IMF Country Report No. 12/166

TONGA

2012 ARTICLE IV CONSULTATION

July 2012

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 2012 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 8, 2012, 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 May 1, 2012. 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** (DSA) prepared by the IMF and the International Development Association.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its May 16, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Tonga.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

May 1, 2012

KEY ISSUES

Context. Economic activity is recovering gradually from the effects of the global slowdown and the domestic credit crunch. Inflation has fallen due to moderating commodity prices and exchange rate appreciation. Reserves have risen and remain comfortable with large trade deficits financed by official inflows and remittances. The key policy challenge now is to navigate the uncertain global environment, create policy space to meet future potential shocks, and build the foundations for faster and more inclusive growth.

Focus. The consultation focused on the following broad themes:

- ***Spillovers and risks.*** After gradually recovering in 2010–11 from the global crisis, thanks in part to a fiscal stimulus funded through concessional loans, growth should move toward its 1¾ percent trend rate led by private domestic demand. But the global environment poses a downside risk, particularly potential spillovers of lower remittance inflows, tourism receipts, and foreign aid.

- ***Enhancing resilience to shocks.*** The economy is undiversified, remittance-dependent and prone to natural disasters. Rebuilding large fiscal, external, and financial buffers would help cushion adverse shocks and support sustainable growth. The key near-term policy challenge is to support economic recovery and control inflation, while moving toward fiscal consolidation and preserving financial and external stability.

- ***Building faster and more inclusive growth*.** Implementing the Tongan development strategy to unleash natural resource endowments in agriculture, tourism and fisheries could raise potential growth and make it more inclusive. However, social protection programs will also be needed to support vulnerable communities in an environment of declining remittances.

Approved By
Thomas Rumbaugh and Thomas Dorsey

Mission team: Shanaka J. Peiris (Head), Huidan Lin, Souvik Gupta (all APD) and Yongzheng Yang (Resident Representative). Shasha Ridzam (OED), Tobias Haque (World Bank) and Lai Tora (AsDB) joined the mission. Mission Dates: February 23–March 8, 2012

CONTENTS

INTRODUCTION

1. Context. The weak global environment is affecting the economy through lower remittances and represents a clear downside risk to the outlook. Tonga also remains at high risk of external debt distress and is vulnerable to natural disasters. The rising debt service burden may squeeze priority public spending and crowd out private investment. A recently concluded economic dialogue with wide stakeholder participation identified the need to raise the relatively low rate of potential growth.

2. Politics. The country was deeply saddened by the sudden passing away of his Majesty King George Tupou V in March 2012. The late king's brother, Crown Prince Tupouto'a Lavaka, has been formally proclaimed as King Tupou VI in a recent ceremony. The coronation is not expected to affect public administration following the transfer of most executive powers to the Parliament in 2006. A new government took office in early 2011 following the first parliamentary elections under which a majority of seats were popularly elected. The cabinet has been reshuffled a few times since then and the authorities will undertake a major restructuring of line ministries in 2012/13 that may disrupt some public services. It was recently announced that a new ministry will be created in charge of revenue services that will be independent of the newly appointed Minister of Finance and National Planning.

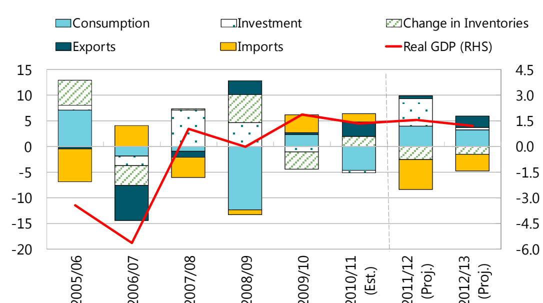
3. In concluding the 2011 Article IV consultation (May 4, 2011), the Executive Directors noted that Tonga's economy is recovering from the recent internal and external shocks on the back of stronger tourism activity and fiscal expansion. The policy challenge now is to reduce the country's vulnerabilities and to boost potential growth. Directors stressed that in the near term, fiscal consolidation is necessary to ensure fiscal sustainability and expand fiscal space to respond to future shocks.

RECENT DEVELOPMENTS

4. Growth. Growth is estimated by staff to have recovered to 1½ percent in FY2010/11 from zero percent in FY2008/09.[1] Two factors have contributed to the recovery. First, gross fixed investment and inventory buildup have strengthened since late 2010, thanks to the construction activity funded by the China EXIM Bank loans. Second, tourism receipts rebounded from the middle of 2010. On the other hand, private consumption has remained anemic due to the decline in remittance inflows. In addition, banks' lending standards have remained tight, constraining private consumption and investment.

5. Inflation. Inflation peaked in the

GDP Growth by Expenditure
(Year-over-year; in percent)

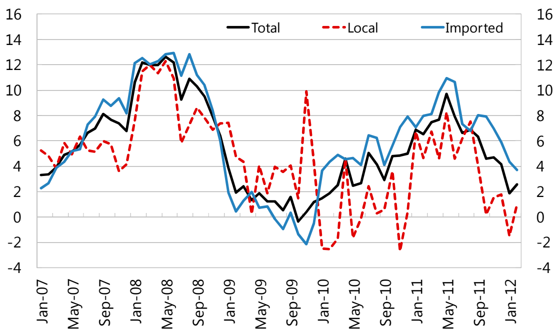


Sources: Country authority; and Fund staff calculations and projections.

[1] Revisions to national accounts data showed a more moderate decline in GDP during the global downturn partly due to a more frontloaded utilization of the China EXIM Bank loans than previously anticipated.

second quarter of 2011 at 8½ percent year-over-year (y/y) and has been on a downward trajectory, due mainly to moderating global food and oil prices as well as exchange rate appreciation. CPI inflation had eased to around 2½ percent y/y in February 2012.

Consumer Price Inflation
(Year-over-year; in percent)



Sources: Country authority; and Fund staff calculations.

6. **Balance of payments.** The trade deficit remained high but the current account balance improved to a deficit of 1½ percent of GDP in FY2010/11 (from a deficit of 6¾ percent in FY2009/10) because of the increase in official grants and tourism receipts. The level of reserves increased to around $120 million in the second quarter of 2011 (from below $90 million in 2011Q1), and had further increased to around $130 million as of end-2011, covering more than 6 months of imports of goods and services.

7. **Public finances.** The fiscal deficit was estimated to have been six percent of GDP in the year ending in June 2011–broadly unchanged from a year ago but higher than anticipated in the last staff report reflecting a more frontloaded utilization of the China EXIM Bank loans. An estimated 3¾ percentage points of GDP increase in capital expenditure was led by utilization of the China EXIM Bank loans (amounting to about 7½ percent of GDP). The overall balance (excluding the China EXIM Bank loan spending) showed a surplus of about 1½ percent of GDP due to restraint on current expenditure. Tax collections remained weak, however, due mainly to anemic consumption and customs taxes.

KEY THEMES FOR THE CONSULTATION

A. Spillovers and Risks

Staff's views

8. **Outlook.** Economic activity is expected to continue its recovery in the medium term, albeit decelerate slightly to 1.2 percent in FY2012/13 from 1.6 percent in 2011/12 due to the withdrawal of fiscal stimulus related to the completion of the constructions funded by the China EXIM Bank loans (Table 1). Over the medium term, growth is expected to remain at around 1.8 percent, in line with the historical average. Underlying this medium-term projection, private consumption is anticipated to be more resilient with the bottoming out of the decline in remittances while both investment and exports are projected to be stronger, helped by a gradual easing of financing conditions and several ongoing programs to boost exports and tourism. On the other hand, Tonga has been one of the region's leading reformers in reducing the costs of doing business and undertaking public enterprise reform according to the Asian Development Bank (Central African Republic) and World Bank (WB), and a further continuation of reforms, if implemented, could raise its

potential growth above what is reflected in the baseline projection.

9. Spillovers and risks. Risks to the outlook are tilted toward the downside. On the domestic front, growth would be lower if the fiscal authorities are unable to boost priority spending on productive sectors due to cash constraints and/or scale-up domestic borrowing. On the external front, given Tonga's interconnectedness to the regional economy (Figure 1 and Box 1), a severe shock to global growth would hit Tonga's economy hard, feeding through a number of channels:

- *Remittances.* Remittances from the large number of Tongans who live abroad had averaged about 32 percent of GDP over the last decade. During 2010/11, remittances dropped by 9¼ percentage points of GDP (from 2007/08) to 21 percent of GDP. Remittances from New Zealand declined by 30 percent and those from the US declined by 25 percent, while remittances from Australia increased by 50 percent, thanks partly to the Pacific Seasonal Worker Pilot Scheme that was launched in August 2008. Staff analysis suggests that macroeconomic conditions in remitting countries (mainly Australia, New Zealand and the United States) and exchange rate fluctuations influence remittances, providing a direct channel of spillover from lower global growth. On the expenditure side of GDP, private consumption (85 percent of GDP) will be affected the most, especially given the ongoing domestic credit crunch.

- *Exports and Tourism.* The export-to-GDP ratio is low (less than 5 percent of GDP) and mainly destined to Australia, New Zealand and the United States (28 percent in total), so the impact through the trade channel is likely to be small. Tourism has been the second largest source of foreign exchange (8–10 percent of GDP) after remittances and a key sector of growth that is highly susceptible to the global business cycle as observed in 2009/10 when tourist arrivals declined by 12 percent from the previous year. Despite signs of bottoming out, both cruise ship and air arrivals in 2010/11 stayed below pre-crisis levels.

- *Foreign Aid.* Foreign aid (about 5–10 percent of GDP) could be susceptible to a tail event in Europe as the European Union has been one of the largest providers of budget support grants.[2] Lower project and budget support grants will lead to reduced public spending given the cash constraints of the government. However, the important role played by multilateral donors (Central African Republic and WB), China, and the planned medium-term rise in foreign aid by Australia and New Zealand would help mitigate those risks.

- *Commodity prices.* A decline in global food and fuel prices could provide some relief to household budgets. However, if fuel prices were to increase due to supply disruptions or geopolitical events, the country would suffer from higher inflation and a wider current account deficit, in addition to weak growth.

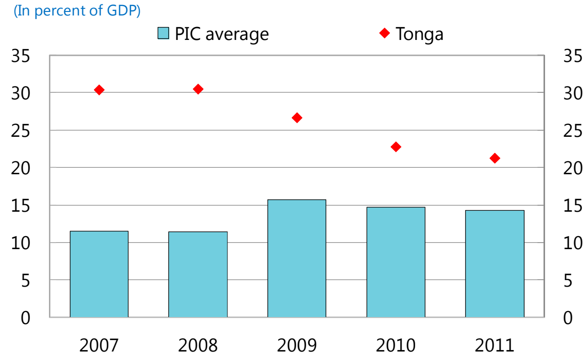
---

[2] Budget support grants from EU are 12.4 million pa'anga in 2011/12 and are projected to be 4.7 million pa'anga in the coming fiscal year.

Figure 1: Channels of Spillovers to Tonga

Remittance–the largest source of foreign exchange–are yet to recover from the crisis…

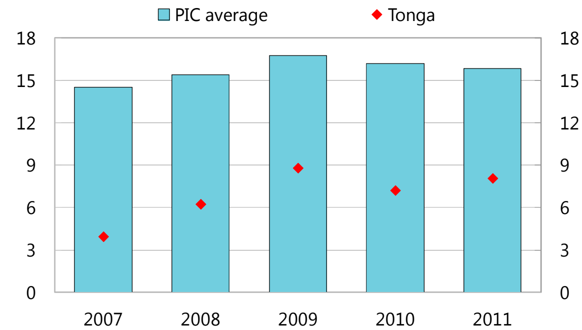
Remittances
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations.

…while tourism receipts seem to have bottomed out.

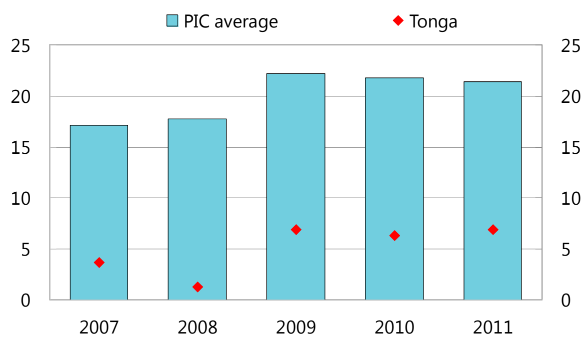
Tourism
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations.

Official grants have been on the rise…

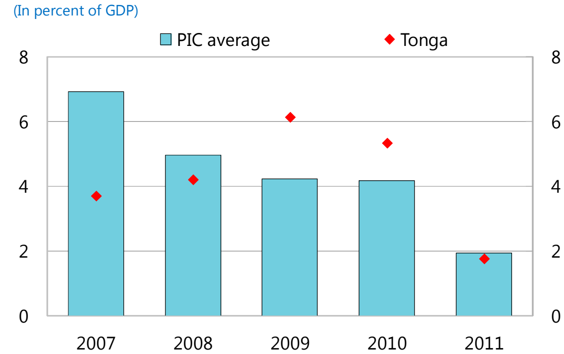
Grants
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations.

…while private capital inflows remain low.

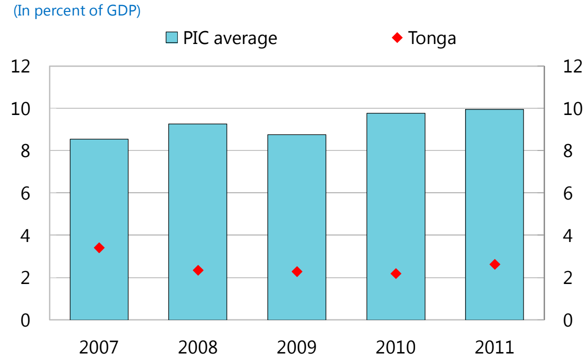
FDI
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations.

Exports of goods have fallen to a very low level…

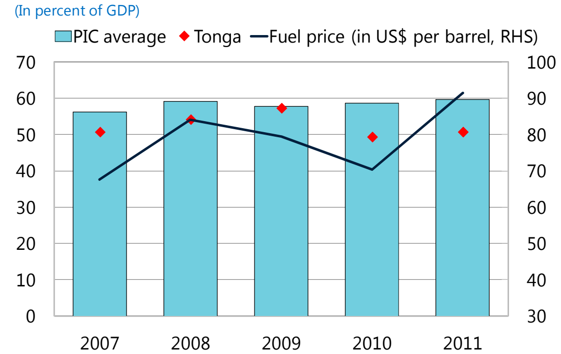
Exports
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations.

…while imports remain high and sensitive to fuel prices.

Imports
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations.

Box 1. Tonga: Growth Spillovers from the Global Economy

Shocks to external growth and terms of trade are found to affect Tonga's growth. Remittances, tourism and exports are important transmission channels for such external shocks.

Methodology

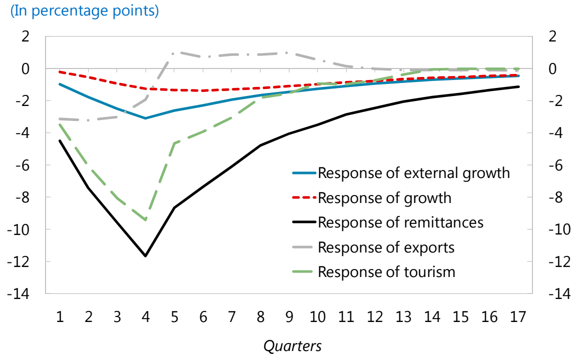
The empirical estimation follows a Bayesian Vector Autoregression (BVAR) approach by Osterholm and Zettelmeyer (2008).[1] This method uses informative priors on steady-state values and thus improves the efficiency and is particularly appropriate given the short sample period. The sample covers the period of 1996Q1–2011Q2. The external GDP growth rate is an average of the growth rates in Australia, New Zealand, and the United States, weighted by their relative shares of Tongan exports during the sample period. The quarterly growth rate in Tonga is estimated as a function of the number of containers that arrived in the country, as quarterly GDP growth data are not available.

Effects of External Growth and Terms of Trade Shocks on Growth in Tonga

Shocks to external growth are found to have a larger impact than shocks to terms of trade on growth in Tonga. A 1-percentage point negative shock to external growth of its major trading partners causes Tongan growth to decline by 1.3 percentage points after four quarters and 1.4 percentage points after six quarters. On the other hand, a 10-percent increase in global fuel prices causes Tongan growth to decline by 0.2 percentage points after two quarters.

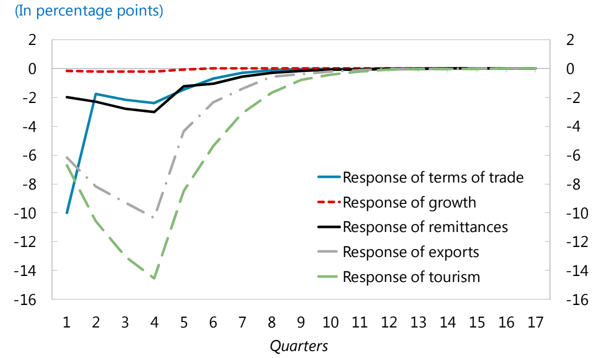
- **Remittances are the most important transmission channel of external growth shocks, followed by tourism and exports**. A 1-percentage point negative external growth causes remittances growth to decline by 12 percentage points after four quarters.
- **Tourism and exports are more important than remittances to transmit the impact of shocks to terms of trade.** A 10-percent increase in global fuel prices causes tourism growth (export growth) to decline by 15 (10) percentage points after four quarters.

Impulse Responses to an External Growth Shock
(In percentage points)



Source: Fund staff estimates.

Impulse Responses to a Terms-of-Trade Shock
(In percentage points)



Source: Fund staff estimates.

---

[1] Osterholm, P. and J. Zettelmeyer, 2008, "The Effect of External Conditions on Growth in Latin America," *IMF Staff Papers*, Vol. 55, No. 4, pp. 595−623 (Washington: International Monetary Fund).

Authorities' views

10. Outlook and risks. The authorities agreed that the China EXIM Bank loans have supported the economic recovery (albeit with a relatively low multiplier effect due to the high import content of the reconstruction loan) but that private domestic demand can replace the fiscal stimulus and help maintain a growth rate of 1–2 percent over the medium term. They also shared the staff's view that the weak global environment represents a clear downside risk, in particular through spillovers on remittances and tourism. The authorities recognized the importance of boosting public priority spending and continuing the public enterprise reform momentum to support private sector development.

B. Enhancing Resilience to Shocks

Rebuilding fiscal buffers

11. Background. Staff projects a fiscal deficit of about 2¾ percent of GDP in FY2011/12 (an improvement of 3¼ percentage points of GDP from the 2010/11 level) primarily due to higher grants, continued restraint on current spending, and lower capital expenditure. Increased budget support grants are expected to help the government build up cash balances to better plan for public services.[3] Capital expenditure is expected to be lower by 2 percentage points of GDP due to the accelerated completion of the reconstruction of the central business district and near completion of the road projects using the China EXIM Bank loans. The overall balance (excluding the China EXIM Bank loans) is expected to rise to a surplus of about 3⅓ percent of GDP in 2011/12 (Table 2).

Staff's views

12. Debt sustainability. While the 2011/12 budget execution goes some way toward reducing fiscal vulnerabilities, Tonga remains at a "high risk of external debt distress" according to the World Bank-IMF debt sustainability analysis (DSA). In addition, free cash balances of the government amount to less than two months of current spending. These vulnerabilities call for rebuilding the fiscal policy buffer that was drawn down following the acquisition of two loans from the China EXIM Bank with a face value totaling around 25 percent of GDP (Figure 2). To create room to deal effectively with potential shocks, including frequent natural disasters, and reduce the net present value (NPV) of public external debt below 30 percent of GDP (indicative DSA threshold level), the authorities should continue to rebuild cash balances in the short term to at least two months of current spending and attain an average primary surplus of about 1 percent of GDP in the medium to long term.

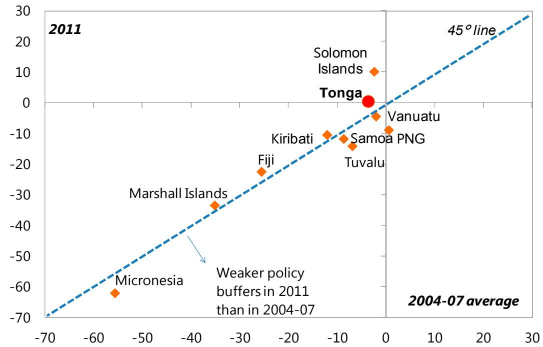
13. 2012/13 budget and medium-term fiscal framework (Table 2). In order to maintain spending on development priorities, laid out in the Tonga Strategic Development Framework (TSDF), and achieve fiscal consolidation, it will be essential to raise the tax effort. The 2012/13 budget and medium-term fiscal framework should aim to raise the relatively low tax-to-GDP ratio by at least 0.5 percentage point of GDP annually for the next two years based on the recommendations of the PFTAC tax review (Box 2).

[3] The World Bank disbursed the first of two proposed budget support grants to Tonga in November 2011 focused on improving public financial management.

