



TONGA

April 2015

2015 ARTICLE IV CONSULTATION—STAFF REPORT; AND PRESS RELEASE

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 2015 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on February 27, 2015, 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 April 7, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Press Release**

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

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TONGA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

April 7, 2015

KEY ISSUES

Outlook and risks. Tonga is expected to revert to a moderate growth path in the coming years, after a contraction in 2012/13. Reconstruction works in the aftermath of Cyclone Ian in 2014 and the preparation for the 2019 Sixteenth South Pacific Games (the Pacific Games) should support growth over the medium term. Inflation is expected to remain low, reflecting weak global commodity prices. International reserves reached a record level in 2013/14, thanks to continued inflows of grants and remittances. The fiscal position has improved, but near-term spending pressures remain high. The main risks arise from a protracted period of slower growth in advanced and emerging economies, potential cost-overrun of the Games, and natural disasters.

Challenges. Medium-term challenges center on raising Tonga's growth potential through improving the business climate to support private sector development. Ensuring external and price stability and fostering financial soundness are also important to reduce vulnerabilities.

Key policy advice. Key policy recommendations are to: (i) gradually improve the primary fiscal balance to ensure fiscal sustainability; (ii) maintain international reserves at the current level to bolster resilience to shocks; (iii) replace the current inflation reference range with a lower reference rate in line with the medium-term inflation trend; (iv) address macro-financial risks by preparing tools to manage excess liquidity and avoid rapid credit growth in the future; and (v) implement business-enabling structural reforms and improve public sector performance to enhance potential growth.

Approved By
Paul Cashin (APD) and
Mark Flanagan (SPR)

Discussion took place in Nuku'alofa during February 16–27, 2015. The team comprised Yasuhisa Ojima (Head), Eva Christiane Kneer (APD), Fei Liu (SEC), and Tubagus Feridhanusetyawan (Resident Representative). Ms. Tangcharoenmonkong and Mr. Marcelo (OED) participated in key discussions. David Knight (WB) and Johannes Wolf (AsDB) also joined the discussions. The mission met Prime Minister Honorable 'Akilisi Pohiva, Minister for Finance and National Planning Honorable Dr. 'Aisake Valu Eke, Governor of the National Reserve Bank of Tonga Dr. Sione Ngongo Kioa, and other senior government officials, as well as development partners and private sector representatives. Antoinette Kanyabutembo, Xueying Yan and Shi Piao assisted in the preparation of this report.

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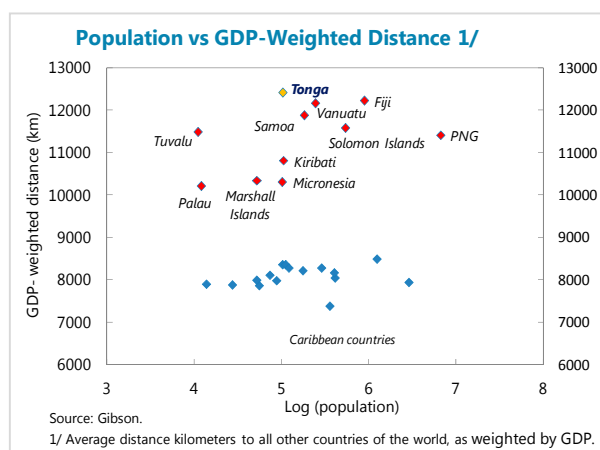
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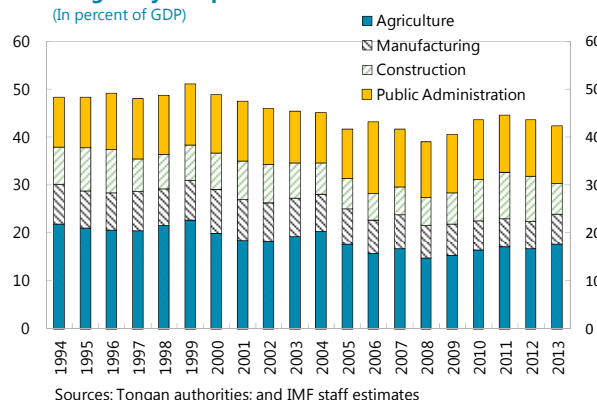
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CONTEXT

1. Setting. Tonga is a small agriculture-based open economy in the South Pacific with a narrow production base and low connectivity, resulting in high transportation costs, limited economies of scale, and low diversification (Figure 1). Tonga's high dependence on remittances, foreign aid and imported energy poses challenges as it increases the economy's sensitivity to exogenous shocks. Other exogenous vulnerabilities stem from natural disasters (e.g., severe cyclones affected Tonga in 1982, 1991 and 2014).



Tonga: Key components of GDP
(In percent of GDP)



2. Political developments. The second general election for the Legislative Assembly was held in November, 2014. A new prime minister was elected in December and took office in January 2015. The previous finance minister and the central bank governor remain in office. King Tupou VI's official coronation is scheduled for July 2015, following his accession to the throne in March 2012.

3. Traction. The authorities have made progress on key policy advice outlined in the last Article IV consultation. In the 2014 staff report, staff emphasized the importance of preserving a prudent fiscal policy stance and continuing to expedite financial sector reform. The authorities have continued to apply the No New Loan policy (no external borrowing) while amending it to allow for concessional budget support provided by development partners. They adopted the Public Financial Management Reform Roadmap in 2014. The authorities also strengthened risk-based supervision, including through PFTAC technical assistance. They are also expected to enact the Receivership bill this year, although progress in business-friendly legal issues (e.g., a bankruptcy law) remains partial.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

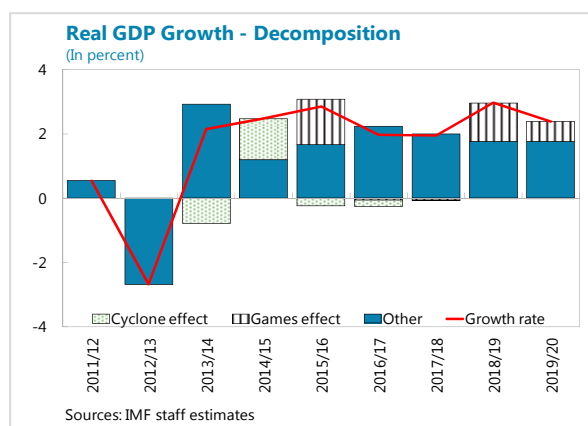
4. Recent developments. Economic growth is estimated to have recovered to around 2 percent in 2013/14, following a sharp contraction in 2012/13 induced by the completion of a large capital project.^{1 2} Inflation has remained subdued in recent years, ranging between 0 to 3 percent per

¹ Fiscal years in Tonga run from July to June.

² The reconstruction of the business district in the capital city was completed in 2011/12.

annum, mainly reflecting low global food prices and, more recently, dramatically weaker global oil prices. This is significantly lower than the current CPI inflation reference range of 6 to 8 percent set by the National Reserve Bank of Tonga (NRBT) in 2011 (Figure 2). The external position has been strengthened, owing largely to increased grant inflows, which have raised international reserves to around 6½ months of prospective imports, well in excess of the NRBT's target range of 3–4 months of imports (Figure 3).

5. Outlook. Growth is expected to accelerate in the coming years owing to several temporary factors (text chart). Reconstruction works in the aftermath of Cyclone Ian in 2014 are being undertaken, while the mid-2015 coronation is expected to boost tourism. The economy is projected to expand in 2015/16, supported by buoyant construction activity on the back of public works spending for the 2019 South Pacific Games (the Pacific Games). Meanwhile, inflation is expected to increase gradually to around 3.5 percent, reflecting stronger demand generated by the Pacific Games and stable global commodity prices.



