



TONGA

August 2014

2014 ARTICLE IV CONSULTATION - STAFF REPORT; STAFF SUPPLEMENT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TONGA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 23, 2014, following discussions that ended on April 29, 2014, with the officials of Tonga on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 19, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Staff Supplement** of July 17, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its July 23, 2014 consideration of the staff report that concluded the Article IV consultation with Tonga.
- A **Statement by the Executive Director** for Tonga.

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TONGA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

June 19, 2014

KEY ISSUES

Context: Tonga's economy is rebounding, partially owing to a recovery in agricultural exports. The outlook for tourism is also improving. The reconstruction from a recent cyclone is expected to lead to both a temporary boost to growth and additional financing needs. Risks to the inflation outlook and the external position are low.

Fiscal Policy: The projected fiscal cost relating to the cyclone will be largely met by confirmed funding mainly from donor agencies. In the near term, the authorities should focus on reconstruction activities, while a medium-term fiscal strategy should aim at gradually stabilizing and then reducing the debt-to-GDP ratio, in order to improve Tonga's moderate risk of debt distress. This will require careful execution of investments related to the 2019 South Pacific Games.

Monetary Policy: The deleveraging cycle of the Tongan banks appears to be ending, and thus National Reserve Bank of Tonga should prepare to gradually withdraw liquidity and tighten monetary conditions once the current signs of a recovery of credit growth are confirmed. The authorities plan to lower the cost of credit through supportive credit policies, including by commercializing the Tonga Development Bank. The successful implementation of such plan requires sound safeguards, including a robust governance structure and firm risk management and accountability frameworks.

Structural Policy: Structural reforms to facilitate the functioning of credit markets need to be implemented with renewed vigor. The authorities' intention to gradually phase out existing ad hoc tax incentives is well placed. The promotion of foreign direct investments should focus on business-enabling structural reforms, while the use of tax incentives should be minimized and well targeted.

Approved By
Luis Breuer and Peter Allum

Discussions took place in Nuku'alofa during April 14–29. The staff team comprised Jookyung Ree (Head), Christiane Eva Kneer (APD), Fei Liu (SEC), and assisted by Yongzheng Yang (Resident Representative). Mr. Santoso and Ms. Moe Moe (OED) participated in key discussions.

CONTENTS

THE MACROECONOMIC SITUATION	4
A. Authorities' Views	4
COPING WITH EXTRA FINANCING NEEDS	5
A. Background	5
B. Staff Views	5
C. Authorities' Views	6
REINVIGORATING FINANCIAL INTERMEDIATION	7
A. Background	7
B. Staff Views	7
C. Authorities' Views	8
REVERSING THE TREND OF SLOWER GROWTH	8
A. Background	8
B. Staff Views	9
C. Authorities' Views	9
STAFF APPRAISAL	10
BOXES	
1. The Macroeconomic Impact of the Cyclone	11
2. Macroeconomic Implications of Hosting the 2019 Pacific Games	12
3. Exchange Rate Assessment	13
4. Previous Fund Recommendations	14
FIGURES	
1. Stylized Facts	15
2. Economic Developments	16
3. Exchange Rate and Fiscal Policy Developments	17
4. Monetary Policy and Financial Sector Developments	18

TABLES

1. Tonga: Selected Economic Indicators, 2008/09–2014/15	19
2. Tonga: Summary of Government Operations, 2008/09–2014/15	20
2.a Summary of Government Operations, 2008/09–2014/15	21
3. Tonga: Depository Corporations Survey, 2008/09–2013/14	22
4. Tonga: Balance of Payments Summary, 2008/09–2014/15	23
5. Tonga: Medium-Term Scenario, 2009/10–2018/19	24
6. Tonga: Financial Soundness Indicators, 2008/09–2012/13	25
7. Tonga: Millennium Development Goals, 1990–2012	26

APPENDIX

I. Risk Assessment Matrix	27
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THE MACROECONOMIC SITUATION

1. Tonga's economy is rebounding supported by a recovery in agriculture and other sectors. The outlook for tourism is also improving. After slowing to 0-1 percent in FY2012/13 (fiscal year ends on June 30), real GDP growth is expected to recover to 1½ percent in FY2013/14, and further to 3½ percent in FY2014/15. The damage caused by the January 2014 Cyclone Ian is expected to reduce growth by about ¾ percent in FY2013/14, but reconstruction activities would boost growth by about 1½ percentage points of GDP in FY2014/15 (Box 1 and Figure 2). Thereafter, growth is expected to gradually converge to the historical trend of 1¾ percent, driven by remittances and tourism receipts, as well as credit growth.

2. Risks to the near-term outlook are tilted to the downside. Spillovers from a protracted period of slower growth in advanced and emerging economies or in China could adversely impact Tonga, notably through its interconnectedness with Australia and New Zealand. On the domestic side, if slippages occur in critical reforms, e.g., owing to the election in late 2014, or a cost overrun takes place in preparation for the 2019 South Pacific Games (hereinafter "the Games"), they may hamper macroeconomic stability. The greater frequency of natural disasters also presents significant risks.

3. Inflation remains significantly below the NRB's reference range (6–8 percent). Headline CPI inflation has largely fluctuated between -1 and 2 percent since mid-2012, reflecting low global food prices, stable oil prices, and weak domestic demand. Despite the projected further decline in commodity prices, staff expects base effects (from the current low levels) and expectation inertia to incrementally raise inflation to 4-5 percent toward FY2018/19, with demand effects relating to the preparation for the Games also adding pressures (Box 2).

4. There are no imminent risks to the external balance. Increases in foreign grants and weak imports have caused international reserves to increase about threefold since 2008—to about 8 months of imports estimated for FY2012/13. In FY2013/14 and 2014/15, the cyclone's impact is expected to 'reduce' the current account deficit by about 1¾ percent of GDP in cumulative terms, with disaster-related grants and insurance payouts more than offsetting increases in imports. In the medium term, the cyclical recovery of imports—boosted further by the Games—and lower levels of foreign grants would decrease international reserves to 7 months of imports by FY2018/19. The real effective exchange rate is broadly in line with medium-term fundamentals (Box 3).

Authorities' Views

5. The authorities broadly agreed with the staff that the economy is rebounding. However, they remained cautious about the extent to which the recovery builds on the underlying strength of the economy. The authorities noted that Tonga's economic growth should not continue to be driven by disaster-related or externally funded project cycles, and thus complacency is unwarranted. The authorities expected inflation to remain subdued through the medium term. They noted that inflation in Tonga tends to be strongly influenced by commodity prices, which are expected to decline over the medium term, and the inflation's link to the output gap is weak.

COPING WITH EXTRA FINANCING NEEDS

Reconstruction spending is a near-term priority, while in the medium term, the authorities should aim to gradually reduce the debt-to-GDP ratio. Tonga's exposure to natural disasters, as well as the country's development needs, require careful management of fiscal space.

A. Background

6. Reconstruction from Cyclone Ian is expected to weaken the fiscal position in the coming years. The initial damage assessment estimated property damage of about 10 percent of GDP and a reduction of the overall fiscal balance by 1.5 percentage points of GDP, leading to a deficit of 0.6 percent of GDP in FY2013/14 (Figure 3). The impact of the cyclone is expected to linger through FY2014/15, raising the overall deficit by 1 percentage point—to 0.7 percent of GDP.

Summary of Fiscal Impact of Cyclone Ian						
	Prov. 2012/13	Budget 2013/14	Projections			
			2013/14 Pre	2013/14 Post	2014/15 Pre	2014/15 Post
(In percent of GDP)						
Total revenue and grants	24.1	29.2	27.2	29.5	27.0	29.0
Total revenue	18.7	18.8	18.6	18.8	18.9	19.0
Grants (in cash)	5.4	10.4	8.6	10.7	8.2	10.0
Total expenditure and net lending	25.1	27.4	26.3	30.0	26.8	29.7
Current expenditure	23.5	25.5	24.7	27.2	24.7	24.7
Capital expenditure	1.6	1.8	1.6	2.8	2.0	5.0
Total financing	1.0	-1.8	-0.9	0.6	-0.3	0.7
External financing	0.2	-1.8	-0.3	0.6	0.1	0.9
Domestic financing	0.8	0.0	-0.6	0.0	-0.4	-0.2
<i>Memorandum items:</i>						
Real GDP growth	0.3	...	2.2	1.4	1.9	3.4
Current Account (percent of GDP)	-4.7	...	-5.4	-3.3	-2.7	-3.0

Sources: Tongan authorities; and IMF staff estimates.

7. The repayment of a large external loan (equivalent to about 15 percent of GDP) provided by a bilateral donor in 2007 appears to have been waived pending renegotiation of the terms. The loan was provided to support reconstruction of Nuku'alofa's central business district, after it was destroyed by a civil unrest in 2006. The 5 year grace period was set to expire in September 2013.

B. Staff Views

8. The projected fiscal cost related to the cyclone (7 percent of GDP; about 60 million pa'anga) will be largely met by confirmed funding mainly from donor agencies. They consist of grants (about 70 percent), loans (about 20 percent), and holdings of disaster trust funds (about 10 percent). In case a gap emerges in cyclone reconstruction financing, the authorities should seek to reallocate fiscal resources, for example, by reprioritizing other spending. Consideration can then be given to domestic bond financing. While government bonds carry relatively high interest costs, there is some space for a cautious use of domestic bonds for high-priority spending.¹

9. For FY2014/15, the authorities should focus on accommodating the financing needs of reconstruction from the cyclone. Given the expected increase in the fiscal deficit owing to the cyclone (about 1 percent), the authorities should maintain a sound position in the overall balance excluding cyclone-related spending. Staff projects a small surplus for the non-cyclone overall balance

¹ The staff's illustrative analysis shows that a 25 million pa'anga increase in outstanding government bonds in the medium term would raise interest costs by 0.2 percentage points of GDP, assuming an interest rate of 5½ percent.

this fiscal year, which would provide some additional flexibility to meet priority expenditures. The authorities appropriately intend to save the waived repayments for the 2007 external loan to the extent possible. For fiscal and debt-management clarity, the new terms of the repayment should be defined as soon as possible.

10. The medium-term fiscal strategy should aim at gradually stabilizing and then reducing the risk of debt distress, anchoring policy by the debt-to-GDP ratio. Given the country's exposure to natural disasters, Tonga also needs to build policy buffers, including by maintaining prudent levels of indebtedness. To this end, the authorities should aim at gradually increasing the primary fiscal surplus to about 1 percent of GDP (average; over the longer-term), which in the staff's analysis, would be consistent with stabilizing external debt at about 30–35 percent of GDP. Wage restraint—in line with the authorities' target—and revenue reform (e.g., broadening the consumption tax base²) are important to improve the fiscal position, while at the same time, preserving capital expenditures and maintaining a cash cushion.³ This will contribute to keeping the risk of debt distress at a moderate level in the medium term, and reducing it to low in the long run. In this context, the authorities should carefully manage fiscal costs associated with hosting the 2019 South Pacific Games. In line with their current plans, focus should be put on avoiding cost overruns and debt-creating financing.

C. Authorities' Views

11. The authorities' FY2014/15 budget strategy continues to anchor the fiscal position to the operating cash balance and will contain the growth of nonpriority expenditure. The authorities intend to implement the 'Amended No New Loan Policy' as follows: no external commercial borrowing, cautious use of concessional loans only in limited cases (e.g. budget support), and restricting domestic debt issuance in principle to refinancing.

12. In terms of their response to the cyclone, the authorities intend to first indentify all available external grants and concessional loans and then adjust spending to this level. If there is a financing gap, the authorities intend to rephase cyclone spending or reprioritize other spending before seeking other options.

13. The authorities took note of the need for prudent management of the South Pacific Games. They are mindful of the fiscal risks that can arise from a potential cost overrun and are seeking lower-cost options to meet facility requirements. They are not considering debt-creating funding of the preparation for the Games.

14. The authorities expected the revenue-to-GDP ratio to increase over time—including from new income sources (e.g. the mineral tax). While acknowledging political challenges, the authorities reaffirmed their intention to incrementally lower the wage bill from 50 percent (as of now) to 45 percent of recurrent spending.

² Zero rating and exemptions in consumption tax and excises are estimated to result in about 4 percent of GDP loss in tax revenues.

³ Staff projects that the cash cushion will gradually increase to 2 months of recurrent spending (from the current level of 1 month) over the medium term.

REINVIGORATING FINANCIAL INTERMEDIATION

The deleveraging cycle of Tongan banks appears to be coming to an end.

A. Background

15. The deleveraging cycle of the Tongan banks appears to be ending. Bank lending to households increased by 2.2 percent in February 2014 despite the continuation of nonperforming loan (NPL) charge-offs, and significant substitution to lending by nonbanks, including retirement funds and microfinance institutions. Asset quality indicators have also substantially improved, for example with the ratio of NPL expenses to total loans falling well below the average levels prior to the global financial crisis. However, business lending continues to decline reflecting still stagnant new lending and continued charge-offs.

16. During the last few years, the NRBT has maintained an accommodative monetary stance. In view of a lower risk of inflation, comfortable international reserves, and a credit squeeze, the focus was placed on maintaining sufficient levels of liquidity.

B. Staff Views

17. A strategy to reinvigorate financial intermediation at present will require:

- *Careful timing of the withdrawal of the monetary impulse.* The NRBT should prepare to gradually withdraw liquidity and tighten monetary policy once current signs about the imminent turn of the credit cycle are confirmed. This could be done by gradually increasing reserve requirement ratio to the levels prior to the global financial crisis. A timely reduction of excess liquidity will help safeguard financial stability, but a premature withdrawal should be avoided as it may hurt the nascent recovery. There is a need to review the NRBT's inflation reference range given the recent low rates of inflation, and the constraints posed by NRBT's commitment to a basket peg of the pa'anga's exchange rate.
- *Judicious use of supportive credit policies.* To support growth and access to finance, the authorities plan to commercialize the Tonga Development Bank (TDB),⁴ including through identifying potential private partners. In this process, proper safeguards against fiscal and governance risks (e.g., a sound risk management and accountability framework) should be put in place, including through the revision of Tonga Development Bank bill and, ideally, continued partnership with the multilateral institutions. In this regard, a thorough peer review of the bill would be useful. The recent increase in credit extended by retirement funds and microfinance institutions presents low risk to financial stability, and the authorities' plan—based on the IMF's recent technical assistance—to expand the NRBT's regulatory mandate to include nonbank financial intermediaries is welcome. Staff takes note of the authorities' goal to lower the cost of credit through competition and expanded policy lending. A safeguard should be carefully crafted to advance the authorities' plans for new policy options, for example, a risk sharing facility or policy lending schemes.

⁴ The plan envisages making TDB to undertake the full range of commercial banking activities (e.g. deposit and foreign exchange services), which is expected to result in significant expansion of its lending book. Currently TDB finances its operation mainly by wholesale borrowing. It has so far not engaged in many activities that are allowed under its banking license, to focus its limited resources on public policy mandates.

- *Continued advances in financial reform.* Structural reforms to address bottlenecks in credit information and creditor rights (e.g., receivership bill, improved credit bureau, and land registry reform) should continue to help promote financial development and strengthen the effectiveness of monetary policy. If these reforms become stalled, the cost of credit will remain structurally high, and the role of the financial sector in supporting private sector development constrained.

18. The current basket peg of the exchange rate has served the country well as a nominal anchor. Despite limited capital mobility, pegging the pa'anga's exchange rate to a currency basket of its main trading partners has constrained NRBT's ability to influence domestic monetary conditions.

C. Authorities' Views

19. The authorities do not intend to tighten monetary policy at this time. While agreeing that excess liquidity needs to be reduced for the NRBT to regain influence on market interest rates, the authorities would like to avoid an increase in interest rates, which could dampen the nascent economic recovery. The authorities also noted that the recent recovery in credit growth resulted largely from lending to a few public enterprises and may, therefore, not be sustainable.

20. The authorities intend to use supportive credit policy instruments to help lower the cost of credit. In their view, Tonga's high interest spread results from weak competition and high staffing costs, rather than structural impediments. The authorities expected the imminent operation of a new bank to help to enhance competition.

21. While recognizing the need for safeguards, the authorities will expedite the commercialization of the TDB. They noted that the revised TDB bill will address safeguarding concerns, for example, by putting in place a good governance framework, and by subjecting the TDB to the NRBT's prudential regulation and supervision. The authorities are also considering more options for channeling excess liquidity to support lending to priority business sectors and start-ups, building on their recent experience in the pilot policy lending schemes to support agriculture, fishery, and manufacturing.

REVERSING THE TREND OF SLOWER GROWTH

Longer-term structural policies should focus on identifying and strengthening engines of growth.

A. Background

22. Tonga's efforts to develop the private sector are ongoing. Tonga's geographical remoteness and weak infrastructure make a breakthrough in tourism challenging, as evidenced by the difficulties in finding a private partner for the International Dateline Hotel, which has been in receivership for years. Nonetheless, the authorities aim to develop tourism as the key engine of growth. While progress since last year has been limited, the authorities put together a comprehensive road map for tourism development, with extensive consultation with the private sector. Tonga's economy has not been able to create sufficient jobs, particularly for the youth. While Tonga's headline unemployment rate is very low ($1\frac{3}{4}$ percent), this is largely a result of low labor force participation, high levels of emigration, and a large share of subsistence workers.

B. Staff Views

23. A robust and sustainable growth model would require identifying and strengthening engines of growth. Given Tonga's remoteness, a growth model relying mainly on exports of goods would have limits. Tonga's small domestic market limits opportunities for import substitution. Tonga should thus significantly strengthen services exports. It should also continue to participate in seasonal worker programs, providing training as needed, and maximizing opportunities that might arise from the new fiber-optic-cable-connection projects, for example, through call centers or access to on-line education. The link between remittance flows and domestic investment should also be strengthened, e.g., through specialized financial products.

24. The authorities intend to promote tourism, agriculture, and fisheries. Continued strengthening of the business environment, including through judicious deregulation, and confidence building through sound macroeconomic policies are welcome. These efforts are very important particularly in view of the challenges posed by Tonga's geographic remoteness and smallness. Ongoing consultations with the private sector through sector growth committees are noteworthy. Strengthened policy coordination, too, is beginning to improve sentiment and deliver results, such as a fumigation facility at the main port.

25. The promotion of foreign direct investments (FDI) should focus on business-enabling structural reforms, while the use of tax incentives should be minimized and well targeted. Introduction of new incentives could be linked to retiring existing incentives that are ad hoc and ineffective. A periodic review of investment incentives based on measurable outcomes would be useful in this regard. A robust revenue reform to broaden the tax base should also help in creating fiscal space toward this end. The staff notes the authorities' intention to find a private partner for the International Dateline Hotel.

26. Efforts should continue for further enhancing public sector performance. As in most microstates, the contribution of the public sector to the economy will remain relatively large. Enhancing public sector performance is thus a perennial priority. A robust public spending framework can also buttress a private sector-led growth strategy by addressing bottlenecks (e.g. infrastructure and education). The authorities' intention to continue civil service reform is welcome, given ample scope for efficiency gains in human resource management. Gradual but continued progress in the integration of corporate planning and budgeting is noted, and the authorities should further enhance communication with and buy-ins of stakeholders. The authorities' intention to finalize a public financial management road map is welcome. Efforts should continue to improve statistical data—to better enable business decisions, as well as policy making—by strengthening resources.

C. Authorities' Views

27. The authorities noted that they intend to promote tourism, agriculture, and fishery sectors, while recognizing the potential of other sectors. The authorities underscored their intention to carefully calibrate the right balance between the need to entice priority FDI projects and to protect the revenue base. They underscored that the new tourism roadmap takes an 'integrated approach'—combining rules-based, targeted tax incentives and regulatory reforms. They are also considering a thorough review of existing tax exemptions and a gradual phasing out of ad-hoc exemptions.

STAFF APPRAISAL

28. Tonga's economy is rebounding, in part because of a recovery in agricultural exports.

Despite structural challenges, the tourism outlook is also gradually improving. The reconstruction from a recent cyclone and the preparations for the 2019 South Pacific Games are expected to lead to both additional financing needs and a temporary boost to growth. Risks to the inflation outlook and the external position are low.

29. The short-term priority is to facilitate reconstruction spending. The projected fiscal cost relating to the cyclone will be broadly met by confirmed funding mainly from donor agencies. In the near term, the authorities should focus on accommodating the financing needs caused by the cyclone. Given the expected increase in the fiscal deficit owing to the cyclone, the authorities should maintain a sound position in the overall balance excluding cyclone effects.

30. The medium-term fiscal strategy should aim at gradually stabilizing and then reducing Tonga's risk of debt distress, anchoring policy by the debt-to-GDP ratio. With a large exposure to natural disasters, Tonga must rebuild fiscal buffers, including by maintaining a prudent level of public debt. To this end, the authorities should aim at gradually increasing the primary fiscal surplus to stabilize the debt ratio in the medium term, and reducing it thereafter. Wage restraint and revenue reform will be needed to accomplish this.

31. The deleveraging cycle of the Tongan banks appears to be ending. Thus the NRBT should prepare itself to gradually withdraw liquidity and tighten monetary conditions once current signs of credit growth are confirmed. The authorities plan to lower the cost of credit through supportive credit policies, including by commercializing the TDB. Robust safeguards should be put in place to implement these plans in a sustainable way.