Figure 2. From Crisis to Recovery – Rebuilding Policy Buffers 1/

Tonga's overall buffer to withstand shocks has remained weak after the crisis…

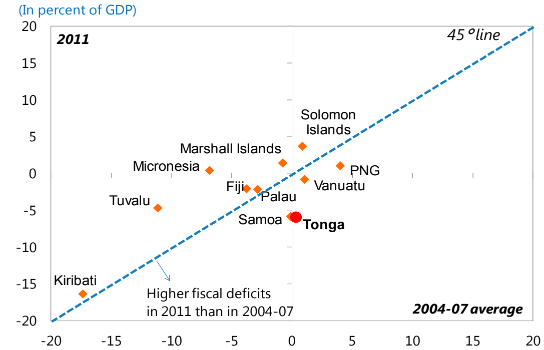
Overall Buffer Index, 2004-07 and 2011



Sources: Country authorities; and Fund staff calculations

…due mainly to a deterioration of the fiscal stance …

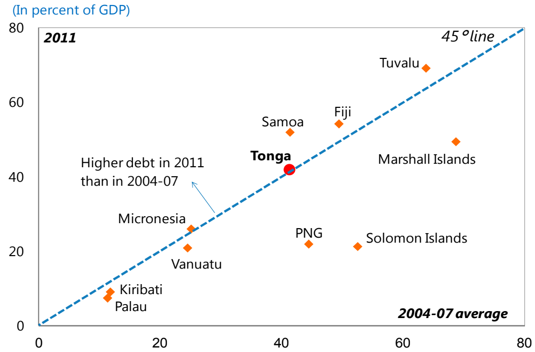
Fiscal Balance
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations

…and the still high level of government debt.

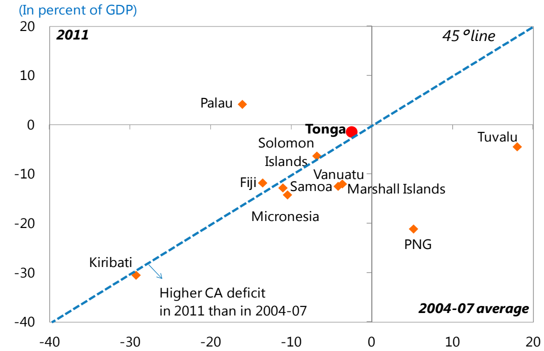
Gross Public Debt
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations

The current account has improved…

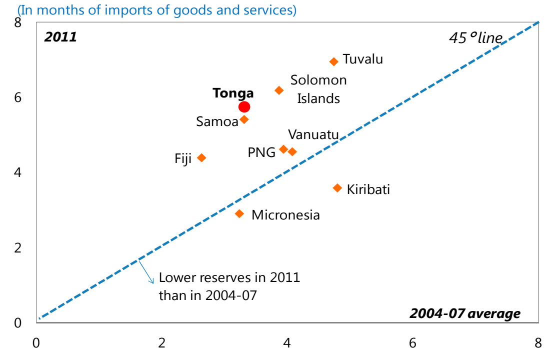
Current Account Balance
(In percent of GDP)



Sources: Country authorities; and Fund staff calculations

…and reserves have been built up on the back of increased grant inflows and improvement in tourism receipts…

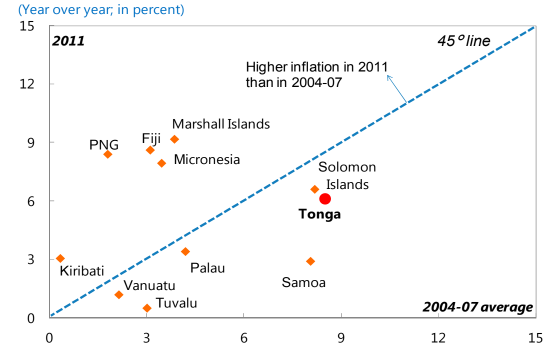
FX Reserves
(In months of imports of goods and services)



Sources: Country authorities; and Fund staff calculations

…while inflation has remained moderate.

Inflation
(Year over year; in percent)



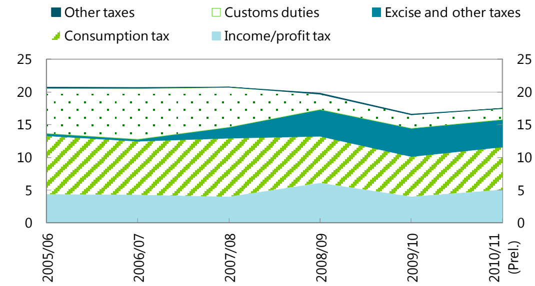
Sources: Country authorities; and Fund staff calculations

1/The overall buffer index is the sum of the 5 individual buffers normalized by their respective standard deviations during 2004–07.

Box 2. Tonga: Tax Reform

Tonga faces a number of fiscal challenges in part due to weak revenue performances. Tonga has implemented a series of tax reforms over the past few years: (i) introduction of a value-added tax known as consumption tax (CT) in 2005, (ii) modernization of income taxes in 2008, and (iii) reduction in customs tariffs since 2008 as part of its accession to WTO. In the early stages of the reforms, revenues rose faster than expected. However, recently collections have been anemic due to the weak economy, decline in remittances and a shrinking share of trade taxes (despite increases in excises).

Composition of Tax Revenue
(In percent of GDP)



Sources: Country authority; and Fund staff calculations.

A recent PFTAC review of Tonga's revenue policy highlighted some of the tax reform priorities.[1] The review finds that the tax policy setting in Tonga is reasonable in a comparative context but there is room for improvement in the efficiency and effectiveness of revenue collection.

The first pillar: Tax policy reforms – remove leakages and reduce distortions

(a) Eliminate discretionary exemptions: The process for approving and monitoring exemptions should be strengthened including by publishing potential costs of the exemptions.

(b) Introduce a simplified presumptive taxation for small- and medium-sized enterprises (SMEs): While rates could be low, it would encourage the SMEs to enter the formal sector of the economy.

(c) Penalties and interest rates: The penalties regime should be reviewed to reduce the severity of the current regime, and to differentiate between interest and penalties for non-compliance versus under-reporting.

(d) Taxation of natural resources: Tonga has already allowed exploration for deep sea mining and a taxation structure should be put in place before any mining agreements are negotiated.

The second pillar: Reforms of tax administration

Success of a country's tax policy lies with the capacity and capabilities of its tax administration. Training of staff, simplifying tax return forms, establishing comprehensive audit and collection monitoring system, and educating taxpayers are essential. Emphasis should be given to arrest the decline in CT productivity and raise it to the levels comparable to regional peers by: (i) increased scrutiny of taxpayers who are close to the threshold to improve compliance; and (ii) faster refunds of input tax credits to encourage businesses to file claims in a timely manner.

Selected PICs: Comparison of Value Added Tax (VAT) Productivity 1/

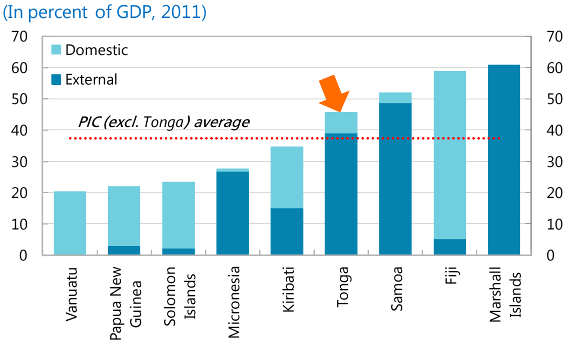
Country	2006	2007	2008	2009	2010
Tonga	0.57	0.55	0.60	0.48	0.43
Samoa	0.81	0.63	0.56	0.54	…
Fiji	0.70	0.57	0.63	0.62	0.72
Vanuatu	0.51	0.56	0.61	0.55	0.51

Source: Cotton, Jenkins, and Mullins (2011).
1/ VAT productivity is defined as VAT-to-GDP ratio divided by the VAT rate.

[1] Cotton, Jenkins, and Mullins (2011): "Revenue Policy and Administration Review", *Aide-Mémoire*, International Monetary Fund, Pacific Financial Technical Assistance Center.

Otherwise, the expenditure envelope available for 2012/13 and 2013/14 would imply a harmful cut in the wage bill and/or increased domestic borrowing to rollover the rising external debt repayments of the China EXIM Bank loans.[4] The higher revenues and the level of budget support grants committed to by the donor community will help raise domestically-funded priority spending as the China EXIM Bank loan stimulus is withdrawn, while achieving an overall surplus (excluding the China EXIM Bank loans) of about 1 percent of GDP in 2012/13 and in the medium term. This should also be accompanied by strengthening debt management and avoiding any new external borrowing at least until 2014/15 when the NPV of debt-to-GDP should fall below the indicative DSA threshold level.

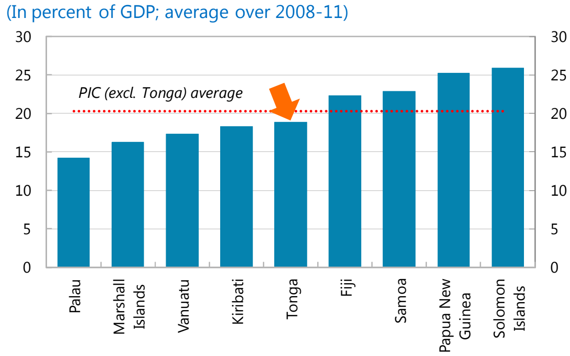
Selected PICs: Public Sector Debt
(In percent of GDP, 2011)



Sources: Country authorities; and Fund staff calcualtions.

14. Tax reforms. The sequenced implementation of the PFTAC tax review will help achieve the revenue targets (Box 2). In particular, the 2012/13 budget should include specific tax reform measures aimed at:
(i) reducing tax concessions and strengthening the process for granting new exemptions;
(ii) broadening the tax base by introducing a presumptive tax for small- and medium-sized enterprises (SMEs); (iii) rationalizing the penalties and interest regime for non-compliance; and (iv) ensuring better revenue services and expediting tax refund processes. The 2013/14 budget could consider limiting deductions for income taxes and introducing a natural resource tax regime particularly for seafloor mining with PFTAC TA.

Selected PICs: Tax Revenues
(In percent of GDP; average over 2008-11)



Sources: Country authorities; and Fund staff calcualtions.

15. Expenditure reforms. On the expenditure side, Tonga needs to build on the recent progress in public financial management (PFM). The publication of monthly financial reports have improved fiscal transparency and clearly identified the need to limit within-year reallocations to non-priority programs. Over the short term, continued efforts should be put on reining in the wage bill by adhering to the partial recruitment freeze and containing across-the-board wage rises instituted in 2011.[5] This would avoid a squeeze on non-wage expenditures, a problem that has plagued Tonga in the past.

[4] Staff discussed the negative implications of a no-tax reform scenario in the context of the DSA.

[5] In July 2011, the cabinet brought recruitment in all parts of the public service under centralized control of the Ministry of Finance and National Planning agreed there would be no across-the-board or sector-specific wage rises in FY2011/12 or FY2012/13.

16. Quality of spending. Over the medium term, the focus should remain on improving the quality of spending and implementing a medium-term budget framework (MTBF). To ensure a sustainable reduction in the share of the wage bill to 45 percent of domestic expenditures as envisaged by the Government, a broader restructuring of the public services that efficiently consolidates line ministries and introduces a performance-management system will be essential. While the authorities aim to reduce the share of the wage bill to 45 percent of domestic spending within three years, the staff projects a more gradual reduction in the wage bill to about 47¼ percent by 2016/17 given the no-redundancy policy and assuming wage rises broadly in line with inflation. This will allow a gradual increase in spending on priority economic and social sectors, including maintaining the recently constructed roads financed by the China EXIM Bank (Box 3). In this context, the implementation of the MTBF will help better align budgetary allocations with government priorities. However, the MTBF alone will not ensure quality spending without improved monitoring of spending outcomes and limiting within-year reallocations. A better quality of spending and improvements to PFM systems should help garner further budget support under the common policy matrix.

Authorities' views

17. The authorities are cognizant of the high debt burden and are committed to a medium-term fiscal consolidation. They recognized the need for revenue enhancement to meet future debt service obligations and deficit targets while maintaining an adequate level of public services. The Ministry of Finance and National Planning intends to submit to cabinet legislation relating to the introduction of a presumptive tax for SMEs and will consider staff's other tax reform proposals for the 2012/13 and 2013/14 budgets. The authorities felt that expenditure prioritization would be a challenging task but would continue its efforts on reducing wasteful expenses and aim to bring down the wage bill to 45 percent of government funded expenditure over the next three years from about 54 percent at present. The Government recognizes that containing the wage bill requires limiting across-the-board pay rises and sees the public sector restructuring as an opportunity to realign personnel with policy priorities. With regard to future infrastructure projects, the authorities wanted to explore public private partnerships as an option and committed not to borrow externally until the risk of external debt distress recedes.

Maintaining external stability

18. Background. Buoyant official development assistance has helped further build up the reserve buffer (Figure 2). The current account balance is projected to be at a deficit of 6 percent of GDP in 2011/12 and average around 3¾ percent of GDP in the medium term as concessional loan funded imports taper off and the decline in remittances bottoms out (Table 4). The capital and financial account is projected to be around 7 percent of GDP in FY2011/12 and gradually decline to around 2 percent of GDP over the medium term as official foreign borrowing is phased out.

Tonga: FX Reserve Adequacy

		Proj.	
	2010/11	2011/12	2012/13
Import coverage 1/	5.7	5.9	6.2
Reserves/M2 (percent)	68.6	69.2	74.0
Reserves/GDP (percent)	29.3	26.6	28.2

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

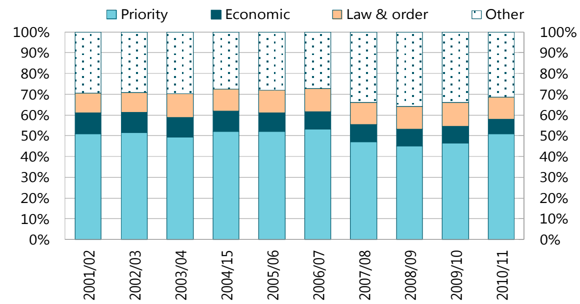
1/ in months of next year's imports of goods and services.

Box 3. Tonga: Improving Expenditure Quality[1]

Improving the quality of spending is critical to maintain public service delivery while pursuing fiscal consolidation. In the 2011/12 budget, the authorities emphasized the importance of carefully reprioritizing public expenditure in order to adequately resource priority areas in the face of tight fiscal constraints. To achieve this, the authorities need to focus on three key principles:

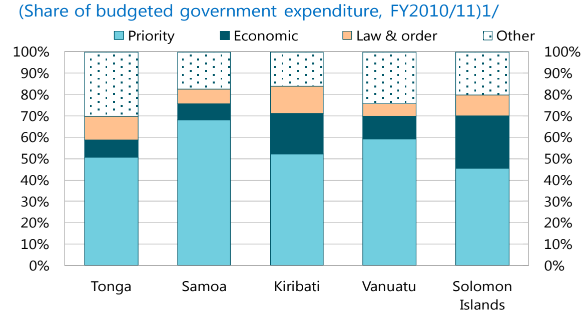
- First, a higher proportion of expenditure needs to be directed to priority sectors in the annual budget, particularly to infrastructure and economic sectors.
- Secondly, a higher proportion of expenditure needs to be directed to critical programs within each sector.
- Thirdly, budget execution needs to be strengthened so that resources are not reallocated away from priority sectors and critical programs within each sector during the budget year.

Allocations to Priority and Other Sectors
(Share of actual government expenditure)



Sources: Country authority, and World Bank staff calculations.

Regional Comparison: Allocations to Priority and Other Sectors
(Share of budgeted government expenditure, FY2010/11)1/



Sources: Country authorities, and World Bank staff calculations.
1/ Indicative allocations.

To date, the authorities have been more successful in prioritizing allocations in the budget (both between and within sectors), than in maintaining those priorities during the budget year through strict budget execution. To address this weakness, a number of aspects of budget execution need to be strengthened over the medium term.

- Expenditure from the Contingency Fund (CF) and the transfer of resources between ministries through the CF has tended to shift resources from higher to lower priority sectors in recent years. This trend needs to be reversed, through the strict reservation of CF funds for urgent, vital and unforeseeable expenditure and the avoidance of inter-ministerial transfers.
- Within ministries, considerable resource transfers are occurring between line items, major expenditure categories and sub-programs. These transfers tend to reduce the quality of expenditure, by shifting resources to lower priority areas and lower value expenditure types.
- The authorities have strengthened in-year budget monitoring in 2011/12, which could provide a solid foundation for improving the dialogue with line ministries on budget execution. The realignment of budgetary allocations to match the new ministerial structure in 2012/13 should be taken as an opportunity to redefine line ministry programs, enabling existing transfer rules to be applied with greater effect. There may also be merit in introducing new rules to limit transfers involving particular line items, major expenditure categories or sub-programs that are critical to the achievement of key policy objectives and where significant problems have been experienced to date.

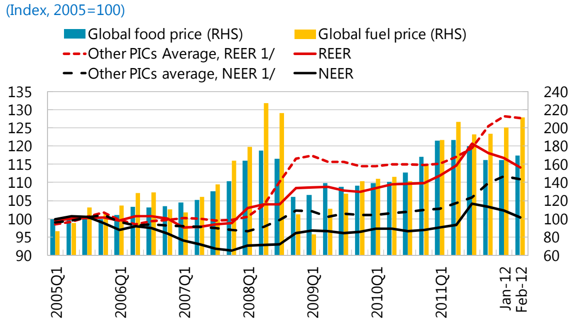
Note: 'Priority' sectors refer to education and training, health, and infrastructure – as identified within the TSDF; 'Economic' sectors refer to agriculture and fisheries, commerce, and tourism; 'Law & order' sectors refer to police and prisons, justice, and crown law; 'Other' sectors refer to all other sectors, with the exception of finance which is excluded from the analysis to avoid distortions caused by equity, redundancy and debt service payments.

[1] Prepared by Virginia Horscroft and Tobias Haque of the World Bank.

As a result, reserves are expected to decline somewhat but remain adequate in terms of traditional prudential metrics and within the National Reserve Bank of Tonga's (NRBT) comfort zone of three–four months of imports.

19. Exchange rate flexibility. The improved balance of payment position, allowed the NRBT to let the currency appreciate by 13 percent against the US$ (and 9 percent in real effective terms) from December 2010 to the peak of August 2011 (before returning to a level of 6 percent appreciation by end-2011) to help curb inflation pressures stemming from rising fuel and food import prices, as in other Pacific Island countries. The currency is assessed to be broadly in line with its medium-term fundamentals (Box 4). The macroeconomic balance approach and the purchasing power parity approach indicate a slight overvaluation that is within the margin of error. In addition, foreign exchange interventions and tourist arrivals continue to show no significant loss of competitiveness. With headline inflation on a downward trajectory and forecast to be around 5 percent in the near term, staff advises against further exchange rate appreciation. In fact, should downside risks to global growth materialize and spill over to Tonga, the exchange rate can absorb most of the shock while reserves can be used to smooth some of the impact.

Effective Exchange Rates vs Commodity Prices
(Index, 2005=100)



Sources: INS; and IMF staff estimates.
1/ Other PICs include Marshall Islands, PNG, Samoa, Solomon Islands, and Vanuatu.

Authorities' views

20. Outlook and policy stance. The authorities shared the staff's exchange rate assessment. They agreed that there is no further need for appreciation given the current inflation trajectory and noted that the NRBT would let the reference currency basket remain broadly at current levels. The authorities recognized that the recent buildup in reserves was due mainly to a surge in official grants and a large one-off private capital inflow, and projected the reserves to decline as the official grants taper off. They stand ready to act preemptively to control inflation risks as well as maintain reserves above the NRBT comfort zone of three–four months of imports.

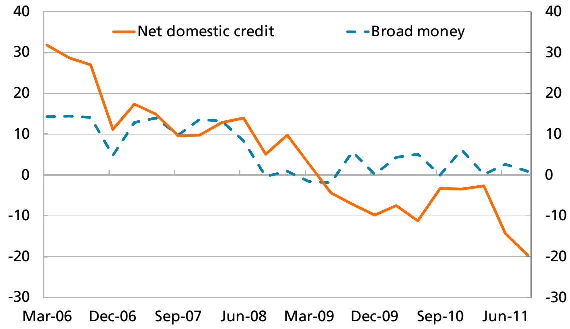
Monetary policy and financial stability

21. Context. Monetary conditions have remained accommodative over the past two years, but with no signs of a pickup in private credit (Figure 3 and Table 3). The increase in international reserves and limited sterilization led to a large accumulation of banks' excess reserves. Yet, private sector credit growth has remained negative (-9.3 percent (y/y) in December 2011) due to the still nascent recovery and tighter lending standards. The banking system is adequately capitalized and profitable but credit costs related to the rise in non-performing loans (NPLs) following the 2004–08 credit bubble remain high; and banks have continued to restrain credit, albeit with some signs of the credit crunch bottoming out (Figure 3 and Table 6).

Figure 3. Monetary Policy and Systemic Risks

Broad money has remained flat due to a contraction in domestic credit...

