



TONGA

2013 ARTICLE IV CONSULTATION

July 2013

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 2013 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 5, 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 July 2. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- **Press Release** summarizing the views of the Executive Board.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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TONGA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 2, 2013

KEY ISSUES

Context: The economic growth is expected to remain weak in fiscal year (FY) 2012/13 but, beyond FY 2012/13, to gradually converge back to the historical trend. Risks to the near-term outlook are tilted to the downside, reflecting external risks and weak business confidence.

Fiscal Policy: In view of Tonga's high level of external debt and the expected increase in debt repayments, fiscal consolidation should be sustained. A sound fiscal consolidation strategy should not factor in debt relief unless it materializes. If debt relief efforts succeed, the fiscal space that would result should be prudently used.

Monetary Policy: The authorities need to start considering an unwinding of the accommodative monetary policy stance. The government's proposal to further commercialize the Tonga Development Bank (TDB) has merits but will need to be accompanied by a thorough due diligence assessment.

Structural Policy: Tonga should continue to strengthen its macroeconomic institutions in key areas, including revenue mobilization and tax policy, public finance and debt management, and financial supervision. Boosting Tonga's long-term growth prospects will also require steps to strengthen investor confidence. Efforts should focus on policy coordination and judicious deregulation.

Approved By
**Luis Breuer and Peter
 Allum**

Discussions took place in Nuku'alofa during March 13–25. The staff team comprised Jookyung Ree (Head), Jones Morco (SEC), Jisung Moon (STA), Scott Roger (PFTAC), Tobias Haque (World Bank), and Lai Tora (AsDB). Alphew Cheng (OED) participated in discussions.

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THE MACROECONOMIC SITUATION

1. **After achieving about 3 percent of annual growth during FY 2008/9–10/11 (fiscal year ends on June 30), real GDP growth slowed down to 0.8 percent in FY 2011/12.** In the previous three years, public investment projects, particularly those funded by China's EXIM Bank, had offset the negative spillovers from the global financial crisis. However, those projects are now completed and exerting a drag on growth—along with weaknesses in remittances, other investment spending, and tourist arrivals. Growth is thus expected to slow further to about ½ percent in FY 2012/13. Starting in FY 2013/14, a gradual recovery of remittances and tourism—along with improved infrastructure—is expected to raise growth to about 1¾ percent.
2. **Headline inflation has fallen significantly.** After peaking at 9.7 percent in May 2011 (above the official reference range of 6–8 percent), inflation decelerated to 0.5 percent in April 2013, led mainly by imported food and oil prices. Going forward, inflation is expected to recover to the historical trend (about 5.5 percent). However, in the near term, there is an upside risk to inflation from the need to realign electricity prices with fuel costs.
3. **There are no imminent risks to the external balance.** Despite the continued contraction of remittances since 2008, increases in foreign grants and, more recently, a decline in imports, led gross official foreign reserves to rise by about 45 percent since December 2010. In the medium term, however, the overall balance of payment is expected to return to a deficit. This will cause gross international reserves to fall but remain above 4 months of imports (the NRBT's target).
4. **Risks to the near-term outlook are tilted to the downside given continued fragilities in the global economy as well as domestic vulnerabilities.** Tonga is highly dependent on growth prospects in Australia and New Zealand, its primary markets for exports, tourism, and seasonal migrant employment. Accordingly, global developments that could adversely impact these regional economies represent the main risks to Tonga. Currently, key risks relate to lingering uncertainties over fiscal policy in the United States, possible re-intensification of euro area stress, and a broad-based and deeper-than-expected slowdown of emerging market economies. On the domestic side, slippages in critical reforms could undermine investor confidence.

A. Authorities' Views

5. **While being more cautious, the authorities broadly agreed with the staff on the macroeconomic outlook.** They noted that remittances, one of the key drivers of Tonga's underlying growth, will likely not soon recover to pre-crisis levels notwithstanding the global economic recovery, considering lags in the recovery of jobs (particularly in California that hosts a large share of the Tongan diasporas) and the need to rebuild household net worth in advanced economies.

REBUILDING POLICY SPACE TO BETTER MANAGE RISKS TO GROWTH

Tonga needs to rebuild policy buffers by strengthening its fiscal position given its high external vulnerability. At the same time, consideration should be given to a timely unwinding of the accommodative monetary policy stance.

A. Background

6. Tonga's fiscal position improved significantly in recent years. The overall budget deficit decreased to 2.7 percent of GDP from 7.6 percent in the previous year. The FY 2012/13 budget aims to eliminate the fiscal deficit in line with the expected ending of China-funded investment projects. Although the mid-year assessment of the FY 2012/13 budget points to shortfalls in both revenue collections including grants, these are expected to be offset by corresponding cuts in grant-related expenditures and savings from the wage freeze.

7. Following an improvement in the World Bank's CPIA rating of Tonga's macroeconomic policies and institutions from weak to medium, the country has been upgraded from high to moderate risk of external debt distress.¹ The government adopted a No New Loan Policy in June 2011 committing to no new borrowing (including concessional ones) in light of Tonga's external debt vulnerability. The authorities are also seeking debt relief from the China EXIM Bank, through either debt reduction or rescheduling.

Tonga: Medium-term Fiscal Financing Projection
(Percent of GDP)

	2012/13	2013/14	2014/15	2015/16	2016/17
Overall deficit/surplus	0.2	-0.1	1.3	1.8	1.7
External financing	-0.7	-0.3	-0.6	-0.8	-0.7
Disbursements	0.9	1.4	1.4	1.3	1.3
Repayments	0.9	1.8	2.0	2.1	2.0
of which: China EXIM Bank	0.1	1.0	1.2	1.4	1.4
Domestic financing	0.5	0.4	-0.7	-1.0	-1.0
Net changes in cash balances	0.3	-0.4	0.7	0.9	0.9

Source: Authorities and IMF Staff estimates.

8. Monetary policy continued to focus on thawing the credit freeze within the constraints set by the NRBT's stated objectives. These objectives include protecting international reserves and stabilizing inflation. Despite a basket peg, limited capital mobility allows the NRBT to maintain substantial control over the reserve money. Since late 2009, the NRBT has continued to limit sterilization to help re-grow private credits. While recent data show

¹ See accompanying Joint IMF/World Bank Debt Sustainability Analysis 2013.

some signs of stabilization in credit growth, there has been concern over the effectiveness of monetary policy transmission mechanism for some time (see Box 1).

B. Staff Views

9. The government should continue to focus on strengthening the fiscal position to restore fiscal space. External indebtedness remains an important vulnerability, and continuing moderate primary surpluses should be targeted over the medium term to strengthen Tonga's debt and debt service indicators (Table 5). Medium-term fiscal consolidation should be supported by strong debt management and continued avoidance of nonconcessional borrowing.² Staff also supports Tonga's intention to maintain usable cash balances equivalent to 2 months' cover of recurrent spending as a fiscal buffer, given its limited options for borrowing and high level of vulnerability to shocks. With a rise in recurrent spending in FY 2013/14 and limited savings to build the cash balance, the latter is projected to slip to about six weeks' cover of recurrent spending by year-end. However, with increased primary surpluses from FY 2014/15, domestic savings would rise sufficiently to stabilize and rebuild cash balances toward the 2-month coverage ratio.

10. For FY 2013/14, the primary fiscal surplus should be maintained at around 1 percent of GDP, in line with the projected FY 2012/13 outcome. Some financing from the World Bank and AsDB that was formerly grant-only is expected to shift to an equal grant-loan mix starting in FY 2013/14, consistent with the upgrade of Tonga's debt distress rating. With this decline in grant financing, a phased increase in the primary fiscal surplus to the 2 percent of GDP medium-term range by FY 2014/15 is reasonable.³ Grace periods on some external loans will also expire in FY 2013/14, and while the government has requested debt service relief, the design of the fiscal consolidation strategy should not count on this being available. This approach would allow any exceptional financing to be used to expand priority spending while also further strengthening the primary surplus to help build cash buffers.

11. Over the medium-term, fiscal consolidation will require wage restraint and revenue reforms. The gradual recovery of economic growth is expected to increase the revenue-to-GDP ratio by 1 percent, supported by revenue reforms. At the same time, the government aims to reduce the share of the wage bill to 45 percent of recurrent spending. This will create fiscal space to enable priority spending to rise to about 1½ percent of GDP, while protecting capital investment outlays of about 2½–3½ percent of GDP (Table 5).

12. The authorities need to start considering an unwinding of the accommodative monetary policy stance. The NRBT's accommodative monetary policy during the last three years,

² Management of currency risks posed by the external debt would also benefit from improvements in hedging.

³ If the reduction in WB and AsDB grant financing is delayed until 2014/15, the government is advised to target a larger primary fiscal surplus in 2013/14, corresponding to the higher baseline for grant inflows.

while appropriate, has resulted in a large liquidity overhang in the banking system, reflecting both weak demand for credit and bank deleveraging. In the absence of a timely unwinding, the overhang may amplify the procyclicality of the credit cycle. In view of this, the NRBT should stand ready to mop up excess reserves, including by raising reserve requirements as needed, once signs become clear that the credit cycle is bottoming out.

13. The authorities intend to add a full commercial banking function to the Tonga Development Bank (TDB). To this end, the authorities would like to seek equity participation from two retirement funds and potential foreign investors to address the credit squeeze. This plan has merits, given Tonga's under-developed financial sector which is prone to market failure. However, expanding commercial banking at TDB could also potentially increase fiscal and governance risks, which should be properly addressed with the completion of a due diligence process being conducted by the IFC. The authorities can also consider a carefully crafted safeguard mechanism to advance its plan to introduce a risk-sharing facility (i.e., a donor-sponsored credit guarantee scheme). Interest rate controls should be resisted.

14. Staff's exchange rate assessment suggests that there is no evidence of misalignment of the exchange rate from the medium-term fundamentals (see Box 2). The current basket peg of the exchange rate has served the country well as a nominal anchor.

C. Authorities' Views

15. While concerned about the expected decline in revenue in FY 2012/13, the authorities did not expect this to require resort to new external financing—which would be contrary to the No New Loan Policy. They expected the wage and hiring freeze policy put in place for the FY 2012/13 budget to be fully effective in restraining recurrent spending. Moreover the authorities intended to offset lower-than-expected project grants through comprehensive expenditure reassessment across line ministries.

16. The authorities agreed on the need for conservative assumptions about possible debt relief from China. They intend to include debt relief in the final budget only when any agreement is reached. Thus, while the FY2013/14 budget was being prepared using two scenarios—with and without debt relief—the authorities are currently focusing on the scenario without relief. The authorities are also reviewing the financial implications of the 2019 South Pacific Games, which they have committed to host.

17. The authorities expect inflation to remain stable below 6 percent, and international reserves to hold at more than 4 months of import in the next 6 to 12 months. Based on this, the authorities intend to maintain an accommodative monetary policy stance in the near term. However, the authorities agreed with the mission on the need to stand ready to mop up liquidity with the bottoming of the credit cycle. The authorities favored recommending the issuance of NRBT notes and adjusting liquidity ratios, should the need arise. The authorities also agreed with the staff on the need for a proper due diligence assessment by the IFC of the plans for TDB.

18. The authorities shared the view that the current basket system has served the Tongan economy well. They noted that external shocks could be absorbed by the exchange rate flexibility (i.e., ± 5 percent of monthly adjustment limit) if needed.

STRENGTHENING THE MACRO POLICY FRAMEWORK

Tonga should continue to strengthen its overall macro policy framework. Focus should be on both expediting financial sector reform and enhancing fiscal policy effectiveness.

A. Background

19. Financial sector reform is an on-going process. Banks in Tonga have been fixing their balance sheets since late 2008. Shrinking the loan books and increasing holdings of reserve assets have prompted negative macro-financial linkages and reduced business confidence. In response, the NRBT has aggressively infused liquidity into the system and stepped up risk-based supervision. Progress in improving the regulatory and institutional infrastructure has also continued, including inauguration of a credit bureau.

20. Revenue reform has progressed gradually. Previously identified priorities include: (i) rationalizing tax exemptions; (ii) developing a natural resource taxation regime; and (iii) introducing a small business taxation system. The government has since established a Revenue Committee including to follow up on them.

21. Public Finance Management (PFM) reforms have moved ahead. The government is currently preparing its own PFM roadmap, and has agreed with development partners on a Joint Policy Action Matrix (in which PFM-related reforms comprise a main pillar) linked to donor budget supports.

B. Staff Views

22. A stronger macro policy framework is critically important in building buffers against future shocks. Banks' painful efforts to clean up their balance sheets are expected to eventually lead to a more resilient banking system. Efforts should continue to expedite this process, and build a more robust regulatory and supervisory framework. The recent drawdown of fiscal space increases the importance of on-going PFM and revenue administration reforms.

- **Financial sector.** The financial deleveraging cycle may have turned the corner, with recent data providing positive signals and banks positioning themselves to harness emerging opportunities. Staff strongly supports the authorities' continued efforts to strengthen on-site supervision capacities. Staff also sees the need to further strengthen the collateral framework including by addressing legal impediments to collateralizing lease rights on allotted lands. The Receivership Bill should be enacted this year as planned. Efforts to promote interbank

and bond market development should be reinvigorated with gradual reduction of excess reserves.

- **Revenue reform.** Staff strongly supports the creation of a presumptive tax regime for SMEs and the natural resource tax regime. Revenue reform efforts should include streamlining and enhancing the transparency of tax exemptions. Given Tonga’s revenue challenges, and the loopholes generated by it, the staff recommends a freeze on new tax incentives. The recent inclusion of tax expenditure in the budget is welcome. Updating both the Revenue and Customs Management Systems is an important priority, as is the rationalization of tax penalties.
- **PFM.** Major gains have been made in: (i) budget transparency; (ii) the establishment of a Treasury Single Account system; and (iii) better prioritization of the budget. Priorities going forward should include: (i) updating personnel/payroll systems; (ii) strengthening the procurement process; and (iii) on-going corporate planning reform and further advances in program budgeting. The formalization of the PFM reform roadmap should also be facilitated.

C. Authorities’ Views

23. The authorities welcomed the observed changes in banks’ attitudes to lend, and acknowledged the need for improving communication with banks—both to better understand their needs and to more closely share policy intentions. The authorities also asked for continued technical assistance on onsite supervision and review of relevant financial laws, including the Reserve Bank Act and Financial Institutions Act, with a view to strengthening the financial regulatory framework. The government indicated that ministries are developing corporate plans which will be integrated into the budget. The medium-term budget is also being developed.

24. While taking note of staff’s recommendation, the authorities informed staff that strategies about tax incentives are internally being debated. In fact, some line ministries are advocating an expansion of these incentives to support investment. Cabinet approved a proposed small business tax and a natural resource taxation framework in September 2012, which was prepared with technical assistance from PFTAC.

REVERSING A WEAKENING OF TREND GROWTH

Tonga's efforts to develop the private sector are ongoing, and further efforts are needed to nurture the business environment to unshackle private investment.

A. Background

25. Tonga, like other PICs, faces significant challenges in raising job and economic growth. New international competition has eroded Tonga's niche markets. At the same time, a catching up of income (to source countries) through remittance channels may have reached its limit. Given declining exports, a very high rate of emigration, and a low investment rate, there are concerns about the economy's transition to permanently slow growth.

26. Tonga's efforts to develop the private sector are ongoing. Tonga is facing difficult structural challenges, including its small size and remoteness. Addressing them in a way that improves growth prospects will require higher investment, in particular private ones. Improving the business environment will clearly facilitate this process, as will strengthening investor confidence. Vast marine resources, potential to grow niche tourism, and a well-educated and English speaking population are opportunities that can be explored, in particular if combined with well-targeted deepening of structural reforms.

B. Staff Views

27. Reforms should focus on policy coordination and judicious deregulation. Recent efforts to enhance intra-government coordination and dialogue with the private sector are welcome. The current framework (e.g., National Growth Committee) should be further strengthened, for example by establishing a high-level government position to coordinate and oversee inter-ministry efforts to address impediments to private sector growth. A tailored support mechanism could be put in place, focusing initially on strategically important foreign investors.

28. The business licensing reform has achieved an important milestone by abolishing the requirement for annual renewal of the headline trade license. The reform initiatives could now focus on easing ancillary licenses required by various regulatory agencies. Improving access to information needed by new investors is also important, as well as enhanced communication on key ongoing reforms, to help boost business confidence.

29. Staff supports the authorities' intention to develop tourism as the key growth engine. An enabling business environment and foreign capital participation would be important to achieve this objective, as well as to revive growth in fishery and agriculture. Consistent and predictable conservation decisions (e.g., in fishery) are also important to promote investor confidence. The authorities' plan to prepare a mining law is welcome given the need to prepare for a comprehensive framework for the emerging deep-sea extractive potential.

30. Continued efforts are needed to restructure distressed public enterprises.

Identification of private partners for these companies would be buttressed by commitment to business enabling reforms. On a related issue, the tariff on electricity should be realigned to fuel costs, while targeted transfers could be used to protect the vulnerable. The financial positions of the public enterprises should be integrated into the national debt management framework, with a focus on fiscal contingent liabilities.

C. Authorities' Views

31. The authorities agreed with staff on the need to further deepen structural reform to nurture business environment, including through strengthened policy coordination. The authorities in particular noted the need to create a full-time position within the government to oversee inter-line ministry coordination. The authorities noted that focus of the reform is shifting to land issues and immigration visa issues. The authorities also took note of the need for a tailored service for strategically important foreign investors.

32. The government's highest priority is on the promotion of tourism, including through more aggressive destination marketing. Nonetheless, the authorities acknowledged the difficulty in determining target niches within the tourism industry. The authorities are working closely with the private sector to address agricultural market access issues, including through joint marketing trips, and noted that support should now focus on overcoming non-tariff barriers and on organizing suppliers. The authorities also noted that the recent establishment of an agricultural marketing fund will help mitigate difficulty in access to finance.