32. Given Tonga's remoteness, a growth model relying mainly on exports of goods could have limits. At the same time, Tonga's small domestic market narrows opportunities for import substitution. Tonga should thus significantly strengthen services exports. It should also continue to participate in seasonal worker programs, providing training as needed, and maximize opportunities from the new fiber-optic-cable-connection projects. The link between remittance flows and domestic investment should also be strengthened, e.g., through specialized financial products. The authorities intend to promote tourism, agriculture, and fisheries. Continued strengthening of the business environment and confidence building are welcome, in view of challenges from Tonga's remoteness and smallness.

33. The promotion of FDI should focus on business-enabling structural reforms, while the use of tax incentives should be minimized and well targeted. Introduction of new incentives could be linked to retiring existing incentives that are ad hoc and ineffective. A periodic review of investment incentives based on measurable outcomes would be useful. A robust revenue reform to broaden the tax base should also help in creating fiscal space toward this end.

34. It is recommended that the next Article IV consultation with Tonga be held on the 12-month cycle.

Box 1. The Macroeconomic Impact of the Cyclone ¹

In January 2014, a category 4 cyclone hit the Ha'apai island group in the northeast of Tonga; this island group's annual contribution to national output is about 6 percent. Cyclone Ian affected around 5,000 residents and destroyed or damaged almost 1,000 houses and buildings.

The Tongan authorities and development partners provided swift emergency assistance and designed a Cyclone Response Plan to address the short-term needs of the affected population. The total damage to the Tongan economy is estimated to amount to about 10 percent of GDP. Losses and damages were concentrated in housing, but the agriculture, hospitality, power, manufacturing, and education sectors were also heavily affected. Reconstruction will mostly take place in FY2014/15.

With the assistance of the World Bank, the government intends to build 550 permanent houses and support the repair of 400 damaged houses, with total construction costs amounting to 20 million pa'anga (2.5 percent of GDP). Rebuilding infrastructure, providing sanitation facilities, and restoring the livelihoods of affected communities will require additional resources. The cyclone is expected have a significant impact on the economy.

	Output Impact of Cyclone Ian (In percent of GDP)	
	FY2013/14	FY2014/15
Agriculture, forestry, and fishing	-0.4	0.0
Manufacturing	-0.3	-0.3
Electricity and water	0.0	0.0
Construction	0.3	1.0
Tourism	-0.2	0.0
Imputed rents	-0.2	-0.3
Total impact on GDP 1/	-0.7	0.4

Source: IMF staff estimates.

Notes: 1/ Difference between pre- and post-cyclone baseline GDP Forecasts.

- Growth: The staff estimates that Cyclone Ian has shaved $\frac{3}{4}$ percent off FY2013/14 GDP (relative to the pre-cyclone baseline forecast). This mainly reflects output losses in agriculture, manufacturing, tourism and imputed rents from housing. Reconstruction activities in the aftermath of the cyclone are expected to boost GDP by 0.4 percent in FY2014 (relative to the same baseline).
- Inflation: The cyclone is not projected to affect official inflation data. The official inflation statistics only capture price developments on the main island and spillover effects from a redirection of food products, additional imports, and wage pressures in construction—based on historical experience—are likely negligible.
- Balance of payments: Disaster-related grants and insurance payouts are expected to more than offset increases in imports, thus improving the current account balance in FY2013/14 by 2 percentage points of GDP. During the peak of the reconstruction phase in FY2014/15 the effect of increased imports of construction materials is projected to dominate, worsening the current account balance by $\frac{1}{4}$ percentage point of GDP.

¹ Prepared by Eva Christiane Kneer (APD).

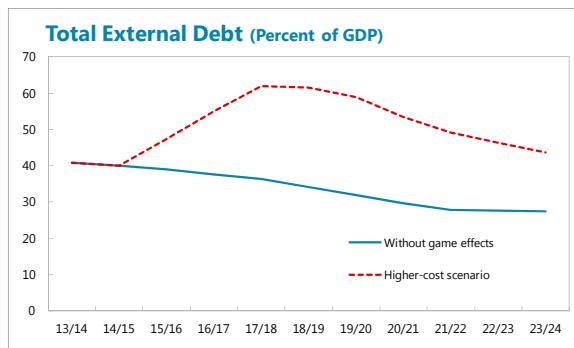
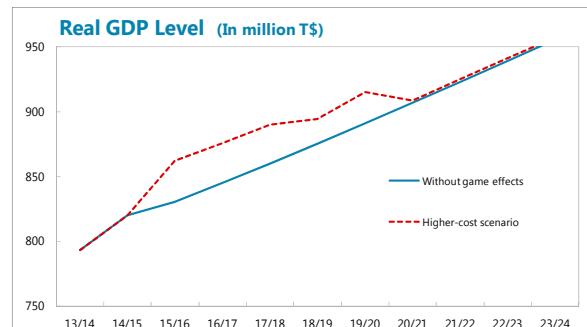
Box 2. Tonga: Macroeconomic Implications of Hosting the 2019 Pacific Games ¹

Tonga will host the sixteenth Pacific Games in Nuku'alofa in August 2019. The Games are held every 4 years with the participation of 22 nations in the South Pacific region. The Games will be operated by the Pacific Games Organizing Committee, a special purpose entity. Tonga plans to upgrade the existing sports facilities and renovate several school facilities in the Games village to accommodate the sports teams.

The authorities' preliminary projected expenditure for hosting the Games is US\$70 million, which represents about 15 percent of current nominal GDP and 50 percent of general government revenue. The authorities currently envisage covering the operating cost (US\$20 million) with the Games revenue, and the capital cost (US\$50 million) with donations and franchises. With nondebt financing covering the entire costs, the authorities' plan is fiscally prudent. When followed through, it would thus not affect Tonga's risk of debt distress—which is moderate.

However, the experiences of other countries have shown that actual Game costs often exceed the original budget. For example, in Papua New Guinea, the projected expenditure was US\$94.5 million when submitting its bid for the 2015 Games. More recent cost estimates have risen to about US\$342 million. The Barcelona Olympics left the central Spanish government US\$ 4 billion in debt, and the city and provincial governments an additional US\$2.1 billion in debt.

Therefore, the authorities should be cautious about the risk of cost overrun, with particular care being taken on avoiding debt financing. As an illustration of risks, we simulated DSA assuming, hypothetically, cost overruns financed by an external debt of US\$170 million (higher-cost scenario). The simulation shows that Tonga will be at high risk of debt distress under this scenario.



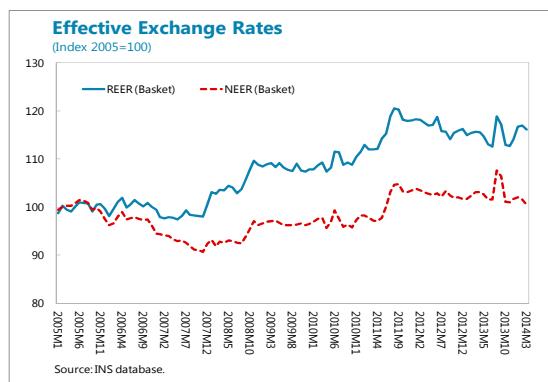
¹ Prepared by Fei Liu (SEC).

Box 3. Exchange Rate Assessment¹

Tonga's real effective exchange rate is broadly in line with medium-term fundamentals.

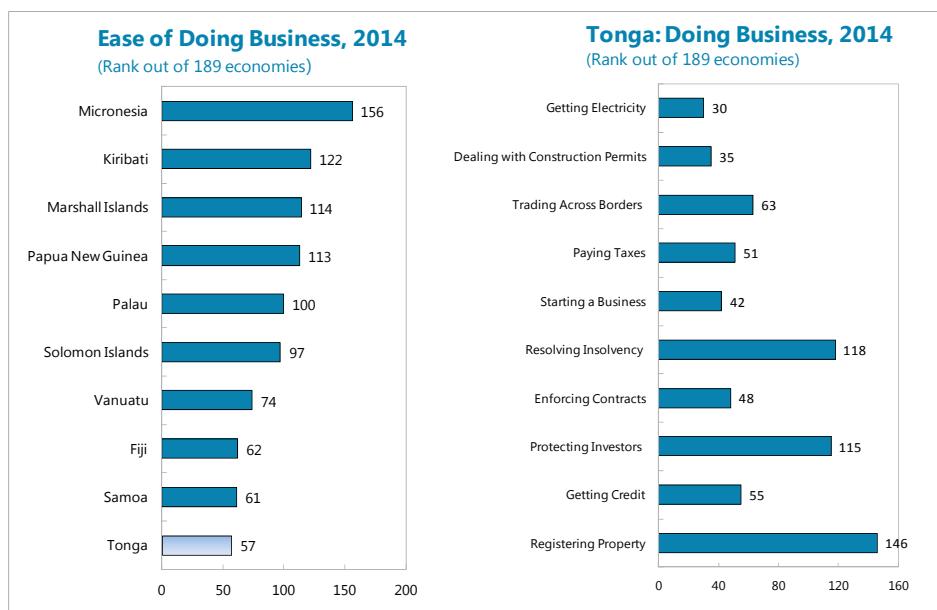
Exchange Rate

- Tonga's real effective exchange rate (REER) is broadly in line with medium-term fundamentals. The purchasing power parity approach—which uses a country's relative price levels as the proxy for the long-run equilibrium exchange rates of its currency—suggests that the Tonga's pa'anga is above its long-run equilibrium level by about 3 percent, while the equilibrium real exchange rate approach—estimated for IMF's standard exchange rate assessment model—indicates an overvaluation of 7 percent.



Nonprice Measures and Other Indicators

- Exports.** Export growth is expected at about 8 percent in the medium term, as the economy continues to recover, and programs to boost exports, including in tourism and agriculture, yield results.
- Costs of doing business.** Tonga made good progress in terms of improving the business environment under the World Bank's *Doing Business 2014* report, in which it is in the top ranking among Pacific island countries.² The ease of getting credit has been improved with the establishment of a private credit bureau to facilitate access to credit information. However, overcoming Tonga's geographical disadvantage will require an even stronger business environment. Further improvements to business climate (e.g. easing tax payment) and enhanced policy coordination to nurture a business-friendly environment will be important.



¹ Prepared by Jingzhou Meng (APD).

² Caution is needed in interpreting the indicators owing to limited number of respondents, a limited geographical coverage, and standardized assumptions on businesses constraints and information availability.

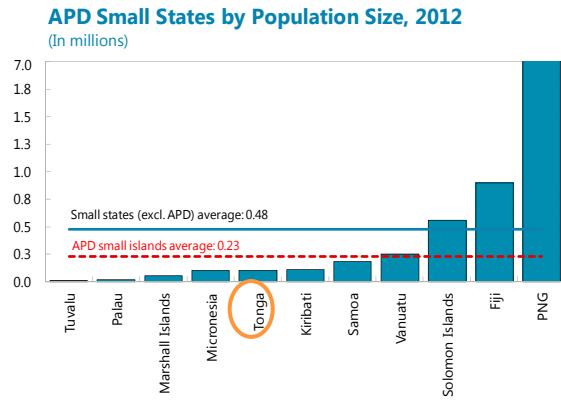
Box 4. Tonga: Previous Fund Recommendations

The staff and the authorities have continued to share comprehensive views in the past about policy priorities. In the 2013 staff report, staff continued to emphasize the importance of preserving cash buffers and a credible fiscal consolidation; continuing to expedite financial sector reform to renew credit growth; improving the business environment to strengthen investor confidence.

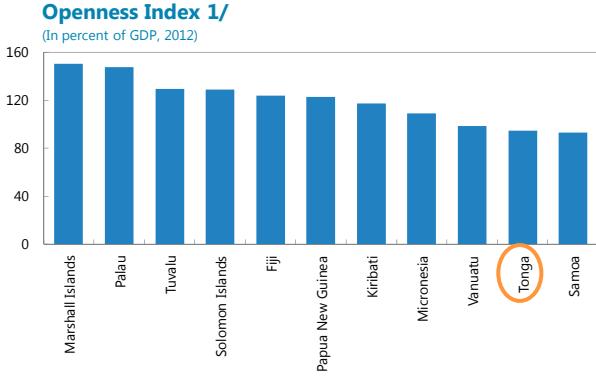
- The authorities continued to manage prudent fiscal policy stance focusing on protecting cash buffers and restraining non-priority spending. They also continued to adopt No New Loan policy while amending it to allow taking of concessional budget support loans provided by IFIs (which is in line with the recommendations from the 2013 staff report).
- The authorities continued to strengthen risk-based supervision, including through PFTAC technical assistance, and expect to enact the Receivership bill this year.
- After removing the annual renewal requirement for the headline business license, the authorities are advancing ancillary licensing reforms, e.g., by easing immigration VISA renewal process.
- The authorities are finalizing legislative process for a presumptive tax regime for SMEs and a natural resource tax regime.

Figure 1. Tonga: Stylized Facts

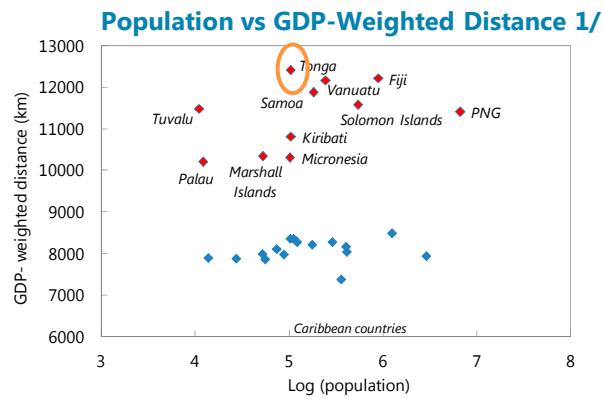
As a Pacific island country, Tonga is a small...



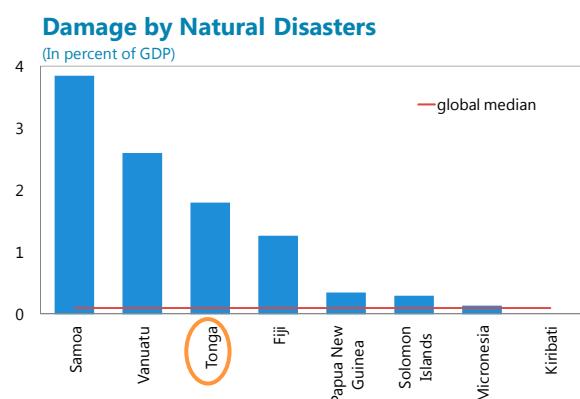
...open economy...



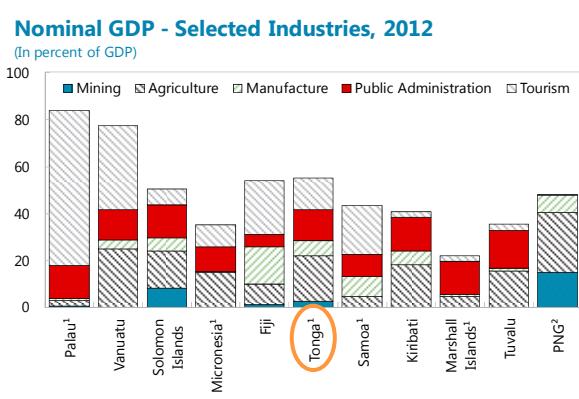
...highly remote...



...and heavily affected by natural disasters...



Its production base is quite narrow...



...and relies heavily on remittances to support income.

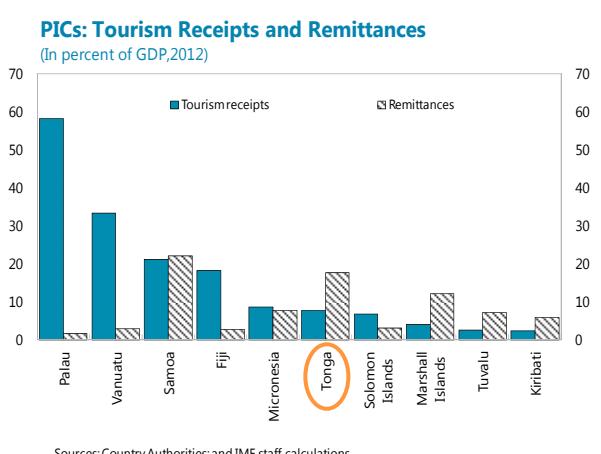
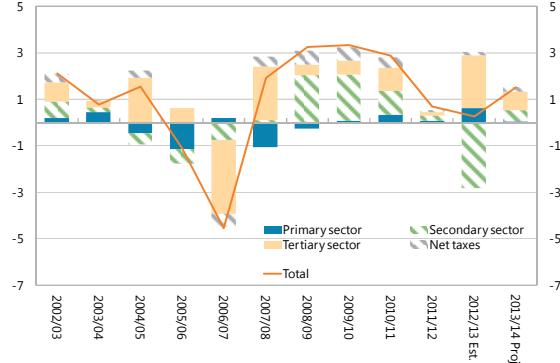


Figure 2. Tonga: Economic Developments

GDP growth is rebounding...

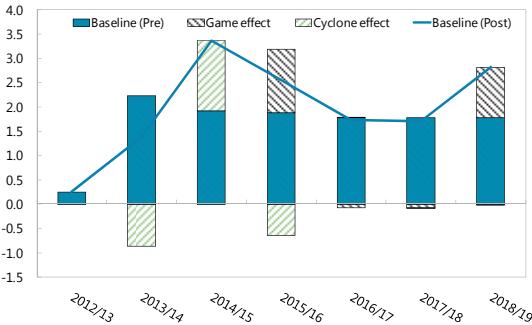
Real GDP Product by Sector
(Annual percent change, contributions to total)



Sources: Tongan authorities; and IMF Fund Estimates.

...with the cyclone reconstruction and the Games exerting an overall positive effect on growth.

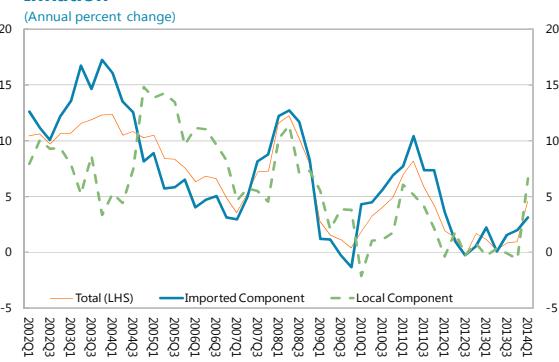
Real GDP Growth Outlook
(In percent)



Source: IMF staff estimates.

Led by local components, inflation has decreased ...

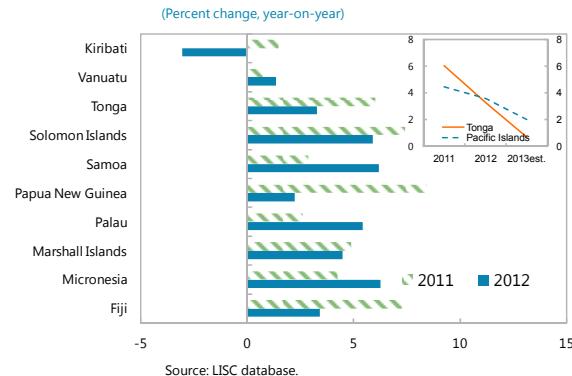
Inflation



Source: Tongan authorities.

...more sharply than in other Pacific island countries

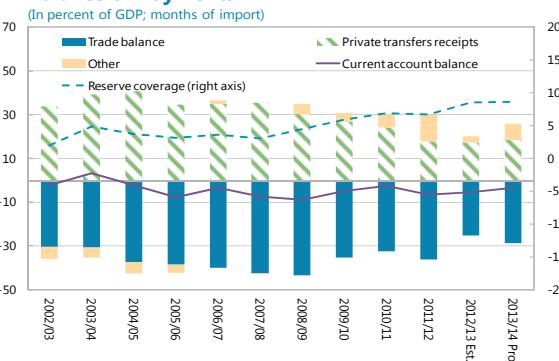
Consumer Prices



Source: LISC database.

Foreign grants and low levels of imports led to a continued build-up of reserves ...

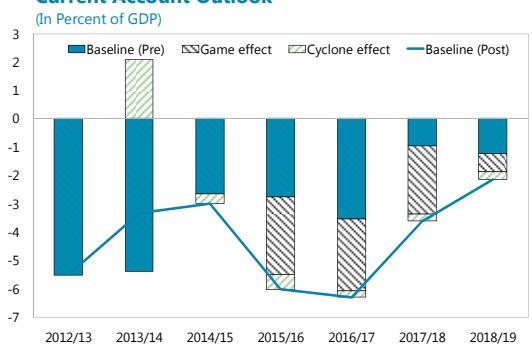
Balance of Payments



Sources: Tongan authorities; and IMF staff estimates.

...with the cyclone likely to reduce current account deficits in the near term.