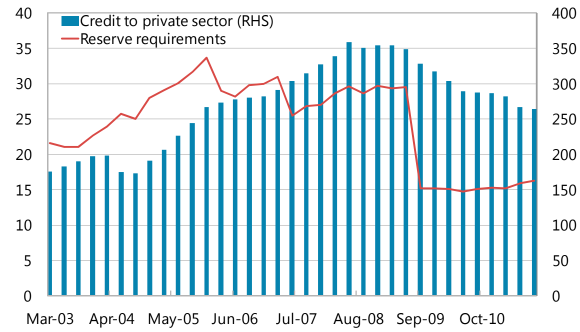
Net Domestic Credit and Broad Money
(In percent, year-on-year change)



Sources: Country authorities; and Fund staff calculations.

Particularly bank credit to the private sector...

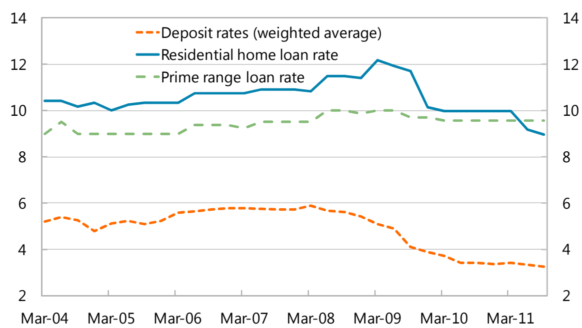
Bank Lending
(In millions of pa'anga)



Sources: Country authorities; and Fund staff calculations.

While interest rates have declined due to ample liquidity,...

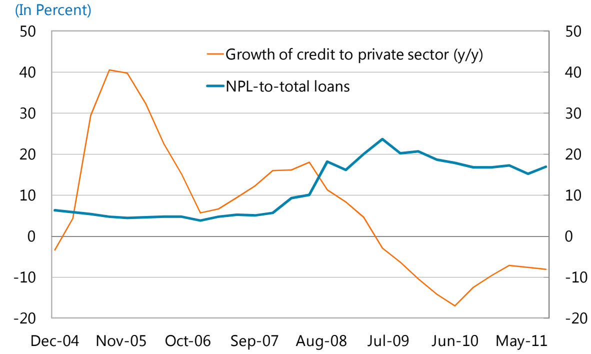
Interest Rates
(In percent)



Sources: Country authorities; and Fund staff calculations.

Bank credit has been held back by high NPLs...

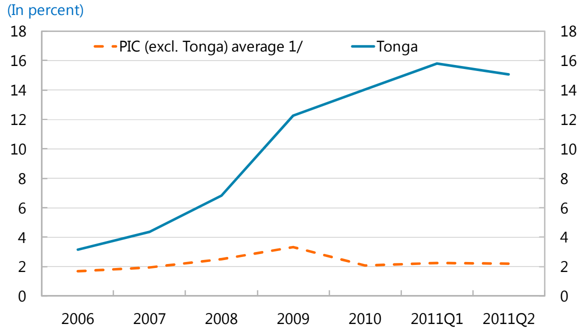
NPL *versus* Credit to Private Sector
(In Percent)



Sources: Country authorities; and Fund staff calculations.

And related provisioning expenses...

Provision Expense to Average Gross Loans
(In percent)

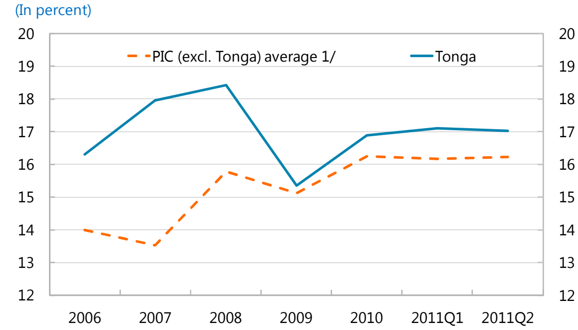


Sources: Country authorities; and Fund staff calculations.

1/ Average of Fiji, Papua New Guinea, Samoa , Solomon Islands, and Vanuatu.

Although bank capital remains more than adequate.

Equity to Assets
(In percent)



Sources: Country authorities; and Fund staff calculations.

1/ Average of Fiji, Papua New Guinea, Samoa , Solomon Islands, and Vanuatu.

Box 4. Tonga: Exchange Rate Assessment

Tonga's exchange rate is assessed to be broadly in line with its medium-term fundamentals based on standard analytical approaches. Other indicators also do not suggest pressures of a misalignment. There is considerable uncertainty in these results, mainly because external balances are heavily influenced by a small number of factors such as tourism and remittances, and these factors (in particular tourism) could be quite volatile going forward.

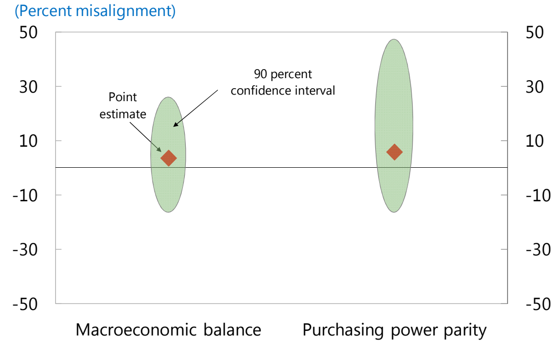
Standard exchange rate assessment methods

- **The macroeconomic balance approach** suggests that the exchange rate is over-valued by 4 percent compared to its equilibrium level, which is determined as a function of fundamentals relative to Tonga's trading partners. These fundamentals include the fiscal balance, economic growth, income, foreign aid, and demographics.
- **The purchasing power parity approach** suggests that Tonga's currency is above its long-run equilibrium level by around 6 percent in real effective terms.

Other indicators

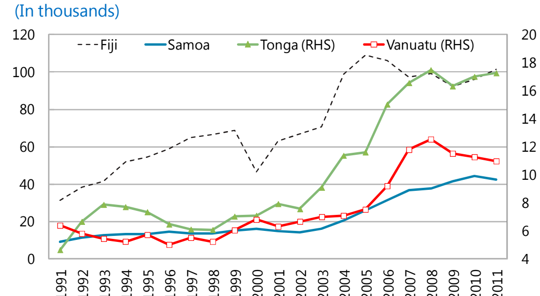
- The **current account deficit** has been improving due to the rise in official grants. While a temporary rise in the deficit is expected in this fiscal year, reflecting higher imports along with the economic recovery, the deficit is expected to average around 3¾ percent of GDP over the medium term.
- **Reserves** are expected to remain adequate within the NRBT comfort zone of three–four months of imports.
- **Exports** have recovered from the low level in 2008/09 and are expected to pick up gradually in the medium term reflecting the ongoing programs to boost exports.
- The **number of tourists** has increased markedly in recent years. Tonga has gained market share as a tourist destination, especially for tourists from New Zealand.
- The **costs of doing business** rankings from the World Bank's *Doing Business Survey* do not suggest any significant loss in competitiveness.

Equilibrium Real Exchange Rate Estimates
(Percent misalignment)



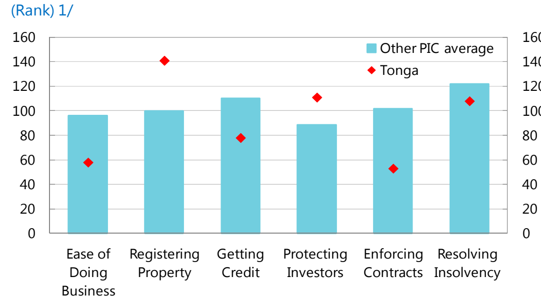
Source: Fund staff estimates.

New Zealand Tourists to Selected Pacific Islands
(In thousands)



Source: New Zealand authorities.

Business Climate Indicators
(Rank) 1/

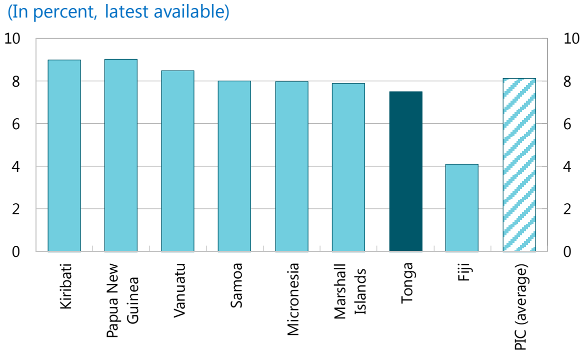


Source: World Bank Doing Business (2012 Doing Business Report).
1/ Higher rank indicates more costly.

Staff's views

22. Policy stance. Staff continues to recommend that the NRBT maintain an accommodative stance. While interest rate spreads remain high due to heightened credit risks and structural issues, albeit in the mid-range of PICs; lending rates have fallen and are expected to decline further. However, in the event of a severe global shock, the country would have little room to implement counter-cyclical monetary policies in view of the limited effectiveness of the transmission mechanism and banks' cautious approach to lending (see below).

Selected PICs: Interest Rate Spreads
(In percent, latest available)



Sources: Country authorities and Fund staff calculations.

23. Financial deepening. Encouraging intermediation will require strengthening banks' balance sheets and the institutional framework for lending. While progress has been made in provisioning for NPLs and reforming the Personal Property Securities Act (the new electronic registry went live in April 2011) to ensure timely registration of collateral, there is an urgent need to institute a centralized credit bureau, facilitate land lease transactions, and enact a bankruptcy protection law to reduce credit risks and improve collateral recoveries. Such changes, together with effective supervision of banks to ensure financial stability and transparency (especially, in interest rate and fee structure), could potentially reduce borrowing costs and improve access to finance. Staff reiterates the importance of continuing to resist pressure to administer banks' interest rates as it may lead to a further rationing of credit. Given the dominant role of credit risks in explaining interest rate spreads in Tonga, mechanisms to encourage greater risk sharing such as a partial guarantee fund (capitalized by donors or the Government through a budgetary allocation) channeled through the banking sector to priority economic sectors with clear eligibility criteria may have a better chance of success. The expansion of a mandatory retirement scheme to the formal private sector could encourage financial savings and provide a secure source of retirement income to its members. At the same time, the retirement fund should be appropriately regulated and prudent investment guidelines established.

Authorities' views

24. Outlook and policy stance. The authorities agreed that it remains appropriate to maintain an accommodative stance and encourage bank lending while banks are repairing their balance sheets. They noted the private sector lobbies' demand to administer banks' interest rates but shared staff's view that administering banks' interest rates would potentially cause a further rationing of credit.

C. Building Faster and More Inclusive Growth

25. Developments. Poverty has risen from 16.2 percent in 2001 to 22.5 percent of the population in 2009 according to the latest Household Income and Expenditure Survey (HIES). The slow pace of economic growth is partly to blame but the recent decline in remittances has also played a role.

26. Higher growth (Box 5). An increase in growth is needed for making a significant dent in poverty levels. The key sources of growth Tonga can harness are those where it can command premium prices to cover the higher production costs endemic to small and remote economies – such as from natural resource rents in agriculture, tourism and fisheries. Exploration for seabed minerals have commenced and hold promise but commercial viability and potential revenues are yet to be determined. Private investment in these sectors could be fostered by reforming the onerous business licensing requirements, privatizing Tonga's largest hotel (currently dilapidated), and lengthening the duration of land lease titles and facilitating their transfer. Implementation of the government's infrastructure investment plan and public enterprise reform program will be critical to further reduce the costs of doing business. Reducing the high cost of electricity could be achieved by implementing the Tonga Energy Road Map (TERM) with assistance of the World Bank and other development partners. While renewable energy capacity is being developed, the installation of a tank farm, consisting of large diesel storage tanks, could result in savings but should be undertaken after a cost-benefit analysis and preferably with private sector participation to minimize fiscal risks.

27. Inclusive policies. In addition to higher growth, a set of mutually reinforcing policies will also likely be needed to increase inclusiveness. While reconstruction using the China EXIM Bank loans supported GDP growth and better infrastructure, linkages to the rest of the economy were limited due to foreign contracting and labor. Going forward, the challenge would be to foster more labor-intensive value-added industries such as tourism and agro-fisheries as well as utilize the seasonal work programs in Australia and New Zealand to absorb a greater proportion of the labor force as the public sector wage bill is contained. In an environment of reduced remittance receipts, recourse to this form of insurance arrangement is limited. Thus, consideration should be given to introducing social protection schemes such as community public work programs and reforming the electricity tariff to build a lifeline tariff to protect the poorest consumers. Currently, Tonga provides good access to basic education and health but formal social protection programs are limited to the public service contributory pension scheme (Table 7).

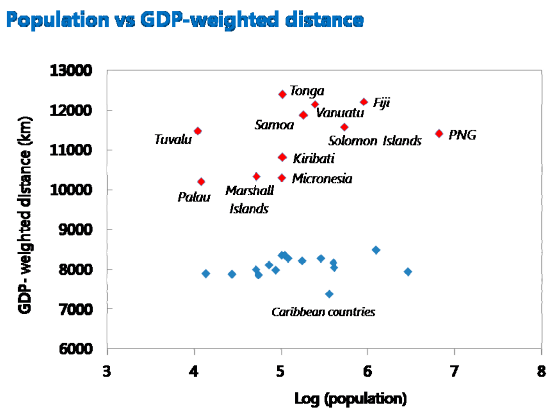
Authorities' views

28. The authorities are ready to act. They agreed with staff on the urgent need to boost growth and reduce poverty. The authorities also concurred on the potential of agriculture, tourism and fisheries as the sources of growth. But they noted the difficulties in expanding the export and production bases due to the capacity constraints and geographic distance. The Government adopted in April 2010 the TERM, which includes measures to increase efficiency in electricity supply and use, and develop grid-connected domestic renewable energy resources. They also committed to implementing public enterprise and business licensing reforms to reduce the costs of doing business to support the private sector led growth strategy outlined in the TSDF.

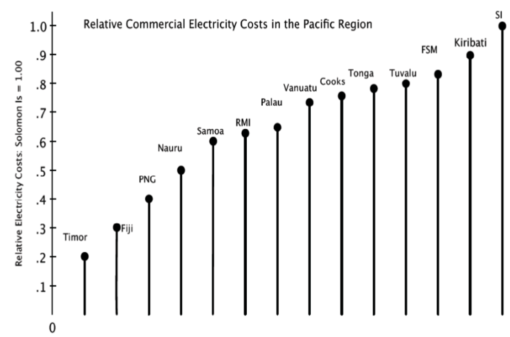
Box 5. Tonga: Raising Potential Growth[1]

Tonga faces numerous constraints to raise its relatively low rate of potential growth. In addition to its exposure to natural disasters, geographic remoteness and narrow economic base have put Tonga in a disadvantage in competing in export markets and attracting foreign investment. To raise potential growth, the country has to step up its effort on structural reforms to promote private sector development.

Tonga is one of the most isolated countries in the World, limiting export opportunities to exploiting its natural resources rents such as in fisheries, seafloor mining and tourism. However, key bottlenecks to private investment hinder growth in such sectors. In particular, business licensing requirements have been cumbersome and utility costs are some of the highest in the world. Moreover, the very low efficiency of state owned enterprises (SOEs) has been a drag on growth and crowded out private investment.



A private sector assessment undertaken by the Central African Republic in 2011 identified the key bottlenecks to promoting growth.[2] In terms of **economic infrastructure development**, the authorities should aim to boost private sector competitiveness by: (i) regularly updating and implementing the infrastructure development plan; (ii) improving access to finance and broadband internet services; (iii) establishing a sustainable fund for better road maintenance; and (iv) reducing the high cost of electricity by implementing the Tonga Energy Road Map (TERM) adopted in April 2010. In particular, for the latter, a broad range of regulatory, legislative and institutional reforms are called for. These include petroleum sector reforms to increase competition, hedge fuel costs, improve safety, and strengthen energy security; and electricity sector reforms to support changes in the energy mix and increases in efficiency and appropriate pricing; as well as measures to mobilize increased renewable energy generation.



Business regulatory environment should be improved through the following priorities: (i) shifting licensing from an "activity" to an "enterprise" basis and providing long-term operating licenses; (ii) broadening the scope of the Companies Act to include provision for the formation of community companies and other indigenous forms of business; and (iii) enacting key business law legislation to fill in the gaps in the commercial legal framework.

Public enterprise reform should help reduce the costs of doing business and "crowd-in" private sector competitors. In the near-term, SOEs should operate on business principles and the Government should continue to enhance effective stewardship of the SOEs by removing ministers and public servants from boards of directors and expanding the pool of skilled directors from the private sector with targeted training. In the medium term, the Government should consider privatization of SOEs to increase efficiency and attract private investment.

---

[1] Prepared by Lai Tora of the Asian Development Bank and Tobias Haque of the World Bank.

[2] "Completing Reform to Promote Growth: An Update to the Private Sector Assessment for Tonga", Central African Republic 2011.

D. Outreach

29. The team participated in a regional workshop organized by the NRBT to discuss the economic challenges facing Tonga. The team also met with local officials and the private sector, and discussed policy priorities with the Prime Minister and the Cabinet Economic Development Committee.

E. Other Issues

30. Exchange restrictions. The authorities have not introduced any new exchange measures since the last Article IV consultation.

31. Data provision. While economic statistics are broadly adequate for surveillance, data deficiencies continue to complicate the monitoring of economic conditions and policy formulation (Annex 1).

STAFF APPRAISAL

32. Outlook and risks. Economic growth is expected to continue its gradual recovery led by a pick-up in private sector activity and remain at around 1.8 percent in the medium term, in line with its historical average. Near-term risks to growth stem mainly from downside risks to global growth particularly through lower remittances and tourism.

33. Fiscal developments. The 2011/12 overall fiscal deficit is expected to narrow primarily due to higher budget support grants, continued restraint on current spending, and lower capital expenditure related to the China EXIM Bank loans that were run down faster than previously anticipated. However, public external debt remains at high risk of distress and cash balances are inadequate to meet the rising debt service burden and maintain public services without additional domestic borrowing.

34. Fiscal stance. Staff recommends rebuilding cash balances to at least 2 months' worth of recurrent expenses and attaining a primary surplus of 1 percent of GDP on average in the medium to long term. The emphasis should be on a prudent fiscal strategy focused on reining in the wage bill, improving tax policy and administration, and strengthening public financial management. The authorities should also strengthen debt management and avoid any new external borrowing until the NPV of external debt-to-GDP ratio falls below 30 percent.

35. Tax reform. A package of tax policy and administrative measures amounting to about 0.5 percentage point of GDP annually for the next two years from a range of options recommended by PFTAC TA should be implemented. These reforms should begin in 2012/13 to allow a gradual increase in priority spending on priority and economic sectors to support the economic recovery as the fiscal stimulus from the China EXIM Bank loans is withdrawn.

36. Monetary policy. The current monetary stance is appropriate. The NRBT efforts to maintain adequate liquidity in the system are appropriately aimed at encouraging banks to reduce lending rates while maintaining financial stability.

37. Exchange rate. The currency is broadly in line with the fundamentals. With headline inflation on a downward trajectory and forecast to be below 5 percent in the near term, the exchange rate is expected to remain broadly stable against the currency basket going forward.

38. Banking system. The banking system is adequately capitalized and profitable but provisioning costs related to the rise in nonperforming loans remain high. In such an environment encouraging financial intermediation will require a continued strengthening of banks' balance sheets and the institutional framework for lending such as facilitating the use of land as collateral and loan recoveries through a bankruptcy law. Administering banks' interest rates should also be avoided as it may lead to a further rationing of credit.

39. **Inclusive growth.** Implementing the private sector led growth strategy to unleash natural resource rents in agriculture, tourism and fisheries could raise potential growth and make it more inclusive. While reconstruction using the China EXIM Bank loans supported GDP growth, it was import and foreign labor dependent. Tourism, utilization of the seasonal worker program to Australia and New Zealand, and agro-fisheries could absorb a greater proportion of the labor force. Staff recommends reforms to improve the business climate particularly the onerous business licensing regime. Investment in renewable energy, given the sole reliance on diesel generators, and public enterprise reform will be critical to reduce the costs of doing business. Consideration should also be given to introducing social protection schemes.

