

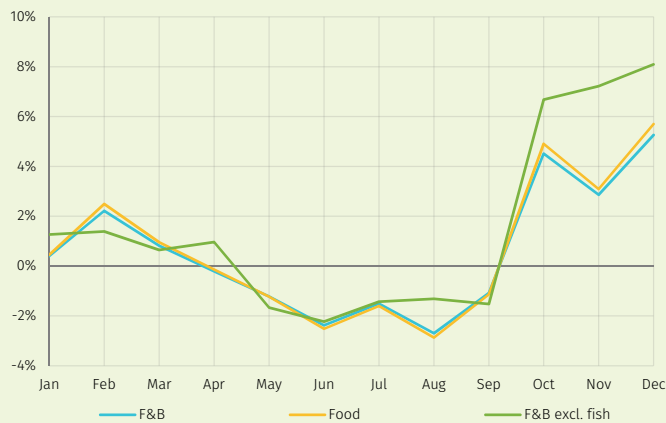
Box 2: Impact of the Change to the Staple Food Subsidy Policy on Inflation

In October 2016, the government of the Republic of Maldives changed its subsidy policy on the staple food items of plain rice, sugar and plain wheat flour, moving from a blanket subsidy to a needs-based, more targeted system. This led to an increase in year-on-year inflation. The subsidy policy change had direct and indirect effects on inflation.

Direct effects

After six consecutive months of deflation, inflation turned positive, averaging 1.8% from October to December 2016. The main contribution to inflation stemmed from the sharp rise in the consumer price index (CPI) sub-group—food and non-alcoholic beverage prices (Figure 1). More specifically, the prices of plain rice, sugar and wheat flour increased significantly, reflecting the impact of the removal of the blanket subsidy on staples. The direct impact of the policy change on rice prices was a change from MVR4.0 per kilogram to MVR8.0 per kilogram immediately following the policy change, while the same for sugar was much larger, with

Figure 1: Inflation of Food and Beverages (National), 2016
(annual percentage change)



Source: National Bureau of Statistics

sugar prices changing from around MVR4.0 per kilogram to MVR8.0 per kilogram. However, the sugar prices also reflected the increasing international sugar prices during the same period, which would have passed through to domestic prices since sugar is an imported good.

The month-on-month inflation numbers for food and beverages, excluding fish, provide evidence that the rise in inflation from October 2016 was mainly due to the change in subsidy policy. In particular, inflation for this category showed a dramatic spike in October 2016, after which the numbers returned to pre-policy change levels of marginal deflation in November and December 2016. This implies that once the base effect of the policy change wears off from October 2017, year-on-year inflation should return to pre-policy change levels, holding all else constant.

Indirect effects

Indirect effects of the policy change appear to be limited to the category of restaurants and cafés. As the demand for staple food items in restaurants and cafés remains high, the cut down in food subsidy led to an increase in prices charged in this category. However, a larger share of the increase in inflation was contributed by the cafés (0.08 percentage points) as opposed to the restaurants (0.03 percentage points). This may be because of a higher usage of plain rice in cafés compared with restaurants. However, these changes are temporary and, as mentioned, would return to pre-policy change levels once the base effect wears off.

Inflation forecast for 2017

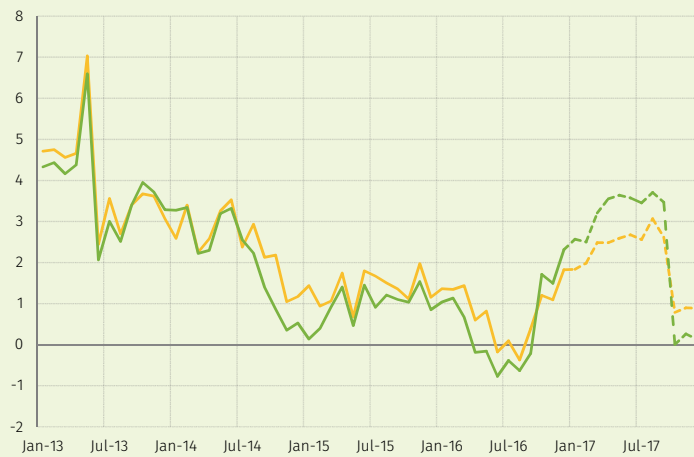
Inflation in the Male' region is expected to increase to an average of 2.1% in 2017 from an average of 0.8% in 2016, while inflation at the national level is expected to increase to 2.5% in 2017 from an average of 0.5% in 2016. The year-end forecasts for inflation stand at 0.9% and 0.1% for Male' and nationally, respectively.

Although average inflation is expected to be lower in Male' compared with the national level, the year-end level is expected to be higher. This is because the base effect of the policy change is estimated to be smaller in Male' than in other regions of the country. Thus, the dissipation of the base effect from October 2017 shifts the inflation rate downwards by a larger amount at the national level than for Male'. This is solely due to the fact that expenditure on food items constitute a

larger share of total expenditure in areas outside Male', and therefore are assigned a larger weight in the CPI basket compared to the weight assigned to the same category in the basket for Male'.

Figure 2 illustrates past developments and the expected evolution of inflation in 2017. The rise in inflation observed in October 2016 is mostly due to the effect of the change to the policy on subsidies on staple food. The base effect is projected to dissipate from October 2017, at which point the year-on-year inflation will return to the pre-policy change level, and inflation will drop accordingly.

Figure 2: Inflation (National), 2013 - 2017
(annual percentage change)



Source: Maldives Monetary Authority, National Bureau of Statistics