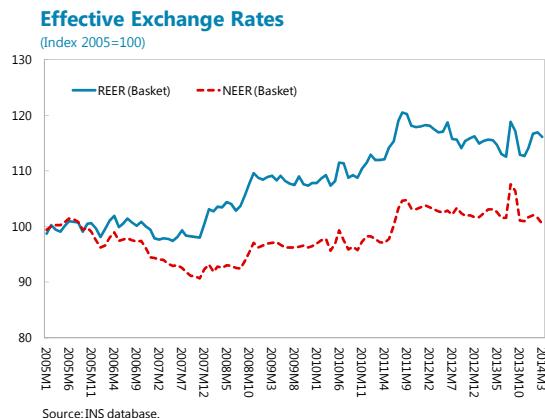
Current Account Outlook



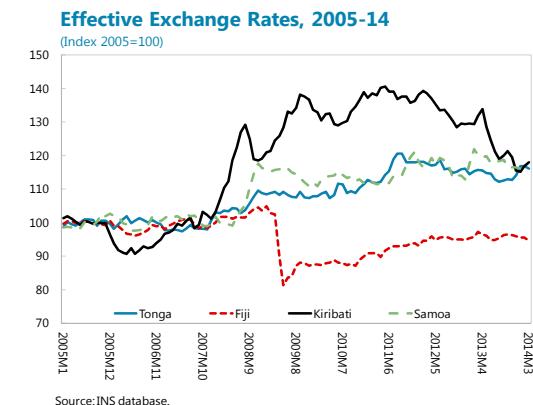
Source: IMF Staff estimates.

Figure 3. Tonga: Exchange Rate and Fiscal Policy Developments

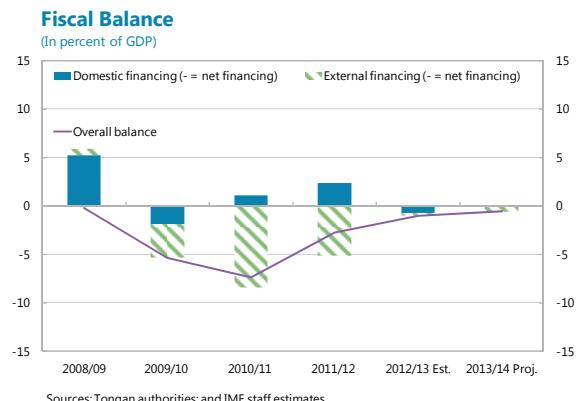
While both the nominal and real effective exchange rates depreciated toward the end of 2013



...the real effective exchange rate remains elevated compared to the level in early 2008, when the appreciation cycle began.

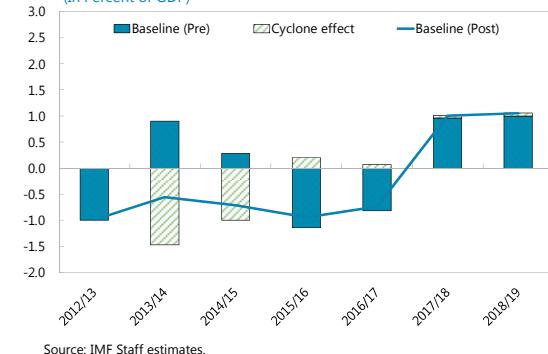


The fiscal position has significantly improved since 2010/11, ...

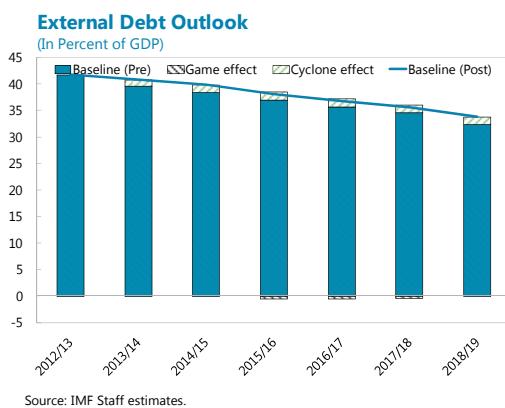


...but cyclone damage is expected to cause extra financing needs...

Overall Balance Outlook (In Percent of GDP)



... however it will only marginally affect consolidation of the external debt ...



...which has been on the high side compared to Tonga's peers.

Total Government Debt (In percent of GDP)

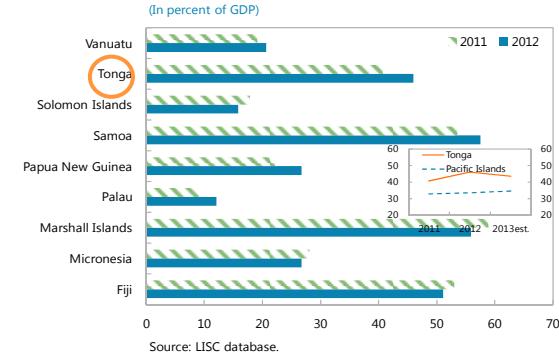
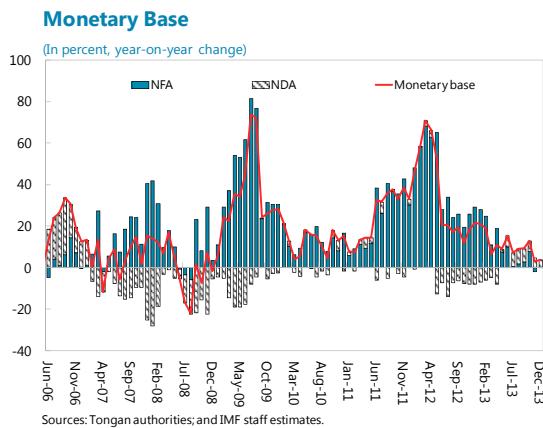


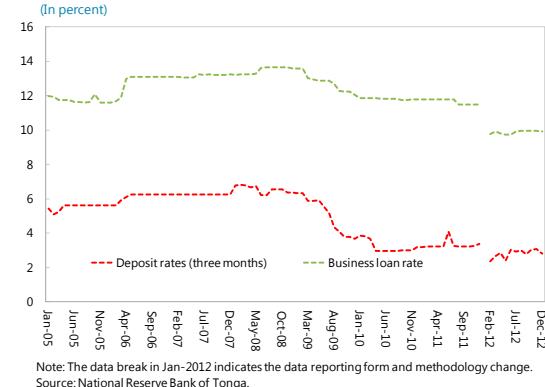
Figure 4. Tonga: Monetary Policy and Financial Sector Developments

The banking system has maintained ample liquidity since the global financial crisis...

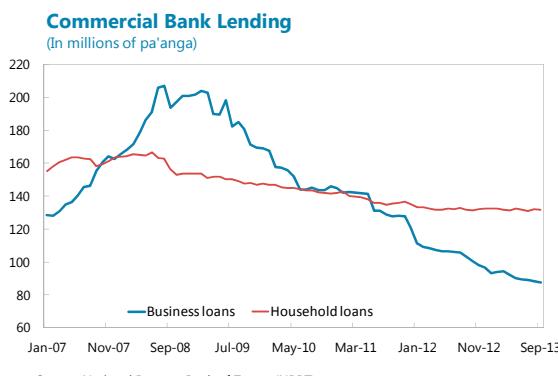


...which helped to lower interest rates.

Interest Rates



The credit contraction appears to be ending ...



...with balance sheet repair indicators having returned to precrisis levels.

Bank balance sheet repair indicators

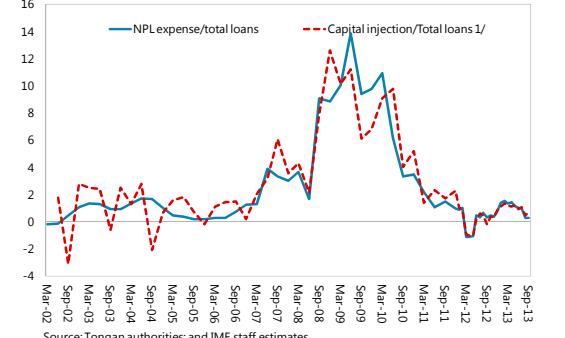


Table 1. Tonga: Selected Economic Indicators, 2008/09–2014/15^{1/}

Nominal GDP (2011/12): US\$471.6 million
 GDP per capita (2011/12): US\$4572.3
 Major exports: fish, root crops, vanilla, squash
 Quota: SDR 6.9 million

	Average	Estimates						Projections	
	2003-12	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	
(Annual percent change)									
Output and prices									
Real GDP 2/	1.1	3.2	3.3	2.9	0.7	0.3	1.4	3.4	
Consumer prices (period average)	7.1	5.5	1.7	6.0	3.3	0.7	1.5	1.7	
Consumer prices (end of period)	6.9	1.2	2.7	7.1	2.3	0.2	1.3	2.2	
GDP deflator	6.2	-2.4	3.7	5.8	2.4	0.7	1.5	1.7	
(In percent of GDP)									
Central government finance									
Total revenue and grants	26.5	34.3	27.0	26.3	27.4	24.1	29.5	29.0	
Total revenue	22.6	27.4	20.2	19.5	18.1	18.7	18.8	19.0	
Grants	3.9	6.8	6.8	6.8	9.4	5.4	10.7	10.0	
Total expenditure and net lending	28.1	34.4	32.3	33.7	30.2	25.1	30.0	29.7	
Of which: Current expenditure	23.9	25.2	25.8	22.6	23.5	23.5	27.2	24.7	
Capital expenditure	2.6	2.7	2.6	9.6	5.6	1.6	2.8	5.0	
Overall balance	-1.5	-0.2	-5.3	-7.4	-2.8	-1.0	-0.6	-0.7	
Overall balance (excl. China's EXIM Bank loans)	1.1	6.1	-0.2	1.8	3.1	0.0	-0.6	-0.7	
External financing (net)	n.a.	-0.7	3.5	8.4	5.2	0.2	0.6	0.9	
Domestic financing (net)	n.a.	-5.2	1.9	-1.1	-2.4	0.8	0.0	-0.2	
(Annual percent change)									
Money and credit									
Total liquidity 3/	7.9	-1.8	5.1	3.1	-1.7	7.2	7.8	...	
Of which: Broad money (M2)	8.2	-2.4	5.6	3.3	-1.8	8.2	8.0	...	
Domestic credit	5.3	-5.2	-11.5	-12.3	-8.7	-3.0	9.5	...	
Of which: Private sector credit	5.5	-3.7	-15.6	-9.9	-2.7	-9.8	1.0	...	
Interest rates (end of period)									
Average deposit rate	n.a.	5.3	3.8	3.4	3.5	...	...	...
Base lending rate	n.a.	10.0	9.6	9.6	9.6	...	...	...
(In millions of U.S. dollars)									
Balance of payments									
Exports, f.o.b.	12.1	7.1	7.9	10.9	14.8	15.2	15.8	17.3	
Imports, f.o.b.	-123.0	-130.5	-130.4	-152.6	-179.3	-139.9	-154.0	-172.5	
Services (net)	-8.7	-15.2	-8.5	3.5	-6.8	6.2	-1.8	-2.8	
Investment income (net)	4.8	6.4	4.0	9.0	11.2	12.7	13.3	14.0	
Current transfers (net)	99.6	104.0	109.0	117.8	129.0	80.2	110.7	129.0	
Of which: Remittances	89.9	84.0	82.0	87.5	66.8	68.8	74.2	77.6	
Current account balance	-15.2	-28.2	-17.9	-11.4	-31.1	-25.6	-16.0	-15.1	
(In percent of GDP)	-4.3	-8.9	-4.9	-2.7	-6.6	-5.5	-3.3	-3.0	
Overall balance	13.6	19.5	19.8	33.3	19.8	12.2	15.5	1.7	
Terms of trade (annual percent change)	0.4	-3.4	5.2	-3.6	0.8	-1.6	0.3	0.9	
Gross official foreign reserves									
In millions of U.S. dollars	65.7	67.8	87.5	120.8	140.6	152.8	168.3	170.0	
(In months of next year's goods and services imports)	4.4	4.6	5.0	5.7	7.8	7.8	7.8	7.3	
External debt (in percent of GDP)									
External debt	32.1	31.5	31.8	36.0	41.9	41.4	40.8	39.9	
Debt service ratio	1.2	0.7	1.2	1.2	1.4	1.7	1.7	1.9	
Exchange rates									
Pa'anga per U.S. dollar (period average)	2.0	2.1	1.9	1.8	1.7	1.7	1.7	1.7	
Pa'anga per U.S. dollar (end of period)	1.9	2.0	1.9	1.7	1.8	1.7	1.7	1.7	
Nominal effective exchange rate (2005=100)	98.8	95.7	96.9	97.4	103.4	104.5	104.4	104.2	
Real effective exchange rate (2005=100)	102.6	107.5	108.3	111.5	118.4	118.4	118.4	118.4	
Memorandum items:									
Remittances (in percent of GDP)	29.3	26.4	22.2	20.7	14.2	14.8	15.4	15.3	
Tourism (in percent of GDP)	6.3	8.7	7.0	7.9	7.7	8.7	7.2	7.9	
FDI (in percent of GDP)	5.2	12.1	2.1	1.5	1.1	3.4	2.4	2.4	
Nominal GDP (millions of T\$)	623.8	664.3	712.2	775.0	799.3	806.7	830.4	873.2	
Population (thousands)	102.0	102.5	102.8	103.0	103.1	103.4	103.7	103.9	

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.

Table 2. Tonga: Summary of Government Operations, 2008/09–2014/15

	2008/09	2009/10	2010/11	2011/12	2012/13	Budget	Proj	Proj
						2013/14	2013/14	2014/15
(In millions of pa'anga)								
Total revenue and grants	227.5	192.1	203.8	219.3	194.5	242.5	244.9	253.2
Total revenue	182.0	143.6	151.0	144.4	150.8	156.5	156.0	165.5
Current revenue	154.8	143.6	149.1	144.2	150.1	155.7	155.2	164.7
Tax revenue	129.1	116.2	133.0	126.8	131.1	135.2	132.4	143.3
Of which: Taxes on income/profits	40.3	28.1	38.3	25.3	29.4	25.2	26.3	31.4
Sales tax and consumption tax	71.3	72.4	81.9	87.8	86.3	94.7	91.4	94.8
Nontax revenue	25.7	27.3	16.1	17.4	19.0	20.5	22.8	21.4
Capital revenue	27.2	0.0	2.0	0.2	0.7	0.8	0.8	0.8
Grants (in cash)	45.5	48.6	52.8	75.0	43.8	86.0	88.9	87.7
Project grants	45.5	35.2	29.2	37.9	32.0	50.3	58.9	61.0
Budget support	0.0	13.4	23.6	37.1	11.8	35.7	30.0	26.7
Total expenditure and net lending	228.8	230.2	261.1	241.5	202.5	227.2	249.5	259.5
Total expenditure	185.3	202.3	249.9	232.4	202.5	226.7	249.0	258.9
Current expenditure	167.5	183.8	175.5	187.8	190.0	211.6	225.6	215.4
Capital expenditure	17.8	18.4	74.4	44.7	12.6	15.2	23.3	43.5
Of which : Funded by China EXIM Bank loans	27.5	28.2	60.4	38.2	8.1	0.5	0.0	0.0
Total lending minus repayments	6.4	27.9	11.2	9.0	0.0	0.0	0.5	0.6
Current balance (excl. project grants)	19.2	-15.7	-5.2	-9.5	-10.6	-22.1	-38.9	-50.7
Overall balance (incl. grants)	-1.3	-38.0	-57.3	-22.1	-8.0	15.3	-4.6	-6.2
Overall balance (excl. grants)	-46.8	-86.6	-110.1	-97.1	-51.8	-70.7	-93.5	-93.9
Overall balance (excl. China EXIM Bank loans)	40.6	-1.7	14.2	24.8	0.0	-	-4.6	-6.2
Primary balance (incl. grants)	3.9	-32.5	-50.8	-15.6	-0.9	22.2	2.6	1.8
Total financing	1.3	38.0	57.3	22.1	8.0	-15.3	4.6	6.2
External financing	-4.4	24.7	65.5	41.2	1.9	-15.3	4.7	8.1
Domestic financing	-34.6	13.3	-8.2	-19.1	6.1	0.0	0.0	-1.8
(In percent of GDP)								
Total revenue and grants	34.3	27.0	26.3	27.4	24.1	29.2	29.5	29.0
Total revenue	27.4	20.2	19.5	18.1	18.7	18.8	18.8	19.0
Current revenue	23.3	20.2	19.2	18.0	18.6	18.7	18.7	18.9
Tax revenue	19.4	16.3	17.2	15.9	16.3	16.3	15.9	16.4
Of which: Taxes on income/profits	6.1	3.9	4.9	3.2	3.6	3.0	3.2	3.6
Sales tax and consumption tax	10.7	10.2	10.6	11.0	10.7	11.4	11.0	10.9
Nontax revenue	3.9	3.8	2.1	2.2	2.4	2.5	2.7	2.5
Capital revenue	4.1	0.0	0.3	0.0	0.1	0.1	0.1	0.1
Grants (in cash)	6.8	6.8	6.8	9.4	5.4	10.4	10.7	10.0
Project grants	6.8	4.9	3.8	4.7	4.0	6.1	7.1	7.0
Budget support	0.0	1.9	3.0	4.6	1.5	4.3	3.6	3.1
Total expenditure and net lending	34.4	32.3	33.7	30.2	25.1	27.4	30.0	29.7
Current expenditure	25.2	25.8	22.6	23.5	23.5	25.5	27.2	24.7
Capital expenditure	2.7	2.6	9.6	5.6	1.6	1.8	2.8	5.0
Of which : funded by China EXIM Bank loans	4.1	4.0	7.8	4.8	1.0	0.1	0.0	0.0
Total lending minus repayments	1.0	3.9	1.4	1.1	0.0	0.0	0.1	0.1
Current balance (excl. project grants)	2.9	-2.2	-0.7	-1.2	-1.3	-2.7	-4.7	-5.8
Overall balance (incl. grants)	-0.2	-5.3	-7.4	-2.8	-1.0	1.8	-0.6	-0.7
Overall balance (excl. grants)	-7.0	-12.2	-14.2	-12.1	-6.4	-8.5	-11.3	-10.8
Overall balance (excl. China EXIM Bank loans)	6.1	-0.2	1.8	3.1	0.0	0.0	-0.6	-0.7
Primary balance (incl. grants)	0.6	-4.6	-6.6	-2.0	-0.1	2.7	0.3	0.2
Total financing	0.2	5.3	7.4	2.8	1.0	-1.8	0.6	0.7
External financing	-0.7	3.5	8.4	5.2	0.2	-1.8	0.6	0.9
Domestic financing	-5.2	1.9	-1.1	-2.4	0.8	0.0	0.0	-0.2
Memorandum items:								
Nominal GDP (in millions of pa'anga)	664.3	712.2	775.0	799.3	806.7	830.4	830.4	873.2
Total external public debt outstanding (in percent of GDP)	31.5	31.8	36.0	41.9	41.4	40.8	39.9	

Sources: Tongan authorities; and IMF staff estimates and projections.

Table 2.a Tonga: Summary of Government Operations, 2008/09–2014/15^{1/}

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	Proj.
(In percent of GDP)								
Revenue	34.3	27.0	26.3	27.4	24.1	29.5	29.0	
Taxes	19.4	16.3	17.2	15.9	16.3	15.9	16.4	
Of which: Taxes on income/profits	6.1	3.9	4.9	3.2	3.6	3.2	3.6	
Sales tax and consumption tax	10.7	10.2	10.6	11.0	10.7	11.0	10.9	
Trade taxes	2.4	2.1	1.6	1.7	1.8	1.9	2.1	
Social contributions	...	...	...	...	...	...	...
Grants (in cash)	6.8	6.8	6.8	9.4	5.4	10.7	10.0	
Project grants	6.8	4.9	4.0	4.7	4.0	7.1	7.0	
Budget support	0.0	1.9	3.0	4.6	1.5	3.6	3.1	
Other revenue	3.9	3.8	2.1	2.2	2.4	2.7	2.5	
Expenditure	23.7	28.4	32.0	29.1	25.0	29.9	29.6	
Expense	25.3	25.9	22.7	23.5	23.6	27.2	24.7	
Compensation of employees	12.3	12.6	13.0	11.4	12.2	12.6	12.3	
Use of goods and services	9.3	9.7	6.6	8.3	8.5	11.0	9.0	
Consumption of fixed capital	...	...	...	...	...	...	...
Interest	0.8	0.8	0.8	0.8	0.9	0.9	0.9	
Of which: To nonresidents	0.6	0.5	0.6	0.6	0.7	0.8	0.7	
Subsidies	0.3	0.2	0.0	0.1	0.0	0.1	0.1	
Grants	0.1	0.2	0.3	0.3	0.2	0.3	0.3	
Social benefits	1.2	1.4	0.9	1.3	0.8	1.1	1.0	
Other expense	1.3	0.9	1.1	1.4	0.9	1.2	1.1	
Net acquisition of nonfinancial assets	-1.6	2.6	9.3	5.6	1.5	2.7	4.9	
Acquisitions of nonfinancial assets	2.5	2.6	9.5	5.6	1.5	2.8	5.0	
Of which: Financed by China EXIM Bank loans	4.1	4.0	7.8	4.8	1.0	0.0	0.0	
Disposals of nonfinancial assets	4.1	0.0	0.3	0.0	0.1	0.1	0.1	
Consumption of fixed capital	...	...	...	...	...	...	...
Gross operating balance	9.0	1.1	3.6	3.9	0.6	2.3	4.3	
Net lending (+)/borrowing (-)	10.5	-1.4	-5.7	-1.6	-0.9	-0.4	-0.6	
Net acquisition of financial assets	1.0	3.9	1.4	1.1	-0.7	0.4	1.1	
Domestic net lending	1.0	3.9	1.4	1.1	0.0	0.1	0.1	
Change in cash balances (+ = increase)	0.0	0.0	0.0	0.0	-0.7	0.3	1.0	
Net incurrence of financial liabilities	0.2	5.3	7.4	2.8	0.3	0.9	1.8	
Of which: China EXIM Bank loans	6.3	5.1	9.1	5.6	0.9	-0.1	-0.4	
Memorandum items:								
Nominal GDP (in millions of pa'anga)	664.3	712.2	775.0	799.3	806.7	830.4	873.2	
Total external public debt outstanding (in percent of GDP)	31.5	31.8	36.0	41.9	41.4	40.8	39.9	

Sources: Data provided by the Tongan authorities; and IMF staff estimates and projections.