40. It is recommended that Tonga remain on the 12-month cycle for the Article IV consultations.

Table 1. Tonga: Selected Economic Indicators, 2007/08–2012/13 1/

Nominal GDP (2010/11): US$ 411.3 million
GDP per capita (2010/11): US$ 3965.4
Major exports: fish, root crops, vanilla, squash
Quota: SDR 6.9 million

				Prelim.	Proj.	
	2007/08	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**
			(Annual percent change)			
Output and prices						
Real GDP 2/	1.1	0.0	1.9	1.4	1.6	1.2
Consumer prices (period average)	9.6	5.5	1.7	6.1	4.6	4.5
Consumer prices (end of period)	12.2	1.2	2.7	7.9	3.0	6.0
GDP deflator	7.9	-1.2	3.7	7.1	4.3	6.4
			(In percent of GDP)			
Central government finance						
Total revenue and grants	25.8	34.6	27.0	27.1	26.0	30.6
Total revenue	24.4	27.7	20.7	20.2	18.8	19.0
Grants	1.3	6.9	6.3	6.9	7.2	11.6
Total expenditure and net lending	24.3	34.8	33.0	33.0	28.7	30.0
Of which: Current expenditure	23.8	25.5	27.7	23.7	21.2	25.5
Capital expenditure	0.5	6.1	4.0	7.8	5.8	4.5
Overall balance	1.5	-0.2	-6.0	-5.9	-2.7	0.6
Overall balance (excl. China's EXIM Bank loans)	...	5.5	-1.8	1.6	3.3	1.2
External financing (net)	0.2	5.5	3.6	6.8	5.2	-0.3
Domestic financing (net)	-1.7	-5.3	2.5	-0.9	-2.5	-0.3
			(Annual percent change)			
Money and credit						
Total liquidity 3/	8.2	-1.8	5.1	3.1	5.4	7.5
Of which: Broad money (M2)	9.2	-2.4	5.6	3.3	5.9	7.7
Domestic credit	13.9	-5.2	-11.5	-12.3	-3.8	8.9
Of which: Private sector credit	17.1	-3.7	-15.6	-9.9	0.9	5.2
Interest rates (end of period)						
Average deposit rate	5.7	4.9	3.4	3.4	...	...
Base lending rate	10.0	10.0	9.6	9.6	...	...
			(In millions of U.S. dollars)			
Balance of payments						
Exports, f.o.b.	8.3	7.2	7.9	10.9	11.7	12.4
Imports, f.o.b.	-142.2	-130.5	-130.4	-152.5	-184.5	-184.7
Services (net)	-13.3	-15.2	-8.5	6.7	4.2	4.3
Investment income (net)	7.5	6.4	4.0	10.2	11.6	11.7
Current transfers (net)	114.2	104.0	102.7	118.6	128.5	145.1
Of which: Remittances	106.7	84.0	82.0	87.5	91.9	96.5
Current account balance	-25.6	-28.1	-24.2	-6.1	-28.6	-11.2
(In percent of GDP)	-7.3	-8.9	-6.7	-1.5	-6.1	-2.3
Current account balance (excl. imports related to China EXIM Bank loans)	-25.6	-19.6	-15.5	14.2	-11.1	-9.0
(In percent of GDP)	-7.3	-6.2	-4.3	3.4	-2.4	-1.9
Overall balance	1.2	19.5	20.9	32.0	3.5	12.3
Terms of trade (annual percent change)	-1.7	-5.3	5.9	-5.1	...	...
Gross official foreign reserves						
In millions of U.S. dollars	48.2	67.7	88.7	120.7	124.2	136.6
(In months of next year's goods and services imports)	3.2	4.6	5.1	5.7	5.9	6.2
External debt (in percent of GDP)						
External debt	24.8	31.9	33.3	36.3	40.8	39.4
Debt service ratio	1.4	0.8	1.3	1.2	1.3	1.5
Exchange rates						
Pa'anga per U.S. dollar (period average)	1.9	2.1	1.9	1.8	...	...
Pa'anga per U.S. dollar (end of period)	1.8	2.0	1.9	1.7	...	...
Nominal effective exchange rate (1990=100)	92.1	95.6	96.8	97.4	...	...
Real effective exchange rate (1990=100)	101.1	107.5	108.3	111.5	...	...
Memorandum items:						
Remittances (in percent of GDP)	30.5	26.7	22.8	21.3	19.7	19.9
Tourism (in percent of GDP)	6.3	8.8	7.2	8.1	8.5	8.6
FDI (in percent of GDP)	4.2	6.1	5.3	1.8	1.7	1.7
Nominal GDP (millions of T$)	664.8	656.8	694.1	753.5	798.2	859.4
Gross Disposable Income (millions of T$)	868.9	840.3	852.4	937.4	982.9	1077.3
Population (thousands)	102.4	102.9	103.3	103.7	104.1	104.6

Sources: Data provided by the Tongan authorities; and Fund 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, 2007/08-2012/13

	2007/08	2008/09	2009/10	Prov. 2010/11	Proj. 2011/12	Proj. 2012/13
			(In millions of pa'anga)			
Total revenue and grants	171.2	227.5	187.5	204.2	207.6	263.1
Total revenue	162.5	182.0	143.5	152.0	149.9	163.5
Current revenue	162.5	154.8	143.5	150.1	148.4	162.0
Tax revenue	138.0	129.1	114.5	132.0	130.1	144.2
Of which: Taxes on income/profits	26.8	40.3	28.1	38.3	30.2	33.7
Sales tax and consumption tax	70.5	71.3	70.7	80.8	85.8	94.1
Trade taxes	40.6	16.1	14.9	12.7	13.9	16.3
Nontax revenue	24.5	25.7	29.0	18.1	18.3	17.8
Capital revenue	0.0	27.2	0.0	1.9	1.6	1.6
Grants (in cash)	8.7	45.5	44.0	52.2	57.7	99.6
Project grants	8.7	45.5	33.0	30.7	20.5	76.9
Budget support	0.0	0.0	11.0	21.5	37.2	22.7
Total expenditure and net lending	161.5	228.8	229.2	248.8	228.9	257.6
Total expenditure	161.5	207.3	220.4	237.3	215.9	258.1
Current expenditure	158.5	167.5	192.4	178.4	169.3	219.5
Wages and salaries	70.2	76.4	82.2	84.3	85.3	90.9
Retirement funds employer contribution	4.4	5.2	6.9	7.5	7.0	7.5
Interest expense	4.2	5.2	5.6	6.5	6.5	7.5
Of which: External	2.4	4.3	4.3	4.3	4.3	5.4
Other current expenditures	79.7	80.7	97.7	80.1	70.5	113.6
Capital expenditure	3.0	39.8	28.0	58.8	46.7	38.6
Of which :China EXIM Bank loans	0.0	22.0	21.0	46.5	37.3	4.7
Total lending minus repayments	0.0	21.4	8.8	11.5	13.0	-0.5
Current balance (excl. project grants)	10.1	19.1	-25.8	-7.0	-6.7	-3.8
Overall balance (incl. grants)	9.7	-1.3	-41.7	-44.6	-21.3	5.5
Overall balance (excl. China EXIM Bank loans)	9.7	35.8	-12.4	12.4	26.5	10.2
Primary balance (incl. grants)	13.8	3.9	-36.2	-38.2	-14.9	13.1
Total financing	-9.7	1.3	41.7	44.6	21.3	-5.5
External financing	1.4	35.9	24.7	51.0	41.6	-2.5
Domestic financing	-11.1	-34.6	17.0	-6.4	-20.2	-3.0
			(In percent of GDP)			
Total revenue and grants	25.8	34.6	27.0	27.1	26.0	30.6
Total revenue	24.4	27.7	20.7	20.2	18.8	19.0
Current revenue	24.4	23.6	20.7	19.9	18.6	18.8
Tax revenue	20.8	19.7	16.5	17.5	16.3	16.8
Of which: Taxes on income/profits	4.0	6.1	4.0	5.1	3.8	3.9
Sales tax and consumption tax	10.6	10.8	10.2	10.7	10.8	10.9
Trade taxes	6.1	2.4	2.2	1.7	1.7	1.9
Nontax revenue	3.7	3.9	4.2	2.4	2.3	2.1
Capital revenue	0.0	4.1	0.0	0.3	0.2	0.2
Grants (in cash)	1.3	6.9	6.3	6.9	7.2	11.6
Project grants	1.3	6.9	4.8	4.1	2.6	8.9
Budget support	0.0	0.0	1.6	2.8	4.7	2.6
Total expenditure and net lending	24.3	34.8	33.0	33.0	28.7	30.0
Current expenditure	23.8	25.5	27.7	23.7	21.2	25.5
Wages and salaries	10.6	11.6	11.8	11.2	10.7	10.6
Retirement funds employer contribution	0.7	0.8	1.0	1.0	0.9	0.9
Interest expense	0.6	0.8	0.8	0.9	0.8	0.9
Of which: External	0.4	0.7	0.6	0.6	0.5	0.6
Other current expenditures	12.0	12.3	14.1	10.6	8.8	13.2
Capital expenditure	0.5	6.1	4.0	7.8	5.8	4.5
Of which : China EXIM Bank loans	0.0	3.4	3.0	6.2	4.7	0.5
Total lending minus repayments	0.0	3.3	1.3	1.5	1.6	-0.1
Current balance (excl. project grants)	1.5	2.9	-3.7	-0.9	-0.8	-0.4
Overall balance (incl. grants)	1.5	-0.2	-6.0	-5.9	-2.7	0.6
Overall balance (excl. China EXIM Bank loans)	1.5	5.5	-1.8	1.6	3.3	1.2
Primary balance (incl. grants)	2.1	0.6	-5.2	-5.1	-1.9	1.5
Total financing	-1.5	0.2	6.0	5.9	2.7	-0.6
External financing	0.2	5.5	3.6	6.8	5.2	-0.3
Domestic financing	-1.7	-5.3	2.5	-0.9	-2.5	-0.3
Memorandum items:						
Nominal GDP (in millions of pa'anga)	664.8	656.8	694.1	753.5	798.2	859.4
Total external public debt outstanding (in percent of GDP)	24.8	31.9	33.3	36.3	40.8	39.4

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

Table 3. Tonga: Depository Corporations Survey, 2007/08-2012/13 1/

	2007/08	2008/09	2009/10	2010/11	Proj. 2011/12	Proj. 2012/13
			(In millions of pa'anga; end of period)			
Net foreign assets	76.0	118.1	143.1	195.9	210.5	238.8
Claims on nonresidents	102.1	155.9	188.5	224.3	242.6	275.3
NRBT	90.7	137.7	171.9	206.0	217.6	250.3
Other depository corporations	11.4	18.3	16.6	18.3	25.0	25.0
Liabilities to nonresidents	-26.0	-37.9	-45.4	-28.4	-32.1	-36.4
NRBT	-3.4	-10.4	-29.5	-22.0	-22.5	-25.5
Other depository corporations	-22.6	-27.5	-15.9	-6.4	-9.6	-10.9
Net domestic assets	211.2	163.9	153.3	109.6	111.4	107.2
Net domestic credit	331.0	313.9	277.7	243.7	234.4	255.2
Net claims on government	-30.9	-34.7	-28.1	-31.4	-51.7	-54.7
Claims on public nonfin. corps.	4.8	4.7	15.5	13.6	22.2	32.2
Claims on private sector	357.1	343.9	290.3	261.5	263.9	277.6
Other items, net	-119.7	-149.9	-124.4	-134.1	-123.0	-148.0
Total liquidity	287.2	282.0	296.4	305.4	321.9	346.0
Broad money (M2)	275.9	269.2	284.4	293.7	311.1	334.9
Narrow money	72.3	77.7	90.0	96.8	88.7	91.0
Quasi money	203.6	191.6	194.4	196.9	222.4	243.9
Securities other than shares 2/	11.3	12.8	12.0	11.8	10.8	11.1
			(Annual percentage change)			
Net domestic assets	-7.6	55.4	21.2	36.9	7.5	13.5
Net domestic assets	15.3	-22.4	-6.5	-28.5	1.6	-3.8
Net domestic credit	13.9	-5.2	-11.5	-12.3	-3.8	8.9
Claims on private sector	17.1	-3.7	-15.6	-9.9	0.9	5.2
Total liquidity	8.2	-1.8	5.1	3.1	5.4	7.5
Broad money (M2)	9.2	-2.4	5.6	3.3	5.9	7.7
			(In millions of U.S. dollars)			
Net foreign assets	40.0	56.6	74.2	105.3	121.5	131.6
Claims on nonresidents	53.7	74.8	97.7	120.5	140.1	151.7
NRBT	47.7	66.0	89.1	110.7	125.6	137.9
ODCs	6.0	8.8	8.6	9.8	14.4	13.8
Liabilities to nonresidents	-13.7	-18.2	-23.5	-15.3	-18.5	-20.1
Memorandum items:						
Velocity (GDP/average M2)	2.4	2.4	2.4	2.6	2.6	2.6
Pa'anga per U.S. dollar (end of period)	1.8	2.0	1.9	1.7	...	...

Sources: Data provided by the Tongan authorities; and Fund 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: Tonga: Balance of Payments Summary, 2007/08–2012/13 1/

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

				Prelim.	Proj.	
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Trade balance	-133.9	-123.3	-122.5	-141.6	-172.9	-172.2
Exports, f.o.b.	8.3	7.2	7.9	10.9	11.7	12.4
Imports, f.o.b.	-142.2	-130.5	-130.4	-152.5	-184.5	-184.7
Services (net)	-13.3	-15.2	-8.5	6.7	4.2	4.3
Receipts	34.2	35.0	39.1	63.1	71.6	74.3
Payments	-47.5	-50.2	-47.5	-56.4	-67.5	-70.0
Investment income (net)	7.5	6.4	4.0	10.2	11.6	11.7
Receipts	11.9	10.2	11.6	16.0	18.2	18.9
Payments	-4.4	-3.8	-7.7	-5.8	-6.6	-7.2
Current transfers (net)	114.2	104.0	102.7	118.6	128.5	145.1
Official transfers (net) 2/	3.5	16.8	11.1	21.6	26.8	38.3
Private transfers (net)	110.7	87.2	91.6	97.0	101.7	106.8
Current account balance	-25.6	-28.1	-24.2	-6.1	-28.6	-11.2
(In percent of GDP)	-7.3	-8.9	-6.7	-1.5	-6.1	-2.3
Capital account balance	-2.4	27.6	15.1	5.5	5.5	16.2
Financial account balance	29.1	19.9	30.1	32.6	26.6	7.3
FDI inflow	14.7	19.3	19.2	7.3	8.1	8.3
Other investment inflow	14.4	21.6	19.3	37.0	28.6	2.9
Of which: China EXIM Bank loans	…	10.6	10.9	25.4	21.8	2.6
Overall balance 3/	1.2	19.5	20.9	32.0	3.5	12.3
Memorandum items:						
Gross official foreign reserves	48.2	67.7	88.7	120.7	124.2	136.6
In months of next year's goods and services import	3.2	4.6	5.1	5.7	5.9	6.2
Exchange rate						
Pa'anga per U.S. dollar (period average)	1.9	2.1	1.9	1.8	…	…
Pa'anga per U.S. dollar (end of period)	1.8	2.0	1.9	1.7	…	…
Nominal GDP (in millions of US$)	349.8	314.9	359.8	411.3	…	…
Commodity price indexes (2005 = 100)						
Food	142.2	145.5	141.7	164.1	172.1	162.8
Fuel	84.1	79.4	70.4	91.5	109.4	112.4

Sources: the Tongan authorities; and Fund staff estimates.
1/ Projections include adjustments for imports related to two loans from the China EXIM Bank.
2/ Includes all official grants excluding project funds related to capital formation.
3/ Change in gross official foreign reserves.

Table 5. Tonga: Medium-Term Scenario, 2009/10–2016/17 1/

		Prelim.	Proj.					
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
				(Annual percent change)				
Output and prices								
Real GDP	1.9	1.4	1.6	1.2	1.8	1.8	1.8	1.8
Consumer prices (end of period)	2.7	7.9	3.0	6.0	6.0	6.0	6.0	6.0
Consumer prices (period average)	1.7	6.1	4.6	4.5	6.0	6.0	6.0	6.0
GDP deflator	3.7	7.1	4.3	6.4	6.8	6.7	6.7	6.8
				(In percent of GDP)				
Central government finance								
Total revenue and grants	27.0	27.1	26.0	30.6	26.2	25.8	25.4	24.8
Total revenue	20.7	20.2	18.8	19.0	19.4	19.5	19.6	19.5
of which: tax revenue	16.5	17.5	16.3	16.8	17.3	17.4	17.5	17.6
Grants	6.3	6.9	7.2	11.6	6.8	6.3	5.8	5.3
Total expenditure and net lending	33.0	33.0	28.7	30.0	25.2	24.8	24.5	24.2
Current expenditure	27.7	23.7	21.2	25.5	22.3	21.8	21.5	21.3
Capital expenditure	4.0	7.8	5.8	4.5	3.0	3.0	3.0	3.0
Net lending	1.3	1.5	1.6	-0.1	0.0	0.0	0.0	-0.1
Overall balance (incl. grants)	-6.0	-5.9	-2.7	0.6	1.0	1.0	0.8	0.6
External financing (net)	3.6	6.8	5.2	-0.3	-1.7	-0.8	-0.2	-0.2
Domestic financing (net)	2.5	-0.9	-2.5	-0.3	0.7	-0.2	-0.6	-0.5
Primary balance (incl. grants)	-5.2	-5.1	-1.9	1.5	1.9	1.8	1.5	1.3
				(In millions of U.S. dollars)				
Balance of payments								
Exports, f.o.b.	7.9	10.9	11.7	12.4	13.4	14.5	15.7	16.8
(Annual percent change)	9.6	36.9	7.4	6.6	7.7	7.9	8.6	7.3
Imports, f.o.b.	-130.4	-152.5	-184.5	-184.7	-191.9	-200.4	-208.6	-218.0
(Annual percent change)	-0.1	17.0	21.0	0.1	3.9	4.4	4.1	4.5
Services and investment income (net)	-4.5	16.9	15.8	16.0	17.6	17.8	21.0	23.6
Transfers (net)	102.7	118.6	128.5	145.1	141.9	150.5	154.9	159.6
Of which: Remittances	82.0	87.5	91.9	96.5	102.3	107.6	112.8	118.1
Current account balance	-24.2	-6.1	-28.6	-11.2	-19.0	-17.6	-17.0	-18.0
(In percent of GDP)	-6.7	-1.5	-6.1	-2.3	-3.8	-3.4	-3.1	-3.2
Capital account balance	15.1	5.5	5.5	16.2	3.9	-0.2	-0.2	-0.2
Financial account balance	30.1	32.6	26.6	7.3	1.5	7.1	11.0	12.9
FDI inflow	19.2	7.3	8.1	8.3	8.7	9.1	9.8	11.8
Other investment inflow	19.3	37.0	28.6	2.9	0.1	6.0	10.0	10.0
Of which: China EXIM Bank loans	19.3	37.0	28.6	2.8	…	…	…	…
Overall balance	20.9	32.0	3.5	12.3	-13.6	-10.7	-6.2	-5.3
Gross international reserves (end of period)								
In millions of U.S. dollars	88.7	120.7	124.2	136.6	123.0	112.2	106.0	100.7
In months of imports (goods and services)	5.1	5.7	5.9	6.2	5.3	4.6	4.2	3.8
External debt (in percent of GDP)								
Public sector external debt	33.3	36.3	40.8	39.4	36.4	34.3	32.8	31.1
Debt service ratio	1.3	1.2	1.3	1.5	2.3	2.5	2.6	2.4
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	91.6	97.0	101.7	106.8	113.3	119.2	125.0	130.9
(In percent of imports of goods and services)	51.5	46.4	40.4	41.9	42.7	42.9	43.1	43.2
Commodity price indexes (2005 = 100)								
Food	141.7	164.1	172.1	162.8	157.4	150.9	146.0	146.0
Fuel	70.4	91.5	109.4	112.4	106.4	100.0	95.2	95.2
Nominal GDP (millions of T$)	694.1	753.5	798.2	859.4	933.8	1013.9	1101.5	1197.2

Sources: Data provided by the Tongan authorities; and Fund staff estimates and projections.
1/ Fiscal year beginning July.

Table 6. Tonga: Financial Soundness Indicators, 2007/08-2010/11 1/

	2007/08	2008/09	2009/10	2010/11
Financial sector		(In percent)		
Total loans/GDP	54.4	53.1	44.0	36.5
Other depository corporations	54.4	53.1	44.0	36.5
Banks				
Net domestic credit		(Year-on-year percent change)		
Public non-financial corporations	27.6	-1.1	229.0	-12.0
Private sector	17.1	-3.7	-15.6	-9.9
		(In percent)		
Risk-weighted capital adequacy ratio	21.4	26.1	22.2	26.3
Net interest income to average assets	5.8	5.6	6.6	6.1
		(In percent of total loans)		
Non-performing loans	10.0	23.7	17.9	15.2
Loan loss reserves to gross loans	4.7	13.3	14.8	15.0

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	1995	2000	2005	2008	2009	2010
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)	..	57	..	..	..	..	..
Goal 2: Achieve universal primary education							
Literacy rate, youth female (% of females ages 15-24)	..	99	..	100	100	..	..
Literacy rate, youth male (% of males ages 15-24)	..	99	..	100	100	..	..
Persistence to last grade of primary, total (% of cohort)	..	..	95	91	..	..	..
Primary completion rate, total (% of relevant age group)	133	114	104	137	100	..	..
Total enrollment, primary (% net)	..	..	96	99	..	..	..
Goal 3: Promote gender equality and empower women							
Proportion of seats held by women in national parliaments (%)	0	0	0	3	3	3	3
Ratio of female to male enrollments in tertiary education (%)	..	..	164	168	..	..	..
Ratio of female to male primary enrollment (%)	98	99	97	96	95	..	..
Ratio of female to male secondary enrollment (%)	104	..	110	104	104	..	..
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)	21	19	17	15	14	14	13
Mortality rate, under-5 (per 1,000)	25	22	20	18	16	16	16
Goal 5: Improve maternal health							
Adolescent fertility rate (births per 1,000 women ages 15-19)	...	...	22	22	21	21	..
Births attended by skilled health staff (% of total)	92	..	95	98	..	..	..
Contraceptive prevalence (% of women ages 15-49)	..	41	33	..	..	..	..
Maternal mortality ratio (national estimate, per 100,000 live births)	..	..	78	..	..	..	..
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	33	28	22	19	18	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 (%, all forms)	64	63	88	79	66	43	63
Goal 7: Ensure environmental sustainability							
CO2 emissions (kg per PPP $ of GDP)	0.4	0.4	0.4	0.4	0.4	..	..
CO2 emissions (metric tons per capita)	0.8	1.1	1.2	1.7	1.7	..	..
Forest area (% of land area)	12.5	..	12.5	12.5	..	..	12.5
Improved sanitation facilities (% of population with access)	96	96	96	96	96	..	..
Improved water source (% of population with access)	..	100	100	100	100	..	..
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	4	8	6	8	..	..
Internet users (per 100 people)	..	..	2	5	8	10	12
Mobile cellular subscriptions (per 100 people)	..	..	0	30	49	51	52
Telephone lines (per 100 people)	5	7	10	14	25	30	30
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	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 compatibility of government operations, data in GFSM 2001 format is presented in this Appendix. The authorities have been informed about the new reporting format.