6. Risks. The overall balance of risks is tilted to the downside (Appendix I). On external risks, spillovers from a protracted period of slower growth in advanced and emerging economies could weigh on Tonga, mainly due to its close ties with Australia and New Zealand through aid, remittances, trade and tourism. On the upside, Tonga would benefit as a net commodity importer if oil and food prices remain low for an extended period of time (Box 1). On domestic risks, slippages in delivering on policy reforms could affect the level of development partners' budget support, leading to lower aid inflows. Any potential cost overruns relating to the Pacific Games could make it necessary to mobilize additional resources. Natural disasters similar to recent cyclones could also take a toll on the economy (with average annual damage of around 4 percent of GDP—see Figure 1—indicating the level of risk).

Authorities' Views

7. The authorities broadly concurred with the overall economic assessment, while stating that they expected higher growth over the medium term. They considered that the expected investment in a major hotel, the government's reform efforts, and private sector development accompanied by accelerated credit growth would provide more impetus to economic activity. They forecast that near-term inflation could be temporarily negative, depending on energy price developments and offsetting effects from higher domestic food prices. On external risks, they agreed that spillovers could be expected through the remittance and trade channels, and are of the view that remittances will probably rise, albeit at a weaker growth rate of remittances, reflecting the favorable growth outlook of the U.S.

Box 1. Tonga: The Macroeconomic Impact of Lower Oil Prices 1/

As a net oil importer, Tonga is expected to benefit from the recent decline in oil prices in the short term, with a favorable impact on growth, inflation, the trade balance and the fiscal balance. As a second round effect, remittances could also be positively affected as key host countries for expatriate Tongans are also net oil importers. However, if the price drops are sustained, prospective investment in renewable energies could be discouraged.

Growth. Lower fuel prices would stimulate domestic demand via a rise in private disposable income and corporate profitability. This would boost several activities, especially in the service sectors (e.g., distribution, transport), which could prop up the near-term growth rates.

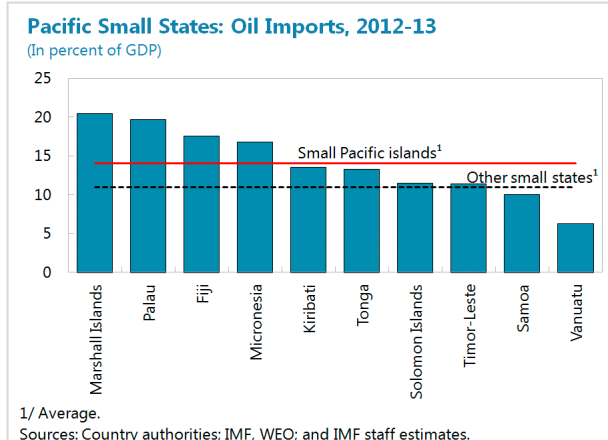
Inflation. The lower import price of oil will ease inflationary pressures, mainly through driving down domestic costs of transportation. Electricity prices are also adjusted in line with the change in the import price of oil. This price effect would dominate the impact of higher domestic demand on inflation. The CPI inflation rate is expected to fall by 0.3 percentage point in 2014/15 and 0.2 in 2015/16.

Trade. Fuel imports account for almost 30 percent of total imports in Tonga. The value of fuel imports should fall since the effect of lower import costs should exceed the impact of possible increases in fuel demand. The lower fuel costs could also lower transportation costs deemed to be a significant portion of costs of imports, given the remoteness of Tonga. As a result, the current account is expected to improve in the near term.

Fiscal. Revenues from import tariffs and VAT would be reduced through lower imports, while higher domestic demand may increase tax revenue. On the spending side, the authorities could save some fuel-related expenditure on the margin, while there is no fuel subsidy in Tonga. Overall, the fiscal balance could improve slightly by 0.1 percentage points both in 2014/15 and 2015/16.

Remittances. Key source countries for the remittances to Tonga are net oil importers including the U.S. and New Zealand. A boost to activity in these countries would favorably affect the inflow of remittances to Tonga, and thus help stimulate domestic demand.

Investment in mineral exploration and renewable energies. A prolonged period of low energy prices, however, could discourage future investment in deep-water mining as well as renewable energies.



¹ Prepared by Yasuhisa Ojima (APD).

POLICY DISCUSSIONS: NAVIGATING A STABLE COURSE

Policy discussions centered on navigating a stable macroeconomic course in terms of fiscal, external, price and financial stability and on raising potential growth over the medium term.

A. Building a Sound Fiscal Position

8. Tonga's fiscal position has improved, supported by large grant inflows, but spending pressures will remain high in the near term. The overall balance improved to a surplus of around 1 percent of GDP in 2013/14, partly due to grant inflows, but is expected to revert to a deficit in 2014/15. Spending pressures in the near-term include: i) cyclone-related reconstruction work; ii) wage pressures from the civil servants association; and iii) preparations for the 2019 South Pacific Games. Most of the reconstruction work, which contributes to the ramp up in capital expenditure in 2014/15, has so far been met by strong grant inflows mainly from World Bank and Asian Development Bank, but strong projected tax revenue performance in 2014/15 is also expected to play a funding role (text table).

Table. Tonga: Summary of Government Operations, 2012/13-2015/16

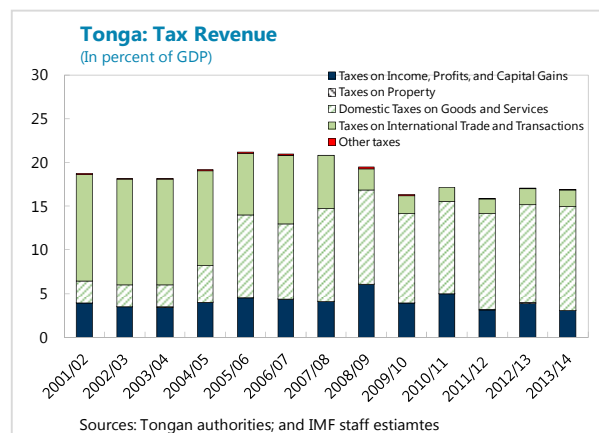
(In percent of GDP)	2012/13	2013/14	Budget		Proj.
			2014/15	2014/15	2015/16
Total revenue and grants	25.6	29.2	29.9	30.6	26.8
Total revenue	19.9	19.8	20.5	21.8	20.8
Of which: tax revenue	17.3	17.0	17.1	18.4	18.1
Grants	5.7	9.4	9.4	8.8	6.0
Total expenditure and net lending	26.9	28.1	29.6	32.5	28.4
Current expenditure	25.3	26.7	27.7	27.8	25.2
Of which: wages and salaries	11.0	11.9	12.3	12.3	12.0
Capital expenditure	1.6	1.3	2.0	3.5	3.2
Overall balance (incl. grants)	-1.3	1.1	0.3	-1.8	-1.5
Primary balance (incl. grants)	-0.4	2.0	-0.8	-1.0	-0.5
Primary balance (excl. grants)	-6.1	-7.4	-8.3	-8.5	-6.5

Sources: Tongan authorities; and IMF staff estimates.