STAFF APPRAISAL

33. The Tongan economy is expected to remain weak in FY 2012/13, following the completion of key public work projects. Beyond FY 2012/13, staff projects the economy to recover gradually, but to a slightly lower growth rate than the historical trend before the global financial crisis. Risks to the near-term outlook are tilted to the downside, reflecting external risks and weak business confidence.

34. The current macroeconomic policy mix, which combines fiscal consolidation and monetary accommodation, is appropriate. The overall fiscal deficit fell from 7.6 percent to 2.7 percent of GDP in FY 2011/12; and the FY 2012/13 budget aims to eliminate the remaining deficit. Monetary conditions have remained accommodative for the past three years.

35. In view of Tonga's level of external debt—an important vulnerability despite the DSA rating upgrade—and the expected increase in debt repayments, fiscal consolidation should be sustained. The FY 2013/14 budget could aim to maintain a similar level of primary balance surplus as in FY 2012/13, to preserve cash buffers with the expected repayments on the external loans and limited borrowing options. A credible fiscal consolidation strategy should not

factor in debt relief until it becomes certain, and the space that could result from debt relief should be prudently used.

36. The authorities need to start considering an unwinding of the accommodative monetary policy stance. In particular, the NRBT should stand ready to mop up excess liquidity with the bottoming out of the credit cycle. At the same time, other efforts to overcome obstacles to renewed credit growth should continue. In this context the government's plan to further commercialize TDB has merits, but a thorough due diligence assessment is essential.

37. Staff strongly supports the creation of a presumptive tax regime for SMEs and the natural resource tax regime. Revenue reform efforts should include streamlining and enhancing the transparency of tax exemptions. Formalization of the PFM reform roadmap is important to demonstrate the authorities' commitment to reform and to inform technical assistance from donors.

38. Tonga's structural challenges to growth call for reforms to strengthen investor confidence. Reforms should focus on policy coordination and judicious deregulation. The current framework for coordination could be further strengthened, for example by establishing a high-level coordinator. A tailored support mechanism for foreign investors should also be put in place. The business licensing reform has achieved an important milestone, and could now focus on easing ancillary licenses.

39. It is recommended that the next Article IV consultation with Tonga be held on the 12-month consultation cycle in accordance with the decision on consultation cycles, Decision No. 14747-(10/96) (9/28/2010).

Box 1. Fixing the Monetary Transmission Mechanism in Tonga

Tonga's banking system, which is dominated by the local operations of two large foreign banks (ANZ and Westpac), has gone through a prolonged period of balance sheet repair since the third quarter of 2008.

During 2004–08, the stock of private credit doubled. The credit boom consisted of three phases. The first phase (2004Q3–05Q4) saw a 50 percent increase in private credit in five quarters, and was triggered by liquidity from the government's severance payments and a subsequent housing boom. Then

political instability, which culminated in a civil uprising, halted the credit expansion for about a year (2006Q1–07Q1). With the restoration of political stability, credit growth resumed at a brisk pace from the second quarter of 2007. Monetary easing aimed at post-civil uprising economic recovery, reconstruction investments, and a pocket of separate large projects provided the impetus during this time.

The credit boom abruptly ended in the third quarter of 2008 against a backdrop of sharply deteriorating debt servicing capacities and moderating asset prices in the wake of the global financial crisis. The remittance and tourism channels were particularly prevalent in transmitting initial impacts. The ensuing stress fully opened up a macro-financial feedback loop. During this process, Tongan banks displayed deep-rooted weaknesses in risk management and governance, despite foreign control and ownership.

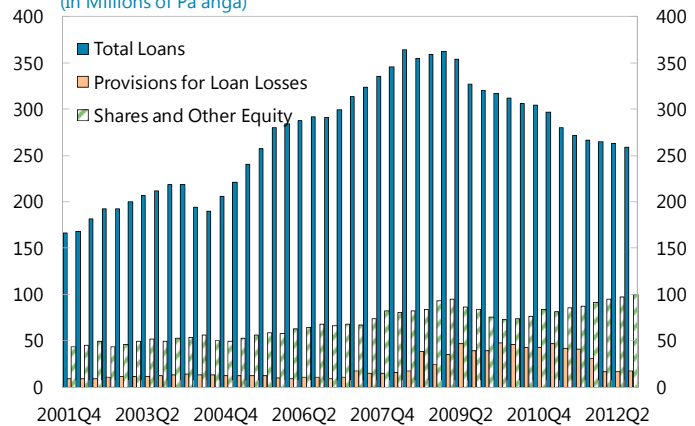
Since then, Tongan banks have continued to fix their balance sheets. Despite aggressive liquidity injection by the NRBT, banks have continued to shrink their loan books and have piled up excess reserves (in order to reduce risk-weighted assets), prompting renewed attention on the need to strengthen Tonga's monetary policy transmission mechanism, which has traditionally been weak. Fortunately, recent data indicate that the deleveraging may soon turn the corner, with the equity-to-asset ratio now reaching 20 percent, credit contraction stabilizing, and loan loss provisioning peaking off.

What can be done to raise the effectiveness of monetary policy?

- The structural weaknesses stemming from financial underdevelopment will have to be addressed through enabling structural reforms: Tonga is making steadfast progress on this front.
- The recent further deterioration of the transmission mechanism has a cyclical nature, stemming mainly from the credit boom-bust cycle; while it will correct itself with the turn of the cycle, policies should be open to various options for expediting the deleveraging (e.g., possible further mobilization of private capital)

Tonga Banks: Key Balance Sheet Indicators

(In Millions of Pa'anga)



Source: Tongan authorities.

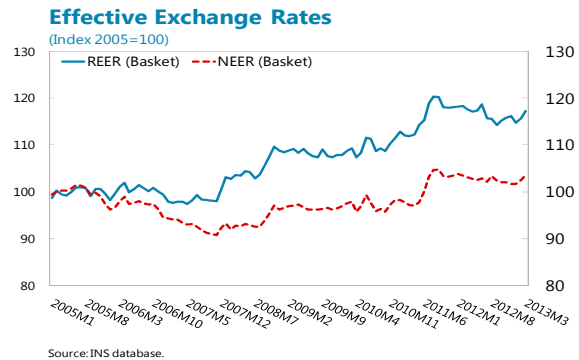
- Efforts to promote interbank and bond market development should be reinvigorated, as the excess reserve overhang, a key conjunctural impediment to the efficient functioning of interbank markets, is removed in time.
- The authorities' plan to broaden TDB's business focus toward SMEs and public enterprises can provide much needed impetus to financial deepening and raise competition. A partnership with the private sector including IFIs will help limit fiscal and governance risks.
- SME credit guarantee programs can also help in this regard, provided that appropriate TAs can be provided, leading to private partnership (especially from IFIs).
- Interest rate controls should be avoided, as they are ineffective, leads to inefficient credit allocation, and do not address the fundamental problem of weak business confidence.

Box 2. Exchange Rate and Competitiveness

Tonga's real effective exchange rate remains broadly in line with its medium-term fundamentals. Other indicators do not indicate a significant loss of competitiveness but suggest room for improvement.

Exchange rate

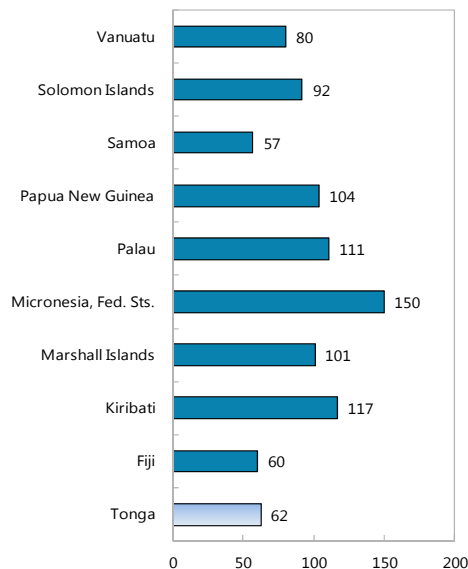
- Tonga's real effective exchange rate (REER) remains broadly in line with its medium-term fundamentals. The macroeconomic balance approach suggests that the Tongan currency is below its long-run equilibrium level by about 3 percent, while the purchasing power parity approach indicates an overvaluation of around 8 percent.



Non-price measures and other indicators

- **Exports.** Export growth is expected at around 8 percent in the medium term (compared to an average rate of 6.5 percent in the past decade), as the economy continues to recover, and programs to boost exports including in tourism yield results.
- **Costs of doing business.** Tonga is matched only by Samoa and Fiji among Pacific island countries in its relatively favorable rating under the World Bank's *Doing Business 2013* report. However, overcoming Tonga's locational disadvantage and small size will require an even stronger business environment. Judicious deregulation (e.g., easing ancillary licenses) and enhanced policy coordination to nurture a business-friendly environment will be important.

Ease of Doing Business, 2013
(rank out of 185 economies)



Tonga: Doing Business, 2013
(rank out of 185 economies)

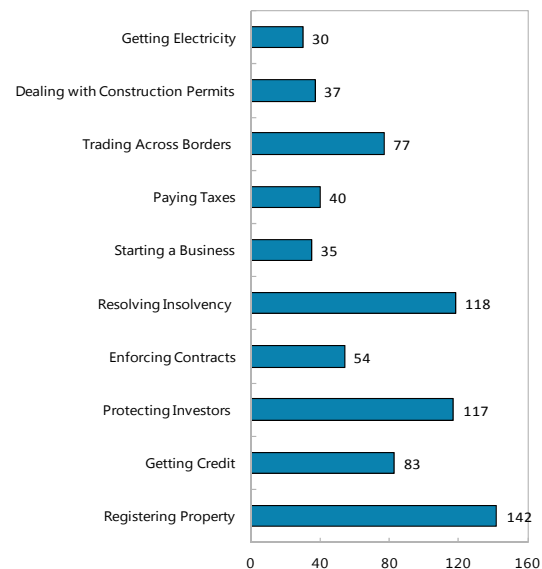
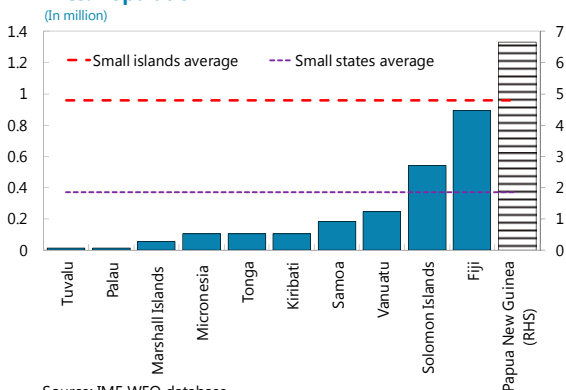


Figure 1. Tonga: Stylized Facts

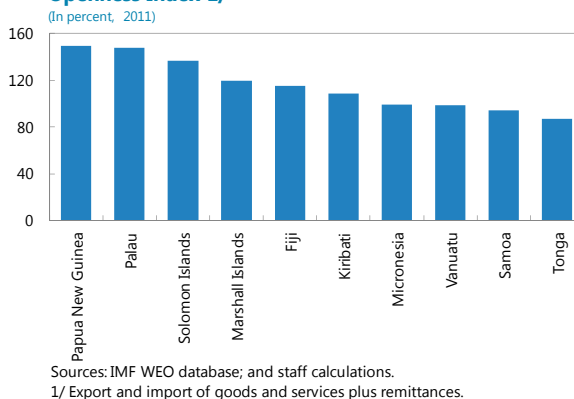
As a Pacific Island country, Tonga is small...

PICs: Population



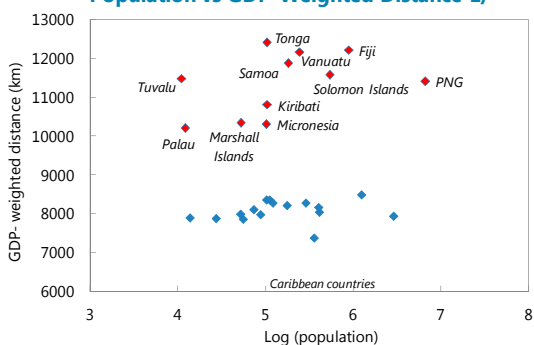
...open Economy (though not as much as its PIC peers)...

Openness Index 1/



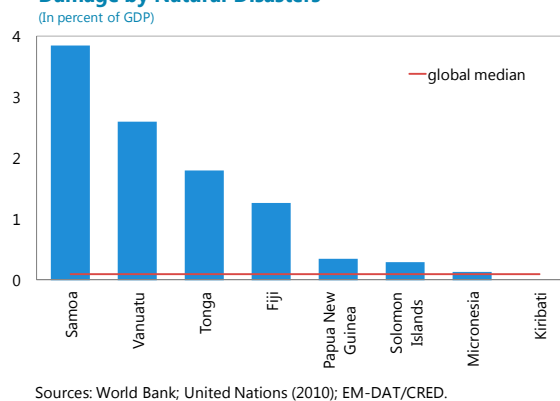
...highly remote...

Population vs GDP-Weighted Distance 1/



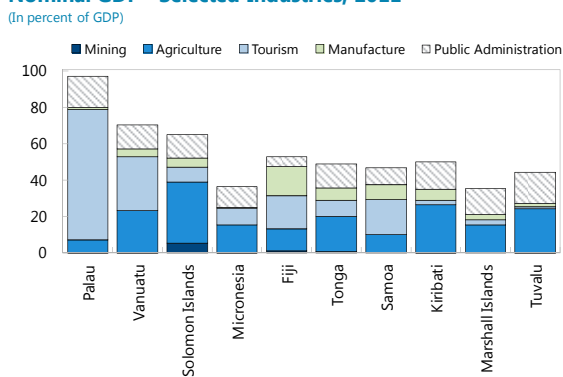
...and heavily affected by natural disasters...

Damage by Natural Disasters



Its production base is quite narrow...

Nominal GDP - Selected Industries, 2011



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

PICs: Tourism and Remittances

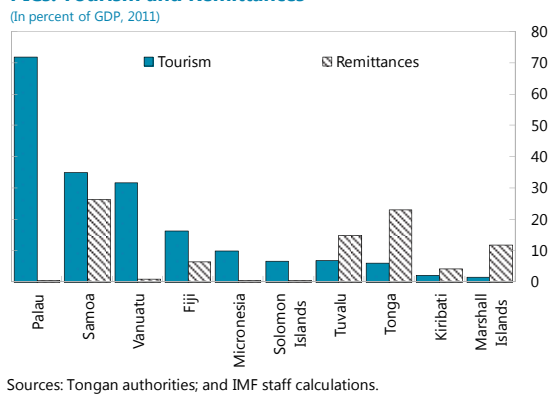
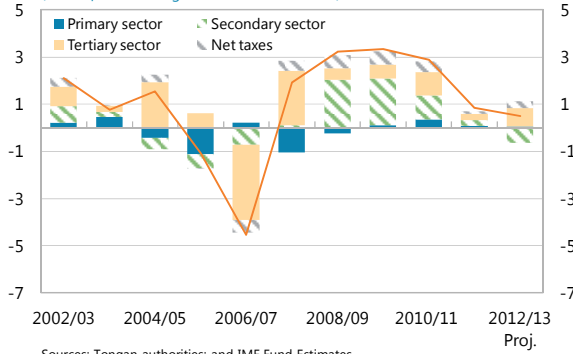


Figure 2. Tonga: Economic Development

GDP growth is estimated to have moderated in 2011/12 with the unwinding of public works...

Real GDP Product by Sector

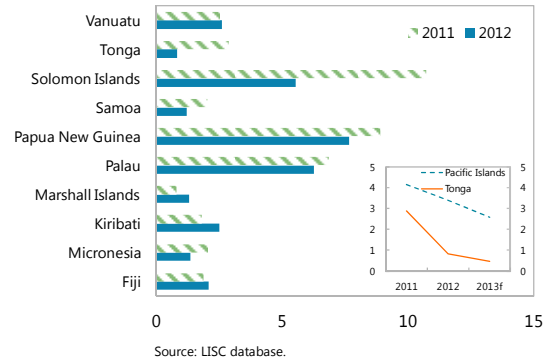
(Annual percent change, contributions to total)



...causing a sharper slowdown than the peers.

Change in Real GDP

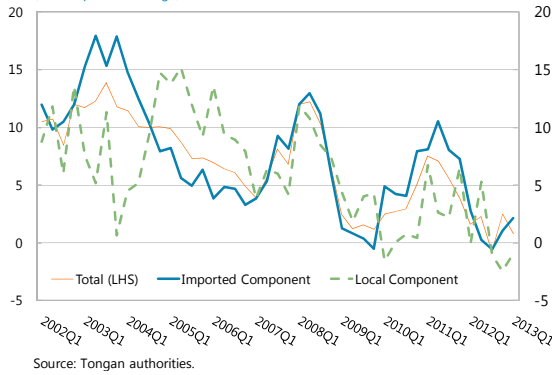
(In percent)



Inflation declined significantly as commodity prices moderated...

Inflation

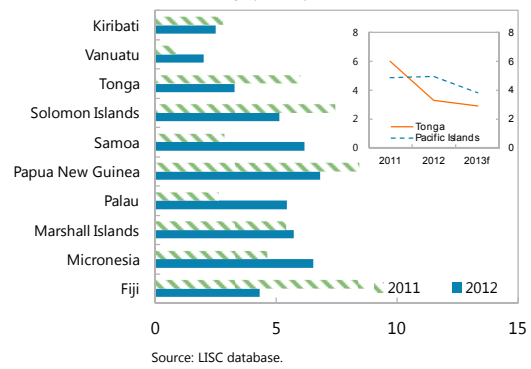
(Annual percent change)



...somewhat sharper than the peer group average.