1/ Table reports central government operations in the GFSM 2001 format.

Table 3. Tonga: Depository Corporations Survey, 2008/09–2014/15^{1/}

	2008/09	2009/10	2010/11	2011/12	2012/13	Projections	
						2013/14	2014/15
(In millions of pa'anga; end of period)							
Net foreign assets	118.1	143.1	195.9	222.3	244.3	268.9	252.4
Claims on nonresidents	155.9	188.5	224.3	262.1	277.2	308.9	287.4
NRBT	137.7	171.9	206.0	248.8	268.5	294.9	273.4
Other depository corporations	18.3	16.6	18.3	13.3	8.7	14.0	14.0
Liabilities to nonresidents	-37.9	-45.4	-28.4	-39.8	-32.9	-40.0	-35.0
NRBT	-10.4	-29.5	-22.0	-24.8	-26.8	-30.0	-30.0
Other depository corporations	-27.5	-15.9	-6.4	-15.1	-6.1	-10.0	-5.0
Net domestic assets	163.9	153.3	109.6	78.0	77.5	78.1	88.9
Net domestic credit	313.9	277.7	243.7	222.6	215.9	236.4	248.2
Net claims on government	-34.7	-28.1	-31.4	-45.9	-30.4	-30.4	-38.6
Claims on public nonfin. corps.	4.7	15.5	13.6	14.0	16.8	35.0	19.0
Claims on private sector	343.9	290.3	261.5	254.4	229.6	231.9	267.8
Other items, net	-149.9	-124.4	-134.1	-144.5	-138.4	-158.3	-159.4
Total liquidity	282.0	296.4	305.4	300.3	321.8	347.0	341.2
Broad money (M2)	269.2	284.4	293.7	288.4	312.1	337.1	331.3
Narrow money	77.7	90.0	96.8	118.1	152.1	156.1	156.1
Quasi-money	191.6	194.4	196.9	170.2	160.0	181.0	175.2
Securities other than shares 2/	12.8	12.0	11.8	11.9	9.7	9.9	9.9
(Annual percentage change)							
Net foreign assets	55.4	21.2	36.9	13.5	9.9	10.1	-12.2
Net domestic assets	-22.4	-6.5	-28.5	-28.8	-0.7	0.8	89.1
Net domestic credit	-5.2	-11.5	-12.3	-8.7	-3.0	9.5	20.3
Claims on private sector	-3.7	-15.6	-9.9	-2.7	-9.8	1.0	16.7
Total liquidity	-1.8	5.1	3.1	-1.7	7.2	7.8	2.0
Broad money (M2)	-2.4	5.6	3.3	-1.8	8.2	8.0	2.1
(In millions of U.S. dollars)							
Net foreign assets	56.6	74.2	106.9	127.0	140.9	156.2	147.2
Claims on nonresidents	74.8	97.7	122.4	149.7	159.9	179.5	167.6
NRBT	66.0	89.1	112.4	142.2	154.9	171.3	159.4
Other Depository Corporations	8.8	8.6	10.0	7.6	5.0	8.1	8.2
Liabilities to nonresidents	-18.2	-23.5	-15.5	-22.8	-19.0	-23.2	-20.4
Memorandum items:							
Velocity (GDP/average M2)	2.5	2.5	2.6	2.8	2.6	2.5	2.6
Pa'anga per U.S. dollar (end of period)	2.0	1.9	1.7	1.8	1.7	1.7	1.7

Sources: Tongan authorities; and IMF staff estimates and projections.

1/ Comprises the National Reserve Bank of Tonga (NRBT) and other depository corporations, including the Tonga Development Bank (TDB).

2/ Comprises bills and promissory notes issued by the financial sector and held outside the sector.

Table 4. Tonga: Balance of Payments Summary, 2008/09–2014/15
 (In millions of U.S. dollars, unless otherwise indicated)

	2008/09	2009/10	2010/11	2011/12	2012/13	Estimates	Projections
						2013/14	2014/15
Trade balance	-123.4	-122.4	-141.7	-164.6	-124.7	-138.1	-155.3
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
Receipts	35.0	39.1	60.5	66.4	82.3	78.0	84.2
Payments	-50.2	-47.5	-57.0	-73.2	-76.1	-79.8	-87.0
Investment income (net)	6.4	4.0	9.0	11.2	12.7	13.3	14.0
Receipts	10.2	11.6	16.0	18.3	20.2	21.2	22.2
Payments	-3.8	-7.7	-7.1	-7.1	-7.5	-7.9	-8.3
Current transfers (net)	104.0	109.0	117.8	129.0	80.2	110.7	129.0
Official transfers (net) 1/	16.8	17.4	20.8	15.4	7.1	30.7	47.1
Private transfers (net)	87.2	91.6	97.0	78.7	73.1	79.9	81.9
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
Capital account balance	27.6	15.5	5.6	25.6	18.0	17.2	0.0
Financial account balance	20.0	22.2	39.2	23.7	16.6	14.3	16.8
FDI (net)	38.4	7.6	6.2	5.0	16.0	11.6	12.1
Other investment (net)	-18.4	14.6	33.0	18.7	0.6	2.7	4.7
Overall balance 2/	19.5	19.8	33.3	19.8	12.2	15.5	1.7
Memorandum items:							
Gross official foreign reserves	67.8	87.5	120.8	140.6	152.8	168.3	170.0
<i>In months of next year's goods and services imports</i>	4.6	5.0	5.7	7.8	7.8	7.8	7.3
Exchange rate							
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 GDP (in millions of US\$)	318.5	369.2	423.0	471.6	464.5	482.2	505.8
Commodity price indices (2005 = 100)							
Food	145.8	142.1	165.0	177.8	176.6	172.9	163.3
Fuel	79.4	70.4	91.5	104.5	104.5	104.1	101.0

Sources: Tongan authorities; and IMF staff estimates and projections.

1/ Includes all official grants excluding project funds related to capital formation.

2/ Change in gross official foreign reserves.

Table 5. Tonga: Medium-Term Scenario, 2009/10–2018/19^{1/}

	2009/10	2010/11	2011/12	2012/13	Estimates		Projections			
					2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
(Annual percentage change)										
Output and prices										
Real GDP	3.3	2.9	0.7	0.3	1.4	3.4	2.5	1.7	1.7	2.8
Consumer prices (end of period)	2.7	7.1	2.3	0.2	1.3	2.2	3.4	3.7	4.3	5.0
Consumer prices (period average)	1.7	6.0	3.3	0.7	1.5	1.7	2.8	3.6	4.0	4.7
GDP deflator	3.7	5.8	2.4	0.7	1.5	1.7	2.8	3.6	4.0	2.3
(In percent of GDP)										
Central government finance										
Total revenue and grants	27.0	26.3	27.4	24.1	29.5	29.0	26.0	23.8	26.0	25.7
Total revenue	20.2	19.5	18.1	18.7	18.8	19.0	19.6	19.9	19.9	20.0
Of which: tax revenue	16.3	17.2	15.9	16.3	15.9	16.4	17.1	17.3	17.4	17.4
Grants	6.8	6.8	9.4	5.4	10.7	10.0	6.3	3.9	6.1	5.7
Total expenditure and net lending	32.3	33.7	30.2	25.1	30.0	29.7	26.9	24.5	25.0	24.6
Current expenditure	25.8	22.6	23.5	23.5	27.2	24.7	24.3	22.5	22.8	22.5
Capital expenditure	2.6	9.6	5.6	1.6	2.8	5.0	2.6	2.0	2.2	2.1
Net lending	3.9	1.4	1.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Overall balance (incl. grants)	-5.3	-7.4	-2.8	-1.0	-0.6	-0.7	-0.9	-0.7	1.0	1.1
External financing (net)	3.5	8.4	5.2	0.2	0.6	0.9	-0.1	0.0	0.1	-0.9
Domestic financing (net)	1.9	-1.1	-2.4	0.8	0.0	-0.2	1.0	0.7	-1.1	-0.1
Primary balance (incl. grants)	-4.6	-6.6	-2.0	-0.1	0.3	0.2	0.0	0.2	2.0	2.0
(In millions of U.S. dollars)										
Balance of payments										
Exports, f.o.b.	7.9	10.9	14.8	15.2	15.8	17.3	18.8	20.6	22.6	23.7
(Annual percent change)	11.7	37.1	36.2	3.0	4.0	9.0	9.0	9.5	9.5	5.0
Imports, f.o.b.	-130.4	-152.6	-179.3	-139.9	-154.0	-172.5	-184.6	-189.9	-195.6	-195.6
(Annual percent change)	-0.1	17.0	17.5	-22.0	10.1	12.1	7.0	2.8	3.0	0.0
Services (net)	-8.5	3.5	-6.8	6.2	-1.8	-2.8	-1.3	1.8	2.9	3.0
Investment income (net)	4.0	9.0	11.2	12.7	13.3	14.0	14.7	15.4	16.2	17.0
Transfers (net)	109.0	117.8	129.0	80.2	110.7	129.0	120.7	117.6	140.6	147.3
Of which: Remittances	82.0	87.5	66.8	68.8	74.2	77.6	86.3	94.6	103.0	110.0
Current account balance	-17.9	-11.4	-31.1	-25.6	-16.0	-15.1	-31.8	-34.5	-13.4	-4.6
(In percent of GDP)	-4.9	-2.7	-6.6	-5.5	-3.3	-3.0	-6.0	-6.3	-2.4	-0.8
Capital account balance	15.5	5.6	25.6	18.0	17.2	0.0	15.6	15.1	14.6	0.0
Financial account balance	22.2	39.2	23.7	16.6	14.3	16.8	12.3	13.4	14.8	9.3
FDI (net)	7.6	6.2	5.0	16.0	11.6	12.1	12.7	13.4	14.0	14.7
Other investment (net)	14.6	33.0	18.7	0.6	2.7	4.7	-0.4	0.0	0.7	-5.4
Overall balance	19.8	33.3	19.8	12.2	15.5	1.7	-3.9	-6.0	16.0	4.7
Gross international reserves (end of period)										
In millions of U.S. dollars	87.5	120.8	140.6	152.8	168.3	170.0	166.1	160.2	176.2	180.9
In months of imports (goods and services)	5.0	5.7	7.8	7.8	7.8	7.3	6.9	6.4	7.0	6.8
External debt (in percent of GDP)										
Public sector external debt	31.8	36.0	41.9	41.4	40.8	39.9	38.4	37.1	36.0	34.2
Debt service ratio	1.2	1.2	1.4	1.7	1.7	1.9	2.1	2.0	1.9	2.9
Memorandum items:										
Private transfers (net, in millions of U.S. dollars)	91.6	97.0	78.7	73.1	79.9	81.9	91.2	100.0	109.7	117.6
(In percent of imports of goods and services)	51.5	46.3	31.2	33.9	34.2	31.5	32.8	34.6	36.7	38.8
Nominal GDP (millions of pa'anga)	712.2	775.0	799.3	806.7	830.4	873.2	920.4	969.6	1025.6	1079.2

Sources: Tongan authorities; and IMF staff estimates and projections.

1/ Fiscal year beginning July.

Table 6. Tonga: Financial Soundness Indicators, 2008/09–2012/13^{1/}

	2008/09	2009/10	2010/11	2011/12	2012/13
	(In percent)				
Financial sector					
Total loans/GDP	52.5	42.9	35.5	33.6	30.5
Other depository corporations	52.5	42.9	35.5	33.6	30.5
Banks					
Net domestic credit	(Year-on-year percent change)				
Public non-financial corporations	-1.1	229.0	-12.0	3.1	19.7
Private sector	-3.7	-15.6	-9.9	-2.7	-9.8
Risk-weighted capital adequacy ratio 2/	21.8	17.2	21.7	28.1	30.9
Net interest income to average assets 2/	4.9	4.2	4.1	3.9	4.2
Non-performing loans	20.5	15.3	15.2	15.3	13.9
Loan loss reserves to gross loans	13.3	14.8	15.0	6.2	7.0

Sources: National Reserve Bank of Tonga and IMF IFS database.

1/ Data as of end of fiscal years.

2/ Monthly data of December 2012 for 2012/13.

Table 7. Tonga: Millennium Development Goals, 1990-2012

	1990	1995	2000	2005	2009	2010	2011	2012
Goal 1: Eradicate extreme poverty and hunger								
Employment to population ratio, 15+, total (%)	..	..	..	..	..	..	..	..
Employment to population ratio, ages 15-24, total (%)	..	..	..	..	..	..	..	..
GDP per person employed (constant 1990 PPP \$ ^{1/})	..	..	..	..	..	..	..	..
Income share held by lowest 20%	..	..	..	..	..	..	..	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	..	..	..	..	..	..
Poverty gap at \$1.25 a day (PPP) (%)	..	..	..	..	..	..	..	..
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	..	..	..	..	..	..	..	..
Prevalence of undernourishment (% of population)	..	..	..	..	..	..	..	..
Vulnerable employment, total (% of total employment)	..	..	..	..	..	..	..	..
Goal 2: Achieve universal primary education								
Literacy rate, youth female (% of females ages 15-24)	..	..	..	..	..	..	..	..
Literacy rate, youth male (% of males ages 15-24)	..	..	..	..	..	..	..	..
Persistence to last grade of primary, total (% of cohort)	..	..	91	90	..	..	..	..
Primary completion rate, total (% of relevant age group)	..	..	..	..	..	..	..	100
Total enrollment, primary (% net)	92	..	..	99	..	..	..	98
Goal 3: Promote gender equality and empower women								
Proportion of seats held by women in national parliament (%)	0	..	0	3	3	0	4	4
Ratio of female to male enrollments in tertiary education (%)	..	..	..	..	..	..	..	..
Ratio of female to male primary enrollment (%)	99	99	95	97	98	98	99	100
Ratio of female to male secondary enrollment (%)	98	..	112	..	128	107	97	104
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	..	..	..	..	..	..	..
Goal 4: Reduce child mortality								
Immunization, measles (% of children ages 12-23 months)	86	94	95	99	99	99	99	95
Mortality rate, infant (per 1,000 live births)	20	17	16	14	12	12	11	11
Mortality rate, under-5 (per 1,000)	23	20	18	16	14	14	13	13
Goal 5: Improve maternal health								
Adolescent fertility rate (births per 1,000 women ages 15-19)	26	24	22	22	21	20	19	..
Births attended by skilled health staff (% of total)	..	..	95	..	..	98	..	..
Contraceptive prevalence (% of women ages 15-49)	..	..	33	..	..	32	..	..
Maternal mortality ratio (national estimate, per 100,000 live births)	67	86	87	100	..	110	..	..
Pregnant women receiving prenatal care (%)	..	..	..	..	..	98	..	..
Unmet need for contraception (% of married women ages 15-49)	..	..	..	..	..	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases								
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	..	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	38	33	28	22	18	17	16	14
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	..	..	..	..
Prevalence of HIV, male (% ages 15-24)	..	..	..	..	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	..	..	..	..	..
Tuberculosis case detection rate (% all forms)	64	63	88	79	43	63	55	73
Goal 7: Ensure environmental sustainability								
CO2 emissions (kg per PPP \$ ^{1/} of GDP)	0.4	0.4	0.4	0.4	0.4	0.3	..	..
CO2 emissions (metric tons per capita)	0.8	1.1	1.2	1.6	1.7	1.5	..	..
Forest area (% of land area)	12.5	12.5	12.5	12.5	12.5	12.5	12.5	..
Improved sanitation facilities (% of population with access)	95.4	94.5	93.5	92.6	91.9	91.7	91.5	..
Improved water source (% of population with access)	98.6	98.6	98.6	98.7	99.1	99.2	99.2	..
Marine protected areas (% of territorial water)	0.2	9.4	2.8	9.4	9.4	3.0	..	3.0
Goal 8: Develop a global partnership for development								
Debt service (PPG and IMF only, % of exports, excluding workers' remittances)	3.5	..	..	8.8	7.4	8.9	8.8	..
Internet users (per 100 people)	0.0	0.1	2.4	4.9	10.0	16.0	25.0	34.9
Mobile cellular subscriptions (per 100 people)	0.0	0.3	0.2	29.6	51.2	52.2	52.6	53.4
Telephone lines (per 100 people)	4.6	6.9	9.9	13.6	29.9	29.8	28.7	28.6
Other								
Fertility rate, total (births per woman)	4.6	4.4	4.3	4.1	4.0	3.9	3.9	..
GNI per capita, Atlas method (current US\$)	1,220	2,010	2,030	2,550	3,330	3,490	3,740	4,220
GNI, Atlas method (current US\$) (billions)	0.1	0.2	0.2	0.3	0.3	0.4	0.4	0.4
Gross capital formation (% of GDP)	18.5	26.3	21.7	22.2	24.5	30.1	36.1	33.4
Life expectancy at birth, total (years)	69.6	70.1	70.8	71.5	72.0	72.2	72.3	..
Literacy rate, adult total (% of people ages 15 and above)	..	..	..	..	..	..	..	..
Population, total (millions)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Trade (% of GDP)	99.0	73.3	62.3	75.3	77.9	71.1	79.1	80.5

Source: World Bank, World Development Indicators database.

1/ \$ represent US dollar

Appendix I. Risk Assessment Matrix ^{1/}

Nature/Source of Main Threats	Overall Level of Concern		Policy Response
	Likelihood of Severe Realization of Threat in the Next one–three Years (high, medium, or low)	Expected Impact if Threat is Realized (high, medium or low)	
1. Protracted period of slower growth in advanced and emerging economies.	High For advanced economies, could result from failure to address the legacies of the financial crisis. For emerging markets, could reflect the maturing of the cycle, investment misallocation, or incomplete structural reforms.	Medium/High Tonga would be significantly affected by economic slowdown in the U.S., Australia, and New Zealand, mainly via lower remittances and exports.	Allow moderation of growth, and delay withdrawal of monetary impulse. Pressures on the BOP could be met by combining depreciation and intervention. The fiscal impulse caused by the post-cyclone activities will help cushion the shock, and the pace of post-reconstruction consolidation can be cautiously fine-tuned, if crucial.
3. Medium term growth slowdown in China	Medium Buildup of excess capacity eventually resulting in large financial and fiscal losses.	Low/Medium Tonga would be affected mainly through China's trade links with Australia, as well as Chinese ODAs.	Same as the above.
4. Natural disasters (regional)	Low/medium Natural disasters similar to the latest cyclone could take significant human and economic tolls.	High Such an event could have far reaching effects, such as damages to infrastructure and the production base, and an increase in the fiscal financing gap, which can potentially be very large.	Design disaster recovery and financing strategy with a view to bolster confidence (particularly by donors) and protecting debt space. Getting ready for next disaster will need a comprehensive approach that makes use of multiple emergency capacities. The capacities include: (i) fiscal space and international reserve buffer, (ii) catastrophic insurance schemes (Tonga already participates in one initiative coordinated by the World Bank), and (iii) toolkits provided by global financial safety nets.
5. Cost overrun relating to the Games (country-specific)	Medium Overly optimistic initial estimates and/or implementation challenges in construction projects may lead to significant cost overrun, which is not improbable in view of the experiences of other countries.	High Such an overrun will cause worsening of debt sustainability and investor/ development partner confidence in the short run, and corrective fiscal consolidation in the longer run—harming growth.	Avoiding such an outcome by early remedial actions. Tonga will need much stronger commitment to fiscal consolidation to redress impaired confidence and re-energize support by the donors.
6. Slippages in delivering on Policy Reform Matrix (country-specific)	Low Weakening of stakeholder supports, capacity constraints, and slippages in the reform process could derail critical reforms agreed with development partners.	High Such an outcome could significantly affect budget support flows, leading to a significantly large gross financing gap.	Same as the above.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.



TONGA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 19, 2014

Prepared By

The Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS	2
PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2013–14	4
WORLD BANK–IMF COLLABORATION	6
RELATIONS WITH THE ASIAN DEVELOPMENT BANK	9
STATISTICAL ISSUES	11

FUND RELATIONS¹

Membership Status

Joined September 13, 1985; Article VIII.

General Resources Account

	SDR Million	Percent Quota
Quota	6.90	100.00
Total holdings of currency	5.19	75.20
Reserve position in the Fund	1.71	24.81

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	6.58	100.00
Holdings	7.09	107.73

Outstanding Purchases and Loans

None

Financial Arrangements

None

Projected Obligations to Fund*

(SDR million; based on existing use of resources and presenting holdings of SDRs)

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

* When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

The exchange rate arrangement is a pegged exchange rate within horizontal bands. Tonga has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international

¹ As of May 31, 2014.

transactions. Since February 11, 1991, the value of the pa'anga is determined based on a weighted basket of currencies comprising the United States, Australian, and New Zealand dollars, with the U.S. dollar as the intervention currency. In July 2000, the Japanese yen was added to the basket, and the monthly maximum adjustment limit was raised to 5 percent from 2 percent that had prevailed since March 1998, when the allowance for adjustment was introduced. Tonga has accepted the obligations of Article VIII, Sections 2, 3, and 4.