9. Medium-term fiscal challenges center on maintaining prudent debt management and implementing public financial management reforms. Tonga's public debt currently stands at around 50 percent of GDP, and given its vulnerability to external shocks, it is important to maintain a prudent debt policy. The staff welcomes the government's conservative borrowing policy (that is, no external commercial borrowing and only limited concessional borrowing) and the agreement with China EXIM Bank to defer repayment of principal on previous loans for a period of five years. As a result, the mission's debt sustainability analysis indicates that Tonga remains at moderate risk of debt distress. The authorities' plan to finance the Pacific Games using non-debt creating funds (for example, the Pacific Games revenue, franchises, and donations) is fiscally prudent. Cost overruns could, however, necessitate borrowing, which could jeopardize fiscal sustainability. Tonga introduced a three-year budget framework in 2013 and adopted a roadmap for public financial management reform in 2014, but has not yet set a clear fiscal target for the medium-term.

10. Against this backdrop, it is imperative to build sound fiscal positions to bolster resilience to shocks.

A key fiscal policy recommendation is to gradually increase the primary fiscal surplus to about 1 percent of GDP over the medium-term, so that external debt stabilizes at about 35–40 percent of GDP (to provide a buffer to relative to debt distress thresholds, to allow the country to safely absorb external shocks). Since grant disbursements can fluctuate from one year to the next, staff also recommends monitoring the primary balance excluding grants as a key performance indicator.



Measures to create such a primary surplus include: i) improving tax administration on consumption tax (for example, reducing the number of zero ratings and exemptions, undertaking a regular review of tax incentives); ii) restraining the wage bill in line with the authorities' target (e.g., continuation of hire freeze, more efficient staffing); and iii) improving the quality and efficiency of spending through ongoing public financial management reforms (Appendix II). The Fund stands ready to provide technical assistance to support these fiscal reforms through the Pacific Financial Technical Assistance Center (PFTAC). Finalizing the debt management strategy, with technical assistance by the World Bank is also critical to lay a solid foundation for prudent debt management.

11. The spending program for the Pacific Games needs to be carefully managed. Staff recommend that the authorities enhance controls on the spending program for the Pacific Games, and caution that the current proposal by the South Pacific Games Committee to raise funds by imposing a levy on foreign exchange transactions could give rise to exchange restrictions subject to Fund approval. Staff have requested further information from the authorities regarding the proposed levy in order to assess its jurisdictional implications. Another proposal to raise funds by imposing an additional departure tax should be carefully studied, in order to determine how much of an adverse effect such a tax would have on tourist arrivals. Against this backdrop, staff also stresses the importance of maintaining a prudent fiscal stance and building sound fiscal positions to bolster resilience to shocks.

Authorities' Views

12. The authorities broadly agreed with staff's views including the need for a medium-term fiscal anchor. They noted that the adoption of a roadmap for public financial management reform and the Debt Management Strategy could form the basis for a medium-term fiscal framework. The authorities aim to further broaden the tax base and strengthen administration, and plan to undertake an expenditure review of all government programs to improve the quality of public spending. They also concurred with the need to restrain the public sector wage bill, and noted that they would like to review technical issues (e.g., coverage of wages) before establishing an explicit monitoring benchmark. They also highlighted that more efficient inter-ministerial staff allocations would be helpful in this regard.

13. The authorities are aware of the potential cost overruns of the Pacific Games. They plan to control cost, for instance, by utilizing existing facilities for the Pacific Games (e.g., using school as

accommodation facilities). The authorities confirmed their prudent stance of not using debt-creating flows to finance the Pacific Games, and that they would consult with the Fund on the possible introduction of foreign exchange levy and increasing the departure tax for overseas travel.

B. Safeguarding External Stability

14. Large grants and remittances in recent years have helped Tonga build up adequate international reserve buffers. The current account deficit is projected to be around 5 percent of GDP in 2014/15, and to move around 2-5 percent of GDP in the medium term, while international reserves are expected to remain above the NRBT's comfort zone of 3–4 months of imports. The increase in foreign assets, largely due to grant inflows, has also contributed to the rise in domestic liquidity. Grant inflows have been relatively stable, reflecting Tonga's favorable performance in policy reforms, and the remittance inflows have also been stable, reflecting diversified sources (e.g., the U.S., New Zealand and Australia).

15. Maintaining international reserves at the current level will help safeguard external stability. Overall, staff's assessment indicates that reserve holdings (in months of imports) are adequate in light of the need to absorb frequent external shocks and the low opportunity cost of holding reserves in Tonga (Box 2). The pegged exchange rate within horizontal bands has served the country well. Staff's exchange rate assessment suggests that the current level of the exchange rate is broadly in line with fundamentals (Box 3). In addition, other indicators (for example, tourist arrivals) continue to show no significant loss of competitiveness for Tonga.

Authorities' Views

16. The authorities concurred with staff's exchange rate assessments. On the foreign reserve adequacy, the authorities recognized the merit of the staff's policy recommendation to safeguard external stability, but they believed that 3–4 months of import cover is a more realistic target for Tonga, partly because the high level of reserves in recent years was due to delays in implementation of donor-funded projects and hence may not be sustainable.

C. Ensuring Price Stability

17. Tonga has adopted an informal inflation reference range. Pursuing an inflation range in the context of a fixed exchange rate regime is challenging, although limited capital flows and the wide bands around the exchange rate target give the NRBT some room for maneuver. A weak transmission mechanism of monetary policy, the current accommodative monetary conditions, and Tonga's sensitivity to external price shocks also complicate the task of controlling inflation. In fact, inflation has consistently been below the reference range (currently at 6 to 8 percent), raising questions about the usefulness of the band.

18. The authorities should consider replacing the current inflation reference range with a lower reference rate. Setting it in line with Tonga's medium term inflation forecast (e.g., using the IMF staff's forecast of 3.5 percent) would help better clarify what would informally guide monetary policy. The new reference rate would need to be clearly communicated to the public, but should be reviewed periodically to ensure consistency with economic fundamentals (Appendix III).

Box 2. Tonga: Assessing Reserve Adequacy 1/

Tonga's international reserves have grown rapidly since the global financial crisis, mainly due to grants and remittance inflows. In 2013/14 reserve holdings peaked at US\$153 million. This corresponds to more than 7 months of goods and service imports and is well in excess of the NRBT's lower bound of 3 to 4 months of import cover (Figure 1). Tonga's reserve position also exceeds levels recommended by standard "rules of thumb" such as coverage of 3 months of imports of goods and services, 100 percent of short-term debt and 20 percent of broad money in the economy (Table 1). The standard IMF formula for assessing reserve adequacy (IMF, 2011) yields minimum adequate reserves for Tonga of US\$61 million or 14 percent of GDP, less than half of the NRBT's actual reserve holdings in 2012/13.² A comparison between actual reserves and benchmark metrics thus raises the question of whether reserve holdings in Tonga might be excessive.

A cost-benefit analysis developed by Dabla-Norris et al. (2011) allows for the determination of optimal levels of reserves specifically for low income countries.³ This framework maximizes the net benefit of holding international reserves by balancing the cost of reserves and the benefits of precautionary reserve holdings as insurance against adverse external shocks. Calibrating the model for Tonga yields optimal levels of reserves in the range of 5 to 10 months of import cover depending on assumptions about the cost of holding reserves (Figure 2). The opportunity cost of holding reserves can be approximated by the difference between real returns on short-term foreign currency assets and alternative domestic investments. For Tonga, the interest differential for government bonds and 3-month U.S. government treasury bills could be a proxy for the cost of holding reserves. The differential of roughly 3 percent implies optimal reserve holdings equivalent to 6 to 7 months of imports coverage.

Overall, reserve holdings are adequate in light of the large benefits of absorbing frequent external shocks and the low cost of holding reserves for Tonga.