Consumer Price

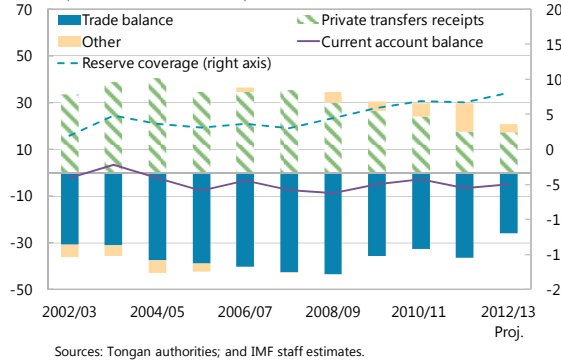
(Percent change, year-on-year)



Despite continued declines in remittances, capital flows and grants led the reserve cover to improve...

Balance of Payments

(In percent of GDP; months of import)



...while Tonga's current account balance compares favorably with other PICs.

Current Account Balance

(In percent of GDP)

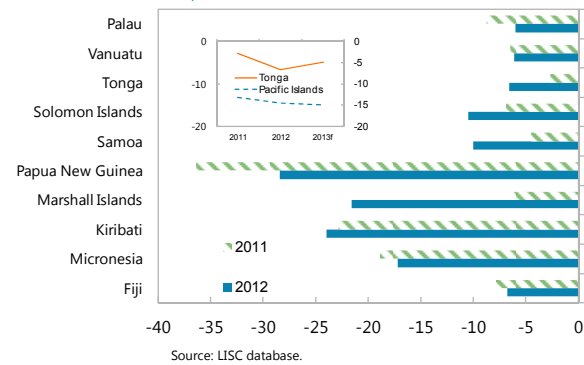
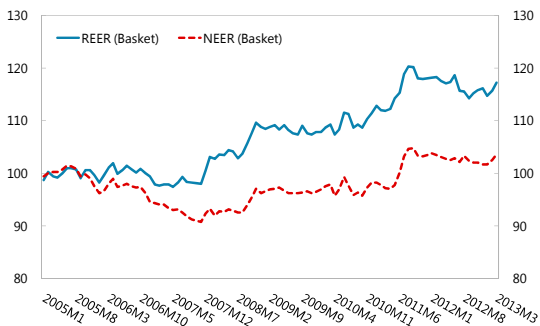


Figure 3. Tonga: Exchange Rate and Fiscal Policy Development

While lower inflation has led to some correction....

Effective Exchange Rates

(Index 2005=100)

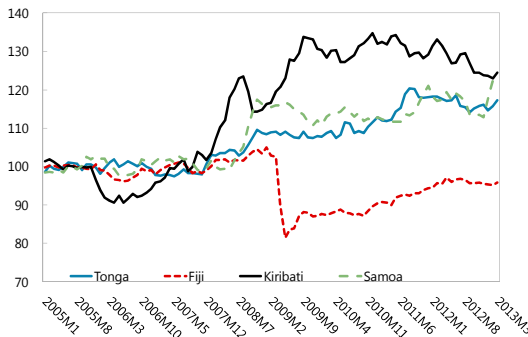


Source: INS database.

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

Effective Exchange Rates, 2005-12

(Index 2005=100)

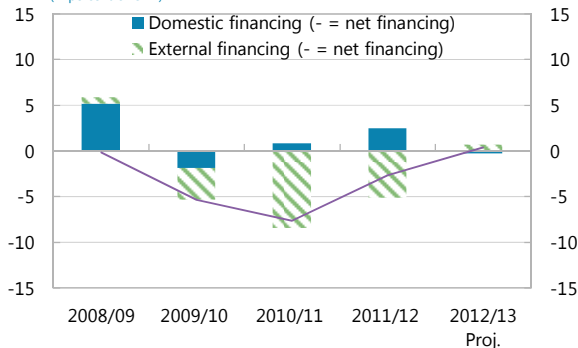


Source: INS database.

The fiscal position has significantly improved in 2011/12...

Fiscal Balance

(In percent of GDP)

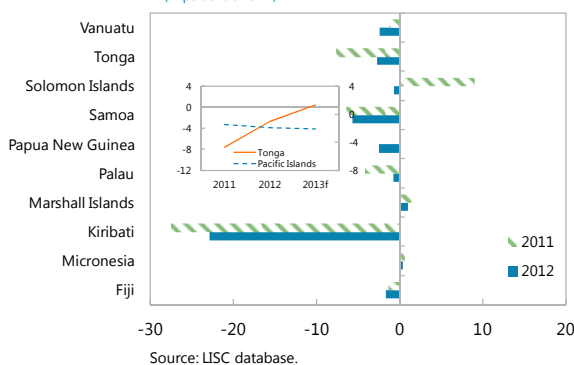


Sources: Tongan authorities; and IMF staff estimates.

...with stronger efforts made on consolidation compared to most other PICs.

Government Overall Balance

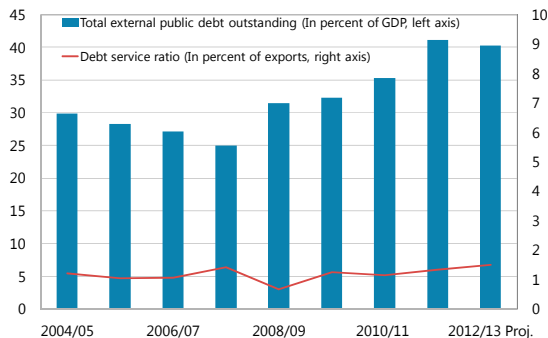
(In percent of GDP)



Source: LISC database.

Public debt has sharply risen...

Public Debt

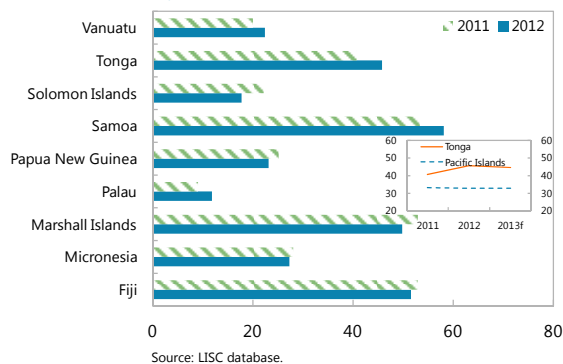


Sources: Tongan authorities; and IMF staff estimates.

...due to large public investment projects.

Total Government Debt

(In percent of GDP)



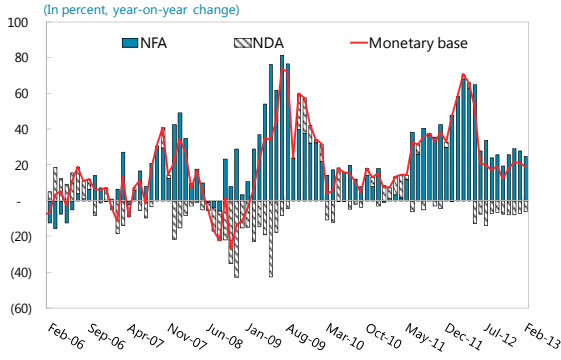
Source: LISC database.

Figure 4. Tonga: Monetary Policy and Financial Sector Developments

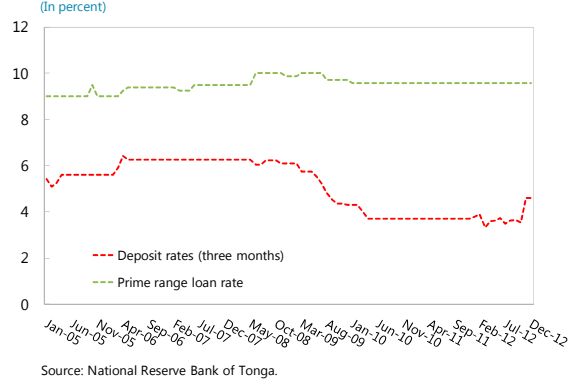
The NRBT has supplied ample liquidity into the system during the past three years...

...leading to a decline of interest rates.

Monetary Base



Interest Rates



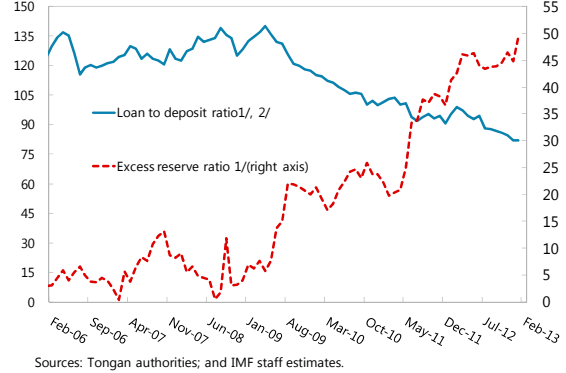
However, bank lending kept decreasing...

...leading to a liquidity overhang.

Bank Lending



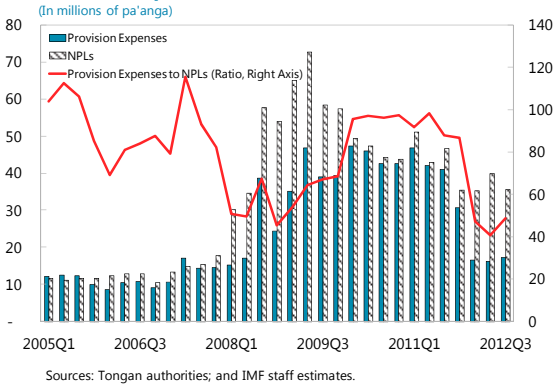
Loan-to-Deposit and Excess Reserve Ratio



Despite efforts to clean up, NPL ratios remain high...

...and bank deleveraging has continued.

Provision Expense vs NPLs



Equity to Assets

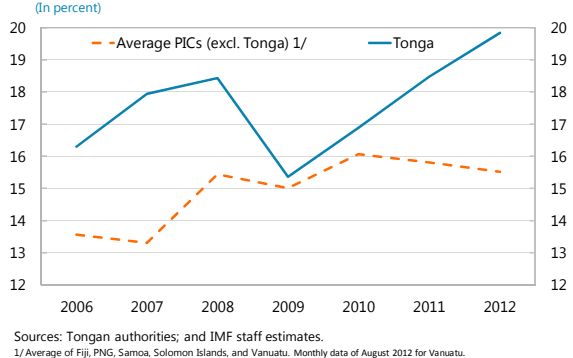


Table 1. Tonga: Selected Economic Indicators, 2008/09–2013/14 1/

^{1/}Nominal GDP (2011/12): US\$471.6 million

^{2/}GDP per capita (2011/12): US\$4565.6

Major exports: fish, root crops, vanilla, squash

Quota: SDR 6.9 million

	Average		Prelim.			Projections	
	2003-12	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
(Annual percent change)							
Output and prices							
Real GDP 2/	1.1	3.2	3.3	2.9	0.8	0.5	1.5
Consumer prices (period average)	7.1	5.5	1.7	6.0	3.3	2.9	3.5
Consumer prices (end of period)	6.9	1.2	2.7	7.1	2.3	3.0	4.0
GDP deflator	6.2	-2.4	3.7	5.8	2.3	2.9	3.5
(In percent of GDP)							
Central government finance							
Total revenue and grants	26.6	34.3	27.0	26.3	28.0	23.9	24.2
Total revenue	22.6	27.4	20.2	19.6	18.1	18.1	18.1
Grants	4.0	6.8	6.8	6.7	9.9	5.8	6.1
Total expenditure and net lending	28.2	34.4	32.3	34.0	30.6	23.7	24.3
<i>Of which:</i> Current expenditure	23.9	25.2	25.8	23.0	23.9	21.6	21.7
Capital expenditure	2.6	2.7	2.6	9.4	5.6	2.0	2.5
Overall balance	-1.6	-0.2	-5.3	-7.6	-2.7	0.2	-0.1
Overall balance (excl. China's EXIM Bank loans)	1.1	6.1	-0.2	1.6	3.2	1.2	-0.1
External financing (net)	n.a.	-0.7	3.5	8.4	5.2	-0.7	-0.3
Domestic financing (net)	n.a.	-5.2	1.9	-0.8	-2.5	0.5	0.4
(Annual percent change)							
Money and credit							
Total liquidity 3/	7.9	-1.8	5.1	3.1	-1.7	8.2	7.0
<i>Of which:</i> Broad money (M2)	8.2	-2.4	5.6	3.3	-1.8	8.4	7.2
Domestic credit	5.3	-5.2	-11.5	-12.3	-8.7	-5.9	10.9
<i>Of which:</i> Private sector credit	5.5	-3.7	-15.6	-9.9	-2.7	-6.9	8.1
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.	12.2	7.2	7.9	10.9	14.8	15.3	16.1
Imports, f.o.b.	-123.0	-130.5	-130.4	-152.5	-179.3	-136.5	-142.0
Services (net)	-8.7	-15.2	-8.5	3.5	-6.8	-4.2	-4.4
Investment income (net)	4.8	6.4	4.0	9.0	11.2	12.7	13.3
Current transfers (net)	99.6	104.0	109.0	117.5	129.0	85.3	94.0
<i>Of which:</i> Remittances	89.9	84.0	82.0	87.5	66.8	70.1	73.6
Current account balance	-15.1	-28.1	-17.9	-11.6	-31.1	-27.6	-23.0
(In percent of GDP)	-4.3	-8.8	-4.9	-2.7	-6.6	-5.9	-4.7
Overall balance	46.9	19.5	19.7	33.2	19.8	2.7	3.6
Terms of trade (annual percent change)	0.1	-4.5	5.1	-4.4	0.0	-0.5	1.2
Gross official foreign reserves							
In millions of U.S. dollars	65.7	67.7	87.5	120.7	140.5	143.3	146.8
(In months of next year's goods and services)	4.4	4.6	5.0	5.7	8.0	7.8	7.4
External debt (in percent of GDP)							
External debt	32.0	31.5	31.8	35.4	41.2	40.3	38.9
Debt service ratio	1.2	0.7	1.2	1.2	1.3	1.6	2.5
Exchange rates							
Pa'anga per U.S. dollar (period average)	2.0	2.1	1.9	1.8	1.7	1.8	1.8
Pa'anga per U.S. dollar (end of period)	1.9	2.0	1.9	1.7	1.8	1.8	1.8
Nominal effective exchange rate (2005=100)	98.8	95.7	96.9	97.4	103.4	102.4	100.6
Real effective exchange rate (2005=100)	102.6	107.5	108.3	111.5	118.4	118.4	118.4
Memorandum items:							
Remittances (in percent of GDP)	29.3	26.4	22.2	20.7	14.2	14.9	15.2
Tourism (in percent of GDP)	6.3	8.7	7.0	7.9	7.7	8.5	8.8
FDI (in percent of GDP)	5.2	12.0	2.0	1.5	1.1	2.3	2.4
Nominal GDP (millions of T\$)	623.8	664.3	712.2	775.0	799.3	826.3	868.1
Population (thousands)	102.0	102.5	102.8	103.0	103.3	103.5	103.8

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, 2008/09–2013/14

	2008/09	2009/10	2010/11	Prov.	Budget	Projections	
				2011/12	2012/13	2012/13	2013/14
(In millions of pa'anga)							
Total revenue and grants	227.5	192.1	204.2	223.4	217.8	197.2	210.4
Total revenue	182.0	143.6	152.0	144.4	149.3	149.6	157.2
Current revenue	154.8	143.6	150.1	144.2	147.0	148.7	157.0
Tax revenue	129.1	116.2	132.0	126.8	127.7	129.7	137.0
<i>Of which:</i> Taxes on income/profits	40.3	28.1	38.3	25.3	21.3	26.4	28.4
Sales tax and consumption tax	71.3	72.4	80.8	87.8	92.5	92.5	97.2
Nontax revenue	25.7	27.3	18.1	17.4	19.3	19.0	20.0
Capital revenue	27.2	0.0	1.9	0.2	2.3	0.9	0.2
Grants (in cash)	45.5	48.6	52.2	79.0	68.5	47.6	53.2
Project grants	45.5	35.2	30.7	41.9	46.0	33.0	29.7
Budget support	0.0	13.4	21.5	37.1	22.5	14.6	23.5
Total expenditure and net lending	228.8	230.2	263.2	244.9	216.6	195.5	210.9
Total expenditure	207.3	202.3	251.2	235.9	216.1	194.9	210.2
Current expenditure	166.9	183.8	178.4	190.8	201.4	178.1	188.5
Capital expenditure	17.8	18.4	72.8	45.1	14.7	16.9	21.7
<i>Of which:</i> Funded by China EXIM Bank loans	27.5	28.2	60.4	38.2	0.5	8.1	0.0
Total lending minus repayments	6.4	27.9	12.1	9.0	0.0	0.5	0.7
Current balance (excl. project grants)	19.8	-15.7	-7.0	-8.9	-54.4	-4.6	-31.5
Overall balance (incl. grants)	-1.3	-38.0	-59.1	-21.5	1.2	1.8	-0.6
Primary balance (incl. grants)	3.9	-32.5	-52.6	-15.0	8.2	10.2	8.0
Total financing	1.3	38.0	59.1	21.5	-1.2	-1.8	0.6
External financing	-4.4	24.7	65.5	41.2	-1.2	-5.6	-2.9
Domestic financing	-34.6	13.3	-6.4	-19.7	0.0	3.8	3.5
(In percent of GDP)							
Total revenue and grants	34.3	27.0	26.3	28.0	26.4	23.9	24.2
Total revenue	27.4	20.2	19.6	18.1	18.1	18.1	18.1
Current revenue	23.3	20.2	19.4	18.0	17.8	18.0	18.1
Tax revenue	19.4	16.3	17.0	15.9	15.5	15.7	15.8
<i>Of which:</i> Taxes on income/profits	6.1	3.9	4.9	3.2	2.6	3.2	3.3
Sales tax and consumption tax	10.7	10.2	10.4	11.0	11.2	11.2	11.2
Nontax revenue	3.9	3.8	2.3	2.2	2.3	2.3	2.3
Capital revenue	4.1	0.0	0.3	0.0	0.3	0.1	0.0
Grants (in cash)	6.8	6.8	6.7	9.9	8.3	5.8	6.1
Project grants	6.8	4.9	4.0	5.2	5.6	4.0	3.4
Budget support	0.0	1.9	2.8	4.6	2.7	1.8	2.7
Total expenditure and net lending	34.4	32.3	34.0	30.6	26.2	23.7	24.3
Current expenditure	25.1	25.8	23.0	23.9	24.4	21.6	21.7
Capital expenditure	2.7	2.6	9.4	5.6	1.8	2.0	2.5
<i>Of which:</i> funded by China EXIM Bank loans	4.1	4.0	7.8	4.8	0.1	1.0	0.0
Total lending minus repayments	1.0	3.9	1.6	1.1	0.0	0.1	0.1
Current balance (excl. project grants)	3.0	-2.2	-0.9	-1.1	-6.6	-0.6	-3.6
Overall balance (incl. grants)	-0.2	-5.3	-7.6	-2.7	0.1	0.2	-0.1
Primary balance (incl. grants)	0.6	-4.6	-6.8	-1.9	1.0	1.2	0.9
Total financing	0.2	5.3	7.6	2.7	-0.1	-0.2	0.1
External financing	-0.7	3.5	8.4	5.2	-0.1	-0.7	-0.3
Domestic financing	-5.2	1.9	-0.8	-2.5	0.0	0.5	0.4
Memorandum items:							
Nominal GDP (in millions of pa'anga)	664.3	712.2	775.0	799.3	826.3	826.3	868.1
Total external public debt outstanding (in percent of GDP)	31.5	31.8	35.4	41.2		40.3	38.9

Sources: Tongan authorities; and IMF Staff estimates.