Last Article IV Consultation

Staff discussions were held during February–March 2013. On July 19, 2013, the Executive Board of the IMF concluded the Article IV consultation with Tonga and considered and endorsed the staff report (IMF Country Report No. 13/234) without a meeting.

Technical Assistance

The Legal Department (LEG) provided assistance on AML/CFT issues for the Pacific islands countries, including Tonga, from 2002 through 2005. LEG also provided assistance on the National Reserve Bank of Tonga Act and Financial Institutions Act from 2013 to 2014.

PFTAC has, on an on-going basis, provided assistance on budgetary management; tax administration; banking legislation and supervision; and balance of payments and national accounts statistics.

Resident Representative

The Regional Resident Representative Office for Pacific Islands, including Tonga, was opened on September 2010 in Suva, Fiji. Mr. Yongzheng Yang is the resident representative.

PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2013–14²

Background

Tonga continues to face a difficult macroeconomic environment. The global economic crisis has led to a sustained period of slow growth, undermining both fiscal and financial stability. Non-performing loans in the banking system remain high, while fiscal policy options are tightly constrained by the high level of public external debt.

PFTAC has provided technical assistance (TA) to Tonga in all sectors in recent years, collaborating closely with other development partners.

This has been particularly so in the public financial management (PFM) area where PFTAC has been working with the Asian Development Bank (AsDB) to assist the authorities design and implement a realistic reform roadmap. TA has also been provided in the compilation of National Accounts in collaboration with an AusAID (now DFAT) funded resident statistics advisor and in Balance of Payments Statistics. Support has also been provided to the National Reserve Bank of Tonga (NRBT) in off-site and on-site banking supervision.

Strategy 2013–14

PFTAC's TA strategy is guided by the APD regional strategy and is planned within the results framework for current PFTAC funding cycle.³ This strategy was discussed with the authorities in June 2011.

PFTAC TA aims to support the authorities sustain progress on fiscal consolidation and to improve the macroeconomic environment. PFTAC will continue to work closely with the broader development partner group to ensure coherence and will aim to support implementation of actions in the development partners' budget support reform matrix. Inputs are expected in all sectors, primarily at the strategic level in the fiscal and statistics sectors with detailed training and capacity building in bank supervision and macroeconomics.

In the **public financial management area**, the focus will primarily be, together with AsDB, on refining the PFM roadmap developed on the basis of the 2010 Public Expenditure and Financial Accountability (PEFA) assessment (1.2). PFTAC will contribute specific technical areas to support the AsDB projects that aim to develop an effective medium-term budget framework (1.5) and improve budget execution. These are likely to be in more accurate macroeconomic analysis (5.1), more rigorous cash/debt management (1.6), and planning improvements to the functioning of their FMIS. In the medium term, PFTAC would look to assist the authorities implement a follow-up PEFA assessment, probably in 2014 (1.1).

² As of March 2014.

³ The specific result in the framework that activities target is identified in italics in the section, for example cash management is referred to as (1.6), where 1.6 is the code in the result framework in the program document.

In the **revenue** area, the main focus remains on assisting the authorities to continue with implementation of the recommendations of the October 2011 PFTAC strategic revenue review. The review and PFTAC's regional benchmarking exercise showed that Tonga is one of the regional leaders in implementing modern revenue administration practices. PFTAC inputs will be determined by ongoing discussions with Ministry of Customs and Revenue and will be supported by two new resident long-term advisors. PFTAC's specific inputs are likely to concentrate on implementing the new small/micro business tax regime (2.3), assisting with development and implementation of natural resource taxation (2.2, 2.3), implementation of risk management and compliance improvement strategies to improve consumption tax administration and collection (2.3), and implementation of a new taxpayer services sub-division (2.3).

In **statistics**, Tonga is relatively well advanced against the overall results framework; based on PFTAC advice, it produces National Accounts on two independent measures (4.1) with production of a range of income indicators (4.3). Balance of payments statistics are now being developed according to BPM6 standards (4.9). However, the quality of statistics and source data need to be strengthened which was assisted during 2011 and 2012 by an AusAID funded resident advisor. As a result, direct PFTAC assistance was minimal during this period. PFTAC continued to coordinate with and be a resource for the resident advisor and to provide focused technical inputs in particular areas. Re-engagement with Tonga resumed during January 2014. Balance of payments and Government Finance Statistics support have been provided by IMF HQ.

In **financial sector supervision**, IMF/PFTAC has assisted the NRBT establish enhanced off-site analysis (3.3) and has provided support to on-site bank supervision (3.4). Intensive support is being provided in 2013/14 to build on-site supervision techniques through training in standard procedures, reports and analytical techniques (3.5-3.7). PFTAC is also providing follow-up support to ensure that NRBT can regularly prepare off-site analysis and monitoring reports (3.1) using base prudential returns developed by AFSPC. In 2014 this is likely to encompass implementation of the Reserve Bank of New Zealand (RBNZ) Financial Sector Information System (FSIS) (3.2). The year 2014/15 will see the introduction of technical assistance in the oversight of credit unions (3.9).

In the **macroeconomic** area, PFTAC continues to assist the NRBT in strengthening its capacity for macroeconomic analysis in cooperation with the research advisor from the Reserve Bank of Australia currently placed with NRBT (5.1). PFTAC also continues to assist the Ministry of Finance and National Planning to strengthen its capacity in macroeconomic and fiscal forecasting (5.3). Staffs of NRBT and MOFNP participated in a regional fiscal analysis and forecasting workshop held jointly by PFTAC and the Singapore Regional Training Institute in March 2014; NRBT staff attended a regional seminar on monetary policy management, analysis and operation held jointly by the Bank of England's Centre for Central Bank Studies and PTAC in March (5.2).

WORLD BANK-IMF COLLABORATION⁴

The IMF team led by Mr. Jookyung Ree (mission chief to Tonga) has a close working relationship with the Bank team led by Mr. Robert Utz (lead economist, East Asia and the Pacific region). The teams have an ongoing dialog on a range of macroeconomic and structural issues. The level of cooperation and coordination is good and includes the following:

- **Article IV Consultation.** The World Bank participated in the 2009–14 Article IV missions, as well as joining several consultations and providing various analytical inputs to the 2014 Article IV Report. This participation facilitated the discussions, especially in areas of mutual interest such as fiscal policy and structural reform. In addition, Bank and Fund staffs prepared jointly the Debt Sustainability Analysis appendix to the staff reports.
- **Economic Updates.** IMF analysis continues to provide a vital framework to the ongoing budget support program, with IMF assessments used as the basis for decisions regarding the appropriateness of the overall macroeconomic policy framework.
- **Structural Fiscal Reforms.** Bank and Fund staffs have worked successfully to provide technical assistance (TA) in public expenditure management and continue to collaborate on the ongoing analytical work on public expenditure, the medium-term macro-framework, and general structural issues.

Based on the above cooperation, the Bank and the Fund share a common view about Tonga's macroeconomic and structural reform priorities, which mainly aim at mitigating the risks to Tonga's external and fiscal sustainability and at promoting long-term growth. These include:

- **Sustainable fiscal management.** Reconstruction financing requirements following the recent cyclone and pressures for further increases in payroll spending pose challenges to fiscal sustainability if not carefully managed. Tonga's recent change in debt distress rating to 'moderate risk' suggests some space for new concessional borrowing. A priority for the authorities is to develop a clear policy framework to guide any new borrowing to ensure that new borrowing supports high priority investments and remains within sustainable limits. It will also be important to ensure that renewed borrowing occurs alongside broader progress towards addressing fiscal challenges, including improved revenue administration and expenditure control, and tighter prioritization of expenditure, as well as structural reforms. The government's fiscal efforts will need to be supplemented by continued provision of grants from donors.
- **Making use of the flexibility afforded by the current exchange rate arrangement.** This remains critical for safeguarding external stability.
- **Promoting private drivers of growth.** Given fundamental constraints of smallness and isolation, growth prospects are likely to remain concentrated in areas where premiums can be generated to cover higher costs of production. Natural resource industries, including tourism,

⁴ As of March 2014.

agriculture, fisheries and mining hold the greatest potential for private sector development. To facilitate development in these areas there is a need to: (i) improve efficiency in the energy sector to reduce costs; (ii) strengthen the institutional framework for lending—including the enforcement of creditor rights to collateral—as a means to increase access to finance and lower the cost of borrowing; (iii) improve vital tourism infrastructure, including through the commercialization of Tonga Communication Corporation; and (iv) lower regulatory barriers to foreign investment.

World Bank Group cooperation with Tonga is set out in a Country Assistance Strategy presented to the Board in October 2010. Given the current depth of policy dialogue and Tonga's difficult position, the Bank is significantly scaling up both analytical and financial support for Tonga. Total IDA and Trust Fund commitments to Tonga over the past three years amount to almost US\$73 million, compared to US\$30 million between 1985–when Tonga became a member—and FY10. All assistance since FY09 has been provided on 100 percent grant terms.

A key focus of engagement has been around energy-sector and general budget support operations. US\$5 million was provided to energy-sector reforms in FY2011, with a series of two development policy operations—focusing on reforms in public financial management, fiscal policy and structural reforms—providing an additional US\$15.8 million of World Bank financing over FY2012–FY2014 through a World Bank-led multi-donor process.

Other World Bank investments are focused around connectivity for sustainable economic development, and include: (i) a broadband cable, cofinanced with AsDB (US\$17.2 million); (ii) transport sector reform, with PRIF and AusAID financing (US\$14.7 million); and (iii) aviation sector support (US\$27.2 million).

The World Bank Group provided TA to the Ministry of Revenue and Ministry of Finance and National Planning during FY2014 review current tax expenditure arrangements and recommend new investment incentives and policy reforms to encourage increased foreign investment. The World Bank Group is providing ongoing assistance to the Ministry of Finance and National Planning to support the privatization of the International Dateline Hotel and to commercialize the operations of the Tonga Development Bank. The World Bank also provided technical assistance for a Debt Management Reform Plan to the Ministry of Finance and National Planning.

An IMF mission visited Tonga in February 2014 to advise on the revision of the Financial Institution Act (FI) and the National Reserve Bank of Tonga Act (NRBT). The mission advised on an amendment of the FI Act to enhance effective banking supervision, and an extension of supervision to non-bank financial institutions. It also assessed the possibility for the NRBT to hold government securities.

The Bank and Fund teams will continue their close cooperation going forward, particularly in supporting the current program of budget support and to assist the Government in responding to ongoing economic difficulties. Table 1 details the specific activities planned by the two country teams over the July 2013–July 2015 period. It was also agreed that further details on collaboration, as necessary, will be agreed at the technical level as work progresses.

Table 1. Tonga: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas (July 2013–July 2015)

	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • Tonga Broadband Connectivity • Tonga Aviation Safety • Second series of two Development Policy Operations • Ongoing TA support to budget reporting and budget formation • TA for review of exemptions and concessions regime (with IFC) • TA for review of Tonga Development Act • TA for privatization of the International Dateline Hotel 	<ul style="list-style-type: none"> • FY2013 • FY2013 • FY2013–15 • FY2013–14 • FY2013–14 • FY2013–14 • FY2014
Fund Work Program	<ul style="list-style-type: none"> • National Accounts Statistics • Article IV Policy Note • TA on The National Reserve Bank of Tonga Act and Financial Institutions Act • PFM Roadmap Completion • Government Finance Statistics • Article IV Staff Report and Board Meeting 	<ul style="list-style-type: none"> • January 2014 • March 2014 • March 2014 • April/May 2014 • November 2013, April 2014, October 2014 • July 2014

RELATIONS WITH THE ASIAN DEVELOPMENT BANK⁵

The goal of the Asian Development Bank's (AsDB) Pacific Approach 2010–2014 of a sustained and resilient and improved standard of living aligns with the vision of the Tonga Strategic Development Framework 2009/2010-2014/2015 (TSDF) to create a society in which all Tongans enjoy higher living standards and a better quality of life. Similarly, the Pacific Approach, which serves as AsDB's country partnership strategy, aims to achieve its goal through inclusive and environmentally sustainable growth, which is consistent with the TSDF vision of equitable and environmentally sustainable private sector-led economic growth. AsDB's Country Operations Business Plan (COBP) 2014-2016 for Tonga shares the same focus as the Pacific Approach and the TSDF.

AsDB's support to Tonga will be through infrastructure development; renewable energy; climate resilience; and prudent macroeconomic and fiscal management. The Pacific Approach focuses on the need to mitigate environmental impact and strengthen climate change resilience through development of renewable energy options; enhancing connectivity via multimodal networks and new technologies; and supporting urban development. Two key drivers of change to promote the focus of the Pacific Approach include improved private sector environment and public sector management. The priority outcome objectives of the TSDF supported by AsDB are: (i) to support the private sector through better engagement with government, appropriate incentives, and streamlining rules and regulations; (ii) maintain and develop infrastructure to improve the everyday lives of people; and (iii) integrate environmental sustainability and climate change into all planning and executing of programs.

AsDB has approved 15 loans and 9 grants totaling US\$131.54 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Sixty seven technical assistance (TA) projects with a value of US\$12.53 million were also provided to improve capacity and strengthen institutional development in various sectors. Past AsDB investments have focused on finance development and infrastructure development in transport, power, agriculture, and fisheries.

Active projects include two grant-financed projects and three TA projects in the country portfolio. The grant-financed program approved in 2013 is helping Tonga to achieve fiscal stability through improved public financial management, improved fiscal policy and ongoing implementation of structural reforms, especially in state-owned enterprise reform. The other grant-financed projects support climate resilience and renewable energy. Of the two ongoing TA projects, one focuses on corporate planning and a medium-term budget framework and the other on implementing sustainable off-electricity grids in the outer islands. Tonga also benefits from a number of regional TA projects in private sector development, economic management, energy efficiency, and public financial management.

⁵ As of March 2014.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2009–13					
	2009	2010	2011	2012	2013
Loan approvals					
Number	0	0	0	0	0
Amount (in millions of US\$)	0.0	0.0	0.0	0.0	0.0
Grant approvals					
Number	1	0	2	0	4
Amount (in millions of US\$)	10.0	0.0	15.76	0.0	6.5
Technical assistance approvals					
Number	2	2	24	3	0
Amount (in millions of US\$)	1.0	0.515	1.4	1.375	1.05

STATISTICAL ISSUES

While economic statistics are broadly adequate for surveillance, data deficiencies continue to complicate the monitoring of economic conditions and policy formulation. The Statistics Department (SD) and the Ministry of Finance and National Planning (MOFNP) have received, on a regular basis, technical assistance (TA) in national accounts, government finance, and balance of payments (BOP) statistics from Fund's Statistics department (STA) as well as the Pacific Financial Technical Assistance Centre (PFTAC). Nevertheless, data provision to the Fund continues with long delays. Capacity of the SD could be increased.

The main sources of statistical information are the SD, the Quarterly Bulletin of the National Reserve Bank of Tonga (NRBT), and the annual and semi-annual budget reports from the MOFNP. The country has been participating in the GDDS since May 30, 2006. The metadata are posted on the Fund's Dissemination Standards Bulletin Board (<http://dsbb.imf.org/Applications/web/gdds/gddscountrycategorylist/?strcode=TON>).

Real Sector Statistics

In June 2012, the SD released a new series of national accounts, which changed the base year from 2000/01 to 2010/11, with the assistance of the AusAID funded resident advisor. Data were improved in line with PFTAC assistance provided in 2008 and 2009 by starting to incorporate the 2009-10 Household Income and Expenditure Survey (HIES) results, by supplementing customs data with quarantine office data in merchandize exports, and by including in-kind donor-funded capital projects and loan projects which were not captured previously. With the release in February 2013 of the preliminary GDP results for 2011/2012, the historical series was further revised to reflect improved deflators. PFTAC resumed its statistical support during January 2014 and made recommendations to further incorporate recent data sources in national accounts estimates. PFTAC will provide remote TA to review the 2012-13 GDP estimates which are planned to be released by the SD in March 2014. The compiler of national accounts statistics at the SD attended the PFTAC regional training course during June 2013.

The Consumer Price Index is based on a basket of goods and services from the 2009 HIES. TA was provided in 2008 on the development of an import price index, but trade data was not of sufficient quality to produce indexes. The compilation of detailed international merchandise trade data is currently hampered by technical problems.

Labor market statistics are weak: employment statistics have not been compiled since 2003; and average earnings statistics are not available. The compilation of international arrival and departure statistics has been hampered by technical problems.

Government Finance Statistics

The FY2002/03 Central Government Budget Statement introduced a presentation of fiscal data compiled according to the methodology of the 1986 Government Finance Statistics Manual. The FY

2014/15 budget is expected to be presented on a GFSM 2001 basis. Improvements are still needed to ensure accurate and reliable fiscal data. Reconciliation with monetary and financing data could be enhanced and lags in updating the accounting system could be shortened. Published data are often subject to significant revisions. Consolidated financial statistics for the broader public sector and general government are not published due to lack of capacity. No data are reported for publication in the GFS Yearbook. Tonga is participating in the three-year GFS-IMF project for the Asia-Pacific region funded by the government of Japan, and is committed to commence reporting for the yearbooks.

External Sector Statistics

The SD produces balance of payments statistics on a quarterly basis, which are published on its website in BPM6 format. However, standard methodology, either of BPM5 or BPM6, is largely not observed, and data are published with a significant lag. Official BOP statistics are compiled annually by the SD with long lags. Monthly trade figures, derived from customs data, are available with a three-month lag. The NRBT compiles monthly balance of payments statistics based on the Overseas Exchange Transactions (OET) records of the banking system with a six-week lag. However, there are significant differences between the BOP estimates compiled by the SD and NRBT. A new OET code system consistent with BPM6 is expected to be implemented in March 2014. Large errors and omissions point to possible under-reporting of imports. Changes in reserves do not distinguish transactions from valuation changes.

With PFTAC assistance in March 2009, the SD revised the BOP statistics and methodology, and made recommendations for further improvements in compilation techniques and source data. A follow-up mission took place in March 2010. As part of the Pacific Region module of the JSA Project on External Sector Statistics (ESS) in the Asia and Pacific Region, a mission from the IMF visited Tonga in November 2012 and November/December 2013 to provide TA in balance of payments and IIP. Tonga made good progress in implementing action plan recommendations. Data have been collected to compile the international investment position (IIP). Due to capacity constraints, quarterly IIP data are expected to become available only in late 2014. The NRBT compiled data reported by foreign exchange dealers (FEDs). The register from these data can be used to improve the compilation of remittances. Furthermore, the register for public external debt in the BOP has been reviewed and an International Investment Survey (IIS) has been implemented to improve information on FDI and other foreign transactions of the private sector.

Monetary and Financial Statistics

NRBT reports data for the central bank, other depository corporations, and monetary aggregates using the standardized report forms (SRFs). These data were published for the first time in the March 2008 issue of *IFS and IFS Supplement on Monetary and Financial Statistics*. The NRBT will have to allocate resources to improve the quality of the monetary and financial statistics by obtaining source data suitable for compilation of the SRFs in line with the recommendations of the *Monetary and Financial Statistics Manual*.

Tonga: Table of Common Indicators Required for Surveillance					
As of May 20, 2014					
	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	Feb-14	Apr-14	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Dec-13	Mar-14	M	M	M
Reserve/Base Money	Dec-13	Mar-14	M	M	M
Broad Money	Dec-13	Mar-14	M	M	M
Central Bank Balance Sheet	Dec-13	Mar-14	M	M	M
Consolidated Balance Sheet of the Banking System	Dec-13	Mar-14	M	M	M
Interest Rates ²	Feb-14	April-14	M	M	M
Consumer Price Index	Mar-14	April-14	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2012/13	Jan-14	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2012/13	Jan-14	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	2012/13	Jan-14	A	A	A
External Current Account Balance	Q4/2012	Nov-13	Q	Q	Q
Exports and Imports of Goods and Services	Q4/2012	Nov-13	Q	Q	Q
GDP/GNP	2011/12	Feb-13	A	A	A
Gross External Debt	2012/13	Jan-14	A	A	A
International Investment Position	NA	NA	NA	NA	NA

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Including currency and maturity composition.

⁶ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).



TONGA

JOINT IMF/WORLD BANK DEBT SUSTAINABILITY ANALYSIS 2014

June 19, 2014

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Tonga remains at a moderate risk of debt distress. Despite some worsening of the underlying debt dynamics owing to the reconstruction needs from a recent cyclone, the risk rating continued to be “moderate.” This was also affected by technical changes under the new DSA framework, namely higher discount factor and stronger focus on debt absorptive capacity of remittances.¹ The public sector DSA shows dynamics that are largely similar to those of public and publicly guaranteed external debt. Tonga’s external debt sustainability continues to be vulnerable to external shocks. Among the different stress tests and alternative scenarios, a significant depreciation and slowdown in exports generate the highest debt ratios. This result underscores the importance of policies to promote export growth and diversification, and to hedge foreign exchange risks on external debt.

¹ The Country Policy and Institutional Assessment (CPIA) rating for Tonga remains at a medium level (Tonga’s three year average CPIA score is 3.45).