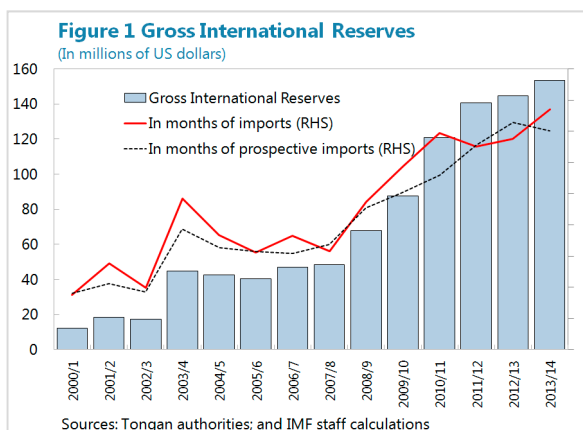
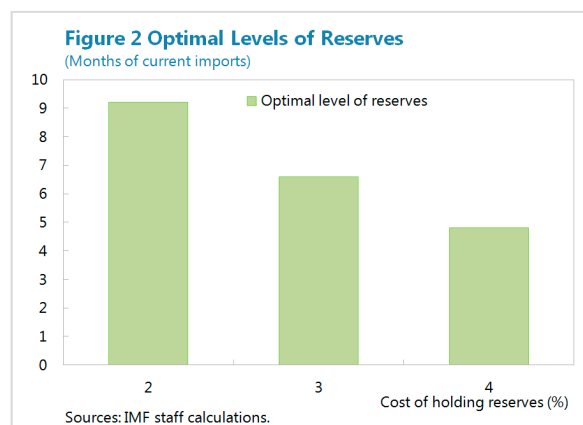


Table 1 Rules of Thumb: Reserves Coverage in 2013/14

Reserves coverage in months of imports	7.7
Reserves as a share of short term external debt	No ST debt
Reserves as a share of broad money (M2)	130%



¹ Prepared by Eva Christiane Kneer (APD).

² The standard IMF metric is based on a weighted average of short term external debt (STD), longer term debt arising from portfolio investment and other investment liabilities (OL), broad money (M2), and exports of goods and services (EX).

³ Dabla-Norris, E. et al., 2011. Optimal Precautionary Reserves for Low Income Countries: A Cost-Benefit Analysis. IMF Working Paper 11/249.

Box 3. Tonga: Exchange Rate and Competitiveness 1/

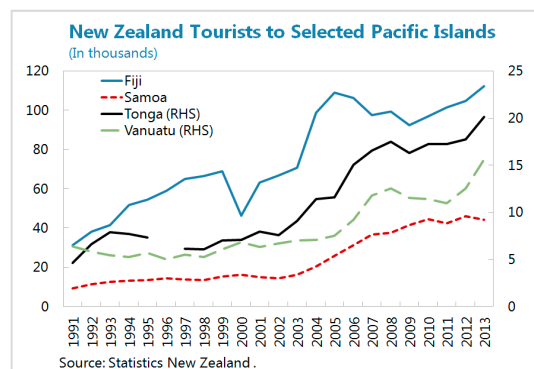
Tonga's real effective exchange rate is broadly in line with medium-term fundamentals. Other indicators suggest that the economy remains competitive.

Exchange rate

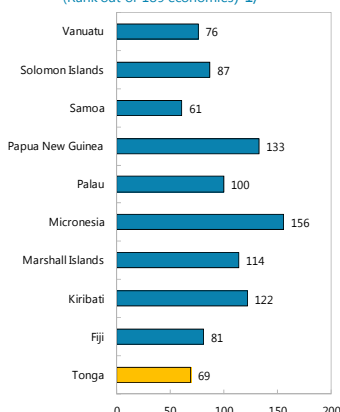
- Tonga's real effective exchange rate (REER) is broadly in line with medium-term fundamentals. The purchasing power parity approach suggests an undervaluation by around 6 percent, while the equilibrium real exchange rate approach indicates an overvaluation by 15 percent.

Other indicators

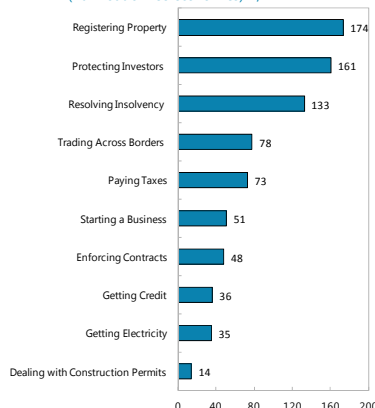
- Reserves.** Gross international reserves are adequate and rising, and reached a level of 7 months of prospective imports in 2013/14.
- Exports.** Exports recovered quickly from a temporary slump during the global financial crisis, and have grown moderately in recent years. In the medium term, exports are projected to grow at an annual rate of 9 percent.
- Number of tourists.** The number of tourists has increased steadily as Tonga is becoming a more attractive tourist destination.
- Costs of doing business.** Tonga remains competitive compared with other PICs, according to the World Bank's Doing Business 2015 report. Relative strengths include access to credit, contract enforcements and the low administrative burden involved in paying taxes and starting a business. There is room for improvement in terms of protecting investors and registering property.



Ease of Doing Business, 2015
(Rank out of 189 economies) 1/



Tonga: Doing Business, 2015
(Rank out of 189 economies) 1/



Source: World Bank Doing Business (2015 Doing Business Report).

1/ Higher rank indicates more costly. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

¹ Prepared by Shi Piao and Eva Christiane Kneer (all APD).

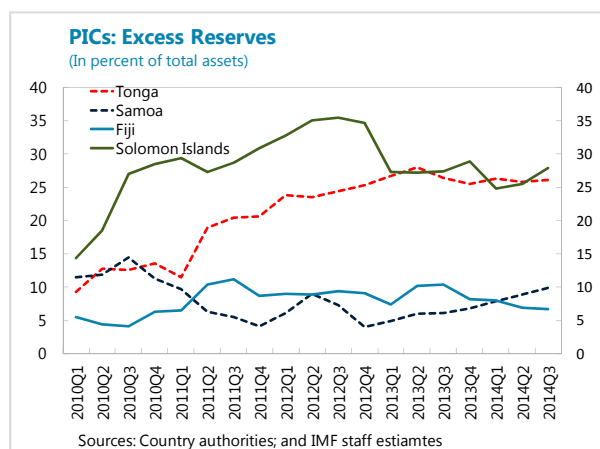
Authorities' Views

19. The authorities agreed with staff's views on the need to revisit the inflation reference range. They indicated that the range should be lowered and replaced by a rate, however, they would need to analyze the appropriate level over the medium term, partly because Tonga is a price taker and its inflation is susceptible to external shocks. They also noted that a lower reference rate would necessitate frequent revisions of the reference rate, should inflation rebound in the future due to an unexpected external shock. They emphasized the difficulty of having monetary policy influence the inflation rate, which is why the NRBT is not targeting inflation. The authorities expressed their interest in further developing their monetary policy framework and operational tools, with technical assistance from the Fund.