Table 3. Tonga: Depository Corporations Survey, 2008/09–2013/14 1/

	2008/09	2009/10	2010/11	2011/12	Projections	
					2012/13	2013/14
(In millions of pa'anga; end of period)						
Net foreign assets	118.1	143.1	195.9	222.3	231.4	231.5
Claims on nonresidents	155.9	188.5	224.3	262.1	269.4	281.5
NRBT	137.7	171.9	206.0	248.8	256.4	268.5
Other depository corporations	18.3	16.6	18.3	13.3	13.0	13.0
Liabilities to Nonresidents	-37.9	-45.4	-28.4	-39.8	-38.0	-50.0
NRBT	-10.4	-29.5	-22.0	-24.8	-23.0	-30.0
Other depository corporations	-27.5	-15.9	-6.4	-15.1	-15.0	-20.0
Net domestic assets	163.9	153.3	109.6	78.0	93.4	116.2
Net domestic credit	313.9	277.7	243.7	222.6	209.4	232.2
Net claims on government	-34.7	-28.1	-31.4	-45.9	-42.0	-38.6
Claims on public nonfin. corps.	4.7	15.5	13.6	14.0	14.6	14.6
Claims on private sector	343.9	290.3	261.5	254.4	236.9	256.2
Other items, net	-149.9	-124.4	-134.1	-144.5	-116.0	-116.0
Total liquidity	282.0	296.4	305.4	300.3	324.8	347.6
Broad money (M2)	269.2	284.4	293.7	288.4	312.6	335.1
Narrow money	77.7	90.0	96.8	118.1	121.2	124.4
Quasi money	191.6	194.4	196.9	170.2	191.4	210.7
Securities other than shares 2/	12.8	12.0	11.8	11.9	12.2	12.6
						0.0
(Annual percentage change)						
Net foreign assets	55.4	21.2	36.9	13.5	4.1	0.0
Net domestic assets	-22.4	-6.5	-28.5	-28.8	19.7	24.4
Net domestic credit	-5.2	-11.5	-12.3	-8.7	-5.9	10.9
Claims on private sector	-3.7	-15.6	-9.9	-2.7	-6.9	8.1
Total liquidity	-1.8	5.1	3.1	-1.7	8.2	7.0
Broad money (M2)	-2.4	5.6	3.3	-1.8	8.4	7.2
(In millions of U.S. dollars)						
Net foreign assets	56.6	74.2	106.9	127.0	130.7	128.0
Claims on nonresidents	74.8	97.7	122.4	149.7	152.2	155.6
NRBT	66.0	89.1	112.4	142.2	144.9	148.4
ODCs	8.8	8.6	10.0	7.6	7.3	7.2
Liabilities to nonresidents	-18.2	-23.5	-15.5	-22.8	-21.5	-27.6
Memorandum items:						
Velocity (GDP/average M2)	2.5	2.5	2.6	2.8	2.6	2.6
Pa'anga per U.S. dollar (end of period)	2.0	1.9	1.7	1.8	1.8	1.8

Sources: Tongan authorities; and IMF staff estimates.

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

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

Table 4. Balance of Payments Summary, 2008/09–2013/14

(In millions of U.S. dollars, unless otherwise indicated)

	2008/09	2009/10	2010/11	Prelim.	Projections	
				2011/12	2012/13	2013/14
Trade balance	-123.3	-122.5	-141.6	-164.5	-121.3	-125.9
Exports, f.o.b.	7.2	7.9	10.9	14.8	15.3	16.1
Imports, f.o.b.	-130.5	-130.4	-152.5	-179.3	-136.5	-142.0
Services (net)	-15.2	-8.5	3.5	-6.8	-4.2	-4.4
Receipts	35.0	39.1	60.5	66.4	69.6	73.0
Payments	-50.2	-47.5	-57.0	-73.2	-73.8	-77.4
Investment income (net)	6.4	4.0	9.0	11.2	12.7	13.3
Receipts	10.2	11.6	16.0	18.3	20.2	21.2
Payments	-3.8	-7.7	-7.1	-7.1	-7.5	-7.9
Current transfers (net)	104.0	109.0	117.5	129.0	85.3	94.0
Official transfers (net) 1/	16.8	17.4	20.5	17.7	4.8	9.6
Private transfers (net)	87.2	91.6	97.0	78.7	80.5	84.4
Current account balance	-28.1	-17.9	-11.6	-31.1	-27.6	-23.0
(In percent of GDP)	-8.8	-4.9	-2.7	-6.6	-5.9	-4.7
Capital account balance	27.6	15.5	5.5	27.1	18.7	16.6
Financial account balance	19.9	22.2	39.3	23.8	11.5	9.9
FDI (net)	38.3	7.6	6.4	5.0	11.0	11.6
Other investment (net)	-18.4	14.6	33.0	18.8	0.5	-1.6
Overall balance 2/	19.5	19.7	33.2	19.8	2.7	3.6
Memorandum items:						
Gross official foreign reserves	67.7	87.5	120.7	140.5	143.3	146.8
<i>In months of next year's goods and services import</i>	4.6	5.0	5.7	8.0	7.8	7.4
Exchange rate						
Pa'anga per U.S. dollar (period average)	2.1	1.9	1.8	1.7	1.8	1.8
Pa'anga per U.S. dollar (end of period)	2.0	1.9	1.7	1.8	1.8	1.8
Nominal GDP (in millions of US\$)	318.5	369.2	423.0	471.6	469.5	485.1
Commodity price indexes (2005 = 100)						
Food	145.4	141.6	163.9	177.0	171.6	164.2
Fuel	79.4	70.4	91.5	104.5	102.4	98.2

Sources: Tongan authorities; and IMF staff estimates.

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, 2009/10–2017/18 1/

	2009/10	2010/11	Prelim.	Projections					
			2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
(Annual percentage change)									
Output and prices									
Real GDP	3.3	2.9	0.8	0.5	1.5	1.7	1.7	1.7	1.7
Consumer prices (end of period)	2.7	7.1	2.3	3.0	4.0	4.7	5.0	5.5	5.5
Consumer prices (period average)	1.7	6.0	3.3	2.9	3.5	4.4	4.9	5.3	5.5
GDP deflator	3.7	5.8	2.3	2.9	3.5	4.4	4.9	5.3	5.5
(In percent of GDP)									
Central government finance									
Total revenue and grants	27.0	26.3	28.0	23.9	24.2	23.8	23.7	23.7	23.5
Total revenue	20.2	19.6	18.1	18.1	18.1	18.4	18.5	18.8	18.9
Of which: tax revenue	16.3	17.0	15.9	15.7	15.8	15.9	16.1	16.3	16.4
Grants	6.8	6.7	9.9	5.8	6.1	5.4	5.2	4.9	4.6
Total expenditure and net lending	32.3	34.0	30.6	23.7	24.3	22.5	21.9	22.0	22.6
Current expenditure	25.8	23.0	23.9	21.6	21.7	19.8	19.1	18.7	19.3
Capital expenditure	2.6	9.4	5.6	2.0	2.5	2.6	2.7	3.2	3.4
Net lending	3.9	1.6	1.1	0.1	0.1	0.1	0.1	0.0	-0.1
Overall balance (incl. grants)	-5.3	-7.6	-2.7	0.2	-0.1	1.3	1.8	1.7	0.9
External financing (net)	3.5	8.4	5.2	-0.7	-0.3	-0.6	-0.8	-0.7	-0.6
Domestic financing (net)	1.9	-0.8	-2.5	0.5	0.4	-0.7	-1.0	-1.0	-0.3
Primary balance (incl. grants)	-4.6	-6.8	-1.9	1.2	0.9	2.2	2.7	2.5	1.6
(In millions of U.S. dollars)									
Balance of payments									
Exports, f.o.b.	7.9	10.9	14.8	15.3	16.1	17.5	18.9	20.6	22.3
(Annual percent change)	9.6	37.6	35.7	3.0	5.5	8.5	8.5	8.5	8.5
Imports, f.o.b.	-130.4	-152.5	-179.3	-136.5	-142.0	-154.7	-166.3	-178.0	-188.7
(Annual percent change)	-0.1	17.0	17.6	-23.9	4.0	9.0	7.5	7.0	6.0
Services (net)	-8.5	3.5	-6.8	-4.2	-4.4	-5.5	-4.4	-2.5	0.6
Investment income (net)	4.0	9.0	11.2	12.7	13.3	14.0	14.7	15.4	16.2
Transfers (net)	109.0	117.5	129.0	85.3	94.0	110.2	120.6	129.4	134.3
Of which: Remittances	82.0	87.5	66.8	70.1	73.6	75.5	84.5	92.6	97.2
Current account balance	-17.9	-11.6	-31.1	-27.6	-23.0	-18.7	-16.5	-15.2	-15.3
(In percent of GDP)	-4.9	-2.7	-6.6	-5.9	-4.7	-3.7	-3.2	-2.8	-2.7
Capital account balance	15.5	5.5	27.1	18.7	16.6	0.0	0.0	0.0	0.0
Financial account balance	22.2	39.3	23.8	11.5	9.9	9.2	8.7	9.5	10.8
FDI (net)	7.6	6.4	5.0	11.0	11.6	12.1	12.7	13.4	14.0
Other investment (net)	14.6	33.0	18.8	0.5	-1.6	-2.9	-4.1	-3.9	-3.3
Overall balance	19.7	33.2	19.8	2.7	3.6	-9.5	-7.9	-5.7	-4.5
Gross international reserves (end of period)									
In millions of U.S. dollars	87.5	120.7	140.5	143.3	146.8	137.4	129.5	123.8	119.3
In months of imports (goods and services)	5.0	5.7	8.0	7.8	7.4	6.4	5.6	5.1	4.7
External debt (in percent of GDP)									
Public sector external debt	31.8	35.4	41.2	40.3	38.9	37.1	35.1	33.2	31.3
Debt service ratio	1.2	1.2	1.3	1.6	2.5	2.7	2.8	2.6	2.4
Memorandum items:									
Private transfers (net, in millions of U.S. dollars)	91.6	97.0	78.7	80.5	84.4	86.5	96.9	106.0	111.4
(In percent of imports of goods and services)	51.5	46.3	31.2	38.3	38.5	36.2	37.7	38.6	38.2
Nominal GDP (millions of pa'anga)	712.2	775.0	799.3	826.3	868.1	921.7	983.2	1052.9	1130.1

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

1/ Fiscal year beginning July.

Table 6. Tonga: Financial Soundness Indicators, 2007/08–2011/12 1/

	2007/08	2008/09	2009/10	2010/11	2011/12
	(In percent)				
Financial sector					
Total loans/GDP	54.9	52.5	42.9	35.5	33.6
Other depository corporations	54.9	52.5	42.9	35.5	33.6
Banks					
Net domestic credit		(Year-on-year percent change)			
Public non-financial corporations	27.6	-1.1	229.0	-12.0	3.1
Private sector	17.1	-3.7	-15.6	-9.9	-2.7
		(In percent)			
Risk-weighted capital adequacy ratio	21.4	21.8	17.2	21.7	28.1
Net interest income to average assets	5.8	4.9	4.2	4.1	3.9
Non-performing loans	9.5	20.5	15.3	15.2	15.7
Loan loss reserves to gross loans	4.7	13.3	14.8	15.0	6.4
Sources: National Reserve Bank of Tonga and IMF IFS database.					
1/ Data as of end of fiscal years.					

Table 7. Tonga: Millennium Development Goals, 1990–2011

	1990	1995	2000	2005	2008	2009	2010	2011
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 \$)	..	..	..	..	..	..	..	..
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)	99	..	..	..	..	..	..	99
Literacy rate, youth male (% of males ages 15-24)	99	..	..	..	..	..	..	99
Persistence to last grade of primary, total (% of cohort)	..	..	95	91	..	..	..	..
Primary completion rate, total (% of relevant age group)	..	..	..	..	..	..	..	..
Total enrollment, primary (% net)	92	..	89	..	93	..	..	99
Goal 3: Promote gender equality and empower women								
Proportion of seats held by women in national parliaments (%)	3	..	6	..	..	..	..	4
Ratio of female to male enrollments in tertiary education (%)	..	67	69	99	..	..	..	..
Ratio of female to male primary enrollment (%)	..	..	..	..	88	..	..	90
Ratio of female to male secondary enrollment (%)	..	97	99	..	97	..	..	89
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	35.7	..	38.6	..	..	..	..
Goal 4: Reduce child mortality								
Immunization, measles (% of children ages 12-23 months)	86	94	95	99	99	99	99	..
Mortality rate, infant (per 1,000 live births)	..	..	13	..	16	15	22	..
Mortality rate, under-5 (per 1,000)	27	..	..	..	26	22	..	..
Goal 5: Improve maternal health								
Adolescent fertility rate (births per 1,000 women ages 15-19)	..	23	25	24	20	..	..	..
Births attended by skilled health staff (% of total)	92	..	95	98	..	98	99	..
Contraceptive prevalence (% of women ages 15-49)	33	41	31	..	27	..	..	..
Maternal mortality ratio (national estimate, per 100,000 live births)	..	205	81	..	76	114	37	..
Pregnant women receiving prenatal care (%)	..	..	..	..	..	..	..	..
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	..	28	..	..	..	17	..
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 (% of all forms)	64	..	88	..	..	..	63	..
Goal 7: Ensure environmental sustainability								
CO2 emissions (kg per PPP \$ of GDP)	0.3	..	0.3	..	0.4	..	..	..
CO2 emissions (metric tons per capita)	0.8	..	1.2	..	1.7	..	..	..
Forest area (% of land area)	12.5	..	12.5	..	5.3	..	13	..
Improved sanitation facilities (% of population with access)	96	..	..	..	..	..	99	..
Improved water source (% of population with access)	100	..	..	99.9	99.9	99.9	99	..
Marine protected areas, (% of territorial water)	..	2.5	2.5	2.5	2.5	2.5	..	..
Goal 8: Develop a global partnership for development								
Debt service (PPG and IMF only, % of exports, excluding workers' remittances)	3.5	..	..	..	..	5.6	9.8	6.9
Internet users (per 100 people)	0.0	..	2.4	4.9	8.1	10.0	12.0	..
Mobile cellular subscriptions (per 100 people)	0.0	..	0.2	29.6	49.0	51.2	52.2	..
Telephone lines (per 100 people)	4.6	..	9.9	..	21.0	..	29.8	..
Other								
Fertility rate, total (births per woman)	4.6	4.4	4.3	4.1	4.0	4.0	..	..
GNI per capita, Atlas method (current US\$)	1,220	2,010	2,030	2,470	3,290	3,280	3,280	..
GNI, Atlas method (current US\$) (billions)	0.1	0.2	0.2	0.2	0.3	0.3	0.3	..
Gross capital formation (% of GDP)	18	26	22	22	26	27	29	..
Life expectancy at birth, total (years)	70	70	71	71	72	72	..	..
Literacy rate, adult total (% of people ages 15 and above)	99	..	..	..	..	..	..	99
Population, total (millions)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	..
Trade (% of GDP)	99	73	62	76	71	77	73	..

Source: World Bank, World Development Indicators database.

Appendix I. Tonga—Transition To GFSM 2001

The presentation of central government operations in the main text of the staff report follows the GFSM 1986 format (on a cash basis). To promote international comparability of government operations, data in GFSM 2001 format is presented in this Appendix. The authorities have been informed about the new reporting format.