BACKGROUND

- 1. Tonga is a small open economy with a narrow production base.** It exports a few agricultural and fishery products, and imports food and services of numerous types. Its high reliance on remittances and foreign aid, which are subject to large fluctuations, poses challenges.
- 2. Economic growth is expected to pick up gradually (Box 1).** In January 2014, a tropical cyclone hit Tonga. The resulting output loss will be more than offset by reconstruction. After recording between 0 and 1 percent in FY2012/13 (fiscal year ends on June 30), real GDP growth is expected to recover to 1½ percent in FY2013/14, and further to 3½ percent in FY2014/15, led by reconstruction from the cyclone. 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 1¾ percent, driven by remittances, tourism receipts, as well as credit growth. Risks to the near-term outlook are tilted to the downside.
- 3. Tonga's total debt stock (mainly external) rose from 30 percent of GDP in FY2007/08 to 42 percent of GDP in FY2012/13.** It is expected to remain substantially above 30 percent in the medium term. The increase in debt levels, so far, has been mainly due to two large loans from a bilateral donor contracted in 2007 and 2010.² They account for about 60 percent of the outstanding external debt, while the long-term loans from international financial institutions (IFIs) account for only about 35 percent. The repayment terms for the 2007 loan to support the reconstruction of Nuku'alofa is currently under discussion by the relevant parties, and there are clear signs that the grace period will be extended, although a formal agreement has yet to be announced. The baseline scenario builds in an additional 5-year grace period.
- 4. Cyclone Ian-related reconstruction activity is expected to weaken the fiscal position.** Assessment of the impact of the cyclone suggests property damage of about 10 percent of GDP and a widening of the overall fiscal balance by 1.5 percentage points of GDP to a deficit of 0.6 percent of GDP in FY2013/14. The effect of the cyclone will linger through FY2014/15, raising the overall deficit by about 1 percentage point compared to the no-cyclone forecast—to 0.7 percent of GDP. The projected fiscal cost relating to the cyclone, about 7 percent of GDP or 60 million pa'anga, is broadly met by funding from donor agencies.³
- 5. In the medium term, the overall fiscal balance is expected to return to a moderate surplus, starting in FY 2017/18.** On current policies, this would lead to the gradual decline of the debt-to-GDP ratio to around 30–35 percent towards the end of the DSA timeframe (2034).

² The loan for reconstruction of the central business district was signed in November 2007, and the loan for road improvement was signed in February 2010. These loans bear a 2 percent interest rate, 5-year grace period, and 20-year maturity.

³ They consist of grants (about 70 percent), loans (about 20 percent), and disaster trust fund (about 10 percent). The new external loans are consistent with the authorities' "no new loan policy" as they are due to the World Bank financing of an equal grant-loan mix for countries with moderate risk of debt distress. The impact of these new external loans on debt sustainability is very small.

Box 1. Key Macroeconomic Assumptions

Real GDP growth is projected at 1½ percent in FY2013/14 and at 3½ percent in 2014/15, before reverting to the historical trend of 1.7 percent in the long term. The near-term pick up reflects the boosts provided by the reconstruction from the cyclone. The driver of the convergence of the underlying growth to the historical trend would be remittances, tourism receipts, and credit growth.

The overall fiscal balance is expected to be in deficit in the near term—given the 5 percent public sector salary increase in FY2013/14 and the extra fiscal costs related to the cyclone—but it will gradually move into small surplus toward the end of the medium term led by wage restraint and revenue reform. The continued efforts in improving tax policy and administration are expected to improve the tax-to-GDP ratio to 17.4 percent, and current expenditures are expected to decrease from about 27.2 percent of GDP in FY2013/14 to 22.5 percent over the medium term.¹ Capital expenditure, after elevating to about 5 percent of GDP in FY2014/15 will return to 2 percent over the medium term. Current and capital expenditures are assumed to be broadly stable as a percent of GDP in the long term, with the former about 2½ percent and the latter about 2 percent of GDP. The primary fiscal balance will average about 1 percent of GDP in the longer term.

Grants and projected loan disbursements are assumed to be mostly spent on development projects and associated maintenance. The external financing from the World Bank and the Asian Development Bank is expected to continue to be a 50 percent grant and 50 percent loan mix in the first eight years or so of the forecasting horizon. Domestic borrowing is assumed to be mainly led by gross financing requirement.

The current account deficit is projected to decline from 5½ percent of GDP in FY2012/13 to 3¼ percent in FY2013/14. This change is mainly due to higher remittances and official transfers that more than enough offset the higher imports. However, the current account deficit will increase to about 6 percent in FY2015/16—2016/17, mainly owing to the hosting of the Games. Afterward, it is expected to steadily decline to average of 3 percent in the long term.

Exports of goods are projected to remain stable at around 4 percent of GDP over the medium term. However, imports of goods are projected to reach 34 percent of GDP in the medium term and increase further to around 40 percent of GDP in the long term.

Remittances and tourism are projected to recover gradually, along with the global economic recovery. Remittances will increase from 15½ percent of GDP in FY2013/14 to about 19 percent of GDP over the medium term, and tourism receipts are projected to increase from 7 percent of GDP in FY2013/14 to about 10 percent over the medium term.

Tonga: Key Macroeconomic Assumptions (In percent)			
	2013 DSA	2014 DSA	
	2013-18 AVG	2014-19 AVG	
Real GDP growth	1.5	2.3	
GDP deflator in U.S. dollar terms (change)	1.5	1.5	
Effective interest rate	1.9	1.5	
Growth of exports of G&S (U.S. dollar terms)	7.6	5.6	
Growth of imports of G&S (U.S. dollar terms)	2.9	5.9	
Grant element of new public sector borrowing	31.3	54.1	

Sources: Country authorities; and IMF staff estimates.

¹Unwinding of the cyclone response cost and decrease in project grants account for about three quarter of this decline, and wage restraint the remainder.

6. Toward the outer years in the medium term, the South Pacific Games could pose risks if there are cost overruns or a shift toward debt-creating financing. The authorities estimate the cost of the Games at US\$70 million which they hope to finance mainly by franchises and donations. The baseline scenario of the DSA uses the authorities' official costing and financing plan⁴ which is fiscally prudent. However, historical experience suggests that cost overruns are not uncommon, and could create larger need for financing.

7. The updated DSA framework (DSF)⁵ is applied to Tonga for the first time. The Country Policy and Institutional Assessment (CPIA) rating for Tonga remains at a medium level (Tonga's three year average CPIA score is 3.45). The new DSF puts greater emphasis on remittances as a source of foreign exchange and uses a higher discount rate (5 percent versus 3 percent in the previous framework), which contribute to technical improvements in debt and debt service indicators.⁶

EXTERNAL DSA

Baseline

8. Under the baseline scenario, the trajectories of external debt and debt service indicators remain comfortably below thresholds (Figure 1).

The new DSA framework classifies Tonga as a large remittances case. In such a case, the external debt DSA is required to incorporate external debt absorption capacity generated by remittances into relevant debt burden and service capacity indicators, as well as distress thresholds tailored to them. With these adjustments, all relevant indicators shift down comfortably below their thresholds.

External Debt Indicators (In percent)		
	Indicative Thresholds	Baseline Value in 2013/14
PV of PPG External Debt		
In percent of GDP	40	29
In percent of GDP and remittances	36	25
In percent of exports	150	148
In percent of exports and remittances	120	83
In percent of revenue	250	153
Debt Service		
In percent of exports	20	8
In percent of exports and remittances	16	4
In percent of revenue	20	8

Sources: Country authorities; and IMF staff estimates.

Alternative Scenario and Sensitivity Analysis

9. Stress tests show that the risk of debt distress is sensitive to a slowdown in exports or a large currency depreciation. For the debt services-to-revenue ratio (Figure 1), a one-time depreciation shock causes the indicator to breach the threshold slightly in FY2018/19, when the

⁴ The authorities currently envisage to cover the operating cost (US\$20 million) with the Games revenue, and the capital cost (US\$50 million) with donations and franchises.

⁵ See Staff [Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries](#) and [Revisiting the Debt Sustainability Framework for Low-Income Countries](#).

⁶ Tonga's external DSA risk rating was reclassified from "high" to "moderate" last year mainly driven by an upgrade of CPIA rating.

extended grace period of the 2007 external loan provided by a bilateral donor (to support reconstruction of Nuku'alofa) is assumed to end. However, this breach is considered a borderline case. For all other indicators, there is no breach of thresholds even in the most extreme shock scenario.

10. To address the borderline issue, a probability approach was adopted. The new DSF contains a probability approach for assessing the risk of external debt distress in borderline cases, which is defined as one where the largest breach or near breach falls within a 10-percent band around the threshold.⁷ Similar to the traditional approach, the risk of debt distress is sensitive to either a slowdown in exports or a significant depreciation, and the stress test results in multiple breaches of the thresholds. These results indicate a moderate risk of debt distress.

11. Coming on top of significant reconstruction needs, the Games could pose significant risks to external debt DSA. With nondebt financing covering the entire costs, the authorities' plan is fiscally prudent. If followed through, it would thus not affect Tonga's risk of debt distress—which is moderate. However, the experience of other countries has shown that actual cost often exceeds the original budget. As an illustration of risks, we simulated DSA assuming, hypothetically, a cost overrun financed by an external debt of US\$170 million⁸. The simulation shows that Tonga will be at high risk of debt distress (see Appendix).

12. The historical scenario provides a substantially more sanguine picture than the baseline. This mainly reflects the higher growth of the GDP deflator in U.S. dollar terms applied to the historical scenario.^{9 10}

PUBLIC SECTOR DSA

Baseline

13. The public sector DSA shows largely similar dynamics to the external debt DSA (Figure 3). However, the overall picture is more benign reflecting relatively small levels (about 4 percent of nominal GDP) of public domestic debt. In the baseline scenario, the PV of the public debt-to-GDP ratio will remain slightly over 30 percent in the medium term, before it steadily declines throughout the projection period to about 20 percent. The debt services-to-revenue ratio shows a hump shape, similar to the case of the external debt DSA.

⁷ The probability approach incorporates a country's individual CPIA score and average GDP growth rate, whereas the traditional approach uses one of three discrete CPIA values (3.25 for weak performers, 3.50 for medium performers, and 3.75 for strong performers), and an average growth rate across LICs (for details see the [Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries](#)).

⁸ The scenario assumes that the actual cost (US\$190 million) would exceed the current official estimates (US\$70 million) by about 3 times. The experience in other countries has shown that a large cost overrun of this tune is not improbable (see Box 2 of 2014 Tonga Staff Report for the 2014 Article IV Consultation).

⁹ Four variables are set at their historical averages: (i) real GDP growth; (ii) growth of GDP deflator in U.S. dollar terms; (iii) non-interest current account in percent of GDP; and (IV) nondebt creating (FDI) flows.

¹⁰ This means more accelerated growth in U.S. dollar nominal GDP given the same real growth rate.

Alternative Scenario and Sensitivity Analysis

14. Alternative scenarios underscore the importance of continued commitment to fiscal prudence. In contrast to the baseline scenario, the PV of public debt in the alternative scenarios—with the primary balance fixed at the FY2013/14 level, and with both real GDP growth and primary balance fixed at historical averages—fails to decline over the medium term. This demonstrates the need for consolidating the primary balance (from the current levels), as well as to resist reverting to the historical tendency of low growth and fiscal imbalance. Stress tests suggest that the public debt positions are particularly vulnerable to a significant depreciation. All indicators increase by a large margin with such a shock.

STAFF ASSESSMENT

15. Tonga remains at a moderate risk of debt distress. The underlying dynamics of the external debt has worsened somewhat compared to the previous DSA, due to the reconstruction needs of the recent cyclone. However, the risk rating continues to be moderate, partly owing to the technical changes under the new DSA framework, namely the higher discount factor and stronger focus on the debt absorptive capacity of remittances.

16. The public sector DSA shows broadly similar dynamics to public and publicly guaranteed external debt. However, the overall picture is more benign reflecting the relatively small levels of public domestic debt.

17. Tonga's external debt sustainability continues to be vulnerable to external shocks. Among the different stress tests and alternative scenarios, significant currency depreciation and a slowdown in exports generate the highest debt ratios. These results underscore the importance of policies to promote export growth and diversification and to hedge against exchange risks on external debt.

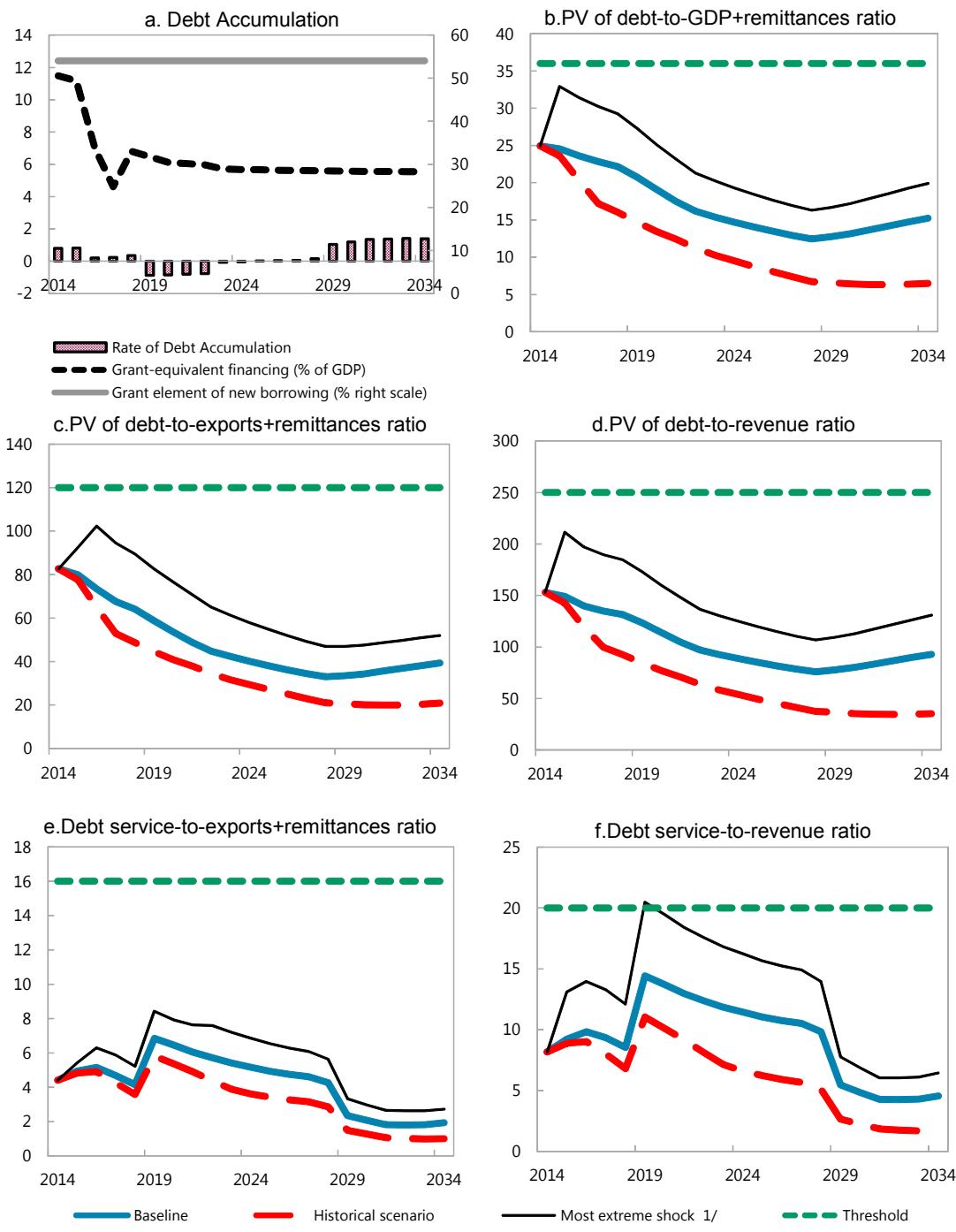
18. Well-designed policies to strengthen growth and improve fiscal management would help enhance debt sustainability. The authorities should continue to prioritize the use of fiscal space to high-impact growth-enhancing projects, while sustaining and expanding service delivery. Continued improvement of the public expenditure framework to attain higher efficiency is important in this regard. Developing a comprehensive debt management strategy, including using financial instruments to hedge exchange risks, is also a perennial priority.

19. Coming on top of significant reconstruction needs, the Games could pose significant risks to external debt DSA. As an illustration of risks, we simulated DSA assuming, hypothetically, a cost overrun financed by an external debt of US\$ 170 million—which shows that Tonga will be at high risk of debt distress.

The Authorities' Views

20. The authorities agreed with the staff's assessment. They recognized that in addition to the existing debt burden, the cyclone damage potentially put more pressure on debt sustainability. They agreed with the need to build fiscal buffers and protect priority spending. The authorities intend to improve debt management framework.

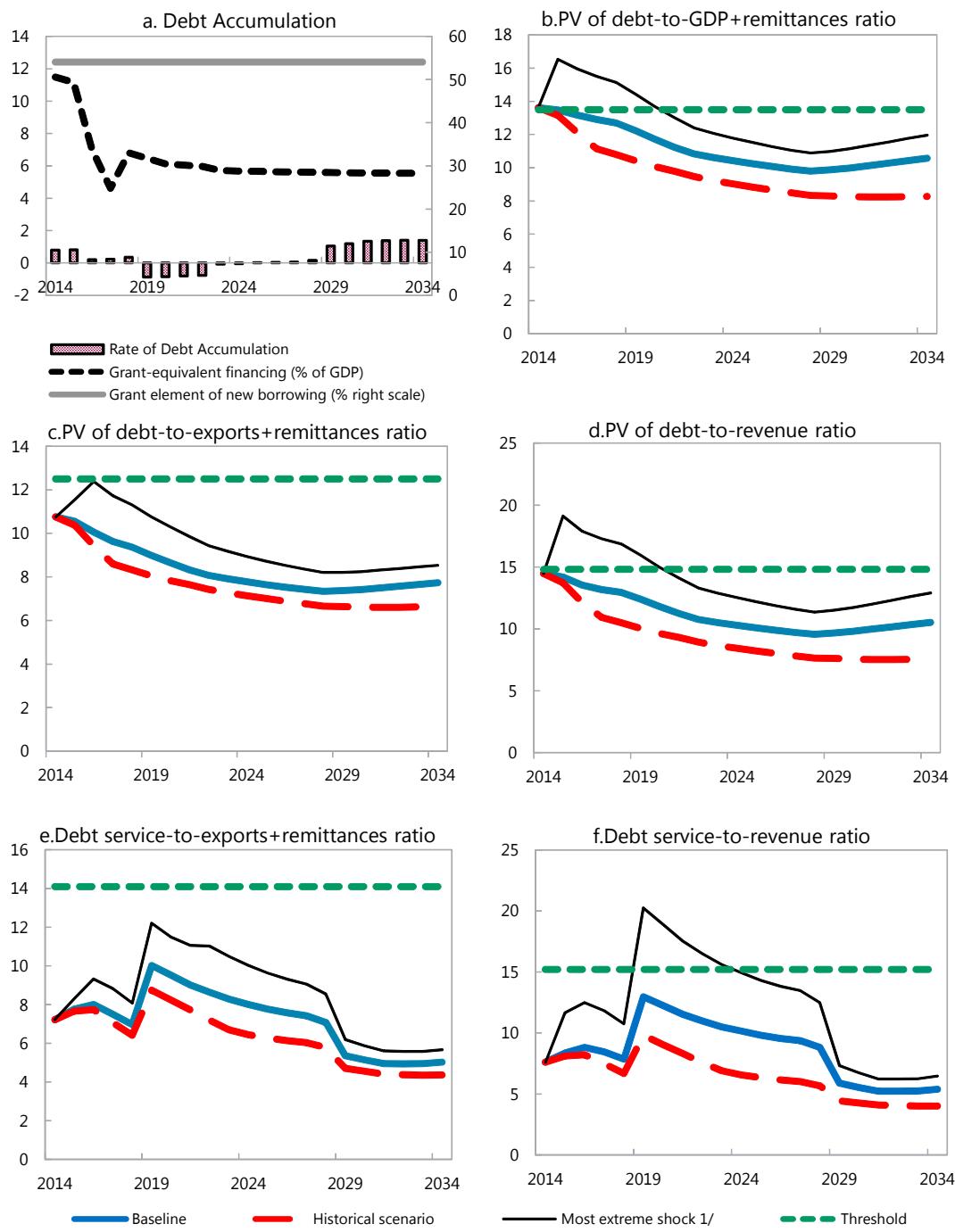
Figure 1. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2014-2034 1/



Sources: Country authorities; and staff estimates and projections.