Table II. 1. Tonga: Summary of Central Government Operations, 2007/08-2012/13 1/

	2007/08	2008/09	2009/10	Prel. 2010/11	Proj. 2011/12	Proj. 2012/13
			(In percent of GDP)			
Revenue	**25.8**	**30.5**	**27.0**	**26.8**	**25.8**	**30.4**
Taxes	20.8	19.7	16.5	17.5	16.3	16.8
Of which: Taxes on income/profits	4.0	6.1	4.0	5.1	3.8	3.9
Sales tax and consumption tax	10.6	10.8	10.2	10.7	10.8	10.9
Trade taxes	6.1	2.4	2.2	1.7	1.7	1.9
Social contributions	…	…	…	…	…	…
Grants (in cash)	1.3	6.9	6.3	6.9	7.2	11.6
Project grants	1.3	6.9	4.8	4.1	2.6	8.9
Budget support	0.0	0.0	1.6	2.8	4.7	2.6
Other revenue	3.7	3.9	4.2	2.4	2.3	2.1
Expenditure	**24.3**	**27.4**	**31.8**	**31.2**	**26.9**	**29.9**
Expense	23.9	25.7	27.8	23.7	21.2	25.6
Compensation of employees	11.2	12.4	12.8	12.2	11.6	11.5
Use of goods and services	9.8	9.5	11.4	7.3	6.5	11.1
Consumption of fixed capital	…	…	…	…	…	…
Interest	0.6	0.8	0.8	0.9	0.8	0.9
Of which: To nonresidents	0.4	0.7	0.6	0.6	0.5	0.6
Subsidies	0.4	0.3	0.2	1.1	0.8	0.7
Grants	0.2	0.1	0.2	0.3	0.2	0.2
Social benefits	0.7	1.2	1.5	1.0	0.7	0.6
Other expense	0.9	1.3	1.0	1.1	0.7	0.7
Net acquisition of nonfinancial assets	0.4	1.8	4.0	7.5	5.6	4.3
Acquisitions of nonfinancial assets	0.4	5.9	4.0	7.7	5.8	4.5
Of which : Financed by China EXIM Bank loans	0.0	3.4	3.0	6.2	4.7	0.5
Disposals of nonfinancial assets	0.0	4.1	0.0	0.3	0.2	0.2
Consumption of fixed capital	…	…	…	…	…	…
Gross operating balance	**1.9**	**4.8**	**-0.7**	**3.1**	**4.6**	**4.9**
Net lending (+)/borrowing (–)	**1.5**	**3.1**	**-4.7**	**-4.4**	**-1.0**	**0.6**
Net acquisition of financial assets	-2.8	8.8	-0.1	2.4	4.2	0.3
Domestic net lending	0.0	3.3	1.3	1.5	1.6	-0.1
Change in cash balances (+ = increase)	-2.8	5.5	-1.3	0.9	2.5	0.3
Net incurrence of financial liabilities	-4.3	5.7	4.7	6.8	5.2	-0.3
Of which : China EXIM Bank loans	0.0	6.4	5.4	8.8	6.0	0.5
Memorandum items:						
Nominal GDP (in millions of pa'anga)	664.8	656.8	694.1	753.5	798.2	859.4
Total external public debt outstanding (in percent of GDP)	24.8	31.9	33.3	36.3	40.8	39.4

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

INTERNATIONAL MONETARY FUND

TONGA

May 1, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION–INFORMATIONAL ANNEX

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

CONTENTS

ANNEX I. TONGA: FUND RELATIONS[1]

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. 67

Outstanding Purchases and Loans: None.

Financial Arrangements: None.

Projected Obligations to Fund:*

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

	Forthcoming				
	2012	**2013**	**2014**	**2015**	**2016**
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

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

Exchange Rate Arrangement:

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 March 2011 and the Executive Board discussed the staff report (IMF Country Report No. 11/110) on May 4, 2011.

Previous Fund Recommendations:

The staff and the authorities have continued to share comprehensive views in the past about policy priorities. During the 2011 consultation, Executive Directors noted that the policy challenge was to reduce the country's vulnerabilities and to boost potential growth. They stressed the importance of fiscal consolidation in ensuring fiscal sustainability and expanding fiscal space to respond to future shocks. But the authorities have followed more moderate steps, primarily

[1] As of April 30, 2012.

owing to capacity constraints and a change in government. Shortcomings continue to be mainly in the area of fiscal policy, where staff recommended reducing current spending, carefully prioritizing spending, improving tax administration, and improving transparency. Staff also recommended setting up a comprehensive medium-term budget framework, improving fiscal management, and strenthening debt management. Progress has been made in setting up a medium-term budget framework.

Technical Assistance:

Legal Department (LEG) has provided assistance on AML/CFT issues for the Pacific islands countries, including Tonga, with an emphasis on risk management.

Pacific Financial Technical Assistance Centre (PFTAC) has provided assistance on budgetary management; tax administration; banking legislation and supervision; and balance of payments and national accounts statistics.

Resident Representative: None.

ANNEX II. TONGA: PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2012–14[1]

Background

Tonga has faced a difficult macroeconomic environment in recent times. Following the global economic crisis growth stagnated, remittances fell and fiscal revenues declined sharply. The financial sector also came under pressure as a result of high levels of non-performing loans in the banking sector. High debt levels constrained fiscal space and the authorities approached development partners to provide budget support to enable key services to continue. Recent donor conferences have endorsed the authorities' prudent fiscal strategy and development partners are currently working on a joint policy matrix to underpin budget support—technical assistance (TA) will be critical for successful implementation.

PFTAC has provided 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 offsite and onsite banking supervision (IMF HQ has also provided TA for on-site supervision) and in exchange rate management.

Strategy 2012–14

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.

[1] As of March 2012.

[2] See http://www-intranet.imf.org/departments/APD … ional 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.

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 project that aims to develop an effective medium-term budget framework (1.5). These are likely to be in more accurate macroeconomic analysis (5.1) and more rigorous cash/debt management (1.6). 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 will be assisting the authorities implement the recommendations of the PFTAC strategic revenue review The review and PFTAC's regional benchmarking exercise showed that Tonga is one of the regional leaders in terms of implementing modern administrative practices; Tonga is also expected to continue to have access to resident TA through AusAID. PFTAC inputs will be determined by ongoing discussions with Ministry of Finance and the revenue administration and are likely to be reliant on resident advisors. PFTAC's specific inputs are likely to be focused on policy enhancements, including natural resource taxation (2.1), IT development (2.3), and risk management and compliance strategies (2.5).

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 is being assisted by an AusAID funded resident advisor. As a result, direct PFTAC assistance is expected to reduce. PFTAC will, however, continue to coordinate with and be a resource for the resident advisor and be available to provide focused technical inputs in particular areas. This may include assistance with rebasing of the National Accounts (4.2) using new Household Income and Expenditure Survey (HIES) data. Balance of payments 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 will be provided in 2012/13 to build on-site supervision techniques through training in standard procedures, reports and analytical techniques (3.5-3.7). PFTAC will also provide follow-up support on 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, the PFTAC macroeconomic advisor will continue to develop measures of pass-through to inflation to assist NRBT enhance its macroeconomic policy making (5.1). PFTAC will coordinate with macroeconomic input under the ADB PFM TA project to ensure GDP and fiscal forecasting becomes more robust (5.3). The advisor may also support the development of debt sustainability analysis (5.4).

ANNEX III. TONGA: WORLD BANK–IMF COLLABORATION[1]

The IMF team led by Mr. Jay Peiris (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 2009–12 Article IV missions as well as joining several consultations and providing various analytical inputs to the 2012 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 prepare jointly the Debt Sustainability Analysis appendix to the staff reports.

- **Economic Updates.** Fund staff provided an "Assessment Letter" on Tonga's macroeconomic situation. This public document was a key input to the Bank's decision to provide budget support to Tonga. IMF analysis continues to provide a vital framework to the ongoing budget support program.

- **Structural Fiscal Reforms.** Bank and Fund staffs have worked successfully to provide technical assistance 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,

[1] As of April 2012.

agriculture, fisheries and mining hold the greatest potential for private sector development. To facilitate development in these areas there is a need to (i) improve efficiency in the energy sector to reduce costs (ii) strengthen the institutional framework for lending—including the enforcement of creditor rights to collateral—as a means to increase access to finance and lower the cost of borrowing; (iii) improve vital tourism infrastructure, including through privatization of the Dateline Hotel and commercialization of Tonga Communication Corporation; (iii) reduce the administrative burden placed on the private sector by the existing system of business licenses; and (iv) lower 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 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$14 million of Woirld 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 FY2012 to strengthen budget execution, monitoring, reporting and transparency, and, with AusAID financing support, is providing additional TA support to the Public Service Commission in managing the current restructure.

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 September 2010–September 2012 period. It was also agreed that further details on collaboration, as necessary, will be agreed at the technical level as work progresses.

Appendix I. Tonga: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas (July 2011–July 2013)		
	Products	**Expected Delivery Date**
Bank Work Program	• Tonga Broadband Connectivity • Aviation Safety (Pacific Region) • Energy Roadmap Technical Assistance and Investment Operations • Series of two Development Policy Operations • In-year budget monitoring and reporting technical assistance • Expenditure analysis and budget execution technical assistance • TA support to the Public Service Commission to	• FY2012 • FY2012 • FY2012 • FY2013 • FY2013 • FY2012 • FY2013
Fund Work Program	• Cash Management • WCO diagnostic • Article IV Policy Note • Medium-Term Budgeting • Balance of Payments Statistics • National Accounts Statistics • Article IV Staff Report and Board Meeting	• October 2010 • January 2011 • February 2011 • March 2011 • March 2011 • March 2011 • April 2011

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

The goal of the Asian Development Bank's (AsDB) Pacific Approach 2010–14 of a sustained and resilient and improved standard of living aligns with the vision of Tonga's Strategic Development Framework 2009/2010–2014/2015 (TSDF) to create a society in which all Tongans enjoy higher living standards and a better quality of life. Similarly, as the Pacific Approach aims to achieve its goal through inclusive and environmentally sustainable growth, the TSDF 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 TSDF.

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 cliamte change resilience through development of renewable energy options; enhancing connectivity via multimodal networks and new technologies; and supporting urban development. Two key drivers of change to promote the focus of the Pacific Approach include improved private sector environment and public sector management. The priority outcome objectives of the TSDF supported by AsDB are: (i) to support 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 (iv) 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 TSDF.

AsDB has approved 15 loans and 4 grants totaling $94.86 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Sixty one technical assistance (TA) projects with a value of $17.6 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 projectss are supporting the preparation of the proposed

[1] As of April 2012.

Tonga-Fiji submarine cable project and the second phase of the integrated urban development project. Tonga also benefits from a number of regional technical assistance projects in private sector development, economic management, energy efficiency, and public financial management. Assistance to climate change adaptation amd 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 who-of-government institutional strengthening.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2007–11

	2007	2008	2009	2010	2011
Loan approvals					
Number	0.0	0.0	0.0	0.0	0.0
Amount (in millions of US$)	0.0	0.0	0.0	0.0	0.0
Grant approvals					
Number	0.0	1.0	1.0	1.0	3.0
Amount (in millions of US$)	0.0	11.3	10.0	10.0	33.5
Technical assistance approvals					
Number	1.0	1.0	4.0	2.0	7.0
Amount (in millions of US$)	0.25	0.7	1.48	1.01	3.27

ANNEX V. 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 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

Following PFTAC assistance in 2008 and 2009 a new series of national accounts was released in June 2009. The new series retains a 2000/01 base year but has been revised to improve coverage and estimation techniques. However, source data remains weak and needs to be improved to allow a long overdue rebase of the national accounts. The SD has obtained the assistance of a statistical advisor from New Zealand to improve the quality of the national accounts and balance of payments statistics. The advisor is helping implement the recommendations of the PFTAC technical assistance mission and expects improvements in the classification and valuation of inputs into the national accounts data.

The Consumer Price Index is based on a basket of goods and services from the 2000/01 Household Income and Expenditure Survey. Technical assistance was provided in 2008 on the development of an import price index.

Labor market statistics are weak: employment statistics have not been compiled since 2003; and average earnings statistics are not available. Currently the migration data is insufficient, in particular the data 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*.

External Sector Statistics

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. There are significant differences between the BOP estimates compiled by the two agencies. Moreover, large errors and omissions point to possible under recording of imports. With regard to international investment positions, no information is published due to lack of capacity.

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. 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*. Technical assistance in monetary and financial statistics will be needed to improve the classification and sectorization of accounts once the new prudential reporting system has been introduced.

Tonga: Table of Common Indicators Required for Surveillance

As of April 30, 2012

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	Apr-12	Apr-12	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb-12	Apr-12	M	M	M
Reserve/Base Money	Feb-12	Apr-12	M	M	M
Broad Money	Feb-12	Apr-12	M	M	M
Central Bank Balance Sheet	Feb-12	Apr-12	M	M	M
Consolidated Balance Sheet of the Banking System	Dec-11	Apr-12	M	M	M
Interest Rates[2]	Feb-12	Apr-12	M	M	M
Consumer Price Index	Feb-12	Apr-12	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	2010/11	Mar-12	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2010/11	Mar-12	A	A	A
External Current Account Balance	Q4/2011	Apr-12	Q	Q	Q
Exports and Imports of Goods and Services	Q4/2011	Apr-12	Q	Q	Q
GDP/GNP	2009/10	Mar-12	A	A	A
Gross External Debt	2010/11	Mar-12	A	A	A
International Investment Position	NA	NA	NA	NA	NA

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

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

[3] Foreign, domestic bank, and domestic nonbank financing.

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

[5] Including currency and maturity composition.

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

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

May 1, 2012

Approved By
Thomas Rumbaugh and Thomas Dorsey (IMF)
Sudhir Shetty and Jeffrey D. Lewis (IDA)

Prepared By
The International Monetary Fund and
The International Development Association

Tonga remains at a high risk of debt distress based on the joint IMF-WB low-income country debt sustainability assessment (LIC DSA). Scheduled repayments on the two loans (reconstruction and roads) from the China EXIM Bank may pose a fiscal challenge unless sufficient cash reserves are built up by improving tax collections and reining in current expenses. Government's balance sheet also faces a currency risk as about 61 percent of the outstanding external debt is denominated in Chinese renminbi. Nonetheless, Tonga's remittance inflows (projected to average around 20 percent of GDP in the medium term)–the largest source of foreign exchange earnings–may help mitigate liquidity risks. Taking into account the cushion provided to the economy by remittances, the projected debt profile is consistent with manageable–if high risk– debt dynamics. A declining path of external public debt is critically dependent on the steadfast implementation of the ambitious medium-term fiscal consolidation strategy envisaged by the authorities. Additional new debt in the short term will further worsen the already high risk of external debt distress, as well as risks to external sustainability, and significantly constrain the space available for social and developmental priorities, as outlined in the Tonga Strategic Development Framework (TSDF). These vulnerabilities underscore the importance of sound macroeconomic policies to improve Tonga's growth potential on a sustained basis, export diversification, and continued efforts on fiscal consolidation.

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 the one hand, it heavily relies on remittances, tourism, and foreign aid. On the other hand, the production and export bases are narrow and include mainly a few agricultural products and fisheries.

2. **The economy is gradually recovering from the effects of the global slowdown and the domestic credit crunch.** The recovery has been led by strengthening gross fixed investment and rebounding tourism. At the same time, the fiscal overall balance excluding the spending funded by the China EXIM Bank loans has improved thanks to a rise in grants and restraint in current expenditure.

3. **Tonga's total public sector debt stock (including publicly guaranteed debt) has risen since FY2008/09, and is expected to reach 45½ percent of GDP by the end of current fiscal year.** External debt accounts for majority of the stock, amounting to about 41 percent of GDP. This rise in debt stock was primarily on account of two external loans (one for reconstruction of the capital city and one for roads) from the China EXIM Bank.[1] These loans account for 61 percent of the outstanding external debt, while long-term loans by international financial institutions (IFIs) account for about 36 percent of external debt. In the current fiscal year, disbursements by the China EXIM Bank are projected to be completed for the reconstruction loan and nearly completed for the road loan. The loan for reconstruction also financed two additional projects: an extension of the Royal Palace and the construction of a new wharf to attract cruise ships. By the end of this fiscal year, about 60 percent of the reconstruction loan will have been used to finance direct government capital spending while the remainder will have been on-lent to the private sector for office, residential, and retail construction. The terms of the on-lending include an interest rate of 5 percent on the outstanding Tongan pa'anga amount and the government is expected to start receiving repayments from the private borrowers after the completion of the projects.[2] The entire road loan will be used to finance direct government capital spending on road improvements, including in outer islands.

4. **Despite the rise in overall debt, the government has continued to reduce its domestic debt level.** Domestic debt-to-GDP ratio had nearly halved by the end of the last fiscal year from an average of 13 percent of GDP seen during the last decade. The majority of the domestic debt (about 70 percent) is in the form of long-term government bonds while the remainder is government guaranteed debt.

5. **Tonga's DSA builds on the baseline scenario assumptions presented in Box 1.** It assumes that the near-term GDP growth will recover to around 1.8 percent and stay at a similar level over the medium to long term as in the last DSA.

[1] These loan commitments were signed in November 2007 (RMB 440 million for reconstruction), and in February 2010 (RMB 291 million for roads), and bear a 2 percent interest rate on the outstanding renminbi amount, 5-year grace, and a 20-year maturity. The arrangement with the contractor performing the work funded by these loans required an initial disbursement of 30 percent to cover the down payment, while outstanding disbursements are paid quarterly as work is completed and claims are filed.

[2] As of March 2012, one private borrower has started repaying to the government.

Box 1. Key Macroeconomic Assumptions

- **Real GDP growth** is projected to be around 1½ percent in 2011/12 and marginally higher in the medium and longer term. The recovery in the near and medium term is led by the fiscal impulse provided by the China EXIM Bank loans, and recovery in tourism and remittances. Longer term growth reflects a return on the ongoing capital projects, but will remain around 1.8 percent constrained by structural impediments.

- The Government is assumed to undertake a revenue-based fiscal consolidation aimed at achieving an overall **fiscal surplus** (excluding the China EXIM Bank loans) of around 1¼ percent of GDP **over the medium term.** Reforms in tax policy and administration is expected to improve the tax-to-GDP ratio to 17½ percent of GDP from 16¼ percent of GDP over the medium term, while cash grants will peak at around 11½ percent of GDP in 2012/13 before declining to 5¼ percent of GDP in 2016/17. Current expenditure (excluding project grants) is expected to slow down, led by a reduction in wage bill by about ¾ percentage point of GDP over the medium term. Domestically-funded capital expenditure is expected to increase from about ½ percent of GDP to 2 percent of GDP.

- **Over the longer term,** the primary fiscal surplus is expected to be about 1 percent of GDP as in the last DSA reflecting a reduction in cash grants. Lower project grants primarily explain the reduction in expenditure (excluding the China EXIM Bank loans) from 25¼ percent of GDP in the medium term to about 22 percent of GDP in the longer term, while wage bill averages about 45 percent of domestically-funded expenditure as targeted by the government Domestically financed capital expenditure is assumed to remain at 2 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 next year, there will be no external borrowing until the debt ratio falls below the DSA threshold and all future external borrowings are assumed comparable to concessional IFI (AsDB and World Bank) facilities that will raise the grant element of future borrowing. On the domestic front, no new (net) domestic borrowing is assumed as fiscal consolidation advances and the public debt is brought down (as percent of GDP).

- The external **current account** is projected to reach a deficit of 6 percent of GDP in 2011/12, from a deficit of 1½ percent of GDP in 2010/11, as increase in imports (along with the economic recovery) more than offset the increase in grants and remittances. The deficit should average around 3¾ percent of GDP over the medium term, while it is expected to improve to around 3¼ percent of GDP over the longer term, reflecting slightly better prospects for remittances, tourism receipts, and exports of goods (see below).