	2008/09	2009/10	2010/11	2011/12	Proj.	
					2012/13	2013/14
	(In percent of GDP)					
Revenue	34.3	27.0	26.3	28.0	23.9	24.2
Taxes	19.4	16.3	17.0	15.9	15.7	15.8
<i>Of which:</i> Taxes on income/profits	6.1	3.9	4.9	3.2	3.2	3.3
Sales tax and consumption tax	10.7	10.2	10.4	11.0	11.2	11.2
Trade taxes	2.4	2.1	1.6	1.7	1.3	1.3
Social contributions	...	...	...	...	...	...
Grants (in cash)	6.8	6.8	6.7	9.9	5.8	6.1
Project grants	6.8	4.9	4.0	5.2	4.0	3.4
Budget support	0.0	1.9	2.8	4.6	1.8	2.7
Other revenue	3.9	3.8	2.3	2.2	2.3	2.3
Expenditure	34.4	32.3	34.0	30.6	23.7	24.3
Expense	25.3	25.9	23.1	23.9	21.6	21.7
Compensation of employees	12.3	12.6	11.8	11.8	11.2	11.0
Use of goods and services	9.3	9.7	7.1	8.5	7.4	7.7
Consumption of fixed capital	...	...	...	...	...	...
Interest	0.8	0.8	0.8	0.8	1.0	1.0
<i>Of which:</i> To nonresidents	0.6	0.5	0.6	0.6	0.8	0.7
Subsidies	0.3	0.2	1.1	0.9	0.7	0.7
Grants	0.1	0.2	0.3	0.2	0.2	0.2
Social benefits	1.2	1.4	0.9	0.8	0.6	0.6
Other expense	1.3	0.9	1.1	0.9	0.6	0.6
Net acquisition of nonfinancial assets	-1.6	2.6	9.1	5.6	1.9	2.5
Acquisitions of nonfinancial assets	2.5	2.6	9.3	5.6	2.0	2.5
<i>Of which:</i> Financed by China EXIM Bank loans	4.1	4.0	7.8	4.8	1.0	0.0
Disposals of nonfinancial assets	4.1	0.0	0.3	0.0	0.1	0.0
Consumption of fixed capital	...	...	...	...	...	...
Gross operating balance	9.0	1.1	3.3	4.1	2.3	2.5
Net lending (+)/borrowing (-)	-0.2	-5.3	-7.6	-2.7	0.2	-0.1
Net acquisition of financial assets	1.0	3.9	1.6	1.1	-0.4	-0.3
Domestic net lending	1.0	3.9	1.6	1.1	0.1	0.1
Change in cash balances (+ = increase)	0.0	0.0	0.0	0.0	-0.5	-0.4
Net incurrence of financial liabilities	0.2	5.3	7.6	2.7	-0.7	-0.3
<i>Of which:</i> China EXIM Bank loans	6.3	5.1	9.1	5.6	0.8	-1.0
Memorandum items:						
Nominal GDP (in millions of pa'anga)	664.3	712.2	775.0	799.3	826.3	868.1
Total external public debt outstanding (in percent of GDP)	31.5	31.8	35.4	41.2	40.3	38.9

Sources: Data provided by the Tongan authorities; and Fund staff estimates.
1/ Table reports central government operations in the GFSM 2001 format.

Appendix II. Tonga—Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	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. Fiscal policy shock in the U.S. (global)	Low Failure to raise the debt ceiling could negatively affect the economic recovery.	Medium In the event of a U.S. economic slowdown, Tonga would be significantly affected mainly via remittances.
2. Stalled or incomplete delivery of Euro area policy commitments (global)	Medium Financial stress could escalate and bank-sovereign-real economy links re-intensify.	Medium Tonga would be indirectly affected by the impact of the shock to global economy.
3. Deeper than expected slowdown in EMs	Medium Synchronized growth shock triggered by financial sector stresses or setbacks in fiscal and structural reforms.	Medium Tonga would be indirectly affected by spillover through its key trade partners, in particular Australia.
4. Natural disasters (regional)	Medium Natural disasters similar to the latest cyclone could cause significant human and economic tolls.	High Such an event could have far reaching multifaceted effects, such as damages on infrastructure and production base, and an increase in fiscal financing gap, which can potentially be very large.
5. Continued weakness in banking intermediation (country-specific)	Medium Continued pressures on bank deleveraging and delays in critical reforms (e.g. collateral framework) can prevent a bottoming out of the credit cycle.	Medium Prolonged weakness in credit supply will exert a significant drag on growth.
6. Slippages in delivering on policy reform commitments (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 significant affect budget support flows, leading to a significantly large gross financing gap.



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STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION– INFORMATIONAL ANNEX

July 2, 2013

Prepared By

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

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TONGA: 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	107.70

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				
	2013	2014	2015	2016	2017
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.

¹ As of March 31, 2013.

Exchange Rate Arrangement

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. 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 2012, and the Executive Board discussed the staff report (IMF Country Report No. 12/166) on May 16, 2012.

Previous Fund Recommendations

The staff and the authorities have continued to share comprehensive views in the past about policy priorities. During the 2012 consultation, Executive Directors emphasized the importance of strengthening policy buffers and of fiscal consolidation to rebuild the government's cash balances and safeguard debt sustainability; continuing to strengthen bank balance sheets; improving the business environment; and following through on the technical assistance (TA) from the Pacific Financial Technical Assistance Centre (PFTAC) on tax reform.

- The authorities expect to achieve significant fiscal consolidation in FY2012/13 through reduced spending. The wage and hiring freeze put in place for the FY2012/13 budget was likely to have constrained recurrent spending, and the lower-than-expected project grants were offset by a corresponding under-implementation of related spending. The government has also adhered to its No New Loan policy.
- The authorities continued to strengthen risk-based supervision, launched a credit bureau, and expect to enact the Receivership bill this year.
- The authorities have removed the annual renewal requirement for the headline business license. However, progress in public enterprise reform was slow due to difficulties in identifying strategic investors.
- The authorities created a presumptive tax regime for SMEs and a natural resource tax regime.

Technical Assistance

The Legal Department (LEG) provided assistance on AML/CFT issues for the Pacific islands countries, including Tonga, from 2002 through 2005.

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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 (see Annex II).

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.

TONGA: PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2013–14¹

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. Regular TA has also been provided in the compilation of National Accounts and Balance of Payment 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 note and is planned within the results framework for current PFTAC funding cycle.² 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

¹ As of March 2013.

² See http://www-intranet.imf.org/departments/APD_Regional_Strategy_Note_FY_2012-14_APD_Final.doc for the APD Regional Strategy Note. 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.

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).

In the **revenue** area, the main focus remains on assisting the authorities to implement 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 Finance and National Planning (MOFNP) and Revenue Services and are likely to be supported by a new resident long-term advisor (yet to be recruited). PFTAC's specific inputs are likely to concentrate on improving corporate planning and strategies (2.2), implementing the new small/micro business tax regime (2.1), natural resource taxation (2.1), risk management and compliance strategies (2.5), and taxpayer services (2.4).

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 (4.8). 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 may begin in 2013. Balance of payments and Government Finance Statistics support will be provided by IMF HQ.

In **financial sector supervision**, IMF/PFTAC has assisted the NRBT establish enhanced off-site analysis (3.1 and 3.2) and has provided support to on-site bank supervision. Intensive support is being provided in 2012/13 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 (3.1-3.3) using base prudential returns developed by AFSPC. In 2013 this is likely to encompass implementation of the Reserve Bank of New Zealand (RBNZ) Financial Sector Information System (FSIS) .

In the **macroeconomic** area, PFTAC will 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). Staffs of NRBT and MOFNP participated in a regional financial programming workshop held jointly by PFTAC and the Singapore Regional Training Institute in late 2012, and a follow-up visit to NRBT by PFTAC's macroeconomic advisor is planned for 2013 (5.2). PFTAC is also providing support for the AsDB PFM TA project (involving a resident long-term adviser) to strengthen macroeconomic and fiscal forecasting (5.3).

TONGA: WORLD BANK–IMF COLLABORATION¹

The IMF team led by Mr. Jookyung Ree (mission chief to Tonga) has a close working relationship with the Bank team led by Mr. Vivek Suri (lead economist, East Asia and the Pacific region) and Mr. Robert Jauncey (senior country officer). 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 2009–13 Article IV missions, as well as joining several consultations and providing various analytical inputs to the 2013 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:

- **Putting public debt firmly on a downward path.** This will require progress on multiple fronts over the medium term, including the effective implementation of current policy to avoid new borrowing, stepping up revenue administration and expenditure control, prioritizing 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, 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

¹ As of March 2013.

the cost of borrowing; (iii) improve vital tourism infrastructure, including through the introduction of private participation in the management of the Dateline Hotel and 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 \$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\$10.8 million of World Bank financing over FY2012–FY2013 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 provided TA to the Ministry of Finance and National Planning during FY2013 to strengthen budget execution, monitoring, reporting and transparency, and, with AusAID financing support, is undertaking a review of current investment incentive arrangements to support Government in identifying priority reforms to encourage increased foreign investment.

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. Appendix I details the specific activities planned by the two country teams over the July 2012–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 2012–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 	<ul style="list-style-type: none"> • FY2013 • FY2013 • FY2013–15 • FY2013–14 • FY2013–14 • FY2013
Fund Work Program	<ul style="list-style-type: none"> • Article IV Policy Note • PFM Roadmap Completion • Government Finance Statistics • Balance of Payments Statistics • National Accounts Statistics • State Owned Banks • Article IV Staff Report and Board Meeting 	<ul style="list-style-type: none"> • February 2013 • October 2013 • November 2013 • June and December 2013 • September 2013 • December 2013 • June 2013

TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

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 Tonga's National Strategic Planning Framework 2009/2010–2014/2015 (NSPF) to create a society in which all Tongans enjoy higher living standards and a better quality of life. Similarly, as the Pacific Approach aims to achieve its goal through inclusive and environmentally sustainable growth, the NSPF aspires to achieve its vision through equitable and environmentally sustainable private sector-led economic growth. AsDB's Country Partnership Strategy (CPS) 2007–12 for Tonga shares the same focus as the Pacific Approach and the NSPF.

AsDB's support to Tonga will be through infrastructure development; renewable energy; effective, prudent macroeconomic and fiscal management; and private sector development. 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 NSPF 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's strategy for Tonga is therefore consistent with the Pacific Approach and the NSPF.

AsDB has approved 15 loans and 4 grants totaling \$94.85 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Fifty six technical assistance (TA) projects with a value of \$10.6 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 2009 helped Tonga mitigate the impact of the global economic crisis, while establishing the basis for higher, more equitable and sustainable growth in the medium term and creating an economy more resilient to future shocks. Another grant-financed project supports enhancing living standards by improving urban infrastructure. Of the three ongoing TA projects, one focuses on economic and strategic management as well as the development of a public finance management roadmap and a medium-term budget framework. Two TA projects are supporting the preparation of the proposed Tonga-Fiji submarine cable project and the second

¹ As of March 2013.

phase of the integrated urban development project. Tonga also benefits from a number of regional TA projects in private sector development, economic management, energy efficiency, and public financial management. Assistance to climate change adaptation and mitigation activities will be made available, in particular, the pilot program for climate resilience will support the mainstreaming of climate change considerations into infrastructure development and through broader whole-of-government institutional strengthening.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2008–12					
	2008	2009	2010	2011	2012
Loan approvals					
Number	0.0	0.0	0.0	0.0	0.0
Amount (in millions of US\$)	0.0	0.0	0.0	0.0	0.0
Grant approvals					
Number	1.0	1.0	0.0	2.0	0.0
Amount (in millions of US\$)	11.3	10.0	0	15.76	0.0
Technical assistance approvals					
Number	1.0	2.0	2.0	24.0	3.0
Amount (in millions of US\$)	0.7	1.0	0.515	1.4	1.375

TONGA: 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.

The two main sources of statistical information are 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 to 2010/11 from 2000/01, with the assistance of a statistical advisor from New Zealand. The new series also made improvements in the classification and valuation of inputs, in line with PFTAC assistance in 2008 and 2009, including: utilization of 2009 Household Income and Expenditure Survey (HIES); supplementation of customs data with quarantine office data in merchandise exports; and inclusion of in-kind donor-funded capital projects and loan projects, which used not to be captured. 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 is planning to resume its statistical support with a mission in national accounts statistics in September 2013. The SD has also been invited to participate in the PFTAC regional seminar on national accounts planned for 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.

Labor market statistics are weak: employment statistics have not been compiled since 2003; and average earnings statistics are not available. Publication of international arrival and departure statistics recommenced in 2012. However, further work is required to develop migration statistics, in particular information on emigration to the United States.

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.

However, improvements are still needed to ensure accurate and reliable fiscal data. Proper classification of transactions is needed to permit reconciliation with monetary financing data. Lags in updating the accounting system should 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 IFS or GFS Yearbook. Tonga is participating in the three-year GFS-IMF project for the Asia-Pacific region funded by the government of Japan, and has given a commitment to commence reporting for the yearbooks. A mapping exercise from GFS 1986 to GFS 2001 has been carried out, but data has not yet been presented publicly on the new GFS basis.

External Sector Statistics

The SD produces balance of payments statistics on a quarterly basis, which are published in 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. Unofficially, 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, although the OET has serious shortcomings in its reporting requirements—the lack of a coding system consistent with needs to compile the balance of payments. There are significant differences between the BOP estimates compiled by the SD and NRBT. Moreover, large errors and omissions point to possible under-recording of imports. With regard to international investment positions (IIP), no information is published due to lack of capacity and a data collection framework. External debt transactions are largely underestimated in the balance of payments. However, attempts are being made to improve reporting of external debt and capital transfers to be consistent with the national accounts. Changes in reserves do not distinguish transactions from valuation changes.

With PFTAC assistance in March 2009, the SD developed revised draft 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 took place in November 2012 to provide TA in balance of payments and IIP. The MOFNP has put in place a system that provides detailed information on official sector external disbursements and debt service.

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*. TA in monetary and financial statistics will be needed to improve the

classification and sectorization of accounts in view of the introduction of a new prudential reporting system.

Tonga: Table of Common Indicators Required for Surveillance					
As of April 25, 2013					
	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	Feb-13	Apr-13	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Feb-13	Apr-13	M	M	M
Reserve/Base Money	Feb-13	Apr-13	M	M	M
Broad Money	Feb-13	Apr-13	M	M	M
Central Bank Balance Sheet	Feb-13	Apr-13	M	M	M
Consolidated Balance Sheet of the Banking System	Feb-13	Apr-13	M	M	M
Interest Rates ²	Dec-12	Mar-13	M	M	M
Consumer Price Index	Mar-13	Apr-13	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2011/12	Mar-13	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	2011/12	Mar-13	A	A	A
External Current Account Balance	Q2/2012	Oct-12	Q	Q	Q
Exports and Imports of Goods and Services	Q2/2012	Oct-12	Q	Q	Q
GDP/GNP	2011/12	Feb-13	A	A	A
Gross External Debt	2011/12	Mar-13	A	A	A
International Investment Position	NA	NA	NA	NA	NA
<p>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.</p> <p>² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.</p> <p>³ Foreign, domestic bank, and domestic nonbank financing.</p> <p>⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.</p> <p>⁵ Including currency and maturity composition.</p> <p>⁶ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).</p>					



TONGA

JOINT IMF/WORLD BANK DEBT SUSTAINABILITY ANALYSIS 2013

July 2, 2013

Approved By
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(IDA) Sudhir Shetty; Jeffrey D. Lewis

Prepared By
The International Monetary Fund and
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Tonga's rating has been changed from high to moderate risk of debt distress based on the joint IMF-WB low-income country debt sustainability assessment (LIC DSA). This change is mainly due to the improvement of the Country Policy and Institutional Assessment (CPIA) rating from 'Weak' to 'Medium' by the World Bank last year. Although the relevant indicators of external and public debt and debt service show a similar path for debt dynamics as last year's DSA, the upgrade of the CPIA rating for Tonga significantly increases thresholds of these indicators, with only a single threshold (PV of debt in percent of exports) now breached for no more than three years under the baseline scenario. Because remittances have declined significantly in recent years, they are excluded from debt burden thresholds and indicators under the baseline scenario, but may mitigate liquidity risks. Notwithstanding the upgrade of the DSA rating, risks remain significant, and a cautious approach is recommended towards new nonconcessional loans. With scheduled repayments on two loans (reconstruction and roads) from the China EXIM Bank, Tonga's debt service burden is expected to rise sharply from FY 2013/14 (July 1 to June 30), substantially draining the government's cash balance. The government's balance sheet is also exposed to a currency risk, with about 60 percent of the outstanding external debt denominated in Chinese renminbi. A declining path of external public debt is critically dependent on steadfast implementation of medium-term fiscal consolidation, as outlined in the Tonga Strategic Development Framework (TSDF).

BACKGROUND

1. As a small open economy, Tonga is facing the dual challenge of large fluctuations on the external side and a limited production base on the domestic side. On one hand, it heavily relies on remittances, tourism, and foreign aid. On the other hand, the production and export bases are quite narrow and based mainly on a few agricultural products and fishery.

2. The economy is gradually recovering from the effects of the global slowdown and the domestic credit crunch. After averaging about 3 percent during the previous three years, economic growth slowed down to 0.8 percent in FY 2011/12. In the previous three years, public investment projects, particularly those funded by China EXIM Bank, had offset spillovers from the global financial crisis. However, those projects have been completed, and a normalization of construction activity has reduced the impetus for growth—along with weaknesses in remittances, other investment spending, and tourist arrivals. In FY 2012/13, the economy is expected to grow by 0.5 percent. Starting in FY 2013/14, however, a gradual recovery of remittances and tourism—along with improved infrastructure—will help growth to gradually increase to about 1¾ percent over the medium term.