D. Fostering Financial Stability

20. Tangible progress has been made in repairing banks' balance sheets and strengthening the legal framework, but challenges to financial stability remain. At present the financial system is bank-centered, comprising one government-owned bank (the Tonga Development Bank) and four commercial banks, one of which has only recently been established. Non-bank financial institutions (for example, provident funds, credit unions, microfinance institutions) are relatively small, and have been expanding only gradually. Key issues include:

- **Improvements in banks' capital and credit quality.** Asset quality in the banking system was deteriorated (e.g., higher non-performing loans (NPL)) during the global financial crisis, but most of Tonga's banks subsequently improved their capital positions. While NPL ratios have declined to less than 13 percent in 2013/14 down from around 20 percent in 2008/09 (Table 6), the level remains high.
- **Excess reserves.** Excess reserves have been large in recent years, hovering around 25 percent of total bank assets. The increase in international reserves and limited sterilization has led to a large injection of liquidity to the banking system.
- **Legal framework.** Efforts have rightly focused on strengthening regulations including amending the National Reserve Bank of Tonga Act and the Financial Institutions Act with technical assistance from the Fund. The thrust of updating these two laws lies in the authorities' initiative to: i) bring all financial institutions in Tonga under the supervision of the NRBT; ii) strengthen the autonomy and accountability of the NRBT and reform its governance framework in line with best practices; and iii) provide the NRBT with the authority to issue binding regulations and entrust the NRBT with clear enforcement actions for any contraventions of its decisions.



21. Banks' excess reserves mirror weak private credit growth. Despite the authorities' efforts to stimulate lending through accommodative monetary policies, credit growth has been sluggish due to constraints from both the supply and demand side (e.g., limited collateral, lack of investment opportunities) (Appendix IV). The authorities have embarked on different initiatives to support credit growth, through, for instance, an on-lending scheme administered by Tonga Development Bank designed to channel funds at favorable terms to selected sectors of the economy (e.g., agriculture, manufacturing). It is important that the authorities carefully examine the effectiveness of this on-lending scheme before scaling up its size. In addition, the establishment of Tonga Business Enterprise Center (TBEC) to assist private businesses with the development of business plans and loan applications is a welcome development.

22. Financial risks can be mitigated through active liquidity management, the introduction of macro-prudential tools, and improved bank supervision.

- *Managing macro-financial risks.* Current high levels of excess liquidity do not pose an immediate risk to financial sector stability, but better tools to manage liquidity are needed to help avoid excessive credit growth in the future. Possible measures to absorb excess reserves include selling treasury bills and raising reserve requirements. Macro-prudential measures (e.g., loan-to-value ratios) could also play a role in safeguarding financial stability.
- *Improving banking supervision.* Enhanced monitoring of banks' asset quality (e.g., through risk-based on-site inspection to make sure that loan loss provisions are adequate) is important to ensure financial stability. This work could be strengthened in coordination with the PFTAC advisor on banking supervision.

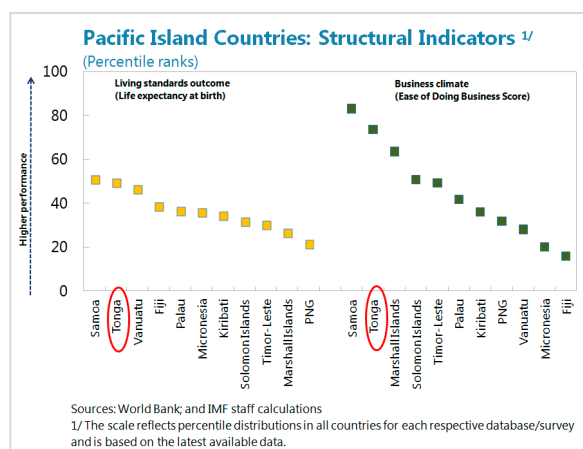
Authorities' Views

23. The authorities agreed on the need to absorb excess liquidity to help manage macro-financial risks. They recognized the importance of structural reforms to create an environment conducive to more investment opportunities. They were also mindful that higher statutory reserve deposit (SRD) requirements might increase lending rates and/or fees and charges, and reduce credit supply to the private sector, particularly small and medium sized enterprises (SMEs). Therefore, they plan to learn from other Pacific countries' experiences (e.g., Fiji and Samoa) as to how to stimulate lending to the private sector especially for SMEs. The effectiveness of the government's Managed Funds (e.g., Economic Growth Facility in the Tonga Development Bank) in stimulating credit growth will be assessed in conjunction with any other measures that may be introduced. The NRBT agreed to use macro-prudential tools to manage macro-financial risks, and noted that they will continue to closely monitor credit growth and examine its impact on monetary policy targets and financial stability.

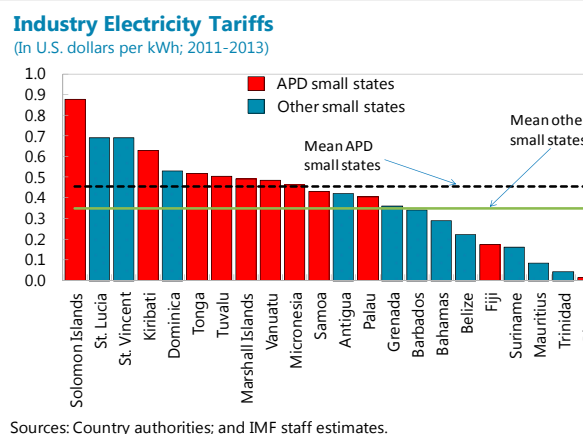
24. The authorities committed to further strengthen banking supervision. This activity is currently assisted by the IMF PFTAC expert. They indicated that the supervision of non-bank financial institutions (NBFIs) (e.g., retirement fund, credit union, micro-credit institution) is a new challenge, and requested continued technical assistance support to help develop the legislative and regulatory framework for NBFIs.

E. Raising Tonga's Growth Potential

25. Raising potential growth remains a key challenge. Tonga's per capita GNP growth over the past two decades was favorable when compared with other non-resource rich Pacific Islands peers, lifting Tonga to the ranks of middle-income countries. Tonga also compares favorably with other PICs in terms of living standards (e.g., high life expectancy at birth) and its business climate. Nevertheless, private sector activity and FDI remain relatively small. In the absence of reform measures over the medium term, longer-term growth would revert to its historical average of around 1¾ percent, once cyclone reconstruction work and Pacific Games-related activities are complete.



26. There are several government initiatives to raise Tonga's growth potential. Tonga's Strategic Development Framework (TSDF), which is currently under the revision to TSDF II, aims to further develop the primary sector (agriculture, forestry and fishery) and tourism as key sources of growth. The Tonga Energy Road Map 2010-2020 aims to reduce Tonga's vulnerability to oil price shocks and to improve the cost-effectiveness of energy use. Nonetheless, these efforts have yet to bear fruit. For instance, the initiative of the authorities to commercialize the Tonga Development Bank (TDB) and to revive the International Dateline Hotel has been challenging reflecting a shallow pool of investors. Key bottlenecks for private sector development include risks and investor uncertainty (for example, ambiguity in law and regulations), relatively high business costs (e.g., high electricity tariffs (chart)), and limited access to external markets (Appendix V).



27. Business-enabling structural reforms to promote private sector development remain crucial. Promoting private sector development through further improvements in the business climate, together with more business-friendly laws and regulations (for example, revising the Foreign Investment Act, introducing new legislation on receivership bankruptcy) is critical. As in most small states, the contribution of the public sector to the economy will remain relatively large in Tonga. Therefore, enhancing public financial management with an appropriate medium-term fiscal framework would improve growth potential. Prioritizing expenditure toward growth enhancing and social spending categories (health, education, and infrastructure) would also promote greater inclusiveness.

Authorities' Views

28. The authorities agreed that structural reforms are critical to raise growth potential.

They noted that the revamped Tongan Strategic Development Framework has identified strategies for lifting potential growth rate to around 3 percent in the next 10 years. The authorities continued to see growth potential in the agricultural and tourism sector, and also indicated that new activities, such as call centers could be promising. The authorities expect to make significant progress in revising the Foreign Direct Investment Act and enacting the Receivership Bill to create more transparent business transactions later this year. They also intend to continue their efforts to make SOEs more efficient, including via commercialization of Tonga Development Bank (TDB).

