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IMF Executive Board Concludes 2014 Article IV Consultation with Tonga

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On July 23, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Tonga.

A major cyclone hit Tonga in January 2014, causing damage estimated at 10 percent of GDP and depressing GDP growth in fiscal year (FY) 2013–14 (to June 30) by about 1 percent. As a result, after sluggish growth of 0–1 percent in FY2012–13, the pace of recovery will rise to just 1.4 percent in FY2013–14 before strengthening to 3.4 percent in FY2014–15, led mainly by the post-cyclone reconstruction. This recovery is also supported by rising agricultural production and an improving outlook for tourism. Over the longer term, growth is expected to gradually converge to the historical trend of 1.7 percent, driven by remittances, tourism receipts, as well as credit growth. Risks to the near-term outlook are tilted to the downside.

Risk to the inflation outlook is low. Headline consumer price index (CPI) inflation has largely fluctuated between 1 to 2 percent since mid 2012, reflecting low global food prices, stable oil prices, and weak domestic demand. Inflation is expected to incrementally increase to 4–5 percent toward FY2018–19. The deleveraging cycle of the Tongan banks appears to be ending, with both lending and asset quality indicators substantially improving.

The projected fiscal cost relating to the cyclone will be broadly met by confirmed funding mainly from donor agencies. As a result, the budget is expected to record only small overall deficits in FY2013–14 and FY2014–15, estimated at around 0.6–0.7 percent of GDP. The external current account is projected to show a deficit of close to 3 percent of GDP in FY2013–14 and FY2014–15, largely financed by foreign direct investment (FDI) inflows. International reserves increased about threefold since 2008—to about 8 months of prospective imports. In the medium term, stronger imports and lower foreign grants will slightly decrease international reserves to 7 months of imports.

Executive Board Assessment²

Executive Directors welcomed that Tonga's economy is rebounding, supported by a recovery in agricultural exports and post-cyclone reconstruction activity. Directors noted that while the near-term focus should be on reconstruction, in the medium term, priority should be given to building buffers to enhance resilience to shocks. Business-enabling structural reforms will be key to achieving sustainable and robust growth.

Directors encouraged the authorities to maintain overall fiscal prudence while accommodating cyclone-related financing needs. They welcomed that the projected fiscal cost related to the cyclone will be broadly met by funding from development partners. Over the medium term, the fiscal strategy should aim to gradually increase the primary surplus, and to reduce the debt-to-GDP ratio. In this context, Directors underscored the need to continue with revenue reform and wage restraint, strengthen debt management, and avoid cost overruns associated with the South Pacific Games.

Directors considered the current accommodative monetary policy stance appropriate. They agreed that the National Reserve Bank of Tonga (NRBT) should consider tightening monetary conditions when signs of credit growth firm up. Directors welcomed the plan to expand the NRBT's regulatory mandate to include nonbank financial institutions, and supported continued efforts to address bottlenecks in credit information and creditor rights. They noted that the authorities' plan to lower the cost of credit through supportive measures, including by commercializing Tonga Development Bank, should be accompanied by robust safeguards to ensure the soundness of the bank.

In view of challenges posed by Tonga's geographic remoteness and smallness, and its exposure to natural disasters, Directors encouraged the authorities to identify and strengthen new engines of growth. They underscored the need to continue to improve the business environment and to bolster confidence. Directors agreed that the promotion of foreign direct investment should focus on business-enabling structural reforms, while the use of tax incentives should be minimized and well targeted.

Tonga: Selected Economic Indicators, 2008/09 to 2014/15 1/

Estimates Projections

2008/09 2009/10 2010/11 2011/12 2012/13 2013/14 2014/15

Output and prices

Real GDP 2/	3.2	3.3	2.9	0.7	0.3	1.4	3.4
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Consumer prices (period average)	5.5	1.7	6.0	3.3	0.7	1.5	1.7
Consumer prices (end of period)	1.2	2.7	7.1	2.3	0.2	1.3	2.2
GDP deflator	-2.4	3.7	5.8	2.4	0.7	1.5	1.7