3. Tonga's total public sector debt stock (including publicly guaranteed debt) has risen since FY 2008/09 and is expected to reach about 45 percent of GDP by the end of FY 2012/13. External debt accounts for the majority of the debt stock, amounting to about 40 percent of GDP, leaving Tonga vulnerable to foreign exchange liquidity and currency risks. This rise in debt stock was primarily on account of two loans (for reconstruction and roads) from China EXIM Bank¹. These loans account for about 60 percent of the outstanding external debt and pose an excessive exposure to a single foreign currency, while long-term loans by international financial institutions (IFIs) account for about 35 percent of external debt. In the current fiscal year, disbursements by China EXIM Bank have been completed for both the reconstruction and road loans. In total, about 80 percent of the reconstruction loan was used to finance direct government capital expenditure while the remainder was used for on-lending to the private sector for office, residential, and retail construction. The terms of the on-lending include an interest of 5 percent on the outstanding Tongan pa'anga amount, and the government receives repayments from the private borrowers after the completion of the project². The entire road reconstruction loan was used to finance direct government capital spending on road improvements, including on the outer islands.

¹These loan commitments were signed in November 2007 (for reconstruction), and in February 2010 (for roads), and bear a 2 percent interest rate, 5-year grace period, and 20-year maturity. The arrangement with the Chinese contractor performing the work associated with these loans required an initial disbursement of 30 percent to cover the down payment, while outstanding disbursements were paid quarterly as work was completed and claims filed. The authorities hope to negotiate with China for a debt relief or a debt rescheduling for another 5 to 10 year grace period.

² Since March 2012, the private borrower has started to repay the government.

4. Tonga’s DSA builds on the baseline scenario assumptions presented in Box 1. Under the baseline scenario, over the medium term, recovery of remittances and tourism, along with improved infrastructure will help growth to gradually increase to about 1¾ percent, slightly lower than its long-term average growth rate of about 2 percent. Public spending is assumed to grow slower than projected revenues and grants over the medium term, limiting the longer-term need for additional external borrowing. Remittances—the largest source of foreign exchange earnings (one-half of Tongans live abroad, mostly in Australia, New Zealand, and the United States)—are assumed to recover in the medium to long term, in line with economic recovery in remittance-originating countries, and remain an important source of foreign exchange inflows. The recovery in remittances is, however, more sluggish than assumed in the previous DSA. Remittances are projected to recover from 14 percent of GDP in FY 2011/12 to 17 percent of GDP by FY 2017/18 and an average of 18 percent of GDP over the longer term. This level is roughly the average during 1994–2000, but much lower than the 32 percent of GDP average observed during 2001–10. Because of recent declines, debt burden indicators and thresholds are exclusive of remittances under the baseline scenario.

5. On the fiscal front, the government is expected to implement a medium-term fiscal reform plan supported by tax reform and restraint on payroll expenditure while increasing priority spending. Under these assumptions, the government will be able to rebuild cash balances and maintain a declining debt path while covering rising debt service costs. Revenues are expected to get some boost from proposed reforms to tax policy and administration, as well as the gradual economic recovery, and this will help offset the gradual decrease of cash grants. The government is expected to continue with its policy to reduce the share of the wage bill to 45 percent of recurrent spending, bringing down current expenditure by about 2 percent of GDP in the medium term. Given all of these, the medium-term overall fiscal balance (excluding the China EXIM Bank loans) is projected to average a surplus of about 1–2 percent of GDP.

6. The Country Policy and Institutional Assessment (CPIA) rating for Tonga was upgraded from ‘Weak’ to ‘Medium’ by the World Bank last year. Credit was given for major gains in macroeconomic policy management, social protection systems, and business environment reforms. Consistent with the stronger rating for Tonga’s macroeconomic policies and institutions, its indicative debt distress thresholds were raised relative to 2012 levels, thereby improving the country’s performance under baseline and alternative debt scenarios (Figures 1a-b).

7. Based on the updated DSA, Tonga has been upgraded from high to moderate risk of external debt distress³. Only one threshold (PV of debt in percent of export) is still breached under the baseline scenario, and this breach is not protracted, lasting for only three years.

Thresholds for External Debt (In percent)		
	Threshold	
Indicator	Before	Now
Present value of debt to GDP	30	40
Present value of debt to exports	100	150
Present value of debt to revenue	200	250
Debt service to exports	15	20
Debt service to revenue	25	20

³ This judgment reflects the *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*.

While remittances are excluded from debt burden indicators and thresholds, remittances are expected to help mitigate liquidity risk.⁴

8. However, Tonga continues to face important debt vulnerabilities, and the current DSA suggests a similar path for debt dynamics as the previous year's DSA. The debt burden peaks early in the projection period and gradually declines in the absence of new nonconcessional external borrowing. It also assumes that going forward, the Tongan government will undertake planned revenue reforms which, together with restraints on recurrent spending, will contribute to a buildup of adequate cash reserves. It also assumes that the Tongan government will continue to refrain from taking new nonconcessional loans until Tonga is upgraded to a low risk of debt distress classification. It does not factor in any debt relief or rescheduling.

EXTERNAL DSA

Baseline

9. Under the baseline, due to the upgrade in the CPIA rating, the external debt trajectory currently breaches only one policy-dependent threshold, the PV of debt-to-export ratio. However, this breach is not protracted, with the ratio falling below the threshold in FY 2015/16 and remaining at lower levels over the medium term (Figure 1a)⁵. The PV of public and publicly guaranteed (PPG) external debt is currently about 35 percent of GDP, which breaches the former indicative threshold (30 percent of GDP) but is below the revised indicative threshold (40 percent of GDP). The PV of debt-to-revenue ratio, meanwhile, would stay well below the threshold throughout the projection period.

10. Debt service is expected to rise in the medium term on account of the expiration of the grace period on the China EXIM Bank loans. But it will remain well below the threshold of both exports and revenue (Figure 1a).

11. Tonga's remittances would help reduce liquidity risks. Remittances to Tonga have averaged about twice export receipts over the past decade, and have provided a considerable source of foreign exchange inflows. Because they have declined significantly in recent years, remittances are excluded from debt burden thresholds and indicators under the baseline scenario. In an alternative scenario including remittances, the PV of PPG external debt relative to exports and remittance is projected to stay below the

⁴ *The Interim Guidance on the Use of Remittances in the DSA Framework for Low-income Countries*, which considers remittances as part of the base case for countries with large remittances, will be used from next year.

⁵ According to the DSA guidelines, countries should be considered at a high risk of debt distress if there is a protracted breach of debt or debt-service thresholds under the baseline scenario.

(lower) modified threshold of 120 percent⁶⁷. When remittances are considered with export earnings, external debt service remains well under 10 percent throughout the projection period (Figure 1b).

Sensitivity Analysis

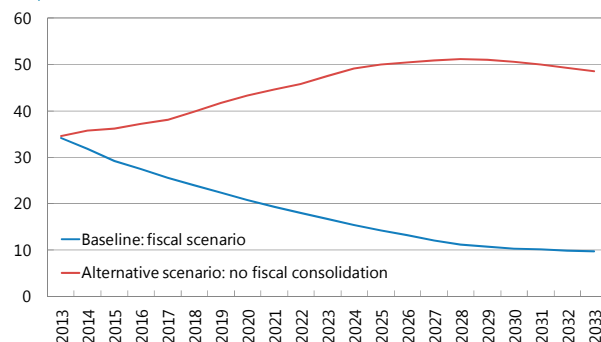
12. Risk of debt distress is sensitive to assumptions regarding the external environment. Stress tests show that the debt position is vulnerable to a significant slowdown in exports and currency risks. An export shock stress test causes the PV of debt-to-export ratio to approach 260 percent of exports and remain above the indicative threshold in the medium terms. Likewise, an exchange rate depreciation shock causes the PV of debt-to-GDP ratio to breach the indicative threshold until FY 2015/16. The alternative scenario based on historical averages (red lines) provides a more sanguine picture than the baseline⁸, mainly because inflation rates of the U.S dollar denominated GDP deflator was higher in the past.

PUBLIC SECTOR DSA

Baseline

13. The public sector DSA reinforces the conclusions of the external DSA⁹. The high level of public sector borrowing for road building and reconstruction of the capital city over the past few years pushed PV of debt to stand to 40 percent of GDP in the current fiscal year. But it is expected to decline steadily under the baseline scenario (Figure 2). This highlights the importance of fiscal prudence and commitment to limiting new nonconcessional PPG borrowing¹⁰.

NPV of Public Sector Debt Under Different Scenarios
(In percent of GDP)



Source: Fund staff calculations.

⁶ Under recently-issued guidance (Interim Guidance on the Use of Remittances), remittances will be included in the base case starting with the 2014 DSA. This is likely to reinforce the conclusion that Tonga is at moderate risk of debt distress.

⁷ In a recent review, the IMF Executive Board approved modifications in some of the thresholds.

⁸ In this alternative scenario, the following four variables are set at their historical levels; (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) non-debt creating flows.

⁹ The public sector DSA covers all Government and Government-guaranteed debt. Public enterprises are not included but all external borrowing by them is accounted for, as public enterprises do not have access to international capital markets.

¹⁰ Domestic debt (including government guaranteed debt) reached \$36.9 million in FY 2012 (about 4.6 percent of GDP), comprising of GoT's bonds issued, with the majority of holdings by Financial Institutions and Retirement Fund Board. GoT's bonds are mainly issued on a roll-over basis with the exception of any redemptions or new issues.

Sensitivity Analysis and Alternative Scenario

14. Stress tests indicate that vulnerabilities remain throughout the projection period, especially to a significant depreciation (Figure 2). The PV of public debt would increase up to 53 percent in FY 2013/14 when a one-time 30 percent real depreciation takes places, but subsequently fall to 42 percent of GDP over the medium term. It should settle at around 19 percent of GDP in FY 2032/33.

15. Alternative scenarios highlight the importance of fiscal consolidation and growth enhancing reforms. An alternative scenario that maintains the primary balance at the FY 2011/12 level results in a slightly slower decline in debt and debt service indicators relative to the baseline. The other alternative scenario, where the long-term real GDP growth and primary balance are fixed at the average of the past decade (both of which are significantly worse than in the baseline), leads the relevant debt and debt service indicators either to fail to improve (PV of debt to GDP ratio and PV of debt to revenue ratio) or to improve only marginally (debt service to revenue ratio).

16. A no-reform scenario also highlights the importance of following through with the government's fiscal reform strategy. In a scenario of no tax reforms coupled with a failure to cut wages expenditures (including due to socio-economical challenges), the authorities will have to borrow domestically to bridge the financing gap. This will cause substantial further stress on the public debt level, increasing the PV of the debt-to-GDP ratio to about 50 percent over time.

STAFF ASSESSMENT

17. Tonga has moved from high to moderate risk of debt distress. This change is driven by an improvement in Tonga's CPIA rating from 'weak' to 'medium' and associated changes in debt distress thresholds. While not included in debt burden indicators and thresholds under the baseline scenario, remittances will mitigate liquidity risks. Threshold breaches under alternative scenarios indicate continued external vulnerabilities.

18. The assessment of reduced risk of debt distress is heavily contingent on successful fiscal consolidation. The fiscal authorities need to build enough cash balances (about 2 months of recurrent expenditure) to ensure servicing of the increased external debt obligations from FY 2013/14 without sacrificing essential public spending¹¹. Alternative scenarios underline the importance of sustained fiscal consolidation for effective debt management. Additionally, there is a currency mismatch on the government's balance sheet (about 60 percent of the external debt are denominated in Chinese renminbi) which, if left unhedged, could pose additional risk to Tonga's debt dynamics.

19. Key medium-term vulnerabilities include major external shocks, currency mismatches, and lower GDP growth. These vulnerabilities underscore the importance of sound macroeconomic policies to improve Tonga's growth potential on a sustainable basis (as highlighted in the staff report), diversification

¹¹ More detailed information is provided in the staff report.

of export products and markets, and continued efforts to build fiscal buffers. Sound public debt management is also essential to guide future development financing in Tonga. Priority should be given to projects that would generate higher growth and employment, especially in the context of the Tonga Strategic Development Framework (TSDF), to help strengthen debt service capacity in the future. Consideration should also be given to hedging exchange risks on foreign liabilities using financial instruments, and developing a comprehensive debt management strategy with technical assistance.

The Authorities' Views

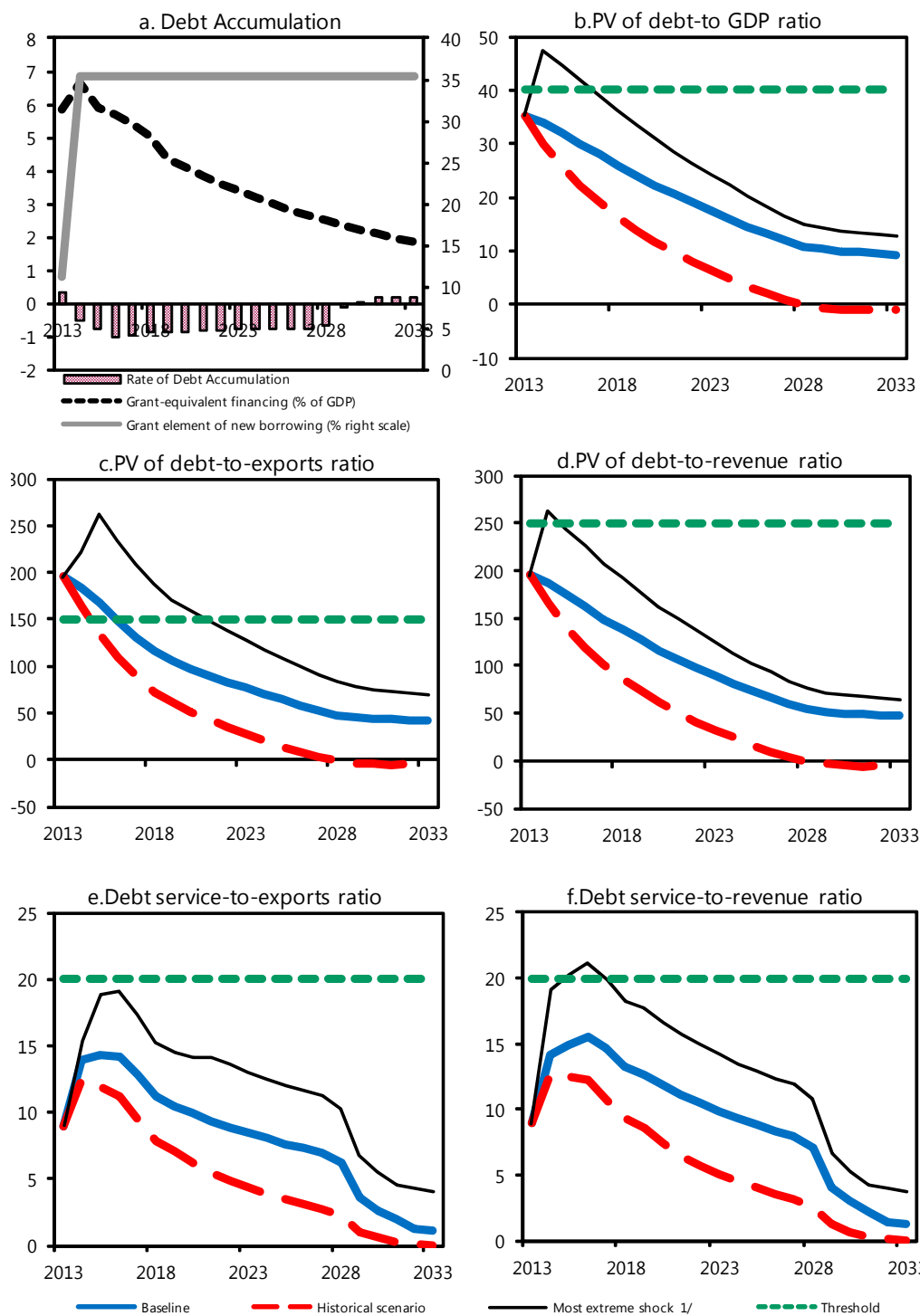
20. The authorities recognize the risks posed by the high debt burden and would like to bring down the public debt below 40 percent of GDP. The authorities agreed that creating fiscal space will be crucial in reducing the debt burden and protecting priority spending. In discussions with staff, the authorities noted that they were seeking to reschedule some of Tonga's debt obligations to China EXIM Bank. They shared staff's concerns about the currency risk posed by the current external debt structure, and noted that they were seeking technical assistance to mitigate this risk.

Box 1. Key Macroeconomic Assumptions

- **Real GDP growth** is projected at 0.5 percent in FY 2012/13. In the previous three years, spillovers from the global economic crisis were offset by public investments, in particular reconstruction and road projects funded by China EXIM Bank in FY 2011/12. However, as construction activities normalize and the recovery of remittances remains slow, economic growth is expected to be weak in FY 2012/13. Over the medium term, recovery of remittances and tourism, along with improved infrastructure, will help growth gradually increase to about 1¾ percent, slightly lower than its long term average growth rate of about 2 percent.
- The government is assumed to achieve an **overall fiscal surplus** of about 1–2 percent of GDP over the medium term, including to meet the expected debt repayment. Reforms in tax policy and administration are expected to improve the tax-to-GDP ratio to 16.4 percent of GDP from 15.7 percent of GDP over the medium term, while cash grants will decline to 4.6 percent of GDP in FY 2017/18 from 9.9 percent of GDP in FY 2011/12. Current expenditures (excluding ones funded by project grants) are expected to slow down, led by a reduction in the ratio of the wage bill to GDP by about 1 percentage points over the medium term. Total capital expenditure is expected to increase from about 2 percent of GDP to 3.4 percent of GDP over the medium term.
- **Over the longer term**, the primary fiscal surplus is expected to be eliminated with the gradual reduction in cash grants. Lower project grants primarily explain the reduction in expenditure, while the wage bill is targeted to average 45 percent of domestically-funded expenditure. Total capital expenditure is assumed to remain at about 4 percent of GDP.
- **Financing.** Majority of the grants, together with projected disbursements from concessional loans, are assumed to be spent on development projects and associated maintenance. Following the final disbursement of the China EXIM Bank road loan, there will be no external nonconcessional borrowing until Tonga is upgraded to low risk of debt distress. The external financing from the World Bank and Asian Development is expected to be under the rule of 50:50 (grants vs loans). On the domestic front, no new (net) domestic borrowing is assumed.
- The **current account deficit** is projected to narrow from 6.6 percent of GDP in FY 2011/12 to 5.9 percent of GDP in FY 2012/13, due mainly to a decline in imports. The current account deficit should average about 3 percent of GDP over the medium term and narrow slightly over the long term, as remittances and tourism receipts improve.
- **Remittances** are expected to recover during the current fiscal year, along with strengthening economic prospects in Australia, New Zealand, and the United States. Remittances are expected to remain an important source of foreign exchange in the medium term.
- **Tourism** receipts are projected to average around 10 percent of GDP and increase to an average of 13 percent of GDP over the long term assuming that the tourism environment continues to improve.
- The **export** base is projected to remain narrow and relatively undiversified. The proper operation of the fumigation facility should help exports by meeting New Zealand's bio-security requirements.