OTHER ISSUES

29. **Data issues.** In staff's view, Tonga's macroeconomic statistics are broadly adequate for surveillance purposes, but improvements in data quality and data dissemination are needed (see the Statistical Issues in the Informational Annex). Better-quality statistics will be imperative to strengthen decision making by investors and policy makers. It is also important to implement previous TA recommendations, including the ones recently provided on national account statistics and external sector statistics.

STAFF APPRAISAL

30. **Tonga's economy has rebounded and the outlook is favorable, while risks remain tilted to the downside.** Growth is recovering and is expected to average 2–3 percent during the next five years, mainly supported by construction and tourism on the back of several large events (the coronation and the Pacific Games). Inflation is projected to remain low, reflecting the weak outlook for global commodity prices. International reserves are expected to stay comfortable at around 6 months of prospective imports largely, thanks to grants and remittances. The balance of risks is tilted to the downside. External risks involve spillovers from a protracted period of slower growth in advanced and emerging economies, which could weigh on Tonga, mainly through its close economic ties with Australia and New Zealand. On the domestic side, potential cost overruns related to the Pacific Games continue to pose downside risks.

31. **The authorities should contain fiscal spending pressures in the near-term and build a sound fiscal position to bolster resilience to shocks over the medium term.** Near-term fiscal pressures stem mostly from potentially large wage increases for civil servants, which can be contained by more efficient staff allocation in order to moderate the share of the wage bill in recurrent spending over the medium term. Controlling the spending program for the Pacific Games is also important to avoid cost overruns. The adoption of a roadmap for public financial management reform and the debt management strategy would lay the groundwork for a medium-term fiscal framework. Continued efforts to increase tax revenue by broadening the tax base and strengthening tax administration could create more room for priority social spending and public investment.

32. The current accommodative monetary policy stance is appropriate in view of the weak economy and low inflation, while large excess liquidity calls for better liquidity management to mitigate macro-financial risk. Preserving the current level of international reserves would help ensure external stability, and lowering the inflation reference rate would better anchor inflation expectations over the medium term. Although the presence of excess liquidity does not pose an imminent risk to financial sector soundness in the near term, the authorities should prepare to manage macro-financial risks by improving liquidity management and adopting macro-prudential tools. The progress in improving banks' balance sheets and strengthening the legal framework in the financial sector is welcome.

33. Structural reforms remain imperative to raising Tonga's potential growth. Progress in updating Tonga's strategic development framework (TSDF II) is welcome. Steadfast implementation of the authorities' reform plan is crucial to make growth more sustainable and inclusive. Implementing key initiatives, such as revising the Foreign Investment Act, would help improve the business climate and promote private sector development.

34. Implementing TA recommendations are important for successful reforms. Improving the quality of data statistics will also help policy formulation and facilitate private sector decisions. In view of limited resources, better coordination and prioritization of Tonga's prospective TA program is needed. The IMF/PFTAC would continue to provide the bulk of technical assistance, in coordination with other development partners.

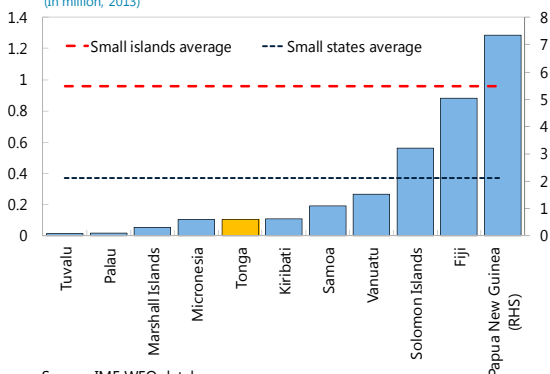
35. It is recommended that the next Article IV Consultation takes place on the standard 12-month cycle.

Figure 1. Tonga: Stylized Facts

Tonga is one of the South Pacific “microstates” ...

PICs: Population

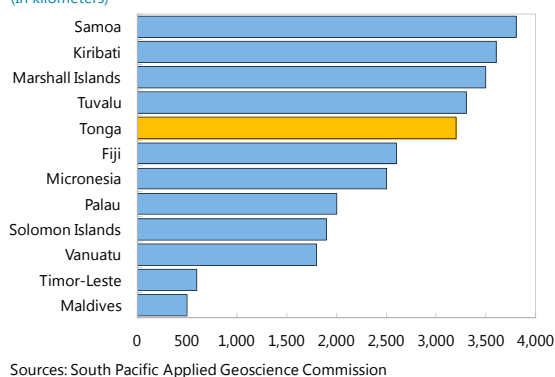
(In million, 2013)



...and faces geographical challenges.

PICs: Distance to the Closest Continent

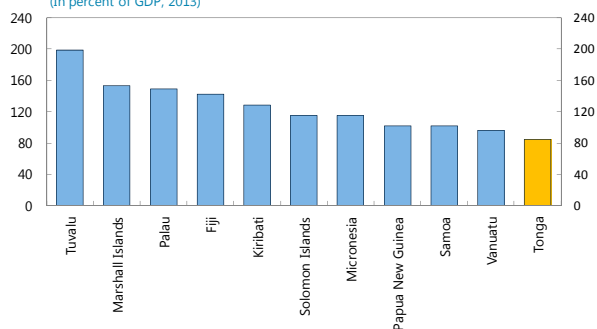
(In kilometers)



Tonga is an open economy, albeit with less trade activities than its PIC peers ...

PICs: Trade Activities 1/

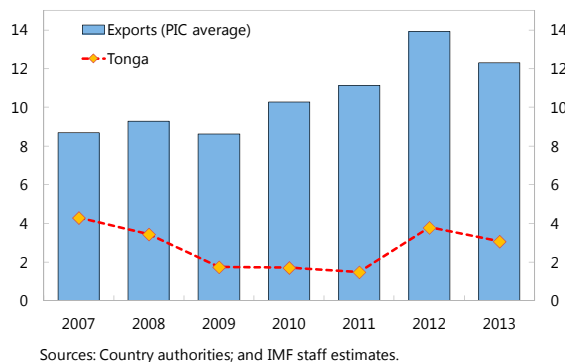
(In percent of GDP, 2013)



...and is constrained by a narrow production and export base.

PICs: Exports

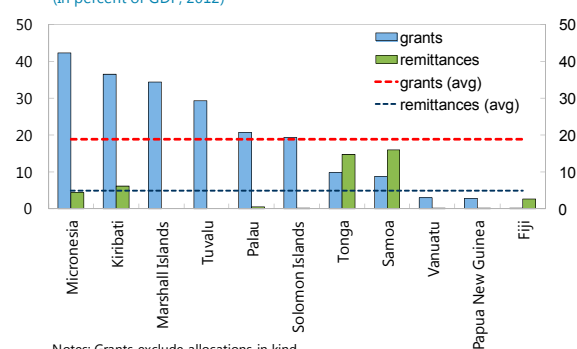
(In percent of GDP)



Tonga relies mainly on remittances and grants...

PICs: Grants and Remittances

(In percent of GDP, 2012)



...and is susceptible to natural disasters.