- The decline in **remittances** is estimated by staff to have bottomed out in FY2009/10 in US$ terms. Remittances are expected to continue picking up along with the economic recovery in Australia, New Zealand and the US, and as Australia implements the Pacific Seasonal Worker Program on July 1, 2012, building on the lessons learned from the pilot program. Remittances are projected to recover to around 22 percent of GDP over the longer term, 10 percentage points of GDP lower than the average observed during the past decade.

- **Tourism** receipts are projected to average around 9 percent of GDP over the medium term and gradually increase to an average of 12 percent of GDP over the longer term, reflecting the return on the ongoing efforts to boost tourism.

- The **export** base is projected to remain narrow and relatively undiversified with a focus on agricultural products. Proper operation of the fumigation facility should help gradually increase exports as the products will meet New Zealand's bio-security requirements. Exports are projected to gradually increase to 3 percent of GDP in medium term (from 2½ percent in 2010/11) and further to 4½ percent by 2030.

- The **capital and financial account** is projected to be around 7 percent of GDP in FY2011/12 and gradually decline to around 2 percent over the medium term as official foreign borrowing is phased out. Over the longer term, it is projected to average 4 percent of GDP, reflecting higher FDI inflows.

On the fiscal front, the government is expected to implement an ambitious medium-term fiscal consolidation plan supported by tax reforms, budget support grants, and restraint on non-priority and 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 a boost from the proposed reforms to tax policy and administration, while cash grants are higher in 2011/12 and 2012/13 than envisaged in the last DSA based on firm commitments by donors. Cash grants are projected to peak in 2012/13 and remain constant in nominal terms at the level of 2013/14 thereafter. The higher level of grants largely explains the more favorable external current account and primary fiscal balance projections over the medium term. The medium-term overall fiscal balance (excluding the China EXIM Bank loans) is projected to average a surplus of about 1¼ percent of GDP, thereby limiting the need for additional 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 external cushion. The recovery in remittances is, however, more sluggish than assumed in the previous DSA. Remittances are projected to recover from 19 percent of GDP in 2011/12 to 21 percent by 2016/17 and 22 percent over the longer term. This level is consistent with the average level during 1994–2000, but much lower than the 32 percent of GDP average observed during 2001–10.

6. The current DSA suggests a similar path for debt dynamics as in last year's DSA, albeit staying at a lower level in the medium term reflecting the more frontloaded drawdown of the China EXIM Bank loans in the past. Tonga continues to be at high risk of external debt distress, with the debt burden peaking early in the projection period and then gradually declining in the absence of any new external borrowing in the short term. However, the slightly lower debt indicators relative to the previous DSA mainly reflect a more front-loaded drawdown of the China EXIM Bank loans and the appreciation of the exchange rate over the last year. The key changes to the macroeconomic assumptions in the DSA are (Box 1): first, it assumes a better non-interest external current account position thanks to better export and tourism prospects, and higher official cash grants.[3] Second, it assumes that going forward the Government will undertake planned revenue reforms that will lead to a greater fiscal consolidation–including a tightening of existing tax concessions and exemptions, and introduction of a presumptive tax regime for SMEs–contributing to a buildup in adequate cash reserves. However, the larger primary surplus in the medium term largely reflects the front-loaded utilization of the China EXIM Bank loans. In the longer term, the fiscal consolidation path is assumed to result in same level of primary surplus (1 percent of GDP on average) as in the previous DSA.

[3] See Box 1 for more detail on the non-interest current account assumptions.

EXTERNAL DSA

Baseline

7. Under the baseline, the external debt trajectory breaches several policy-dependent thresholds in the short term before receding to lower levels over the medium term (Figure 1a). The present value (PV) of public and publicly guaranteed (PPG) external debt is above 30 percent of GDP, the indicative threshold level. The PV of PPG external debt is projected to peak at about 33 percent of GDP in the current fiscal year, 3 percentage points above the threshold, and drop below the threshold in FY2014/15, (a few years earlier than suggested in the last DSA) further declining to around 25 percent of GDP by 2016/17.

8. External debt remains well above the PV of debt-to-export distress threshold over the medium term. Reflecting Tonga's low exports, the PV of PPG external debt-to-exports ratio would peak at 183 percent in the current fiscal year and remain above the threshold until 2018/19. The PV of debt-to-revenue ratio, however, would stay below the threshold throughout the projection period, thanks to the impact of expected revenue reforms and significant grant inflows in the medium term.

9. However, Tonga's remittances would help reduce liquidity risks (Figure 1b). Tonga's remittances have averaged about eight times the export receipts over the past decade, and have provided a stable source of foreign exchange inflows. Relative to remittances and exports, the PV of PPG external debt is projected to stay above the (lower) modified threshold of 80 percent for the next two years, starting to fall below the threshold five years sooner than when remittances are ignored.[4] Therefore, scenario analysis that takes into account remittances has been added, though the risk assessment is still based on the regular thresholds.

10. Debt service is expected to rise in the medium term on account of expiration of the five-year grace period on the China EXIM Bank loans. In terms of exports, debt service will stay close to the threshold of 15 percent in the medium term (Figure 1a). Given its narrow export base, Tonga will be unable to expand its exports in the short term, aggravating the possibility of solvency and liquidity risks. However, when remittances are considered with export earnings, external debt service remains well under the (lower) modified threshold of 12 percent throughout the projection period (Figure 1b). Remittances are expected to have bottomed out in US$ terms and will likely stabilize at around 22 percent of GDP over the longer term. As mentioned earlier, this represents a modest recovery from the recent weakness, although remittances (in percent of GDP) would be lower than in the years before the global financial crisis. With regard to revenue, the ratio of debt service-to-revenue remains well below the threshold of 18 percent throughout the projection period albeit with a deterioration in the short to medium term (Figure 1a).

[4] In a recent review (SM/12/10), the IMF Executive Board approved modifications in some of the thresholds, while keeping other thresholds unchanged. The revised thresholds for countries with weak CPIA ratings, such as Tonga, are: (i) 80 percent for PV of PPG external debt-to-exports and remittances (revised from 90 percent), (ii) 12 percent for debt service-to-exports and remittances (revised from 15 percent); and (iii) 18 percent for debt service-to-revenue (previously 25 percent).

Sensitivity Analysis

11. Stress tests show that the external debt position is vulnerable to a significant depreciation or a slowdown in exports. A large one-time depreciation (assumed 30 percent in FY2012/13) would cause the PV of external debt to rise to nearly 45 percent of GDP and remain persistently above the 30 percent threshold in the medium term (Figure 1a). The same depreciation shock also causes the PV of debt-to-revenue ratio to breach its threshold in the short term, and debt service-to-revenue ratio to breach the threshold later in the medium term. The export shock stress test causes the PV of external debt to approach nearly 250 percent of exports and remain above the 100 percent threshold well into the next decade. The debt service-to-exports ratio also rises above the threshold in the medium term. Similar stresses emerge when remittances are considered though debt service does not breach the threshold. (Figure 1b).

12. However, a shock to remittances is found not to be the most extreme one to the external debt position (Table 1b, Bound Test B4). Remittance inflows have been relatively stable; therefore, a shock of the size of one standard deviation is not severe enough to cause a large deterioration in the debt position, compared to the baseline scenario.

13. An alternative scenario based on historical averages provides a more sanguine picture than the baseline.[5] It is mainly because the recent China EXIM Bank loans and donor financed construction projects have caused a larger current account deficit than in the past. If the current account deficit were at historical levels, debt could be reduced faster.

PUBLIC SECTOR DSA

Baseline

14. The public sector DSA reinforces the conclusions of the external DSA.[6] The high level of public sector borrowing for road building and reconstruction of the capital city over the past few years makes the PV of debt rise to about 37 percent of GDP in the current fiscal year before starting to decline under the baseline assumption of fiscal consolidation (Figure 2a).

Alternative Scenario and Stress Tests

15. Stress tests indicate that vulnerabilities remain throughout the projection period, especially to a slowdown in real GDP growth (Figure 2a). The PV of public debt would virtually remain unchanged over most of the medium term and would be around 29 percent of GDP in 2032. Considering remittances yields a similar conclusion (Figure 2b).

16. Two alternative scenarios suggest a very different picture of the debt dynamics over the longer term relative to the baseline. On the one hand, maintaining the primary balance at its 2011 level worsens the debt situation given higher deficit in 2011 related to the utilization of the China EXIM Bank loans. On the other hand, in a historical scenario where the long-term real GDP growth and primary balance are fixed at the average of the past decade (both of which are worse than in the baseline), the debt

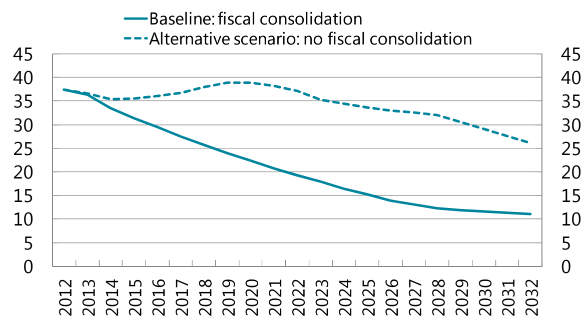
[5] In this alternative scenario, the following four variables are set at their historical levels; (i) real GDP growth; (ii) growth of GDP deflator (in U.S. dollar terms); (iii) non-interest account in percent of GDP; and (iv) non-debt creating flows.

[6] 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.

position would deteriorate over the medium to long term and remain close to its 2011/12 level over the medium term. The results of these alternative scenarios highlight the importance of achieving primary surpluses of around 1 percent of GDP in the medium to long term, and raising the potential rate of growth in order to ensure a more manageable debt dynamics.

17. A no-reform scenario also highlights the importance of implementing the ambitious fiscal consolidation strategy articulated by the Government. In a scenario of no tax reforms coupled with the status quo in current government expenditure, the authorities will have to borrow domestically to bridge the financing gap. In such a scenario, additional external funding may not be forthcoming due to lack of commitment to reforms. This will cause further stress on the already high public debt level, and will keep the NPV of the debt-to-GDP ratio close to the current level for more than a decade due to the greater debt accumulation as well as lower growth related to a crowding-out of private investment. Debt dynamics would deteriorate in a no-tax-reform scenario even if the authorities attempt to cut capital spending and avoid excessive domestic borrowing, due to the multiplier effects of the lower public investment on economic growth (see figure).

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



Source: Fund staff calculations.

STAFF ASSESSMENT

18. Tonga remains at a high risk of external debt distress. While Tonga benefits from high remittance inflows, which clearly reduces its liquidity risks, remittances are insufficient to limit risks from projected debt service payments. Fiscal authorities need to build enough cash balances to ensure servicing of the increased external debt obligations from FY2013/14 without sacrificing essential public services. In the absence of further fiscal consolidation through an increased tax-to-GDP ratio and expenditure prioritization, Tonga risks repayment difficulties. Additionally, the authorities have exposed themselves to a currency mismatch on the government's balance sheet (about 61 percent of the external debt are denominated in Chinese renminbi) which, if left unhedged, could pose an additional risk to Tonga's debt dynamics.

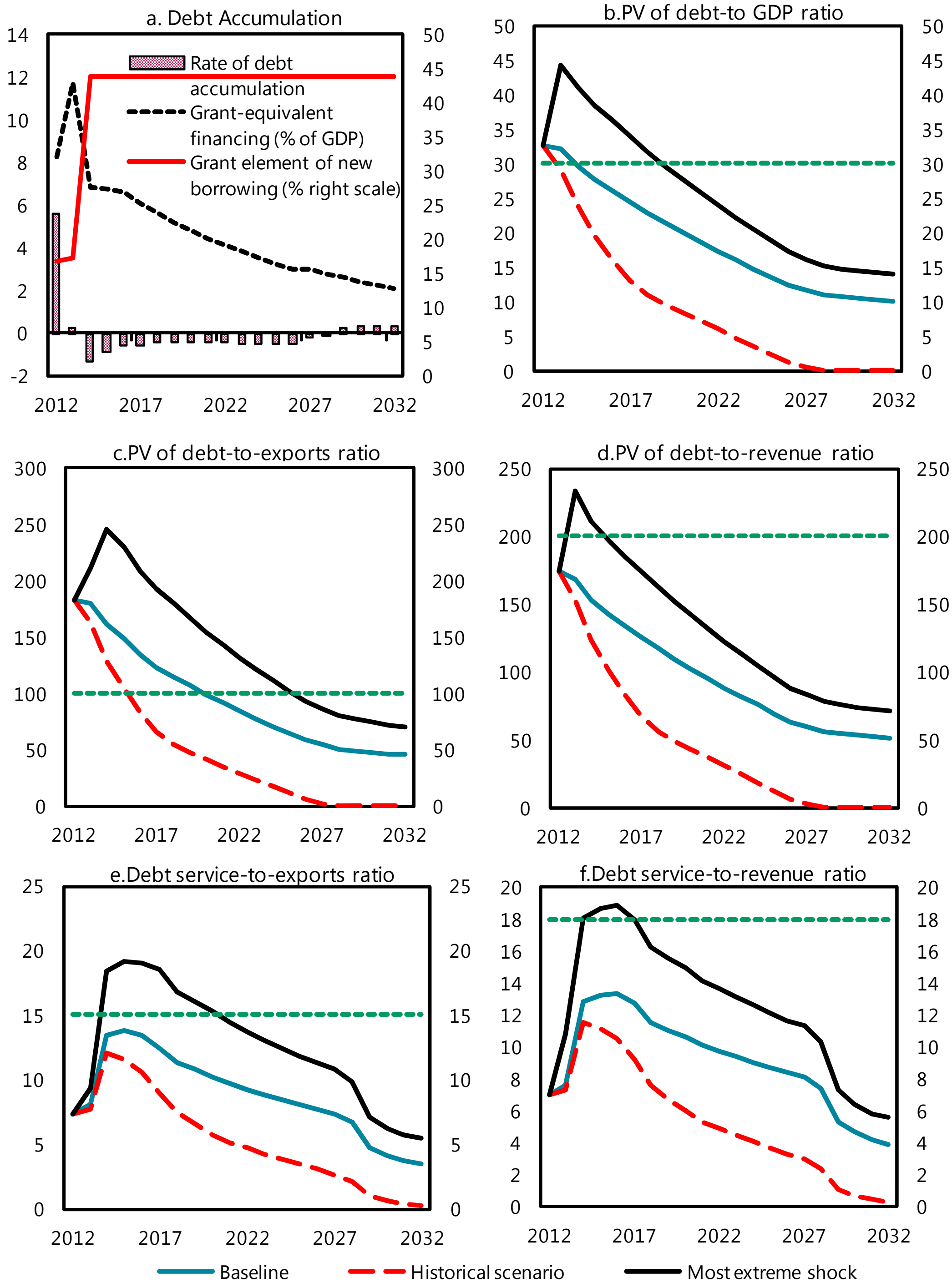
19. Despite being at high risk, Tonga's debt dynamics are manageable. Tonga is able to service its current obligations, and the overall public sector debt situation, while elevated over the short term, shows a downward trend over the longer run assuming that the authorities avoid taking on significant additional new debt in the short to medium term, and undertake reforms aimed at raising potential growth and achieving fiscal consolidation.

20. Key medium-term vulnerabilities include lower GDP growth, major external shocks, currency mismatches and credit risks on government's balance sheet, and new borrowings on less concessional terms. These vulnerabilities underscore the importance of sound macroeconomic policies to improve Tonga's growth potential on a sustained basis, export diversification, and continued efforts in fiscal consolidation. Moreover, utilization of donor grants and avoidance of new borrowing in the next two–three years is necessary to reduce the risk of external debt distress. Sound public debt management, anchored in a medium-term debt management strategy and in line with the medium-term fiscal framework, is also essential to guide future development financing in Tonga. Priority should be given to projects which would help generate higher growth and employment, especially in the context of the Tonga Strategic Development Framework (TSDF), to help build debt service capacity in the future. Consideration should also be given to hedging exchange risks on its foreign liabilities using financial instruments and developing a comprehensive debt management strategy with technical assistance.

Authorities' views

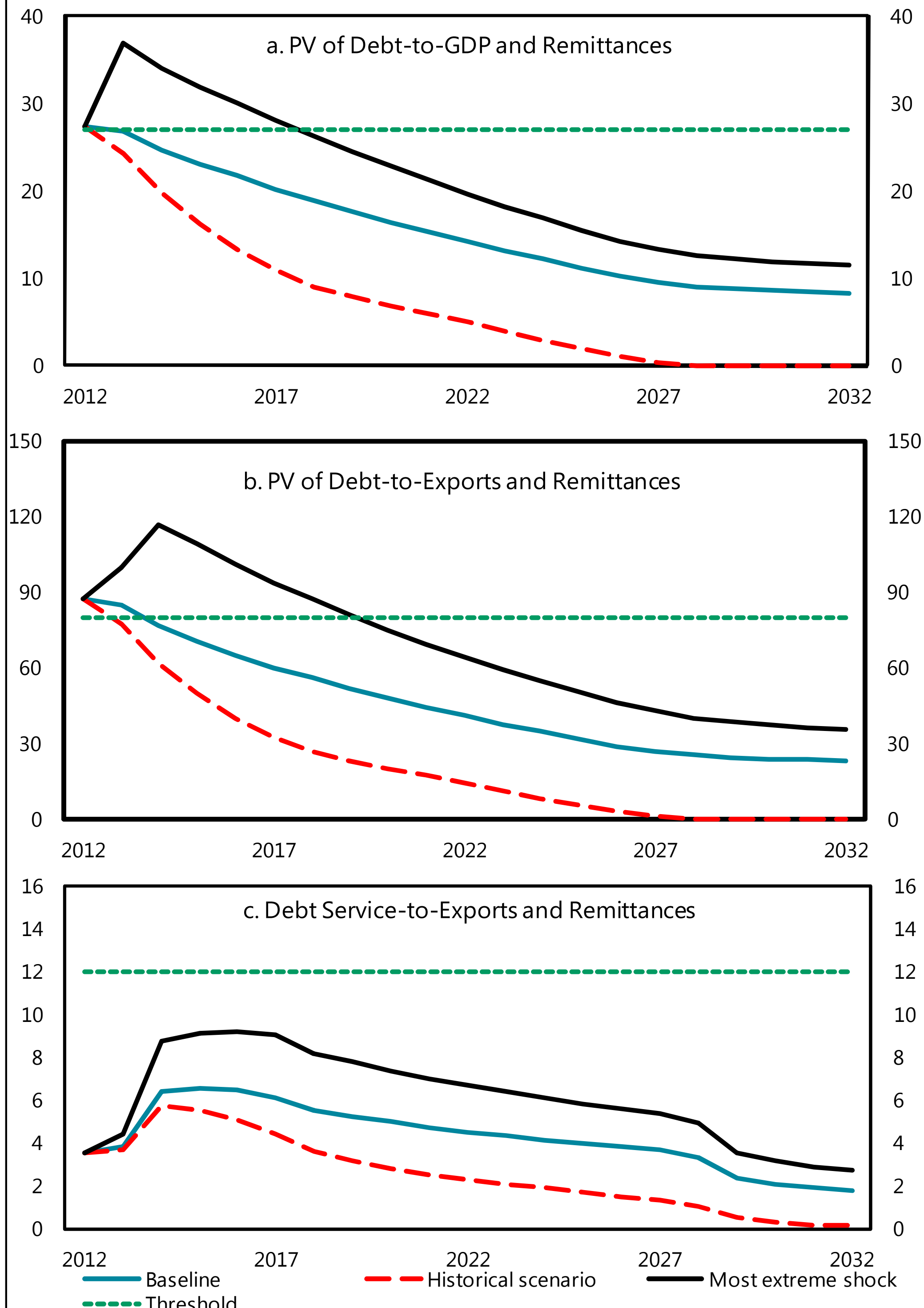
21. The authorities recognize the risks posed by the high debt burden and wanted to bring down the public debt below 40 percent of GDP. The authorities agreed that further fiscal consolidation and no new borrowing will be crucial in reducing the debt burden and creating fiscal space for priority spending. In discussions with staff, the authorities noted that they might seek to reschedule some of its debt obligations to China EXIM bank, and were also concerned about the currency risk posed by the current external debt structure and wanted to learn about possible ways to mitigate it.

Figure 1a. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2012–32 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2022. 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. Data refer to last date in fiscal year (e.g., 2012, refers to FY ending June 30, 2012). Revenues are defined inclusive of grants.

