

Impact of Currency Band on Economy

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Background:

The Maldives Government had maintained a managed floating rate between 1987 and 1994 wherein the exchange rate of US dollars in terms of Rufiyaa ranged between 8.50 and 11.50. In 1994, Maldives moved to a pegged exchange rate regime. The Maldivian Rufiyaa has been fixed against dollar at 12.85 per dollar since 2001.

However, Maldivian economy has been witnessing foreign exchange shortages during years of economic stress due to increases in imports and fluctuations in the tourist traffic. Also, the widening of the fiscal deficit since 2004 tsunami and the hike in global food and oil prices in 2008 resulted in pressure on foreign exchange reserves. In addition to this, foreign exchange earnings from tourism were affected owing to global economic recession in 2009. This made it challenging to maintain the current US dollar peg, requiring disciplinary action for effective exchange rate management. Besides, the growth of the grey market for dollars had also posed an issue to the authorities.

On 10th April 2011, the President of Maldives announced that the Rufiyaa would no longer have a fixed value but will trade within a band of 20% around the previous rate of 12.85 i.e. 10.28 and 15.42, thus moving towards a managed float. The selling rate has been closer to the upper level since this measure was invoked.

Why has the government gone for such a managed float policy?

Table 1: Major Economic indicators affecting decision

	2006	2007	2008	2009	2010	2011
Foreign Reserves (\$ mn)	231.6	308.4	240.6	261.0	349.9	N.A
Imports (\$ mn)	927	1,096	1,388	967	1,095	N.A
Imports cover (months)	3.0	3.4	2.1	3.2	3.8	2.8
Fiscal Deficit(% GDP)	-6.9	-5.3	-16.9	-30.9	-16.4	-15.3

Source: Maldives Monetary Authority

The government has ostensibly taken preemptive action to address the issue of strengthening the foreign exchange position as well as migrating all such transactions to the official channels. The forex reserves had in fact increased significantly in 2010 with the import cover also improving from 3.2 to 3.8 months (Table 1). However, given that the ratio of imports to GDP is very high at over 100% between 2006 and 2008, controlling the growth in forex outflows becomes an important issue (Table 2). But, this ratio has come down in the last two years and was at 74% in 2010 showing hence significant improvement. At the same time the government has also

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worked on lowering the overall fiscal deficit ratio which though still high at 15.3% for 2011 is a major improvement over the same in 2009 when the ratio peaked at 30.9%. Therefore, the move to go in for a managed float of the currency should be viewed in the context of the overall economic restructuring process that has been invoked to put the economy on a stronger footing.

May be viewed as part of an overall economic reforms package

Table 2: Imports to Nominal GDP ratio (%)

	2005	2006	2007	2008	2009	2010
Import/GDP	99.3	101.3	104.0	110.2	73.3	74.0

Source: MMA

Immediate Impact:

The higher exchange rate that has resulted with this move will immediately help to better manage the dollar reserves and prudently puts another layer of control on the system of allocation of dollars within the country. With the introduction of the new exchange rate regime, market forces will play a major role in determining the exchange rate of the Rufiyaa within the specific band. Given the change introduced, MMA can expand its Open Market Operations to tighten domestic liquidity. MMA can now target a level of reserves and adjust currency till such a time that these reserves are maintained. The change in the exchange regime also results in reducing the size of the grey market and makes the dollar expensive relative to the Rufiyaa.

Better allocation of dollars internally

Economic Impact:

Trade balance

Owing to the devaluation of the currency, imports would typically become expensive resulting in lowering of demand. Also, the exports become more competitive since the rate is almost at the upper end of the band. This will result in narrowing of trade balances and ease the pressure on foreign reserves. However, given the nature of imports and exports, the impact may be mixed. Imports will be affected to the extent that the goods are non-essentials. Similarly, exports of marine products, which are driven more by demand that may not be too sensitive to price, would receive a limited boost on account of exports becoming cheaper in the international market.

Trade deficit to improve

Inflation

However, as most imports are essentials where demand is typically inelastic, demand per se may not come down thus keeping import levels at the same level. In this case, costlier imports will add pressure on prices. The critical part will be the route taken by the monetary authority in supporting growth in money supply as this may be required to support higher value of imports.

But, prices of all essential items will tend to increase

In 2010 imports were of the order of \$ 1,095 mn or Rf 14,071 mn. Valuing the same at 20% premium on account of the new rate, could mean additional liquidity of Rf 2,814 mn, which has to be addressed by the MMA. Growth in money supply needs to be controlled through monetary actions or else gains through exchange rate will be evened out by higher credit and

MMA has to take a proactive policy stance

money growth. Therefore, inflation would be the main concern resulting from this action.

Wages

A balance to be struck with wage adjustments

The exchange rate depreciation becomes even more significant in the context of the structure of the economy of Maldives because of the high dependence on imports and resulting inflation. A balance will have to be struck between inflation and adjustment in wages in a non-disruptive manner.

Revenue collections

Revenue collections to increase at margin

Higher valuation of imports will improve revenue collections which will have a soothing effect on budget deficit. However, the challenge will be to maintain expenditure at the existing levels and controlling the growth in the wage bill.

Looking Forward:

Moving towards market oriented exchange rate

An interesting issue arises if this can be seen as a first step towards the movement to a system of flexible rate that are driven by markets. The Monetary Authority can intervene whenever needed but the equilibrium can be established through the market forces.

How then to judge this move?

Steadiness in balance of payments and fiscal balance

The new exchange rate regime is the right step by the government for an economy which is fully dependent on the external sector for growth both in terms of imports and tourist traffic. This step would also make balance of payments more robust and strengthen fiscal balances.

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