies* are to be taken to protect the environment against global ecological degradation. An important means of raising prosperity is to develop a more educated and skilled workforce using modern information technology.

#### **2.2.10 Trade Agreements and Arrangements:**

The Maldives became an original member of the **WTO** on 31 May 1995. It had been a **GATT** contracting party since 19 April 1983. Maldives is a founding member of the *South Asian Association for Regional cooperation (SAARC)*, *South Asian Preferential Trading Arrangements (SAPTA)*, signed in April 1993 and effective from 7 December 1995. Leaders recently reaffirmed their vision for a *South Asian Economic Union* and for *South Asian Free Trade Area (SAFTA)*.

The Maldives ' only bilateral trade agreement is with India. It became effective on 31 March 1981. It stipulates that the countries provide each other no less favorable treatment than extended to any trading partner. However, it excludes privileges granted to neighboring countries to facilitate trade like customs unions, free-trade areas or similar arrangements and preferences accorded under any general scheme for expanding among developing countries.

### **2.2.11 Investment policies and Procedures**

Although there are no minimum investment levels, all FDI must have a capital level "acceptable to the Government". There are no joint venture requirements. 100% of foreign ownership is permitted. No activities are excluded or restricted from foreign investment. Foreign applicants must have their financial status guaranteed by a bank or institution acceptable to the government. Foreign investors must use local raw materials which are locally available and commercially viable. This rarely operates in practice since the Maldives has limited raw materials. Most incentives apply equally to foreign and domestic investors. Investment incentives depend upon the level of foreign investment.

### **2.2.12 Supply side constraints**

Supply-side constraints are also major obstacles to the Maldives's trade expansion. These include its small and many dispersed islands, which greatly compound the problems of regional development. These include heavy dependence on fishing and tourism, limited natural resources, smallness of the domestic market; limited technology, limited *trade, industry, and export financing*, inadequate skilled manpower, lack of adequate trade representation network abroad, limited knowledge of export opportunities, weak infrastructure including transportation facilities, weak human and resource capacities of support institutions, inadequate investment regime, inefficient legal system, and heavy reliance on imported inputs. These problems are interlinked and compounded, impairing the overall trading environment. Other infrastructural bottlenecks, relating to comprehensive but expansive telecommunications and utility services such as electricity, water and sewerage facilities, may be linked to inappropriate technology, non-competitive market structure and inadequate investment. The government has taken some action to address supply-side constraints. However numerous needs still exist.

### **2.2.13 Environments**

There is growing concern about coral reef and marine life damage because of coral mining (used for building and jewelry making), sand dredging, and solid waste pollution. Mining of sand and coral have removed the natural coral reef that protected several important islands, making them highly susceptible to the erosive effects of the sea. These practices have recently been banned. In April 1987, high tides swept over the Maldives, inundating many islands. That event prompted high-level Maldivian interest in global climatic changes, as its highest point is about 8 feet above sea level. The *Asian Brown Cloud of Pollution* over the Indian Ocean has the potentiality of wreaking havoc on the tourism and fishery-based Maldivian economy.

#### **2.2.14 The Macro-Variables for the Study:**

The present study involves the examination of '*Causal*' relation between budget deficit and trade deficit in Maldives. Consequently, these variables have become the focus of our attention in this study.

We have identified major three macro-economic variables with priori support, which would enlighten on general understanding of the direction of Maldivian economy too. Time representations of these variables range from 1979 to 2003. These 25 years of time span is believed to be adequate for drawing an appropriate inference on the basis of compatible empirical findings on the issues of interest. Included variables are budget deficit (BD<sub>t</sub>), and Trade Deficit (TD<sub>t</sub>).

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