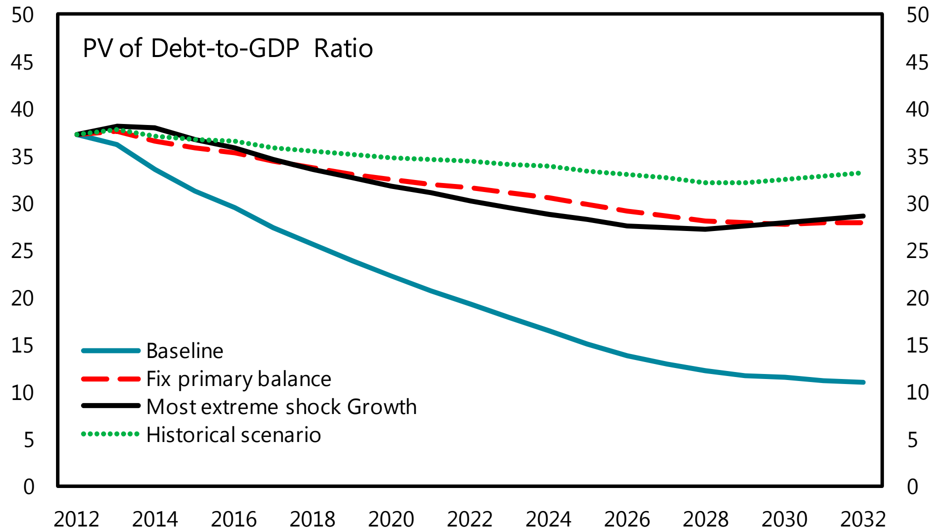
Figure 1b. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, with Remittances, 2012–32 1/

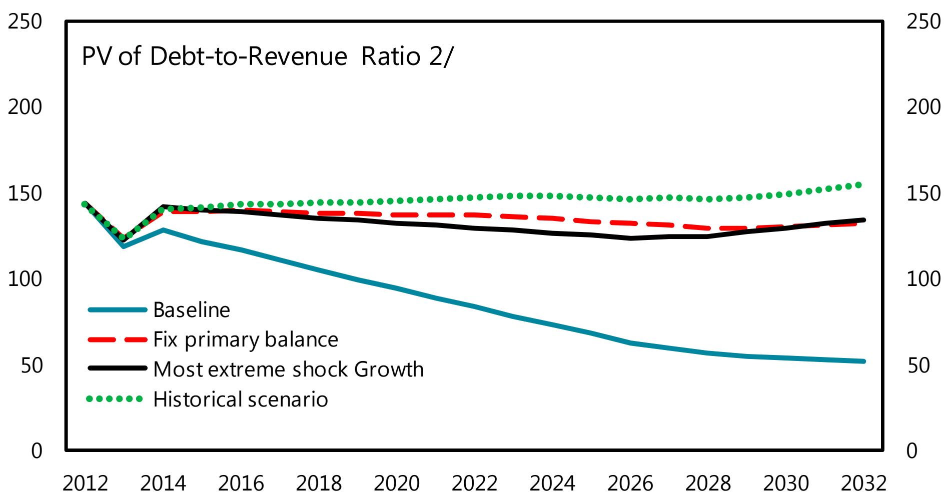


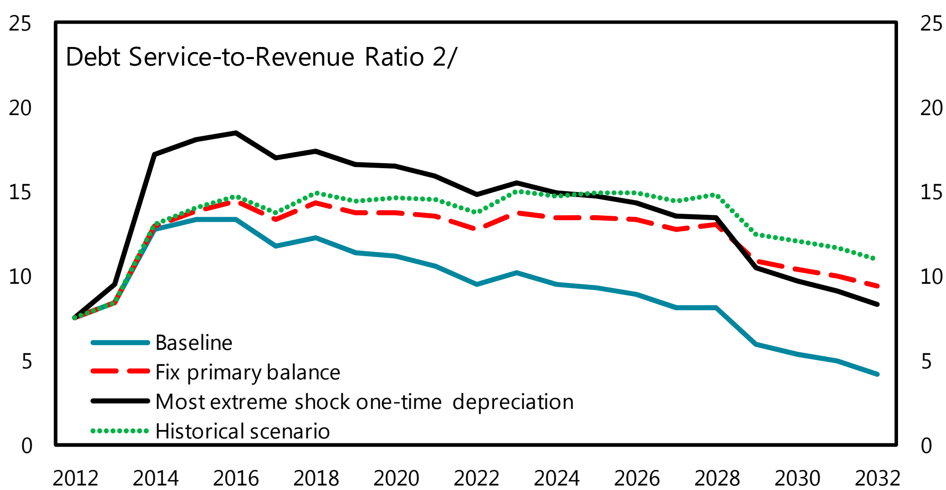
Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure a, it corresponds to a one-time depreciation shock; in b, to a exports shock; and in c, to a exports shock. Data refer to last date in fiscal year (e.g., 2012, refers to FY ending June 30, 2012).

Figure 2a.Tonga: Indicators of Public Debt Under Alternative Scenarios, 2012–32 1/

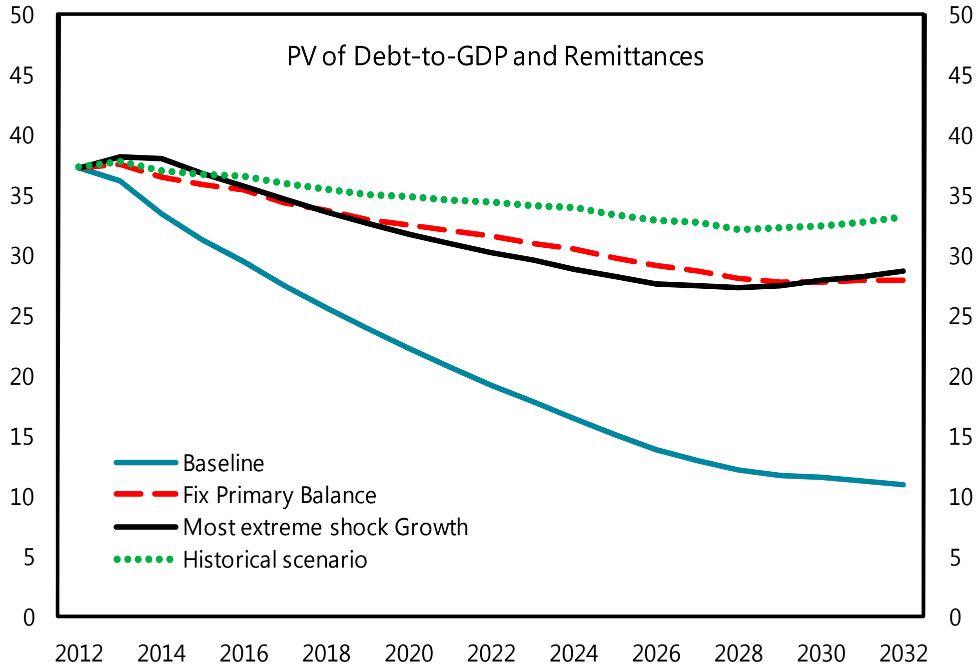






Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2022. Data refer to last date in fiscal year (e.g., 2012, refers to FY ending June 30, 2012).
2/ Revenues are defined inclusive of grants.

Figure 2b.Tonga: Indicators of Public Debt Under Alternative Scenarios, with Remittances, 2012–32 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. Data refer to last date in fiscal year (e.g., 2012, refers to FY ending June 30, 2012).

Table 1a.Tonga: External Debt Sustainability Framework, Baseline Scenario, 2009–32 1/

(In percent of GDP, unless otherwise indicated)

	Actual					Projections									
				Historical	Standard							2012–17			2018–32
	2009	2010	2011	Average	Deviation	2012	2013	2014	2015	2016	2017	Average	2022	2032	Average
External debt (nominal) 1/	31.7	32.8	36.3			40.8	39.4	36.2	34.0	32.4	30.6		23.2	16.5	
Of which public and publicly guranteed (PPG)	31.7	32.8	36.3			40.8	39.4	36.2	34.0	32.4	30.6		23.2	16.5	
Change in external debt	8.8	1.1	3.6			4.4	-1.3	-3.3	-2.2	-1.6	-1.8		-1.4	-0.1	
Identified net debt-creating flows	5.3	-2.6	-4.4			3.8	0.1	1.4	1.0	0.8	0.6		-0.8	-0.4	
Non-interest current account deficit	8.3	6.1	0.9	2.9	4.4	5.6	1.7	3.2	2.8	2.6	2.7		2.9	3.1	3.0
Deficit in balance of goods and services	44.0	36.4	32.8			36.1	34.6	34.4	34.7	34.2	33.8		33.1	31.3	
Exports	13.4	13.1	18.0			17.8	17.9	18.5	18.7	19.5	19.9		20.6	22.3	
Imports	57.4	49.4	50.8			54.0	52.6	52.9	53.4	53.7	53.7		53.7	53.5	
Net current transfers (negative = inflow)	-33.0	-28.5	-28.8	-31.2	2.5	-27.5	-29.9	-28.3	-28.9	-28.7	-28.3		-27.5	-25.7	-26.9
Of which official	-5.3	-3.1	-5.3			-5.7	-7.9	-5.7	-6.0	-5.5	-5.1		-3.3	-1.4	
Other current account flows (negative = net inflow)	-2.7	-1.7	-3.1			-3.0	-3.0	-3.0	-2.9	-2.9	-2.8		-2.7	-2.5	
Net FDI (negative = inflow)	-6.1	-5.3	-1.8	-4.0	2.8	-1.7	-1.7	-1.7	-1.8	-1.8	-2.1		-3.7	-3	-3.5
Endogenous debt dynamics 2/	3.2	-3.4	-3.5			0.0	0.2	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	
Contribution from nominal interest rate	0.6	0.6	0.6			0.5	0.6	0.6	0.6	0.5	0.5		0.3	0.2	
Contribution from real GDP growth	0.0	-0.5	-0.4			-0.5	-0.5	-0.7	-0.6	-0.6	-0.6		-0.4	-0.3	
Contribution from price and exchange rate changes	2.5	-3.4	-3.7			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	3.6	3.7	8.0			0.6	-1.5	-4.7	-3.2	-2.3	-2.4		-0.5	0.3	
Of which exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	28.6			32.7	32.1	29.7	27.9	26.3	24.5		17.3	10.2	
In percent of exports	...	...	158.8			183.4	179.4	161.1	148.8	134.5	123.2		84.2	45.8	
PV of PPG external debt	...	...	28.6			32.7	32.1	29.7	27.9	26.3	24.5		17.3	10.2	
In percent of exports	...	...	159			183	179	161	149	135	123		84	46	
In percent of government revenues	...	...	142			174	169	153	143	134	126		88	52	
Debt service-to-exports ratio (in percent)	5.6	9.8	6.9			7.4	8.1	13.5	13.8	13.4	12.5		9.3	3.5	
PPG debt service-to-exports ratio (in percent)	5.6	9.8	6.9			7.4	8.1	13.5	13.8	13.4	12.5		9.3	3.5	
PPG debt service-to-revenue ratio (in percent)	2.7	6.2	6.1			7.0	7.6	12.8	13.2	13.4	12.8		9.7	3.9	
Total gross financing need (Millions of U.S. dollars)	9.0	7.4	1.6			24.1	6.9	19.8	19.0	18.6	17.6		8.4	5.4	
Non-interest current account deficit that stabilizes debt ratio	-0.6	5.0	-2.7			1.2	3.0	6.4	5.0	4.2	4.5		4.3	3.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	0.0	1.9	1.4	0.8	3.4	1.6	1.2	1.8	1.8	1.8	1.8	1.7	1.8	1.8	1.8
GDP deflator in US dollar terms (change in percent)	-10.0	12.1	12.8	8.1	8.3	11.8	2.5	1.8	1.7	2.0	2.7	3.8	3.2	3.2	3.2
Effective interest rate (percent) 5/	2.5	2.2	2.0	1.4	0.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.4	1.0	1.3
Growth of exports of G&S (US dollar terms, in percent)	-0.4	11.3	57.4	14.2	23.6	12.6	4.2	6.8	5.0	8.3	6.5	7.2	5.9	5.6	5.8
Growth of imports of G&S (US dollar terms, in percent)	-4.7	-1.6	17.4	10.5	12.9	20.6	1.1	4.2	4.6	4.4	4.5	6.6	5.0	4.9	5.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	16.8	17.2	43.9	43.9	43.9	43.9	34.9	43.9	43.9	43.9
Government revenues (excluding grants, in percent of GDP)	27.7	20.7	20.2			18.8	19.0	19.4	19.5	19.6	19.5		19.6	19.7	19.6
Aid flows (in Millions of US dollars) 7/	21.8	22.8	28.5			33.7	56.2	34.2	38.6	41.2	40.0		35.3	32.9	
Of which grants	21.8	22.8	28.5			33.7	56.2	34.2	32.6	31.2	30.0		25.3	17.9	
Of which concessional loans	0.0	0.0	0.0			0.0	0.1	0.1	6.0	10.0	10.0		10.0	15.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			8.3	11.7	6.8	6.8	6.6	6.1		4.1	2.1	3.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			61.5	96.0	99.9	91.3	86.4	86.0		84.1	74.5	80.7
Memorandum items:															
Nominal GDP (Millions of US dollars)	314.9	359.8	411.3			466.9	484.5	502.1	520.0	540.1	564.6		721.6	1178.6	
Nominal dollar GDP growth	-10.0	14.3	14.3			13.5	3.8	3.6	3.6	3.9	4.5	5.5	5.0	5.0	5.0
PV of PPG external debt (in Millions of US dollars)			127.6			150.8	152.1	145.8	141.6	138.8	135.9		122.9	118.2	
(PVt-PVt-1)/GDPt-1 (in percent)						5.6	0.3	-1.3	-0.8	-0.5	-0.5	0.5	-0.4	0.3	-0.2
Gross remittances (Millions of US dollars)	84.0	82.0	87.5			91.9	96.5	102.3	107.6	112.8	118.1		157.0	257.2	
PV of PPG external debt (in percent of GDP + remittances)	...	...	23.6			27.3	26.8	24.7	23.1	21.7	20.3		14.2	8.4	
PV of PPG external debt (in percent of exports + remittances)	...	...	72.8			87.2	84.9	76.6	70.7	65.0	60.0		40.9	23.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.1			3.5	3.8	6.4	6.5	6.5	6.1		4.5	1.8	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt. Data refer to last date in fiscal year (e.g., 2012 refers to FY ending June 30, 2012).

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) 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, 2012–32 1/

(In percent)

						Projections						
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2032**
PV of debt-to GDP ratio												
Baseline	33	32	30	28	26	24	23	21	20	19	**17**	10
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 2/	33	29	24	20	16	13	11	10	8	7	**6**	0
A2. New public sector loans on less favorable terms in 2012-2032 3/	33	32	29	28	27	26	25	24	23	22	**21**	18
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	33	33	32	30	28	26	24	23	21	20	**18**	11
B2. Export value growth at historical average minus one standard deviation in 2013-2014 4/	33	33	34	32	30	28	26	25	23	22	**20**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	33	32	30	29	27	25	24	22	21	19	**18**	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014	33	33	30	28	27	25	24	22	21	19	**18**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	33	31	29	27	25	24	22	21	19	18	**17**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 6/	33	44	41	38	36	34	32	30	28	26	**24**	14
PV of debt-to-exports ratio												
Baseline	183	179	161	149	135	123	115	107	99	91	**84**	46
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 2/	183	163	129	105	83	66	55	48	41	35	**29**	0
A2. New public sector loans on less favorable terms in 2012-2032 3/	183	176	158	148	137	130	124	119	113	108	**103**	80
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	183	175	157	145	131	121	113	105	97	90	**83**	45
B2. Export value growth at historical average minus one standard deviation in 2013-2014 4/	183	211	246	229	209	192	179	167	155	143	**132**	70
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	183	175	157	145	131	121	113	105	97	90	**83**	45
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014	183	181	164	152	137	126	118	110	101	94	**86**	47
B5. Combination of B1-B4 using one-half standard deviation shocks	183	177	162	149	135	124	116	108	99	92	**85**	46
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 6/	183	175	157	145	131	121	113	105	97	90	**83**	45
PV of debt-to-revenue ratio												
Baseline	174	169	153	143	134	126	118	110	102	95	**88**	52
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 2/	174	154	123	101	83	68	56	49	43	37	**31**	0
A2. New public sector loans on less favorable terms in 2012-2032 3/	174	166	150	142	137	132	127	122	117	113	**108**	90
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	174	171	162	151	142	134	125	117	109	102	**94**	55
B2. Export value growth at historical average minus one standard deviation in 2013-2014 4/	174	173	173	162	154	145	136	127	118	110	**103**	59
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	174	170	157	146	138	129	121	113	105	98	**91**	53
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014	174	171	156	145	137	129	121	113	105	98	**91**	53
B5. Combination of B1-B4 using one-half standard deviation shocks	174	165	147	137	129	121	113	106	98	92	**85**	50
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 6/	174	233	211	197	185	174	163	152	142	132	**123**	72

Table 1b.Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012–32 (continued)

(In percent)

						Projections						
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2032**
Debt service-to-exports ratio												
Baseline	7	8	13	14	13	13	11	11	10	10	**9**	3
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 2/	7	8	12	12	11	9	7	7	6	5	**5**	0
A2. New public sector loans on less favorable terms in 2012-2032 3/	7	8	11	11	11	11	10	10	9	9	**8**	4
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	7	8	13	14	13	12	11	11	10	10	**9**	3
B2. Export value growth at historical average minus one standard deviation in 2013-2014 4/	7	9	18	19	19	19	17	16	15	14	**14**	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	7	8	13	14	13	12	11	11	10	10	**9**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 5/	7	8	14	14	14	13	12	11	10	10	**9**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	7	8	14	15	14	13	12	11	11	10	**10**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 6/	7	8	13	14	13	12	11	11	10	10	**9**	3
Debt service-to-revenue ratio												
Baseline	7	8	13	13	13	13	12	11	11	10	**10**	4
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 2/	7	7	12	11	11	9	8	7	6	5	**5**	0
A2. New public sector loans on less favorable terms in 2012-2032 3/	7	8	11	11	11	11	10	10	10	9	**9**	4
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	7	8	14	14	14	14	13	12	11	11	**10**	4
B2. Export value growth at historical average minus one standard deviation in 2013-2014 4/	7	8	13	14	14	14	13	12	12	11	**11**	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	7	8	13	14	14	13	12	12	11	11	**10**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 5/	7	8	13	13	14	13	12	11	11	10	**10**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	7	8	13	13	13	13	11	11	10	10	**10**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 6/	7	11	18	19	19	18	16	16	15	14	**14**	6
Memorandum item:												
Grant element assumed on residual financing (i.e., financing required above baseline) 7/	37	37	37	37	37	37	37	37	37	37	**37**	37

Sources: Country authorities; and staff estimates and projections.

1/ Data refer to last date in fiscal year (e.g., 2012 refers to FY ending June 30, 2012).

2/ 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.

3/ 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.

4/ 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).

5/ Includes official and private transfers and FDI.

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

7/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 3.

Table 2a.Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, 2009–32 1/

(In percent of GDP, unless otherwise indicated)

	Actual					Projections									
	2009	2010	2011	Historical Average	Standard Deviation	2012	2013	2014	2015	2016	2017	2012-17 Average	2022	2032	2018-32 Average
Public sector debt 2/	39.3	41.2	41.8			45.4	43.6	40.0	37.5	35.7	33.6		25.2	17.3	
Of which foreign-currency denominated	31.7	32.8	36.3			40.8	39.4	36.2	34.0	32.4	30.6		23.2	16.5	
Change in public sector debt	8.0	1.9	0.7			3.5	-1.8	-3.6	-2.5	-1.8	-2.1		-1.5	-0.2	
Identified debt-creating flows	2.6	3.0	-1.3			0.7	-2.2	-2.7	-2.6	-2.4	-2.4		-2.4	-1.3	
Primary deficit	-0.6	5.2	5.1	0.6	2.8	1.9	-1.5	-1.9	-1.8	-1.5	-1.3	-1.0	-1.5	-0.7	-1.0
Revenue and grants	34.6	27.0	27.1			26.0	30.6	26.2	25.8	25.4	24.8		23.1	21.2	
of which: grants	6.9	6.3	6.9			7.2	11.6	6.8	6.3	5.8	5.3		3.5	1.5	
Primary (noninterest) expenditure	34.0	32.2	32.2			27.9	29.1	24.4	24.0	23.8	23.5		21.6	20.5	
Automatic debt dynamics	3.2	-2.2	-6.5			-0.6	-0.5	-0.8	-0.8	-0.9	-1.1		-0.9	-0.7	
Contribution from interest rate/growth differential	0.4	-0.5	-0.7			-0.6	-0.2	-0.4	-0.5	-0.5	-0.5		-0.4	-0.3	
of which: contribution from average real interest rate	0.4	0.2	-0.1			0.1	0.3	0.3	0.2	0.2	0.1		0.1	0.0	
of which: contribution from real GDP growth	0.0	-0.7	-0.6			-0.6	-0.5	-0.8	-0.7	-0.7	-0.6		-0.5	-0.3	
Contribution from real exchange rate depreciation	2.8	-1.7	-5.8			0.0	-0.3	-0.4	-0.3	-0.4	-0.6		...	...	
Other identified debt-creating flows	0.0	0.0	0.1			-0.6	-0.2	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	0.0	0.1			-0.6	-0.2	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	5.4	-1.1	2.0			2.8	0.4	-0.9	0.1	0.6	0.4		0.8	1.1	
Other Sustainability Indicators															
PV of public sector debt	...	...	34.1			37.3	36.3	33.5	31.4	29.5	27.5		19.3	11.1	
Of which foreign-currency denominated	...	...	28.6			32.7	32.1	29.7	27.9	26.3	24.5		17.3	10.2	
Of which external	...	...	28.6			32.7	32.1	29.7	27.9	26.3	24.5		17.3	10.2	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 3/	0.3	6.7	8.0			3.8	1.1	1.5	1.7	1.9	1.6		0.7	0.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	125.7			143.6	118.4	127.9	121.6	116.3	110.7		83.5	52.1	
PV of public sector debt-to-revenue ratio (in percent)	...	...	168.9			198.8	190.6	172.7	160.7	150.5	140.8		98.5	56.2	
Of which external 4/	...	...	141.6			174.2	168.9	153.1	142.8	134.1	125.6		88.5	51.9	
Debt service-to-revenue and grants ratio (in percent) 5/	2.6	5.4	10.7			7.5	8.4	12.8	13.3	13.4	11.8		9.5	4.2	
Debt service-to-revenue ratio (in percent) 5/	3.2	7.1	14.4			10.4	13.5	17.3	17.6	17.3	15.0		11.2	4.6	
Primary deficit that stabilizes the debt-to-GDP ratio	-8.6	3.3	4.4			-1.7	0.3	1.7	0.7	0.3	0.8		0.1	-0.5	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	0.0	1.9	1.4	0.8	3.4	1.6	1.2	1.8	1.8	1.8	1.8	1.7	1.8	1.8	1.8
Average nominal interest rate on forex debt (in percent)	2.5	2.2	2.0	1.4	0.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.4	1.0	1.3
Average real interest rate on domestic debt (in percent)	2.8	-1.2	-3.2	-4.2	4.4	0.9	-0.5	-0.7	-0.6	-0.6	-0.6	-0.3	-0.6	-0.6	-0.6
Real exchange rate depreciation (in percent, + indicates depreciation)	12.0	-5.6	-17.8	-6.5	7.5	-0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-1.2	3.7	7.1	7.2	5.2	4.3	6.4	6.8	6.7	6.7	6.8	6.3	6.8	6.8	6.8
Growth of real primary spending (deflated by GDP deflator, in percent)	0.4	0.0	0.0	0.1	0.2	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	16.8	17.2	43.9	43.9	43.9	43.9	34.9	43.9	43.9	...