Average Annual Damage¹

(In percent of GDP)

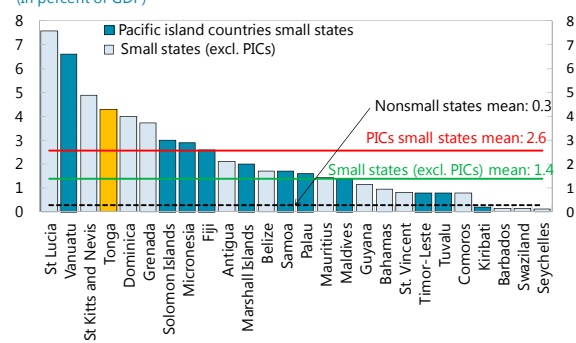
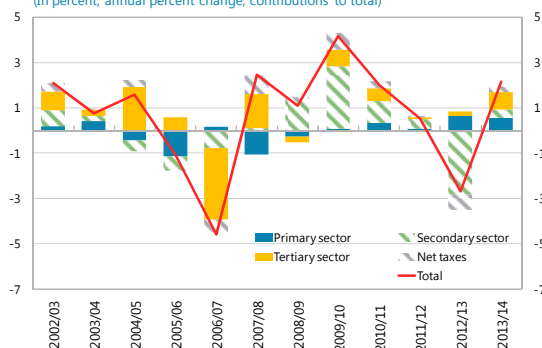


Figure 2. Tonga: Recent Economic Developments

GDP growth is estimated to have rebounded in 2013/14...

Tonga: Real GDP by Sector

(In percent, annual percent change, contributions to total)

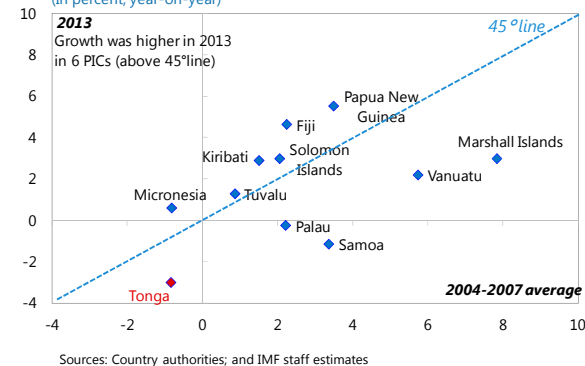


Sources: Tongan authorities; and IMF staff estimates.

...following a sharp contraction in 2012/13 due mainly to the completion of large public works projects.

PICs: Real GDP Growth

(In percent, year-on-year)

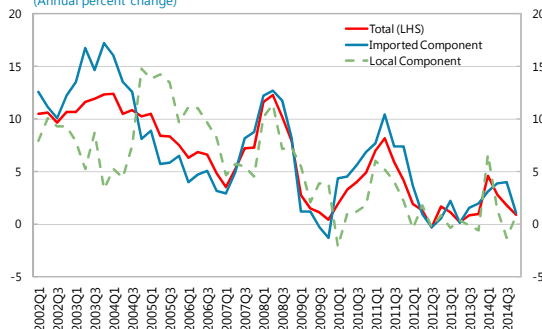


Sources: Country authorities; and IMF staff estimates

Inflation remains subdued, reflecting weaker commodity prices, ...

Tonga: Inflation

(Annual percent change)

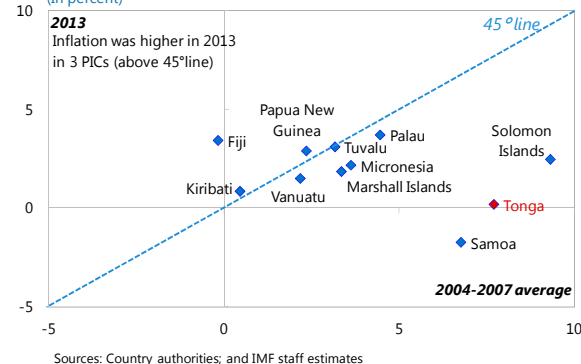


Source: Tongan authorities; and IMF staff estimates.

...and even lower than in many PIC peers.

PICs: Inflation

(In percent)

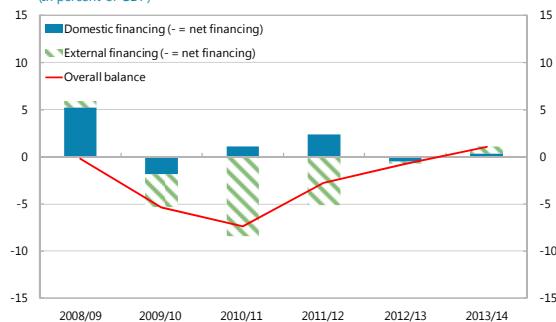


Sources: Country authorities; and IMF staff estimates

The fiscal position has gradually improved over the last few years.

Tonga: Fiscal Balance

(In percent of GDP)

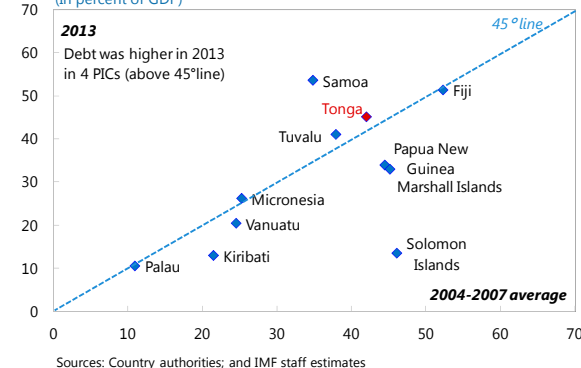


Sources: Tongan authorities; and IMF staff estimates.

Total government debt, however, remains high compared to Tonga's peers.

PICs: Government Debt

(In percent of GDP)

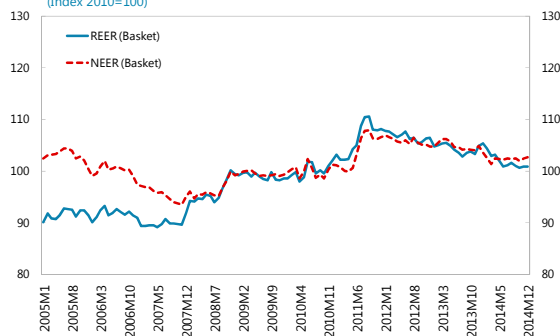


Sources: Country authorities; and IMF staff estimates

Figure 3. Tonga: External and Monetary Developments

Both the nominal and real effective exchange rates have been stable over the past few years...

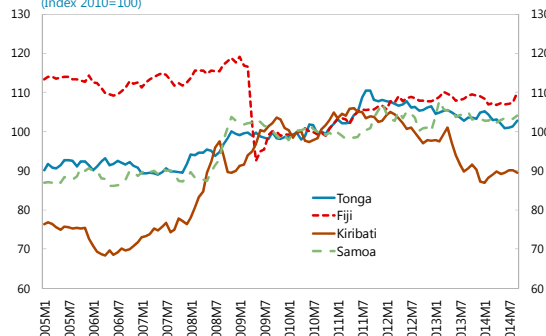
Tonga: Effective Exchange Rates
(Index 2010=100)



Source: IMF INS database.

...and appear to be less volatile than some of Tonga's peers.

PICs: Real Effective Exchange Rates, 2005-14
(Index 2010=100)

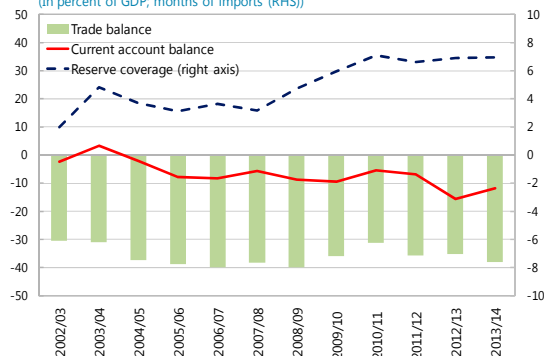


Source: IMF INS database.