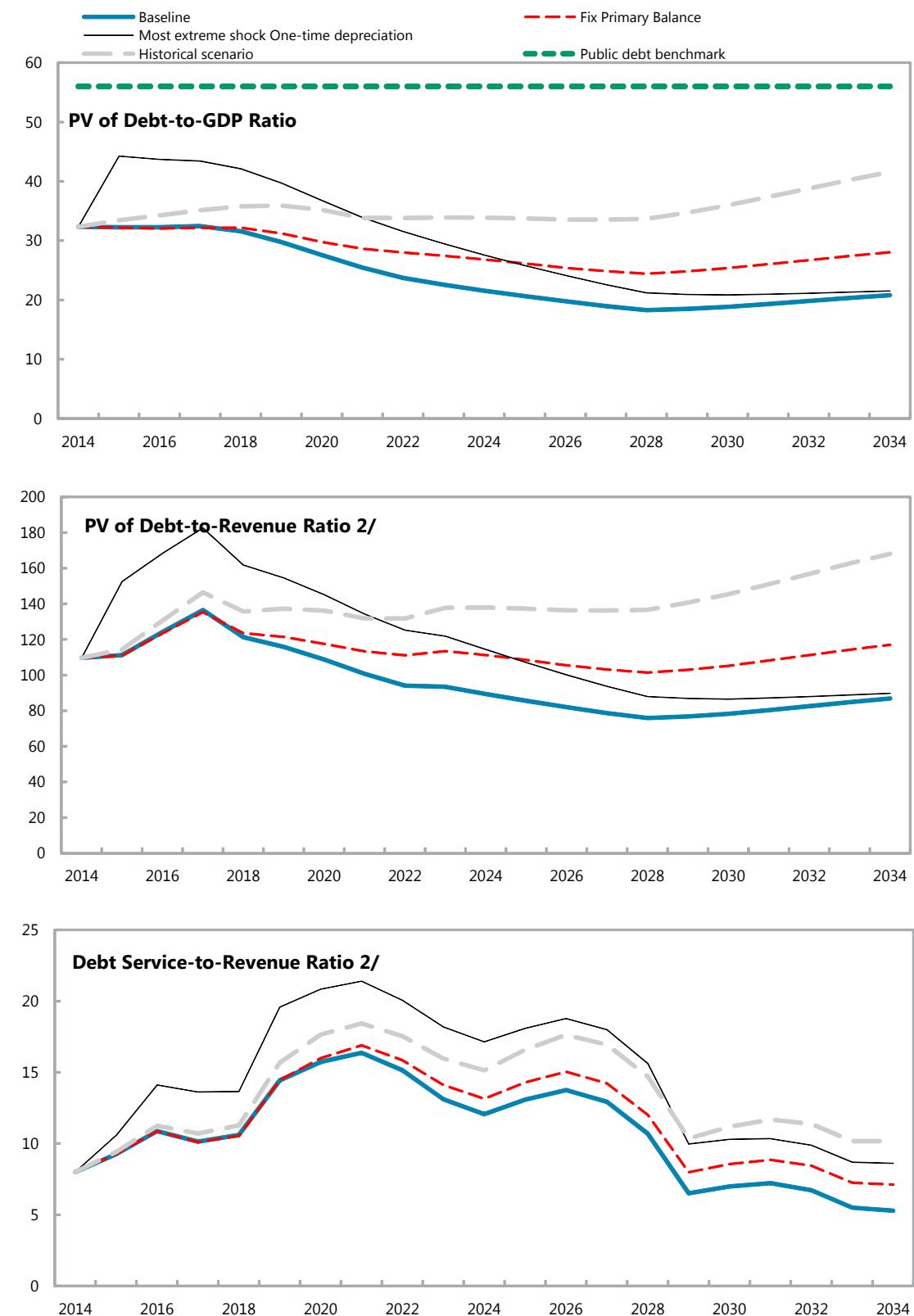
1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2. Tonga: Probability of Debt Distress of Public and Publicly Guaranteed External Debt under Alternatives Scenarios. 2014-2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 3. Tonga: Indicators of Public Debt Under Alternative Scenarios, 2014-2034 1/

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.

2/ Revenues are defined inclusive of grants.

Table 1a .Tonga: External Debt Sustainability Framework, Baseline Scenario, 2011-2034 1/
 (In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard Deviation	Projections						2014-2019		2020-2034	
	2011	2012	2013			2014	2015	2016	2017	2018	2019	Average	2024	2034	Average
External debt (nominal) 1/	36.0	41.9	41.4			41.0	40.3	39.0	37.9	37.0	35.2		28.6	35.4	
of which: public and publicly guaranteed (PPG)	36.0	41.9	41.4			41.0	40.3	39.0	37.9	37.0	35.2		28.6	35.4	
Change in external debt	4.2	5.9	-0.5			-0.5	-0.6	-1.3	-1.1	-0.9	-1.8		-0.2	1.1	
Identified net debt-creating flows	-2.8	1.8	2.7			0.4	-0.7	2.6	3.2	-0.7	-2.7		-0.3	0.3	
Non-interest current account deficit	2.2	6.1	4.6	4.2	3.5	2.7	2.4	5.4	5.8	1.8	0.3		2.5	2.8	2.5
Deficit in balance of goods and services	32.7	36.3	25.5			29.0	31.3	31.7	30.7	30.0	29.0		30.4	32.7	
Exports	16.9	17.2	21.0			19.5	20.1	21.1	22.3	22.7	23.1		23.7	24.9	
Imports	49.5	53.5	46.5			48.5	51.3	52.8	52.9	52.7	52.1		54.0	57.6	
Net current transfers (negative = inflow)	-27.8	-27.4	-17.3	-30.1	5.3	-23.0	-25.5	-22.9	-21.5	-24.8	-25.3		-24.6	-26.7	-25.8
of which: official	-4.9	-3.3	-1.5			-6.4	-9.3	-5.6	-3.2	-5.4	-5.1		-3.7	-3.6	
Other current account flows (negative = net inflow)	-2.7	-2.9	-3.6			-3.4	-3.4	-3.4	-3.4	-3.4	-3.4		-3.2	-3.2	
Net FDI (negative = inflow)	-1.5	-1.1	-3.4	-4.6	3.6	-2.4	-2.4	-2.4	-2.4	-2.5	-2.5		-2.6	-2.2	-2.5
Endogenous debt dynamics 2/	-3.5	-3.2	1.6			0.1	-0.7	-0.4	-0.1	-0.1	-0.5		-0.2	-0.3	
Contribution from nominal interest rate	0.6	0.5	0.9			0.6	0.6	0.6	0.6	0.5	0.5		0.3	0.3	
Contribution from real GDP growth	-0.8	-0.2	-0.1			-0.6	-1.3	-1.0	-0.7	-0.6	-1.0		-0.5	-0.6	
Contribution from price and exchange rate changes	-3.2	-3.5	0.7			...	...	...	...	...	...		...	...
Residual (3-4) 3/	7.0	4.1	-3.2			-0.8	0.1	-3.9	-4.4	-0.2	0.9		0.1	0.8	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	28.9			28.8	28.3	27.5	26.8	26.2	24.7		17.7	18.7	
In percent of exports	...	...	137.6			147.9	141.1	130.5	120.3	115.4	106.9		74.9	74.9	
PV of PPG external debt	...	...	28.9			28.8	28.3	27.5	26.8	26.2	24.7		17.7	18.7	
In percent of exports	...	...	137.6			147.9	141.1	130.5	120.3	115.4	106.9		74.9	74.9	
In percent of government revenues	...	...	154.6			153.2	149.4	139.9	134.8	131.5	123.6		88.9	93.0	
Debt service-to-exports ratio (in percent)	7.1	7.7	8.6			7.9	8.7	9.2	8.3	7.5	12.5		9.6	3.7	
PPG debt service-to-exports ratio (in percent)	7.1	7.7	8.6			7.9	8.7	9.2	8.3	7.5	12.5		9.6	3.7	
PPG debt service-to-revenue ratio (in percent)	6.2	7.3	9.6			8.2	9.2	9.8	9.3	8.5	14.4		11.4	4.5	
Total gross financing need (Millions of U.S. dollars)	8.0	29.9	13.7			8.8	8.7	26.1	28.2	6.0	3.6		15.4	16.7	
Non-interest current account deficit that stabilizes debt ratio	-2.0	0.1	5.1			3.1	3.0	6.7	6.9	2.8	2.1		2.7	1.7	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.9	0.7	0.3	0.9	2.4	1.4	3.4	2.5	1.7	2.8	2.3		1.7	1.7	1.6
GDP deflator in US dollar terms (change in percent)	11.4	10.7	-1.8	8.0	8.1	2.4	1.5	1.6	1.8	2.0	0.0		1.5	2.5	2.6
Effective interest rate (percent) 5/	2.0	1.5	2.2	1.6	0.7	1.6	1.6	1.5	1.5	1.5	1.4		1.5	1.2	1.0
Growth of exports of G&S (US dollar terms, in percent)	51.9	13.6	20.2	10.0	19.0	-3.8	8.2	9.4	9.5	5.8	4.4		5.6	4.8	4.8
Growth of imports of G&S (US dollar terms, in percent)	17.8	20.5	-14.5	8.3	13.3	8.2	11.0	7.2	3.9	3.3	1.5		5.9	4.9	5.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	54.1	54.1	54.1	54.1	54.1	54.1		54.1	54.1	54.1
Government revenues (excluding grants, in percent of GDP)	19.5	18.1	18.7			18.8	19.0	19.6	19.9	19.9	20.0		20.0	20.1	20.0
Aid flows (in Millions of US dollars) 7/	28.8	44.2	25.2			58.7	61.3	40.1	28.5	42.0	41.3		50.0	75.3	
of which: Grants	28.8	44.2	25.2			51.6	50.8	33.3	21.3	34.5	33.4		29.8	42.5	
of which: Concessional loans	0.0	0.0	0.0			7.1	10.6	6.8	7.2	7.5	7.9		20.2	32.9	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			11.5	11.2	7.0	4.6	6.8	6.5		5.7	5.5	5.7
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			94.5	92.1	92.2	88.4	91.8	91.2		81.5	80.0	82.7
Memorandum items:															
Nominal GDP (Millions of US dollars)	423.0	471.6	464.5			482.2	505.8	527.0	545.9	566.3	582.1		716.8	1087.3	
Nominal dollar GDP growth	14.6	11.5	-1.5			3.8	4.9	4.2	3.6	3.7	2.8		3.8	4.3	4.3
PV of PPG external debt (in Millions of US dollars)			135.2			138.8	142.7	143.7	144.9	146.8	141.8		126.1	201.3	
(Pvt-Pvt-1)/GDPt-1 (in percent)						0.8	0.8	0.2	0.2	0.3	-0.9		0.2	0.0	0.4
Gross workers' remittances (Millions of US dollars)	87.5	66.8	68.8			74.2	77.6	86.3	94.6	103.0	110.0		147.2	244.3	
PV of PPG external debt (in percent of GDP + remittances)	...	...	25.2			24.9	24.5	23.6	22.8	22.2	20.7		14.7	15.2	
PV of PPG external debt (in percent of exports + remittances)	...	...	80.7			82.6	80.0	73.4	67.6	64.1	58.8		40.1	39.4	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	5.0			4.4	4.9	5.2	4.7	4.2	6.9		5.2	1.9	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - p(1+g)]/(1+g+p+gp)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and p = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1b. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014-2034
 (In percent)

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of debt-to GDP ratio								
Baseline	29	28	27	27	26	25	18	19
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	29	27	23	20	18	17	11	7
A2. New public sector loans on less favorable terms in 2014-2034 2	29	29	28	28	28	26	22	31
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	29	30	30	29	28	27	19	20
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	29	30	32	31	31	29	22	21
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	29	29	28	27	27	25	18	19
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	29	29	28	27	27	25	18	19
B5. Combination of B1-B4 using one-half standard deviation shocks	29	28	27	26	25	24	17	18
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	29	40	39	38	37	35	25	26
PV of debt-to-exports ratio								
Baseline	148	141	131	120	115	107	75	75
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	148	135	111	89	81	73	45	28
A2. New public sector loans on less favorable terms in 2014-2034 2	148	144	134	125	122	115	94	123
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	148	141	129	119	114	106	74	74
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	148	176	216	200	192	180	130	119
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	148	141	129	119	114	106	74	74
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	148	146	133	123	118	109	77	76
B5. Combination of B1-B4 using one-half standard deviation shocks	148	150	147	135	129	119	83	85
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	148	141	129	119	114	106	74	74
PV of debt-to-revenue ratio								
Baseline	153	149	140	135	132	124	89	93
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	153	143	119	100	93	85	54	35
A2. New public sector loans on less favorable terms in 2014-2034 2	153	152	144	140	139	133	112	153
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	153	156	152	146	142	133	96	101
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	153	157	162	157	153	145	108	103
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	153	151	143	138	134	126	91	95
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	153	154	143	138	134	126	91	94
B5. Combination of B1-B4 using one-half standard deviation shocks	153	149	137	131	128	119	86	92
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	153	211	197	190	185	173	125	131

Table 1b.Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014-2034 (continued)
 (In percent)

	Debt service-to-exports ratio							
Baseline	8	9	9	8	7	12	10	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/								
A1. Key variables at their historical averages in 2014-2034 1/	8	8	8	7	6	10	6	1
A2. New public sector loans on less favorable terms in 2014-2034 2	8	9	9	9	8	13	11	7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	8	9	9	8	7	12	10	4
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	8	10	13	12	11	18	15	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	8	9	9	8	7	12	10	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	8	9	9	8	8	13	10	4
B5. Combination of B1-B4 using one-half standard deviation shocks	8	9	11	10	9	15	11	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	8	9	9	8	7	12	10	4
	Debt service-to-revenue ratio							
Baseline	8	9	10	9	9	14	11	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	8	9	9	8	7	11	7	2
A2. New public sector loans on less favorable terms in 2014-2034 2	8	9	10	10	9	15	13	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	8	10	11	10	9	16	12	5
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	8	9	10	10	9	15	13	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	8	9	10	10	9	15	12	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	8	9	10	9	9	14	12	5
B5. Combination of B1-B4 using one-half standard deviation shocks	8	9	10	9	9	15	11	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	8	13	14	13	12	20	16	6
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	52	52	52	52	52	52	52	52

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 2a. Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011-2034
 (In percent of GDP, unless otherwise indicated)

	Actual			Average	5/ Standard Deviation	Estimate					Projections				
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	41.3	46.5	45.1			44.5	44.3	43.8	43.6	42.3	40.3		32.4	37.6	
of which: foreign-currency denominated	36.0	41.9	41.4			41.0	40.3	39.0	37.9	37.0	35.2		28.6	35.4	
Change in public sector debt	1.3	5.2	-1.4			-0.6	-0.2	-0.5	-0.2	-1.3	-2.1		-0.4	1.0	
Identified debt-creating flows	0.3	2.3	-1.0			-0.8	-1.2	-0.7	-0.8	-2.6	-2.3		-2.0	-1.8	
Primary deficit	6.6	2.0	-0.1	0.7	3.0	-0.2	-0.1	0.2	-0.1	-1.8	-1.8	-0.6	-1.1	-0.7	-1.1
Revenue and grants	26.3	27.4	24.1			29.5	29.0	26.0	23.8	26.0	25.7		24.1	24.0	
of which: grants	6.8	9.4	5.4			10.7	10.0	6.3	3.9	6.1	5.7		4.2	3.9	
Primary (noninterest) expenditure	32.9	29.5	24.0			29.3	28.9	26.1	23.7	24.2	23.8		23.0	23.3	
Automatic debt dynamics	-6.4	0.8	0.1			-0.6	-1.1	-0.8	-0.8	-0.8	-0.4		-0.9	-1.1	
Contribution from interest rate/growth differential	-1.2	-0.3	0.3			-0.5	-1.4	-1.1	-0.8	-0.9	-1.2		-0.7	-1.0	
of which: contribution from average real interest rate	0.0	0.0	0.4			0.1	0.1	0.0	-0.1	-0.1	0.0		-0.2	-0.3	
of which: contribution from real GDP growth	-1.1	-0.3	-0.1			-0.6	-1.5	-1.1	-0.7	-0.7	-1.2		-0.6	-0.6	
Contribution from real exchange rate depreciation	-5.2	1.1	-0.3			-0.1	0.2	0.3	0.1	0.1	0.8		...	...
Other identified debt-creating flows	0.1	-0.6	-0.9			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.1	-0.6	-0.9			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	1.0	2.9	-0.4			0.2	1.0	0.2	0.6	1.3	0.2		1.6	2.8	
Other Sustainability Indicators															
PV of public sector debt	...	...	32.6			32.3	32.3	32.3	32.5	31.6	29.8		21.6	20.8	
of which: foreign-currency denominated	...	...	28.9			28.8	28.3	27.5	26.8	26.2	24.7		17.7	18.7	
of which: external	...	...	28.9			28.8	28.3	27.5	26.8	26.2	24.7		17.7	18.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	9.4	3.9	2.8			2.2	2.6	3.0	2.4	0.9	1.9		1.8	0.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	135.0			109.7	111.2	124.3	136.5	121.4	115.9		89.5	86.9	
PV of public sector debt-to-revenue ratio (in percent)	...	...	174.2			172.2	170.2	164.2	163.4	158.5	149.2		108.1	103.8	
of which: external 3/	...	...	154.6			153.2	149.4	139.9	134.8	131.5	123.6		88.9	93.0	
Debt service-to-revenue and grants ratio (in percent) 4/	10.7	7.0	12.2			8.0	9.3	10.9	10.1	10.6	14.4		12.1	5.3	
Debt service-to-revenue ratio (in percent) 4/	14.4	10.6	15.8			12.6	14.2	14.4	12.1	13.9	18.6		14.6	6.3	
Primary deficit that stabilizes the debt-to-GDP ratio	5.2	-3.2	1.3			0.4	0.2	0.6	0.2	-0.6	0.2		-0.7	-1.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	2.9	0.7	0.3	0.9	2.4	1.4	3.4	2.5	1.7	1.7	2.8	2.3	1.7	1.7	1.6
Average nominal interest rate on forex debt (in percent)	2.0	1.5	2.2	1.6	0.7	1.6	1.6	1.5	1.5	1.5	1.4	1.5	1.2	0.9	1.0
Average real interest rate on domestic debt (in percent)	-2.0	1.6	4.3	-2.0	4.9	1.3	3.6	2.6	1.8	1.4	3.0	2.3	1.3	1.3	1.2
Real exchange rate depreciation (in percent, + indicates depreciation)	-16.8	3.2	-0.6	-4.8	8.3	-0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.8	2.4	0.7	5.3	5.2	1.5	1.7	2.8	3.6	4.0	2.3	2.7	4.1	4.1	4.2
Growth of real primary spending (deflated by GDP deflator, in percent)	0.1	-0.1	-0.2	0.0	0.2	0.2	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	54.1	54.1	54.1	54.1	54.1	54.1	54.1	54.1	54.1	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b.Tonga: Sensitivity Analysis for Key Indicators of Public Debt 2014-2034

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	32	32	32	32	32	30	22	21
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	32	33	34	35	36	36	34	42
A2. Primary balance is unchanged from 2014	32	32	32	32	32	31	27	28
A3. Permanently lower GDP growth 1/	32	32	33	33	33	31	26	34
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	32	34	37	38	38	37	32	38
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	32	34	36	36	35	33	25	23
B3. Combination of B1-B2 using one half standard deviation shocks	32	35	37	38	37	36	30	34
B4. One-time 30 percent real depreciation in 2015	32	44	44	43	42	40	28	22
B5. 10 percent of GDP increase in other debt-creating flows in 2015	32	37	37	38	37	35	26	24
PV of Debt-to-Revenue Ratio 2/								
Baseline	110	111	124	137	121	116	89	87
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	110	114	131	146	136	137	138	168
A2. Primary balance is unchanged from 2014	110	111	123	135	124	122	111	117
A3. Permanently lower GDP growth 1/	110	112	126	140	125	121	105	138
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	110	116	138	157	142	140	131	158
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	110	118	139	152	135	130	103	98
B3. Combination of B1-B2 using one half standard deviation shocks	110	118	139	156	141	138	124	142
B4. One-time 30 percent real depreciation in 2015	110	153	168	183	162	155	114	90
B5. 10 percent of GDP increase in other debt-creating flows in 2015	110	129	144	158	141	135	108	102
Debt Service-to-Revenue Ratio 2/								
Baseline	8	9	11	10	11	14	12	5
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	8	9	11	11	11	16	15	10
A2. Primary balance is unchanged from 2014	8	9	11	10	11	14	13	7
A3. Permanently lower GDP growth 1/	8	9	11	10	11	15	13	8
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	8	10	12	11	12	16	15	9
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	8	9	11	11	12	15	13	6
B3. Combination of B1-B2 using one half standard deviation shocks	8	9	12	11	12	16	14	9
B4. One-time 30 percent real depreciation in 2015	8	11	14	14	14	20	17	9
B5. 10 percent of GDP increase in other debt-creating flows in 2015	8	9	11	12	12	16	13	6

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

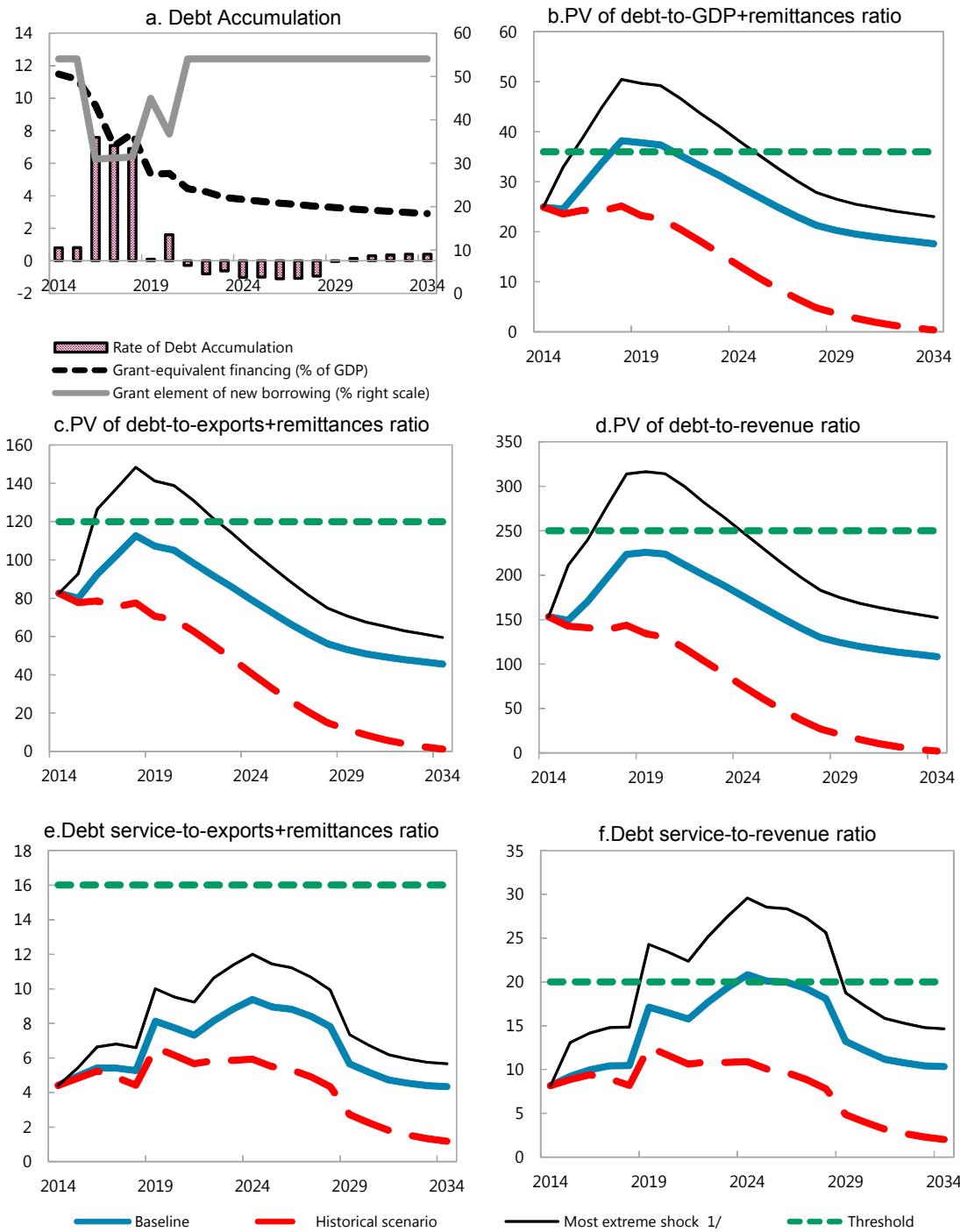
Appendix. The 2019 Pacific Games: High-Cost Scenario

Tonga will host the 2019 Pacific Games. While the authorities' original plan is fiscally prudent, international experience suggests that cost overrun often takes place. As an illustration of risks, we simulate a DSA assuming, hypothetically, a cost overrun (by US\$120 million) financed by an external debt (US\$170 million). We assume the hypothetical external loans will be made on terms and conditions similar to the loans provided by China's EXIM bank in recent years (2 percent interest rate, 20-year maturity, and 5-year grace period).