Tonga: Key Macroeconomic Assumptions (in percent)		
	2012 DSA	2013 DSA
	2012-17 AVG	2013-18 AVG
Real GDP growth	1.7	1.5
GDP deflator in US dollar terms (change)	3.8	1.5
Effective interest rate	1.6	1.9
Growth of exports of G&S (US dollar terms)	7.2	7.6
Growth of imports of G&S (US dollar terms)	6.6	2.9
Grant element of new public sector borrowing	34.9	31.3

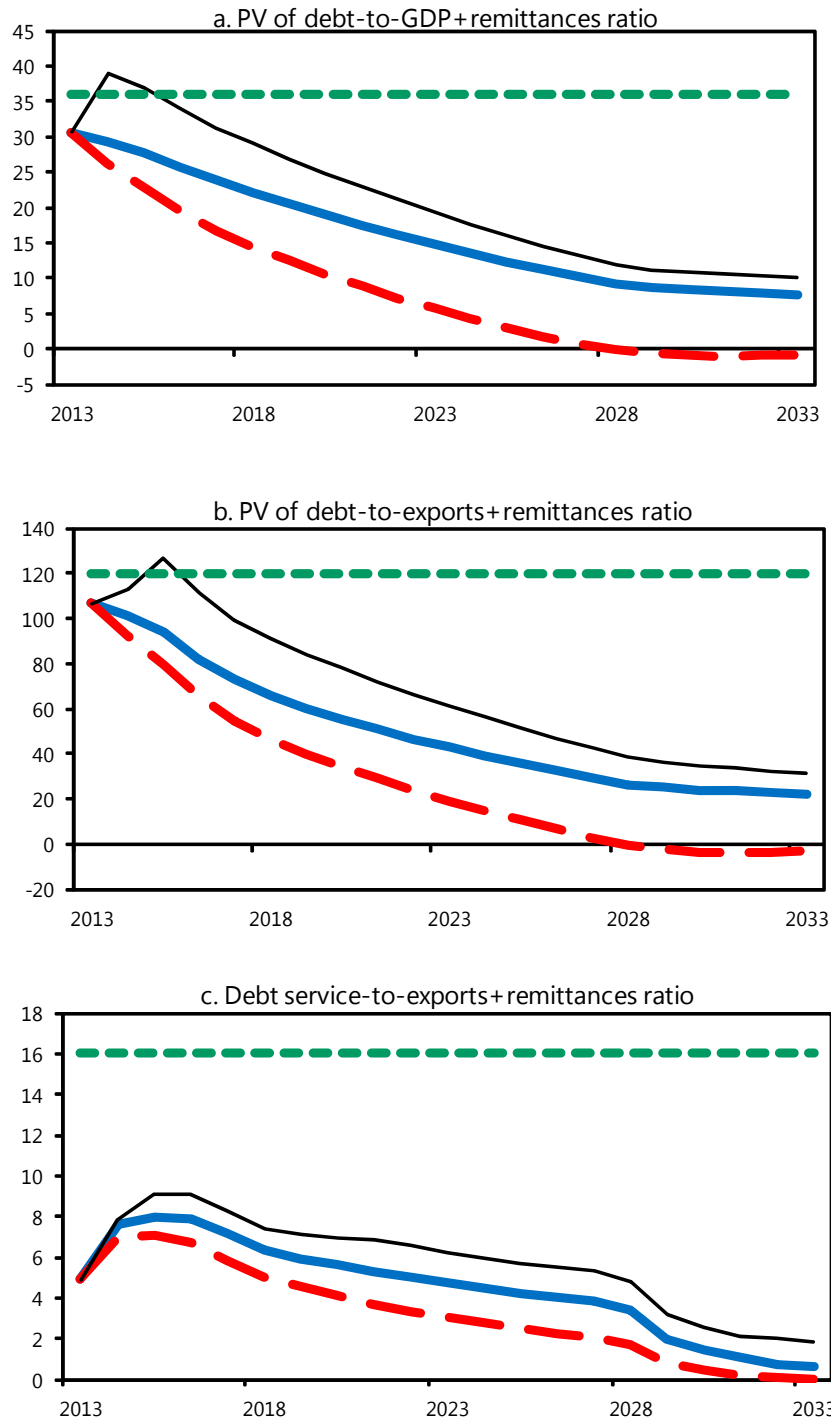
Figure 1a. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2013–33 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2033. 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.

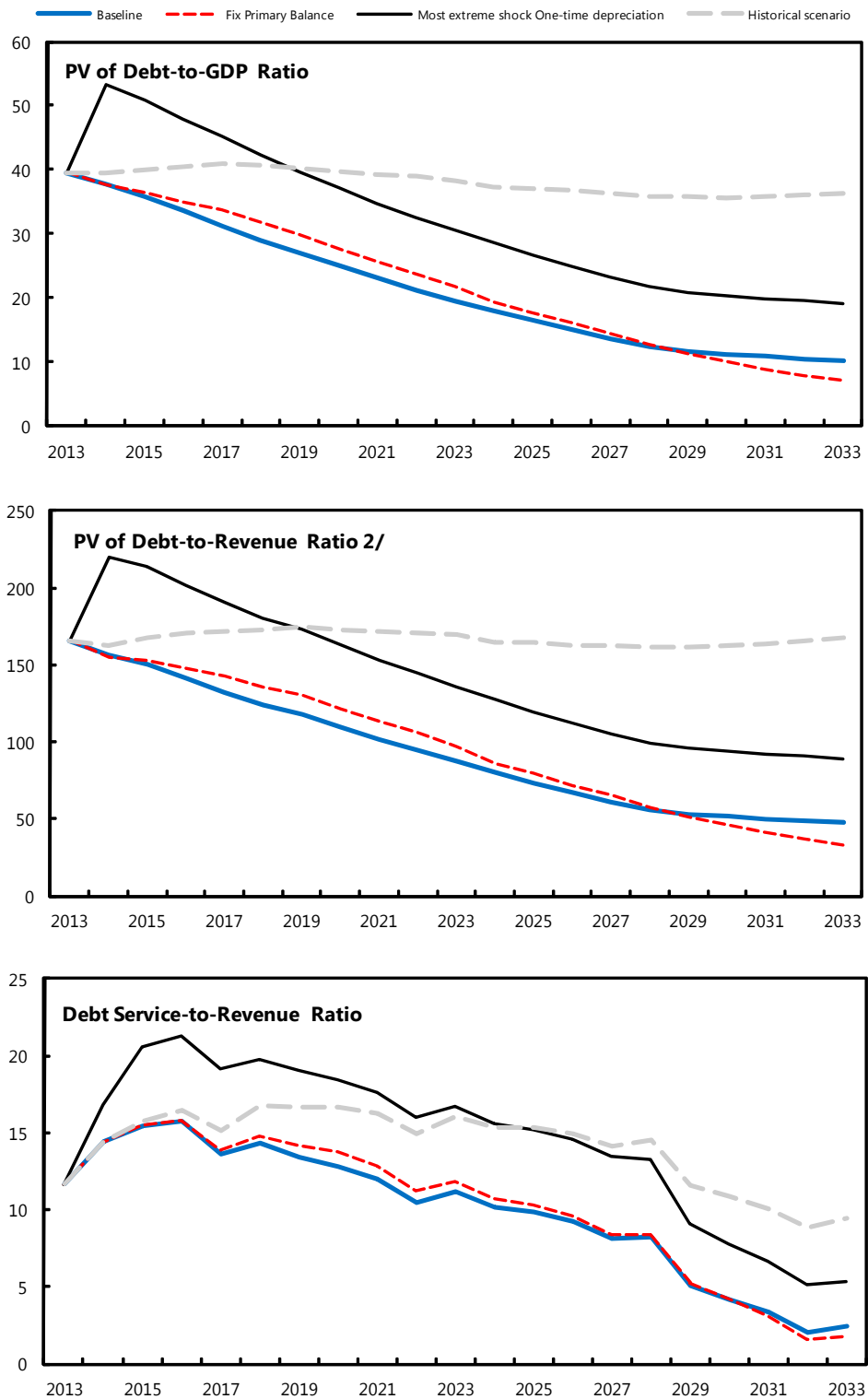
Figure 1b. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, with Remittances, 2013–33 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023. 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: Indicators of Public Debt under Alternative Scenarios, 2013–33 1/



Sources: Country authorities; and staff estimates and projections.
 1/ The most extreme stress test is the test that yields the highest ratio in 2023.
 2/ Revenues are defined inclusive of grants.

Table 1a. Tonga: External Debt Sustainability Framework, Baseline Scenario, 2010–33 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Projections						2013-2018 Average		2019-2033 Average	
	2010	2011	2012			2013	2014	2015	2016	2017	2018	2023	2033		
External debt (nominal) 1/	31.8	35.4	41.2			40.3	38.9	37.1	35.1	33.2	31.3		23.0	14.2	
<i>of which: public and publicly guaranteed (PPG)</i>	31.8	35.4	41.2			40.3	38.9	37.1	35.1	33.2	31.3		23.0	14.2	
Change in external debt	7.1	3.5	5.8			-0.9	-1.4	-1.8	-2.0	-1.9	-1.9		-1.5	-0.3	
Identified net debt-creating flows	-0.6	-2.8	1.9			3.4	1.8	0.7	0.1	-0.2	-0.3		0.0	-0.4	
Non-interest current account deficit	4.3	2.2	6.1	3.9	3.6	5.1	4.0	3.0	2.5	2.2	2.2		2.6	2.6	
Deficit in balance of goods and services	35.5	32.6	36.3			26.7	26.9	28.4	29.2	29.6	29.5		29.1	29.3	
Exports	12.7	16.9	17.2			18.1	18.4	19.2	20.2	21.3	22.4		22.8	22.3	
Imports	48.2	49.5	53.5			44.8	45.2	47.6	49.4	50.9	51.9		51.9	51.6	
Net current transfers (negative = inflow)	-29.5	-27.8	-27.4	-31.3	2.8	-18.2	-19.4	-21.9	-23.2	-24.0	-23.9		-23.3	-23.6	
<i>of which: official</i>	-4.7	-4.8	-3.8			-1.0	-2.0	-4.7	-4.6	-4.3	-4.1		-2.7	-1.4	
Other current account flows (negative = net inflow)	-1.7	-2.7	-2.9			-3.5	-3.5	-3.5	-3.5	-3.5	-3.4		-3.3	-3.0	
Net FDI (negative = inflow)	-2.0	-1.5	-1.1	-4.3	3.9	-2.3	-2.4	-2.4	-2.4	-2.5	-2.5		-2.6	-2.9	
Endogenous debt dynamics 2/	-2.8	-3.5	-3.1			0.6	0.2	0.1	0.0	0.0	0.0		0.0	-0.1	
Contribution from nominal interest rate	0.6	0.6	0.5			0.8	0.7	0.7	0.7	0.6	0.6		0.4	0.1	
Contribution from real GDP growth	-0.7	-0.8	-0.3			-0.2	-0.6	-0.7	-0.6	-0.6	-0.6		-0.4	-0.2	
Contribution from price and exchange rate changes	-2.7	-3.2	-3.4			...	...	...	...	...	...		...	...
Residual (3-4) 3/	7.7	6.3	3.9			-4.2	-3.2	-2.4	-2.2	-1.7	-1.6		-1.5	0.1	
<i>of which: exceptional financing</i>	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/	...	...	35.7			35.3	33.8	32.0	29.9	27.9	26.0		17.4	9.2
In percent of exports	...	...	207.5			195.1	184.1	166.9	147.9	131.0	115.9		76.5	41.4
PV of PPG external debt	...	...	35.7			35.3	33.8	32.0	29.9	27.9	26.0		17.4	9.2
In percent of exports	...	...	207.5			195.1	184.1	166.9	147.9	131.0	115.9		76.5	41.4
In percent of government revenues	...	...	197.6			194.8	186.8	174.4	161.9	148.9	137.6		89.8	46.7
Debt service-to-exports ratio (in percent)	9.8	7.1	7.6			9.0	13.9	14.2	14.2	12.9	11.2		8.4	1.1	
PPG debt service-to-exports ratio (in percent)	9.8	7.1	7.6			9.0	13.9	14.2	14.2	12.9	11.2		8.4	1.1	
PPG debt service-to-revenue ratio (in percent)	6.2	6.1	7.2			8.9	14.1	14.9	15.5	14.6	13.3		9.9	1.3	
Total gross financing need (Billions of U.S. dollars)	12.8	8.0	29.7			20.6	20.2	16.7	15.3	13.3	12.2		13.1	-0.2	
Non-interest current account deficit that stabilizes debt ratio	-2.8	-1.4	0.3			6.0	5.4	4.8	4.6	4.1	4.1		4.1	2.9	
Key macroeconomic assumptions															
Real GDP growth (in percent)	3.3	2.9	0.8	1.1	2.4	0.5	1.5	1.7	1.7	1.7	1.7	1.5	1.7	1.7	
GDP deflator in US dollar terms (change in percent)	12.2	11.4	10.5	9.0	7.4	-0.9	1.8	1.8	1.9	2.0	2.2	1.5	2.4	2.4	
Effective interest rate (percent) 5/	2.7	2.0	1.6	1.5	0.7	1.9	1.9	1.9	1.9	1.8	1.8	1.9	1.7	0.9	
Growth of exports of G&S (US dollar terms, in percent)	11.3	52.0	13.6	10.4	19.3	4.6	5.0	8.1	9.3	9.3	9.3	7.6	4.0	4.0	
Growth of imports of G&S (US dollar terms, in percent)	-1.6	17.8	20.5	12.8	12.4	-16.7	4.3	9.0	7.5	7.0	6.0	2.9	4.2	4.0	
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	11.1	35.4	35.4	35.4	35.4	35.4	31.3	35.4	35.4
Government revenues (excluding grants, in percent of GDP)	20.2	19.6	18.1			18.1	18.1	18.4	18.5	18.8	18.9		19.4	19.8	
Aid flows (in Billions of US dollars) 7/	25.2	28.5	46.6			27.1	29.7	27.2	27.1	26.6	26.0		21.0	16.8	
<i>of which: Grants</i>	25.2	28.5	46.6			27.1	29.7	27.2	27.1	26.6	26.0		21.0	16.8	
<i>of which: Concessional loans</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			5.9	6.6	5.9	5.7	5.4	5.1		3.4	1.8
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			88.0	87.7	86.8	86.7	86.5	86.3		83.8	81.0
Memorandum items:															
Nominal GDP (Billions of US dollars)	369.2	423.0	471.6			469.5	485.1	502.3	520.6	540.2	561.9		690.6	1043.2	
Nominal dollar GDP growth	15.9	14.6	11.5			-0.4	3.3	3.5	3.6	3.8	4.0	3.0	4.2	4.2	
PV of PPG external debt (in Billions of US dollars)	...	...	163.0			164.7	162.3	158.5	153.5	148.4	143.7		118.4	94.8
(PVt-PVt-1)/GDPt-1 (in percent)	...	...	...			0.3	-0.5	-0.8	-1.0	-1.0	-0.9	-0.6	-0.8	0.2
Gross workers' remittances (Billions of US dollars)	82.0	87.5	66.8			70.1	73.6	75.5	84.5	92.6	97.2		124.0	202.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	31.3			30.7	29.4	27.8	25.7	23.8	22.1		14.8	7.7
PV of PPG external debt (in percent of exports + remittances)	...	...	113.8			106.8	100.8	93.6	82.0	72.6	65.4		42.8	22.2
Debt service of PPG external debt (in percent of exports + remittances)	...	...	4.2			4.9	7.6	8.0	7.9	7.1	6.3		4.7	0.6

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g)] / (1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = 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, 2013–33 1/

(In percent)

	Projections							
	2013	2014	2015	2016	2017	2018	2023	2033
PV of debt-to GDP ratio								
Baseline	35	34	32	30	28	26	17	9
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	35	30	26	22	19	16	6	-1
A2. New public sector loans on less favorable terms in 2013-2033 2	35	34	33	31	29	28	21	15
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	35	34	33	31	29	27	18	10
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	35	35	37	35	33	31	21	11
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	35	34	32	30	28	26	17	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	35	29	24	22	20	18	11	6
B5. Combination of B1-B4 using one-half standard deviation shocks	35	26	19	17	15	14	8	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	35	47	45	42	39	36	24	13
PV of debt-to-exports ratio								
Baseline	195	184	167	148	131	116	77	41
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	195	163	134	109	89	73	28	-4
A2. New public sector loans on less favorable terms in 2013-2033 2	195	186	170	153	138	125	93	68
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	195	182	165	146	129	114	75	40
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	195	221	262	234	209	187	127	69
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	195	182	165	146	129	114	75	40
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	195	156	124	107	93	80	48	26
B5. Combination of B1-B4 using one-half standard deviation shocks	195	150	116	99	84	71	39	21
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	195	182	165	146	129	114	75	40
PV of debt-to-revenue ratio								
Baseline	195	187	174	162	149	138	90	47
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	195	166	140	119	101	86	32	-4
A2. New public sector loans on less favorable terms in 2013-2033 2	195	188	178	168	157	148	109	77
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	195	190	182	169	155	144	93	48
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	195	194	200	187	174	162	109	57
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	195	185	172	160	147	136	88	46
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	195	158	129	117	105	95	57	29
B5. Combination of B1-B4 using one-half standard deviation shocks	195	143	104	93	82	73	40	21
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	195	262	244	226	207	192	125	65