Central government finance

Total revenue and grants	34.3	27.0	26.3	27.4	24.1	29.5	29.0
Total revenue	27.4	20.2	19.5	18.1	18.7	18.8	19.0
Grants	6.8	6.8	6.8	9.4	5.4	10.7	10.0
Total expenditure and net lending	34.4	32.3	33.7	30.2	25.1	30.0	29.7
<i>Of which:</i> Current expenditure	25.2	25.8	22.6	23.5	23.5	27.2	24.7
Capital expenditure	2.7	2.6	9.6	5.6	1.6	2.8	5.0
Overall balance	-0.2	-5.3	-7.4	-2.8	-1.0	-0.6	-0.7
Overall balance (excl. China's EXIM Bank loans)	6.1	-0.2	1.8	3.1	0.0	-0.6	-0.7
External financing (net)	-0.7	3.5	8.4	5.2	0.2	0.6	0.9
Domestic financing (net)	-5.2	1.9	-1.1	-2.4	0.8	0.0	-0.2

Money and credit

Total liquidity 3/	-1.8	5.1	3.1	-1.7	7.2	7.8	...
<i>Of which:</i> Broad money (M2)	-2.4	5.6	3.3	-1.8	8.2	8.0	...
Domestic credit	-5.2	-11.5	-12.3	-8.7	-3.0	9.5	...
<i>Of which:</i> Private sector credit	-3.7	-15.6	-9.9	-2.7	-9.8	1.0	...
Interest rates (end of period)							
Average deposit rate	5.3	3.8	3.4	3.5
Base lending rate	10.0	9.6	9.6	9.6

Balance of payments

Exports, f.o.b.	7.1	7.9	10.9	14.8	15.2	15.8	17.3
Imports, f.o.b.	-130.5	-130.4	-152.6	-179.3	-139.9	-154.0	-172.5

Services (net)	-15.2	-8.5	3.5	-6.8	6.2	-1.8	-2.8
Investment income (net)	6.4	4.0	9.0	11.2	12.7	13.3	14.0
Current transfers (net)	104.0	109.0	117.8	129.0	80.2	110.7	129.0
<i>Of which: Remittances</i>	84.0	82.0	87.5	66.8	68.8	74.2	77.6
Current account balance	-28.2	-17.9	-11.4	-31.1	-25.6	-16.0	-15.1
(In percent of GDP)	-8.9	-4.9	-2.7	-6.6	-5.5	-3.3	-3.0
Overall balance	19.5	19.8	33.3	19.8	12.2	15.5	1.7
Terms of trade (annual percent change)	-3.4	5.2	-3.6	0.8	-1.6	0.3	0.9
Gross official foreign reserves							
In millions of U.S. dollars	67.8	87.5	120.8	140.6	152.8	168.3	170.0
(In months of next year's goods and services imports)	4.6	5.0	5.7	7.8	7.8	7.8	7.3
External debt (in percent of GDP)							
External debt	31.5	31.8	36.0	41.9	41.4	40.8	39.9
Debt service ratio	0.7	1.2	1.2	1.4	1.7	1.7	1.9
Exchange rates							
Pa'anga per U.S. dollar (period average)	2.1	1.9	1.8	1.7	1.7	1.7	1.7
Pa'anga per U.S. dollar (end of period)	2.0	1.9	1.7	1.8	1.7	1.7	1.7
Nominal effective exchange rate (2005=100)	95.7	96.9	97.4	103.4	104.5	104.4	104.2
Real effective exchange rate (2005=100)	107.5	108.3	111.5	118.4	118.4	118.4	118.4
Memorandum items:							
Remittances (in percent of GDP)	26.4	22.2	20.7	14.2	14.8	15.4	15.3
Tourism (in percent of GDP)	8.7	7.0	7.9	7.7	8.7	7.2	7.9
FDI (in percent of GDP)	12.1	2.1	1.5	1.1	3.4	2.4	2.4
Nominal GDP (millions of T\$)	664.3	712.2	775.0	799.3	806.7	830.4	873.2

Population (thousands)	102.5	102.8	103.0	103.1	103.4	103.7	103.9
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Sources: Tongan authorities; and IMF staff estimates and projections.

1/ Fiscal year beginning July.

2/ Including preliminary data.

3/ From the Banking Survey, which includes the Tonga Development Bank.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

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