The macroeconomic assumptions remain broadly similar, compared to the baseline. In the run-up to the Games, the projects of building new sports facilities and improving existing accommodations and infrastructure would directly boost GDP. However, the growth rate decreases rapidly afterward, reflecting cooling-down effect after the pre-Games construction. During the game year of 2019, the positive effects brought by additional tourists and services provided will help spur a second round of growth windfall followed by a year of unwinding.

The simulated DSA causes Tonga's rating to change from moderate to high risk of debt distress. The present value of public and publicly guaranteed debt to GDP plus remittances ratio would breach its threshold for 3-4 years under the baseline (Figure A1. High-cost). Under stress tests, four out of five debt and debt service indicators would breach the relevant thresholds. In addition, the PV of public debt to GDP also breaches the threshold under a stress scenario.

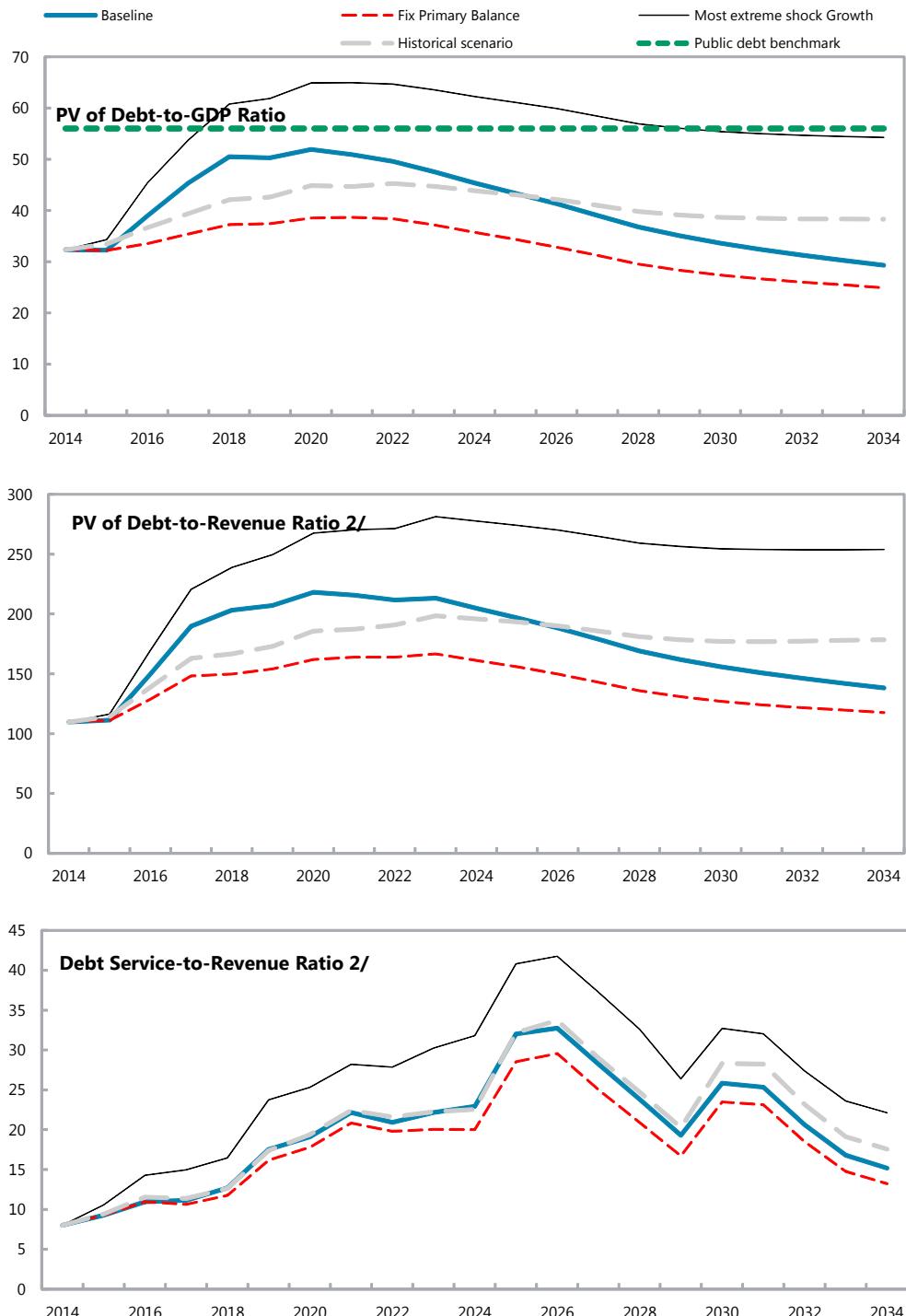
Figure A1. High-cost. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2014-2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure A2. High-cost Tonga: Indicators of Public Debt Under Alternative Scenarios, 2014-2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.

2/ Revenues are defined inclusive of grants.



TONGA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Prepared By

Asia and Pacific Department

- July 17, 2014
1. This supplement to the staff report summarizes the main developments since the staff report was issued on June 24, 2014. Staff projections and the thrust of the staff appraisal remain unchanged.
 2. On June 24, the Parliament passed the FY2014/15 government budget.
 - Total expenditures estimated for FY2014/15 amount to 451 million pa'anga, including donor-supported in-kind expenditures of around 181 million pa'anga. This is broadly in line with the staff's projection.
 - The budget entails a moderate deficit (13.7 million pa'anga).
 3. The latest data releases are broadly consistent with the staff's projections.
 - CPI inflation decelerated from 4.7 percent in March to 3.0 percent in May.
 - Through May, international reserves declined to 9.4 months of current imports from 9.9 months at the beginning of the year.

Recent macroeconomic indicators

	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14
CPI inflation (In percent, year-on-year)	0.2	0.2	0.9	1.4	1.4	0.6	0.8	4.2	4.7	4.7	3.9	3.0
International reserves (In months of imports)	9.1	8.8	9.0	8.8	9.1	9.3	9.8	9.9	9.9	9.6	9.3	9.4

Source: Tongan authorities.



INTERNATIONAL MONETARY FUND



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FOR IMMEDIATE RELEASE
August 6, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Tonga

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

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.

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.

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/misctools/qualifiers.htm>.

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

	2008/09	2009/10	2010/11	2011/12	Estimates	Projections	
						2013/14	2014/15
(Annual percent change)							
Output and prices						(In percent of GDP)	
Real GDP 2/	3.2	3.3	2.9	0.7	0.3	1.4	3.4
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
Of which: 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	...
Of which: 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	...
Of which: 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	...	...	...
(In millions of U.S. dollars)							
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
Of which: Remittances	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

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.

**Statement by Wimboh Santoso, Executive Director for Tonga
and Tin Moe Moe, Senior Advisor to Executive Director**
July 23, 2014

1. On behalf of the Tongan authorities, we would like to express the authorities' sincere gratitude to Mr. Jookyung Ree and his team responsible for the 2014 Article IV Consultation. This year's discussion focused on the recovery following Cyclone Ian, and encouraging sustainable long-term growth. The authorities broadly agree with the substance of the report.

Recent Economic Development and Outlook

2. The Tongan economy experienced annual growth of around 3 per cent over the period between 2008-09 and 2010-11 on the back of public investment projects particularly funded by China's EXIM Bank. However, growth started to decelerate in 2011-12 following the completion of investment projects together with weak remittances and tourists arrival. Despite this, the estimated nominal GDP for 2012-13 was T\$802.4 million (US\$446.1 million), giving GDP per capita of T\$7,771 (US\$4,320) placing Tonga now in the upper-middle income group of countries for the first time.

3. In January 2014, tropical Cyclone Ian hit remote regions of Tonga. It was the most powerful storm ever recorded in the country, severely affecting housing, agriculture, manufacturing, dwelling services output, water resources and electricity supply. Given this, the NRBT revised forecasts downward, anticipating the economy to grow by 2.0 per cent in 2013-14. GDP growth is expected to reach around 3.2 per cent in 2014-15, partly supported by reconstruction of cyclone-affected areas which are boosting construction activity.

4. The Tongan economy is expected to continue recovering from the effects of Cyclone Ian supported by the recovery in agriculture and tourism and in other areas such as remittances and credit growth in the banking sector. The authorities noted the staff's view regarding the need to identify and strengthen engines of growth in order to achieve a sustainable and inclusive growth in the medium and long-term. Additionally, relying heavily on imports for domestic consumption is a major risk to the economy. The authorities welcome the advice to promote tourism, agriculture, and fishery sectors and others through implementation of policy mix involving tax incentives and regulatory reform. Up-skilling Tonga's labor force through continued participation in the seasonal employment programs is essential to facilitate the country's growth model. This benefit could amplify by considering similar programs for high-skilled labor, such as for workers in the health and education sectors. The authorities intend to introduce growth friendly policy measures by lowering the cost of credit with robust safe guards. The authorities welcome the staff's recommendation to tighten monetary conditions once the turnaround in credit growth is clear.

5. The authorities acknowledge the downside risk related to spillovers from slower growth in emerging economies and frequent natural disaster. Nevertheless, the authorities stand ready to mitigate the effect from this downside risk by gradually building fiscal surplus to about 1 percent of GDP on average over the long-term.

6. Year-ended inflation rose from 1.1 percent in February 2013 to 4.7 percent in February 2014, reaching its highest level since September 2011 (5.6 per cent). This sharp increase was mainly owing to the increase in the price index of imported components due to the pa'anga's depreciation against the New Zealand dollar, as well as rises in domestic fruit and vegetable prices due to unfavorable

weather conditions. However inflation fell over May 2014 to 3.0 per cent following a sharp decline in the price of domestic fruit and vegetables coinciding with the onset of the harvesting season. The authorities project year-ended headline inflation to be around 4.0 percent in June 2014, and to fall further based on the assumptions of a further decline in world food prices, an increase in the world food supply and the pa'anga exchange rate would remain unchanged. For the medium-term, authorities share staff views that inflation would be higher with demand-pull effects relating to the preparation of hosting South Pacific Games in 2019. Notwithstanding this, authorities and staffs noted that current peak level of inflation is still below the authorities' reference range of 6 to 8 percent. In light of this, authorities have requested assistance from the IMF to review the current reference range and await the IMF's advice on the next steps.

7. Gross official foreign reserves stood at T\$266.8 million at the end of May 2014, which is equivalent to 9.4 months of import cover and well above the NRBT benchmark of 3 to 4 months of imports. Ongoing increase of foreign exchange reserves is because of mainly materializing inflows grants and aids in terms of size and timing from Tonga's development partners. The authorities also agree with staffs that, to some extent, the expected increase in the level of foreign exchange reserves will be offset by increase in cyclone recovery of imports. Nonetheless, authorities reiterated that the level of foreign reserves will remain comfortably above the NRBT benchmark over the near term.

Monetary Policy

8. Authorities agree with staff that the current expansionary monetary policy stance is appropriate given the nascent recovery of economic growth. The Tongan authorities remain focused on maintaining internal and external monetary stability; and promoting a sound and efficient financial system in a manner that supports macroeconomic stability and economic growth. To maintain internal and external monetary stability through maintaining official foreign reserves and promoting price stability, NRBT set the threshold for maintaining official foreign reserve at 3 to 4 months of imports cover, and inflation reference range at 6 to 8 percent. It is well noted that the current level of international reserves is well above the set threshold level and inflation is well below the reference range.

9. While protecting high levels of foreign exchange reserves, the NRBT anticipates maintaining conventional monetary policy at its expansionary limit, supporting economic activity over the near term. The NRBT will not pay banks any interest on their exchange settlement account balances; will not issue any NRBT securities and will maintain the banks' Statutory Required Deposit ratio in its effective lower bound of 5 per cent of deposits. The NRBT will also continue its monthly dialogue with the banks on other ways to encourage lending. In this context, authorities viewed that growth could be strengthened by increasing banks' lending viable corporations to stimulate private sector growth. The authorities stand ready to mitigate the risk against building up in the level of non-performing loans while encouraging lending for commercially viable investments.

10. Regarding implementation of monetary policy through lower cost of intermediation going forward, the authorities will continue with its efforts to increase competition with the opening of a new bank (Pacific International Commercial Bank) while ensuring all banks continue to follow prudent lending rules; and support the commercialization of Tonga Development Bank (TDB). The amendments to the Tonga Development Act have been enacted from July 2014, supporting the commercialization of the bank. Further effort includes the amendments to the NRBT Act and Financial Institutions Act to strengthening the Reserve Bank's role to economic development,

monetary stability, and the soundness and resilience of the financial sector. This includes bringing non-banks to the regulatory framework of the NRBT. Nevertheless, the authorities acknowledge the staff's recommendation to tighten monetary policy once credit growth has sustained.

Fiscal Policy

11. Total public debt is estimated at \$368.2 million (44 percent of GDP) at 30 June 2014; with total external debt, of T\$338.7 million (40 percent of GDP) of which nearly two thirds is owed to EXIM Bank. Total Domestic debt, of T\$29.5 million (3 percent of GDP) consists only of Government bond issuance with 56 percent held by financial institutions and over 24 percent by retirement funds. On the issue of increasing high debt burden, authorities share staffs' view that well-designed policies to strengthen growth and improve fiscal management would help enhance debt sustainability. The authorities also agree with the staffs that building fiscal buffers while protecting priority spending is warranted.

12. Recent improvement in economic and public management conditions resulted in IMF upgrading Tonga from high debt distress to medium. This improved classification, however, raises a number of key issues, as well as changing World Bank and ADB project and budget support from 100 percent grant to 50 percent grant and 50 percent loan. This provides some room for prudent debt financing. In the area of domestic borrowing, public debt management will stimulate direct cost savings and economic growth.

13. To strengthen fiscal management, the authorities remain committed to its fiscal consolidation strategy started two years ago, which includes ensuring better management of public finances and returning to a more sustainable position. This consolidation is required to strengthen the long-term position of the budget and rebuild policy buffers against future external shocks. The authorities fulfill their commitments by improving their estimation of funding ceilings based on realistic assessments of revenue raising capacity, budget support and development assistance, and where appropriate prudent borrowing.

14. The authorities are also aware that revenue reform is warranted to improve the fiscal position while preserving capital expenditures and maintaining contingency funds. The authorities will implement revenue measures including continued improvements to revenue collection while avoiding the burden on businesses and consumers; limiting erosion of the revenue base from exemptions by applying clear policy guidance rather than ad hoc decisions (taking account of target sectors, addressing structural disadvantages, improving performance of business, non-discretionary, fairness and transparency and protecting the revenue base); seeking predictable levels of budget support, to support sound budgeting; increasing the revenue base through increased non tax revenue sources, e.g. offshore companies; and improving returns from Government assets.

15. The authorities will also make efforts to further enhance prudent debt management by ensuring that the sustainable debt policy remains up to date and managing the currency composition of debt to avoid over exposure to any one currency, or one source of funding.

16. The authorities took note the medium-term fiscal strategy to ensure gradual stabilizing and reducing the risk of debt stress. Policy measures to anchor the fiscal position have been the authorities' priority including the policy of no new external commercial borrowing and cautious use of concessional loans only in limited basis. The authorities are mindful of the fiscal risk arising from a potential cost overrun and lower cost options to build South Pacific Game facilities, however, debt

related financing for the game facilities is not an option that the authorities are looking at as the authorities do have the fiscal space available as buffer to absorb the downside risk.

Financial Sector

17. Total bank lending balances increased by 10.9 per cent over the year to May 2014. This follows a 11.2 increased over the year in April 2014. This is the fastest growth recorded for five years reflecting lower lending rates. The NRBT is forecasting lending to grow by around 10 per cent in 2013-14. This is on the basis of imminent drawdown of some large loan commitments; the expected fall in interest rates; and an anticipated improvement in economic conditions more broadly. Faster growth is expected in financial year 2015.

18. Tonga's weighted average interest rate spread was less than 6.9 percentage points in May 2014. The lowest in at least 36 months of comparable records since at least January 2001. The weighted average deposit rate increased over the year to May 2014 by 9 basis points. Lending rates are now low by the standards of the past decade. The result can be explained by the increased competition in the banking sector together with the continued support from the NRBT's expansionary monetary policy setting. Tongan lending rates has been unable to decline further due to structural issues contributing to high risk in lending in Tonga that need to be addressed, such as the land administration issues and lack of bankruptcy laws.

19. The authorities agree with the staffs that excess liquidity needs to be reduced gradually to support economic growth and prudent lending. Unsafe and unsound practices through aggressive competition should be avoided to ensure financial stability is maintained. This will also avoid resulting increase in interest rate which can hamper the nascent economic recovery. In this respect, given the limited monetary policy instruments, the authorities intend to introduce growth friendly policy measures along with continuously seeking means to enhance support for credit growth. On the supervisory front, the NRBT's oversight continues to focus on banks' credit risk management systems as well as enhanced oversight over the new bank and TDB's commercialization process.

Structural Reforms

20. The authorities are committed to further strengthening the private public sector partnership to increase competition which helps improve quality and lower prices for consumers. The authorities share staffs' view that promoting FDI should focus on business-enabling structural reforms, and they highlighted the need to strike the right balance between promoting FDI projects and protecting revenue base. In this context, the authorities are seeking to further improve the business enabling environment so that government regulations and revenue reforms are more efficient and effective so as to reduce regulatory burden on the businesses.

21. Regarding achieving sustainable growth, the authorities are introducing measures to protect the vulnerable by expanding support to the elderly in a way of lowering the starting point for aged welfare payments from 75 to 70 years. With the support of a number of Tonga's development partners, new policies to protect the most vulnerable are also being in the process of designed. Other reforms are underway including public financial management reform, improving corporate plans related to budgets of ministries, strengthening staff performance management system with job descriptions aligned to ministry outputs, and improving the monitoring and evaluation of our progress at all levels. The authorities noted that sound governance is essential for building public confidence in government and creating the trust needed for building good public-private partnerships.

Final Remarks

22. To conclude, the authorities are committed to safeguarding the Tongan economy and the financial system against shocks while maintaining monetary and fiscal prudence. At the same time, the continued implementation of structural reform measures is essential to secure growth momentum in the medium and long-term. The authorities are cognizant of the considerable challenges that lie ahead and realize that results would take time to materialize. Given Tonga's capacity constraints, domestic efforts would need to be supplemented by support from multilateral institutions and other countries. In this regard, the Tongan authorities would like to express their sincere gratitude to the Fund, the World Bank, ADB, PFTAC and donors for their invaluable technical guidance and support over the years.