Sources: Country authorities; and staff estimates and projections.

1/ Data refer to last date in fiscal year (e.g., 2012 refers to FY ending June 30, 2012).

2/ Data covers general government and nonfinancial public enterprises. Gross debt is used.

3/ 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.

4/ Revenues excluding grants.

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

6/ 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 2012–32 1/

(In percent)

	Projections							
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2022**	**2032**
PV of Debt-to-GDP Ratio								
Baseline	37	36	34	31	29	27	**19**	11
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	37	38	37	37	37	36	**34**	33
A2. Primary balance is unchanged from 2011	37	38	37	36	35	34	**32**	28
A3. Permanently lower GDP growth 2/	37	37	34	33	31	30	**26**	31
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	37	38	38	37	36	35	**30**	29
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	37	39	40	38	36	34	**25**	15
B3. Combination of B1-B2 using one half standard deviation shocks	37	39	40	38	37	35	**29**	23
B4. One-time 30 percent real depreciation in 2013	37	51	48	46	43	40	**29**	17
B5. 10 percent of GDP increase in other debt-creating flows in 2013	37	43	40	38	36	34	**24**	15
PV of Debt-to-Revenue Ratio 3/								
Baseline	144	118	128	122	116	111	**84**	52
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	144	123	141	142	143	143	**147**	154
A2. Primary balance is unchanged from 2011	144	123	139	139	140	139	**137**	132
A3. Permanently lower GDP growth 2/	144	119	130	126	123	120	**111**	146
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	144	123	142	140	139	137	**130**	134
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	144	129	153	147	142	136	**107**	71
B3. Combination of B1-B2 using one half standard deviation shocks	144	128	151	148	144	141	**124**	110
B4. One-time 30 percent real depreciation in 2013	144	168	185	177	169	162	**125**	81
B5. 10 percent of GDP increase in other debt-creating flows in 2013	144	140	153	147	141	135	**106**	70

Table 2b.Tonga: Sensitivity Analysis for Key Indicators of Public Debt 2012-2032 1/ (continued)

(In percent)

	Projections							
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2022**	**2032**
Debt Service-to-Revenue Ratio 3/								
Baseline	8	8	13	13	13	12	**10**	4
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	8	8	13	14	15	14	**14**	11
A2. Primary balance is unchanged from 2011	8	8	13	14	14	13	**13**	9
A3. Permanently lower GDP growth 2/	8	8	13	14	14	12	**11**	10
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	8	9	14	14	15	13	**13**	10
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	8	8	13	14	15	14	**11**	6
B3. Combination of B1-B2 using one half standard deviation shocks	8	9	14	15	15	14	**12**	8
B4. One-time 30 percent real depreciation in 2013	8	10	17	18	18	17	**15**	8
B5. 10 percent of GDP increase in other debt-creating flows in 2013	8	8	13	15	16	14	**11**	6

Sources: Country authorities; and staff estimates and projections.

1/ Data refer to last date in fiscal year (e.g., 2012 refers to FY ending June 30, 2012).

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

3/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/64
FOR IMMEDIATE RELEASE
June 27, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Tonga

On May 16, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.[1]

Background

Tonga's economy is recovering gradually from the effects of the global slowdown and the domestic credit crunch, thanks to the pickup in construction activity and rebound in tourism. However, private consumption has been anemic due to the decline in remittance inflows. In addition, banks' lending standards have remained tight, constraining private consumption and investment. Real GDP growth is forecast to be around 1½ percent in FY2011/12, led by stronger tourism activity and a continued fiscal stimulus funded by donor aid and previously contracted concessional loans.

CPI inflation declined to 2½ percent y/y in February 2012, reflecting mainly stabilization in fuel and food prices as well as exchange rate appreciation. Inflation is likely to average around 4½ percent in FY2011/12.

The fiscal position has strengthened but vulnerabilities remain. Generous grant inflows from donors contributed to narrowing the fiscal deficit to an estimated 2¾ percent of GDP in 2011/12 (from about 6 percent of GDP in FY2010/11). Capital expenditure is

---

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

expected to be lower by 2 percentage points of GDP due to the completion of the reconstruction of the central business district and near completion of the road projects using the China EXIM Bank loans. Nevertheless, Tonga remains at a “high risk of external debt distress” according to this year’s World Bank-IMF debt sustainability analysis.

Buoyant official development assistance helped improve the balance of payment position, which allowed the National Reserve Bank of Tonga (NRBT) to let the currency appreciate by 6 percent against the US$ and real effective terms in 2011 to help curb inflation pressures stemming from rising fuel and food import prices. The level of reserves increased to around $130 million as of end-2011, covering more than 6 months of imports of goods and services.

Monetary conditions have remained accommodative over the past two years, but with no signs of a pickup in private credit. Monetary policy has been appropriately geared toward encouraging bank lending. The banking system is adequately capitalized and profitable but credit costs related to the rise in non-performing loans (NPLs) following the 2004-08 credit bubble remain high; and banks have continued to restrain credit amidst an uncertain outlook.

Executive Board Assessment

Directors welcomed Tonga’s recovery from the global crisis but noted remaining vulnerabilities and a high debt burden. With downside risks clouding the outlook, Directors emphasized the importance of strengthening policy buffers and the foundation for faster and more inclusive growth.

Directors concurred that fiscal consolidation is needed to rebuild the government’s cash balances and safeguard debt sustainability. Accordingly, containing the public sector’s wage bill, prioritizing expenditures, and broadening the tax base remain top policy priorities for the period ahead. More broadly, Directors encouraged the authorities to implement their fiscal plans within a medium-term framework and further improve the quality of public spending to meet Tonga’s development objectives.

Directors considered the current accommodative monetary policy stance appropriate in light of the banks’ cautious approach to lending. Taking note of the staff’s assessment that the exchange rate is broadly in line with fundamentals, Directors agreed that, going forward, the exchange rate could absorb the bulk of external shocks with official intervention limited to smoothing operations.

Directors supported steps underway to reduce credit risk and strengthen financial intermediation. They welcomed recent legislation to improve the registration of collateral and recommended further financial sector reforms such as establishing a centralized credit bureau, facilitating land leases, and enacting a bankruptcy law. Directors also urged the authorities to continue to resist pressure to administer bank lending rates.

Directors underscored the importance of removing structural hurdles to private investment and reducing the cost of doing business, including through public enterprise reforms. Steps in this direction would lay the groundwork for broadening the production base and reducing poverty.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Tonga: Selected Economic Indicators, 2007/08–2012/13 1/

				Prelim.	Proj.	
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
			(Annual percent change)			
Output and prices						
Real GDP 2/	1.1	0.0	1.9	1.4	1.6	1.2
Consumer prices (period average)	9.6	5.5	1.7	6.1	4.6	4.5
Consumer prices (end of period)	12.2	1.2	2.7	7.9	3.0	6.0
GDP deflator	7.9	-1.2	3.7	7.1	4.3	6.4
			(In percent of GDP)			
Central government finance						
Total revenue and grants	25.8	34.6	27.0	27.1	26.0	30.6
Total revenue	24.4	27.7	20.7	20.2	18.8	19.0
Grants	1.3	6.9	6.3	6.9	7.2	11.6
Total expenditure and net lending	24.3	34.8	33.0	33.0	28.7	30.0
Of which: Current expenditure	23.8	25.5	27.7	23.7	21.2	25.5
Capital expenditure	0.5	6.1	4.0	7.8	5.8	4.5
Overall balance	1.5	-0.2	-6.0	-5.9	-2.7	0.6
Overall balance (excl. China's EXIM Bank loans)	...	5.5	-1.8	1.6	3.3	1.2
External financing (net)	0.2	5.5	3.6	6.8	5.2	-0.3
Domestic financing (net)	-1.7	-5.3	2.5	-0.9	-2.5	-0.3
			(Annual percent change)			
Money and credit						
Total liquidity 3/	8.2	-1.8	5.1	3.1	5.4	7.5
Of which: Broad money (M2)	9.2	-2.4	5.6	3.3	5.9	7.7
Domestic credit	13.9	-5.2	-11.5	-12.3	-3.8	8.9
Of which: Private sector credit	17.1	-3.7	-15.6	-9.9	0.9	5.2
Interest rates (end of period)						
Average deposit rate	5.7	4.9	3.4	3.4	...	...
Base lending rate	10.0	10.0	9.6	9.6	...	...
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	8.3	7.2	7.9	10.9	11.7	12.4
Imports, f.o.b.	-142.2	-130.5	-130.4	-152.5	-184.5	-184.7
Services (net)	-13.3	-15.2	-8.5	6.7	4.2	4.3
Investment income (net)	7.5	6.4	4.0	10.2	11.6	11.7
Current transfers (net)	114.2	104.0	102.7	118.6	128.5	145.1
Of which: Remittances	106.7	84.0	82.0	87.5	91.9	96.5
Current account balance	-25.6	-28.1	-24.2	-6.1	-28.6	-11.2
(In percent of GDP)	-7.3	-8.9	-6.7	-1.5	-6.1	-2.3
Current account balance (excl. imports related to China EXIM Bank loans)	-25.6	-19.6	-15.5	14.2	-11.1	-9.0
(In percent of GDP)	-7.3	-6.2	-4.3	3.4	-2.4	-1.9
Overall balance	1.2	19.5	20.9	32.0	3.5	12.3
Terms of trade (annual percent change)	-1.7	-5.3	5.9	-5.1	...	...
Gross official foreign reserves						
In millions of U.S. dollars	48.2	67.7	88.7	120.7	124.2	136.6
(In months of next year's goods and services imports)	3.2	4.6	5.1	5.7	5.9	6.2
External debt (in percent of GDP)						
External debt	24.8	31.9	33.3	36.3	40.8	39.4
Debt service ratio	1.4	0.8	1.3	1.2	1.3	1.5
Exchange rates						
Pa'anga per U.S. dollar (period average)	1.9	2.1	1.9	1.8	...	...
Pa'anga per U.S. dollar (end of period)	1.8	2.0	1.9	1.7	...	...
Nominal effective exchange rate (1990=100)	92.1	95.6	96.8	97.4	...	...
Real effective exchange rate (1990=100)	101.1	107.5	108.3	111.5	...	...
Memorandum items:						
Remittances (in percent of GDP)	30.5	26.7	22.8	21.3	19.7	19.9
Tourism (in percent of GDP)	6.3	8.8	7.2	8.1	8.5	8.6
FDI (in percent of GDP)	4.2	6.1	5.3	1.8	1.7	1.7
Nominal GDP (millions of T$)	664.8	656.8	694.1	753.5	798.2	859.4
Gross Disposable Income (millions of T$)	868.9	840.3	852.4	937.4	982.9	1077.3
Population (thousands)	102.4	102.9	103.3	103.7	104.1	104.6

Sources: Data provided by the Tongan authorities; and Fund staff estimates and projections.
1/ Fiscal year beginning July.
2/ Including preliminary data.
3/ From the *Banking Survey* , which includes the Tonga Development Bank.

Statement by Aida S. Budiman, Alternate Executive Director and Shasha Ridzam, Advisor May 16, 2012

1. On behalf of the Tongan authorities, we would like to thank the IMF team for the focused and constructive discussions on macroeconomic developments and policy issues in Tonga. The useful advice rendered during the Article IV consultation will be reflected upon and considered within the authorities' short- and medium-term plans. For the most part, there is broad agreement on almost all of the major policy thrusts.

Economic outlook for FY 2012/13

2. The Tongan economy continues to show encouraging signs of recovery from the prolonged impact of the global financial crisis. The economy experienced a slowdown in growth, a sharp fall in remittances and a decline in revenues. The financial sector also came under pressure as a result of high levels of nonperforming loans in the banking sector. In addition to these factors, high oil prices and the uncertainties in the global economy further complicated macroeconomic and financial conditions. However, in the recent period, domestic economic activity has rebounded with the support of donor-funded construction and infrastructure projects as well as tourism activity.

3. Going forward, growth is projected at 1.2 percent in FY 2012/2013, slightly lower than the 1.6 percent estimated in the previous fiscal year. This is on account of the withdrawal of the fiscal stimulus provided by the China EXIM Bank loans. The authorities assessed that there has been limited immediate positive spillover to the indigenous economy, as these projects utilised imported materials and foreign labour. Nonetheless, the resultant increase in capital stock – in terms of a reconstructed central business district and improved roads – is expected to facilitate business activity over the longer term. In the medium-term horizon, growth is estimated to be in line with historical average. Domestic demand is expected to anchor growth supported by improving private consumption and investment conditions.

4. Notwithstanding these challenges, the external balance of the country continued to improve and confidence in the financial sector was maintained. The level of foreign reserves continued to increase and remains at comfortable levels. After peaking in mid-2011, inflationary pressures have eased and inflation is projected to remain relatively low in the coming months.

5. Tonga remains vulnerable to external shocks and natural calamities due to its geographic isolation, small-sized economy and narrow resource base. The authorities note that the still-fragile and uncertain global outlook coupled with high commodity prices present downside risks to the economy via the potential spillover channels as highlighted by staff. The authorities appreciate work that has been done by the Fund on

Pacific Island countries. This is particularly pertinent considering the increased opportunities and challenges presented by the region's enhanced economic integration with neighbouring countries and emerging Asia.

Navigating a Challenging Global Environment: Policy Challenges and Responses in 2012 – 2013

Fiscal Policy

6. The authorities broadly agree with staff's assessment on fiscal policy. Notwithstanding capacity constraints, reforms are being pursued to consolidate the medium-term fiscal position to ensure fiscal sustainability and promote macroeconomic stability. Fiscal policy is geared to creating more fiscal room to enable the economy to deal with potential shocks and to place the economy on a sustainable debt trajectory. Work in this area is guided by the Medium Term Budget Framework (MTBF), whereas careful prioritization of strategic development projects are laid out in the Tonga Strategic Development Framework (TSDF), the medium-term national development strategy.

7. Thus far, the overall performance of the 2011/12 budget estimate remains satisfactory. The authorities continue to carefully and prudently manage the execution of the budget with significant consideration to not jeopardise the 2011/12 budget that was based on the principle to *"Maintain Macroeconomic Stability without Compromising Service Delivery"*. Measures that were pursued included containing the wage bill, maintaining current spending by way of careful expenditure rationalisation and prioritisation, improving transparency through regular reporting budget performance, and more importantly, pursuing non-distortionary revenue enhancement by improving tax administration and considering presumptive tax for small businesses.

8. The budget for 2012/13 will be built on the theme "Creating Opportunity in Extraordinary Times, in recognition that the fiscal situation will still remain under pressure. Concurrent efforts will be aimed at restoring fiscal space which will allow the authorities to better address the known events, such as the increase in debt repayment from 2013/14, as well as the unforeseen events, including the frequent natural disasters.

9. In anticipation of the lower budgetary support from donors, the authorities are developing non-discriminatory tax measures to enhance revenue. Coordination among related ministries will be enhanced to improve corporate planning and to be in line with the Medium Term Budget Framework. This will improve value for money in public expenditure by appropriately allocating resources to ministries and sectors that have the greatest role to play in achieving the development priorities. This maximises the opportunities to improve both the credibility of the budgetary process and result in more effective and sustainable resource allocation decisions.

Monetary Policy & Exchange Rate

10. The National Reserve Bank of Tonga (NRBT) will remain vigilant to price developments and stands ready to respond to contain inflation risks and maintain comfortable level of foreign reserves. At present, the NRBT continues to pay 1% remuneration on banks' Exchange Settlement Account balances that are above 1 million pa'anga. This endeavour has had some success as bank interest rates continued to decline, by up to 2.65% since the policy took effect in January 2010. However, private sector credit growth (excluding loans from the China EXIM Bank) remains subdued, declining by 11.5 percent over the year ending March 2012, compared to -7.1 percent in the preceding year. The envisaged stimulus to economic activity, therefore, has yet to materialize. Meanwhile, the Reserve Bank will continue to enhance transparency and disclosure processes and to strengthen the transmission mechanism for monetary policy framework.

11. The authorities agreed with the staff's assessment of the exchange rates and will continue to use the exchange rate flexibility if required.

Financial Sector

12. The authorities note staff's view that it is more effective to incentivise credit flow via measures that directly tackle the impediments to bank lending, as opposed to administering interest rates. The latter could entail distortionary effects such as hampering banks' ability to price risks and cause a further rationing of credit to the most creditworthy borrowers. Since the last Board meeting, the new electronic registry under the Personal Property Securities Act which ensures timely registration of collateral, went live in April 2011. Further measures to strengthen the credit environment such as the establishment of the credit bureau and reforms to land administration under the Land Act are work in progress. The bankruptcy protection law is to be resubmitted for reconsideration in the 2012 parliamentary session. In addition, effective supervision of banks to ensure financial stability and transparency (especially, in interest rate and fee structure), could potentially reduce borrowing costs and improve access to finance. Given the dominant role of credit risks in explaining interest rate spreads in Tonga, mechanisms to encourage greater risk sharing such as partial guarantee fund (capitalised by donors or Government through a budgetary allocation) channeled through the banking sector to priority economic sectors with clear eligibility criteria is under consideration. Furthermore, there is a need to build financial competence and inclusion through the formal education curricula.

13. On the supervisory front, the NRBT's oversight continues to focus on banks' credit risk management owing to the heightened level of NPLs. The spate of loose lending prior to the global financial crisis, economic malaise and the decline in remittances have contributed to the rise in NPLs over the past three years. Tonga has received technical assistance from the IMF and PFTAC to fortify its supervisory

framework, such as in designing new prudential returns, onsite examinations, enhancing offsite monitoring tools and staff training.

Structural Reforms

14. The authorities recognize that Tonga's medium-term prospects depend on the continued implementation of its structural reforms. To promote and remove impediments to private sector development, broaden the sources of growth, reduce reliance on remittances and build policy space to respond to future shocks, various measures have been implemented while others are in the pipeline. The TSDF which encompasses nine priority areas will continue to guide macroeconomic policy for 2011–2014.

15. In the latest Doing Business Report by the World Bank, Tonga was ranked as the top performer in the Pacific for ease of doing business. However, the authorities realise that more needs to be done in order to dismantle barriers to private sector-led growth. In recognition of these substantial challenges faced by Tonga, an Economic Dialogue that gathered stakeholders from various facets of the economy was organized by NRBT in March 2012. The authorities have agreed to prioritise raising inclusive economic growth by focusing on the tourism, agriculture and fisheries sectors. This would be through improving access to finance, improving market access and enhance trade capacity, improving infrastructure, and enhancing training and capacity building. The proposed strategies and specific actions have been presented to the first meeting of the Government's National Growth Committee in April 2012. This Committee will analyse and consider the tradeoffs from these strategies, identify priorities given available resources and capacity and will facilitate implementation under an agreed timeline.

Final Remarks

16. Tonga has embarked on a far-reaching structural reform agenda that would elevate it to the next stage of growth and development. The authorities are cognizant of the considerable challenges that lie ahead and realise that results would take time to materialise. Given Tonga's capacity constraints, domestic efforts would need to be supplemented by support from multilateral institutions and other countries. In this light, our Tongan authorities would like to express their sincere gratitude to the Fund, the World Bank, PFTAC and donors for their invaluable technical guidance and support over the years.

17. In the immediate term, the authorities are mindful of the significant downside risks posed by the current challenging global environment. The authorities will closely monitor developments in the external environment and will respond as appropriate.

.