Table 1b. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2013–33 (continued)

(In percent)

Debt service-to-exports ratio

Baseline	9	14	14	14	13	11	8	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	9	12	12	11	9	8	4	0
A2. New public sector loans on less favorable terms in 2013-2033 2	9	13	14	14	13	11	9	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	9	13	14	14	12	11	9	2
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	9	15	19	19	17	15	13	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	9	13	14	14	12	11	9	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	9	13	13	13	12	10	7	1
B5. Combination of B1-B4 using one-half standard deviation shocks	9	14	15	14	13	11	7	1
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	9	13	14	14	12	11	9	2

Debt service-to-revenue ratio

Baseline	9	14	15	16	15	13	10	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	9	13	12	12	11	9	5	0
A2. New public sector loans on less favorable terms in 2013-2033 2	9	13	14	15	14	13	11	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	9	14	15	16	15	14	11	3
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	9	13	14	15	14	13	11	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	9	14	14	15	14	13	10	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	9	13	14	14	13	12	8	1
B5. Combination of B1-B4 using one-half standard deviation shocks	9	13	13	14	13	12	7	1
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	9	19	20	21	20	18	14	4
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	31	31	31	31	31	31	31	31

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, 2010–33 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Average ^{5/}	Standard Deviation ^{5/}	Estimate						Projections			
	2010	2011	2012			2013	2014	2015	2016	2017	2018	2013-18 Average	2023	2033	2019-33 Average
Public sector debt 1/	40.0	40.7	45.8			44.6	43.0	41.0	38.7	36.5	34.4		25.1	15.2	
<i>of which: foreign-currency denominated</i>	31.8	35.4	41.2			40.3	38.9	37.1	35.1	33.2	31.3		23.0	14.2	
Change in public sector debt	7.7	0.7	5.1			-1.2	-1.6	-2.0	-2.3	-2.2	-2.1		-1.7	-0.4	
Identified debt-creating flows	2.5	0.5	2.2			-1.4	-1.2	-2.7	-3.3	-3.2	-2.4		-1.5	-0.9	
Primary deficit	4.5	6.8	1.9	0.9	3.1	-1.2	-0.9	-2.2	-2.7	-2.5	-1.6	-1.9	-0.8	-0.4	
Revenue and grants	27.0	26.3	28.0			23.9	24.2	23.8	23.7	23.7	23.5		22.4	21.4	
<i>of which: grants</i>	6.8	6.7	9.9			5.8	6.1	5.4	5.2	4.9	4.6		3.0	1.6	
Primary (noninterest) expenditure	31.5	33.1	29.9			22.6	23.3	21.6	21.0	21.1	21.8		21.6	21.0	
Automatic debt dynamics	-2.0	-6.4	0.8			0.0	-0.3	-0.5	-0.6	-0.6	-0.8		-0.6	-0.5	
Contribution from interest rate/growth differential	-0.7	-1.2	-0.2			0.4	-0.1	-0.4	-0.4	-0.4	-0.4		-0.3	-0.3	
<i>of which: contribution from average real interest rate</i>	0.4	0.0	0.1			0.6	0.6	0.4	0.3	0.3	0.3		0.1	0.0	
<i>of which: contribution from real GDP growth</i>	-1.0	-1.1	-0.3			-0.2	-0.7	-0.7	-0.7	-0.7	-0.6		-0.5	-0.3	
Contribution from real exchange rate depreciation	-1.4	-5.2	1.0			-0.4	-0.2	-0.1	-0.3	-0.3	-0.4		...	...
Other identified debt-creating flows	0.0	0.1	-0.6			-0.2	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	0.0	0.1	-0.6			-0.2	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	5.3	0.2	2.9			0.3	-0.4	0.7	1.0	1.0	0.3		-0.2	0.5	
Other Sustainability Indicators															
PV of public sector debt	...	...	40.3			39.6	37.9	35.9	33.5	31.3	29.1		19.6	10.3
<i>of which: foreign-currency denominated</i>	...	...	35.7			35.3	33.8	32.0	29.9	27.9	26.0		17.4	9.2
<i>of which: external</i>	...	...	35.7			35.3	33.8	32.0	29.9	27.9	26.0		17.4	9.2
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	6.0	9.6	3.8			1.5	2.6	1.5	1.0	0.7	1.7		1.7	0.1	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	144.2			165.8	156.4	150.9	141.5	132.1	123.9		87.3	47.9
PV of public sector debt-to-revenue ratio (in percent)	...	...	223.1			218.5	209.3	195.4	181.4	166.8	154.3		100.9	51.8
<i>of which: external 3/</i>	...	...	197.6			194.8	186.8	174.4	161.9	148.9	137.6		89.8	46.7
Debt service-to-revenue and grants ratio (in percent) 4/	5.5	10.7	6.8			11.7	14.4	15.5	15.8	13.6	14.3		11.2	2.4	
Debt service-to-revenue ratio (in percent) 4/	7.4	14.4	10.5			15.4	19.3	20.1	20.2	17.2	17.8		12.9	2.6	
Primary deficit that stabilizes the debt-to-GDP ratio	-3.2	6.1	-3.1			-0.1	0.7	-0.2	-0.4	-0.4	0.5		0.8	0.0	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	3.3	2.9	0.8	1.1	2.4	0.5	1.5	1.7	1.7	1.7	1.7	1.5	1.7	1.7	
Average nominal interest rate on forex debt (in percent)	2.7	2.0	1.6	1.5	0.7	1.9	1.9	1.9	1.9	1.8	1.8	1.9	1.7	0.9	
Average real interest rate on domestic debt (in percent)	-0.3	-2.0	1.8	-3.1	4.6	2.8	2.4	1.6	1.1	0.7	0.5	1.5	0.0	0.0	
Real exchange rate depreciation (in percent, + indicates depreciation)	-5.6	-16.8	3.0	-5.3	8.2	-1.0	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.7	5.8	2.3	6.2	5.0	2.9	3.5	4.4	4.9	5.3	5.5	4.4	6.0	6.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	0.1	-0.1	0.0	0.2	-0.2	0.0	-0.1	0.0	0.0	0.1	0.0	0.0	0.0	
Grant element of new external borrowing (in percent)	...	...	...	...	...	11.1	35.4	35.4	35.4	35.4	35.4	31.3	35.4	35.4

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, 2013–33 1/

	Projections							
	2013	2014	2015	2016	2017	2018	2023	2033
PV of Debt-to-GDP Ratio								
Baseline	40	38	36	34	31	29	20	10
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	40	39	40	40	41	41	38	36
A2. Primary balance is unchanged from 2013	40	38	36	35	34	32	22	7
A3. Permanently lower GDP growth 1/	40	38	36	34	33	31	25	26
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	40	39	39	38	36	34	28	25
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	40	42	44	42	39	37	26	16
B3. Combination of B1-B2 using one half standard deviation shocks	40	41	43	41	39	37	29	22
B4. One-time 30 percent real depreciation in 2014	40	53	51	48	45	42	31	19
B5. 10 percent of GDP increase in other debt-creating flows in 2014	40	45	43	41	38	36	26	15
PV of Debt-to-Revenue Ratio 2/								
Baseline	166	156	151	142	132	124	87	48
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	166	162	168	170	172	172	169	168
A2. Primary balance is unchanged from 2013	166	155	153	148	143	136	97	33
A3. Permanently lower GDP growth 1/	166	157	153	145	137	131	109	121
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	166	161	163	157	150	145	124	114
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	166	172	186	176	166	157	118	73
B3. Combination of B1-B2 using one half standard deviation shocks	166	169	180	173	164	158	129	102
B4. One-time 30 percent real depreciation in 2014	166	220	214	202	191	180	136	89
B5. 10 percent of GDP increase in other debt-creating flows in 2014	166	187	182	173	163	154	115	70
Debt Service-to-Revenue Ratio 2/								
Baseline	12	14	15	16	14	14	11	2
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	12	14	16	16	15	17	16	9
A2. Primary balance is unchanged from 2013	12	14	15	16	14	15	12	2
A3. Permanently lower GDP growth 1/	12	14	16	16	14	15	12	6
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	12	15	16	17	15	16	13	6
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	12	14	16	17	16	17	13	4
B3. Combination of B1-B2 using one half standard deviation shocks	12	15	16	17	16	17	14	6
B4. One-time 30 percent real depreciation in 2014	12	17	21	21	19	20	17	5
B5. 10 percent of GDP increase in other debt-creating flows in 2014	12	14	16	17	16	17	13	4

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.



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IMF Executive Board Concludes 2013 Article IV Consultation with Tonga

On July 19, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga¹ on a lapse of time basis².

Economic growth slowed to 0.8 percent in fiscal year 2011/12 (July-June), from an average of about 3 percent during the previous three years. Reflecting the completion of public investment projects, Tonga's growth is likely to remain low in 2012/13, at about ½ percent. Starting in 2013/14, recovery of remittances and tourism—along with improved infrastructure—will lead economic growth to recover to a slightly lower growth rate than the historical trend.

Headline inflation has fallen significantly. After peaking at 9.7 percent in May 2011 (above the official reference range of 6–8 percent), inflation decelerated to 0.5 percent in April 2013, led mainly by imported food and oil prices. Going forward, inflation is expected to recover to about 5.5 percent.

There are no imminent risks to the external balance. Despite the continued contraction of remittances since 2008, increases in foreign grants and, more recently, a decline in imports led gross official foreign reserves to rise to about 8½ months of imports as of March 2013.

The overall budget deficit decreased to 2.7 percent of GDP in 2011/12 from 7.6 percent in the previous year. The 2012/13 budget aims to eliminate the fiscal deficit. While a mid-year assessment of the 2012/13 budget suggests that revenue collections could be less than budgeted, this is projected to be matched by spending restraint. Following an upgrade by the World Bank of its Country Policy and Institutional Assessment rating for Tonga's macroeconomic policies and institutions, the risk of external debt distress for the country has been reclassified from high to moderate. Monetary policy continues to be accommodative, and recent data show some signs of stabilization in credit growth.

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. 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.

² Under the IMF's lapse of time procedures, the Executive Board completes Article IV consultations without convening formal discussions.

Progress in improving the regulatory and institutional infrastructure has continued, including inauguration of a credit bureau.

Executive Board Assessment

On July 19, 2013, the Executive Board of the IMF concluded the Article IV consultation with Tonga and considered and endorsed the staff appraisal without a meeting.

The Tongan economy is expected to remain weak in FY 2012/13, following the completion of key public work projects. Beyond FY 2012/13, staff projects the economy to recover gradually, but to a slightly lower growth rate than the historical trend before the global financial crisis. Risks to the near-term outlook are tilted to the downside, reflecting external risks and weak business confidence.

The current macroeconomic policy mix, which combines fiscal consolidation and monetary accommodation, is appropriate. The overall fiscal deficit fell from 7.6 percent to 2.7 percent of GDP in FY 2011/12; and the FY 2012/13 budget aims to eliminate the remaining deficit. Monetary conditions have remained accommodative for the past three years.

In view of Tonga's level of external debt—an important vulnerability despite the Debt Sustainability Assessment rating upgrade—and the expected increase in debt repayments, fiscal consolidation should be sustained. The FY 2013/14 budget could aim to maintain a similar level of primary balance surplus as in FY 2012/13, to preserve cash buffers with the expected repayments on the external loans and limited borrowing options. A credible fiscal consolidation strategy should not factor in debt relief until it becomes certain, and the space that could result from debt relief should be prudently used.

The authorities need to start considering an unwinding of the accommodative monetary policy stance. In particular, the National Reserve Bank of Tonga should stand ready to mop up excess liquidity with the bottoming out of the credit cycle. At the same time, other efforts to overcome obstacles to renewed credit growth should continue. In this context the government's plan to further commercialize Tonga Development Bank has merits, but a thorough due diligence assessment is essential.

Staff strongly supports the creation of a presumptive tax regime for small and medium-sized companies and the natural resource tax regime. Revenue reform efforts should include streamlining and enhancing the transparency of tax exemptions. Formalization of the Public Financial Management (PFM) reform roadmap is important to demonstrate the authorities' commitment to reform and to inform technical assistance from donors.

Tonga's structural challenges to growth call for reforms to strengthen investor confidence. Reforms should focus on policy coordination and judicious deregulation. The current framework for coordination could be further strengthened, for example by establishing a high-level coordinator. A tailored support mechanism for foreign investors should also be put in place. The business licensing reform has achieved an important milestone, and could now focus on easing ancillary licenses.

Tonga: Selected Economic Indicators, 2008/09–2013/14 1/

	Average				Prelim. 2011/12	Projections	
	2003-12	2008/09	2009/10	2010/11		2012/13	2013/14
Output and prices (annual percent change)							
Real GDP 2/	1.1	3.2	3.3	2.9	0.8	0.5	1.5
Consumer prices (period average)	7.1	5.5	1.7	6.0	3.3	2.9	3.5
Consumer prices (end of period)	6.9	1.2	2.7	7.1	2.3	3.0	4.0
GDP deflator	6.2	-2.4	3.7	5.8	2.3	2.9	3.5
Central government finance (in percent of GDP)							
Total revenue and grants	26.6	34.3	27.0	26.3	28.0	23.9	24.2
Total revenue	22.6	27.4	20.2	19.6	18.1	18.1	18.1
Grants	4.0	6.8	6.8	6.7	9.9	5.8	6.1
Total expenditure and net lending	28.2	34.4	32.3	34.0	30.6	23.7	24.3
<i>Of which:</i> Current expenditure	23.9	25.2	25.8	23.0	23.9	21.6	21.7
Capital expenditure	2.6	2.7	2.6	9.4	5.6	2.0	2.5
Overall balance	-1.6	-0.2	-5.3	-7.6	-2.7	0.2	-0.1
Overall balance (excl. China's EXIM Bank loans)	1.1	6.1	-0.2	1.6	3.2	1.2	-0.1
External financing (net)	n.a.	-0.7	3.5	8.4	5.2	-0.7	-0.3
Domestic financing (net)	n.a.	-5.2	1.9	-0.8	-2.5	0.5	0.4
Money and credit (annual percent change)							
Total liquidity 3/	7.9	-1.8	5.1	3.1	-1.7	8.2	7.0
<i>Of which:</i> Broad money (M2)	8.2	-2.4	5.6	3.3	-1.8	8.4	7.2
Domestic credit	5.3	-5.2	-11.5	-12.3	-8.7	-5.9	10.9
<i>Of which:</i> Private sector credit	5.5	-3.7	-15.6	-9.9	-2.7	-6.9	8.1
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	...	...
Balance of payments (in millions of U.S. dollars)							
Exports, f.o.b.	12.2	7.2	7.9	10.9	14.8	15.3	16.1
Imports, f.o.b.	-123.0	-130.5	-130.4	-152.5	-179.3	-136.5	-142.0
Services (net)	-8.7	-15.2	-8.5	3.5	-6.8	-4.2	-4.4
Investment income (net)	4.8	6.4	4.0	9.0	11.2	12.7	13.3
Current transfers (net)	99.6	104.0	109.0	117.5	129.0	85.3	94.0
<i>Of which:</i> Remittances	89.9	84.0	82.0	87.5	66.8	70.1	73.6
Current account balance	-15.1	-28.1	-17.9	-11.6	-31.1	-27.6	-23.0
(In percent of GDP)	-4.3	-8.8	-4.9	-2.7	-6.6	-5.9	-4.7
Overall balance	46.9	19.5	19.7	33.2	19.8	2.7	3.6
Terms of trade (annual percent change)	0.1	-4.5	5.1	-4.4	0.0	-0.5	1.2
Gross official foreign reserves							
In millions of U.S. dollars	65.7	67.7	87.5	120.7	140.5	143.3	146.8
(In months of next year's goods and services imports)	4.4	4.6	5.0	5.7	8.0	7.8	7.4
External debt (in percent of GDP)							
External debt	32.0	31.5	31.8	35.4	41.2	40.3	38.9
Debt service ratio	1.2	0.7	1.2	1.2	1.3	1.6	2.5
Exchange rates							
Pa'anga per U.S. dollar (period average)	2.0	2.1	1.9	1.8	1.7	1.8	1.8
Pa'anga per U.S. dollar (end of period)	1.9	2.0	1.9	1.7	1.8	1.8	1.8
Nominal effective exchange rate (2005=100)	98.8	95.7	96.9	97.4	103.4	102.4	100.6
Real effective exchange rate (2005=100)	102.6	107.5	108.3	111.5	118.4	118.4	118.4
Memorandum items:							
Remittances (in percent of GDP)	29.3	26.4	22.2	20.7	14.2	14.9	15.2
Tourism (in percent of GDP)	6.3	8.7	7.0	7.9	7.7	8.5	8.8
FDI (in percent of GDP)	5.2	12.0	2.0	1.5	1.1	2.3	2.4
Nominal GDP (millions of T\$)	623.8	664.3	712.2	775.0	799.3	826.3	868.1
Population (thousands)	102.0	102.5	102.8	103.0	103.3	103.5	103.8

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.