International reserves remain large due in part to continued inflow of foreign aid and remittances...

Tonga: Balance of Payments

(In percent of GDP; months of imports (RHS))

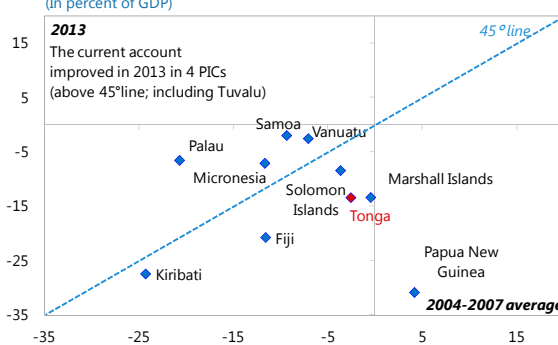


Sources: Tongan authorities; and IMF staff estimates.

...while the current account deficit widened compared with some PIC peers.

PICs: Current Account Balance

(In percent of GDP)

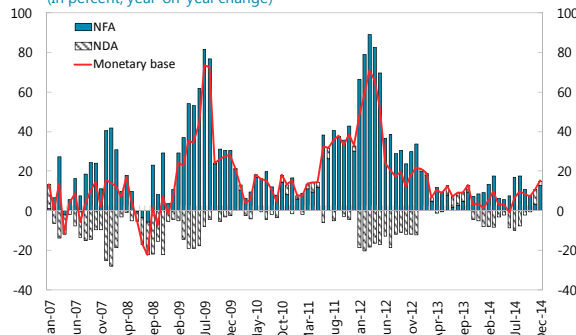


Sources: Country authorities; and IMF staff estimates

The NRBT has maintained an accommodative stance since the global financial crisis.

Tonga: Monetary Base

(In percent, year-on-year change)

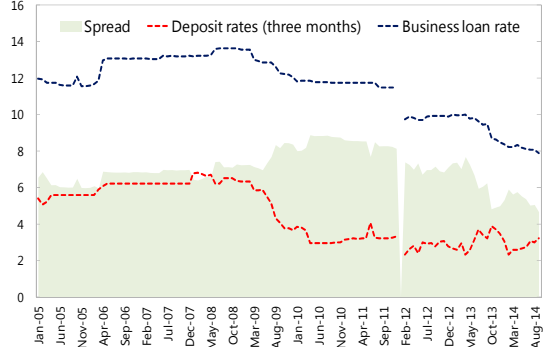


Sources: Tongan authorities; and IMF staff estimates.

This stance mitigates the credit crunch and led to lower domestic interest rates.

Tonga: Interest Rates

(In percent)

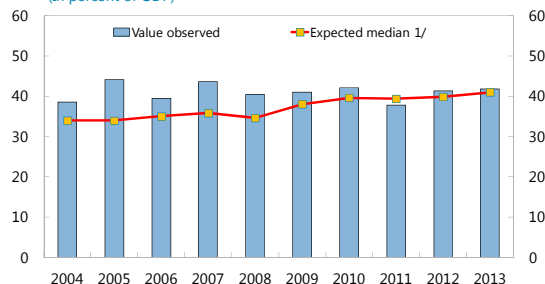


Note: The data break in Jan-2012 indicates the data reporting form and methodology change.
Source: Tongan authorities; and IMF staff estimates.

Figure 4. Tonga: Financial Intermediation

Domestic deposits have grown in tandem with nominal GDP...

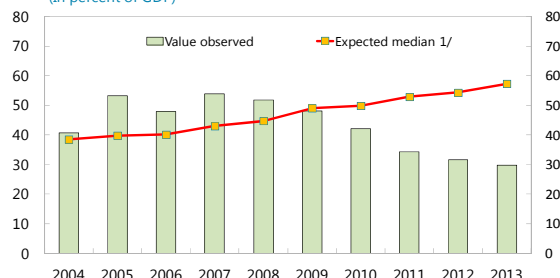
Tonga: Domestic Deposit
(In percent of GDP)



Sources: World Bank FinStat database; and IMF staff estimates
1/ Expected median values are obtained from a regression that controls for structural factors (economic development, demographics, population density, and other fundamentals).

...while private credit has remained anemic since the global financial crisis in 2008.

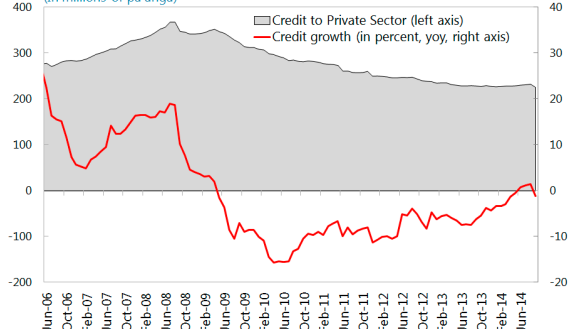
Tonga: Private Credit
(In percent of GDP)



Sources: World Bank FinStat database; and IMF staff estimates
1/ Expected median values are obtained from a regression that controls for structural factors (economic development, demographics, population density, and other fundamentals).

However, the credit cycle appears set for a turn...

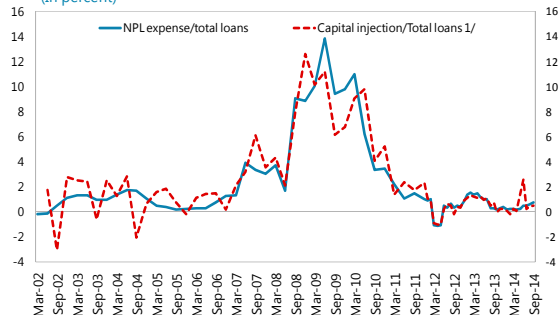
Tonga: Bank Lending
(In millions of pa'anga)



Sources: Tongan authorities; and IMF staff estimates.

...as asset quality indicators revert to pre-crisis levels...

Tonga: Bank balance sheet repair indicators
(In percent)

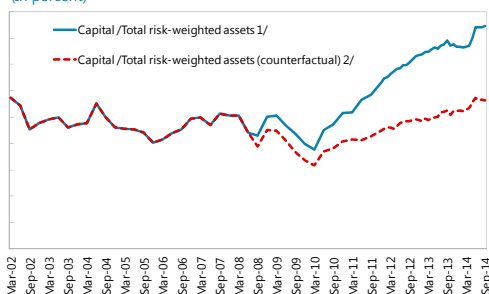


Source: Tongan authorities; and IMF staff estimates.

1/ Capital injection is estimated by the following formula: $\text{Capital (t)} = \text{Capital (t-1)} - \text{NPL Expense (t)} + \text{Capital injection (t)}$.

And bank capital ratios recover...

Tonga: Capital Buildup
(In percent)



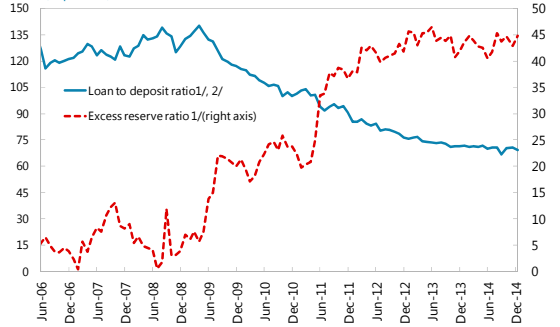
Notes: 1/ Assuming 100 percent weight for loans and 10 percent weights for liquid assets.

2/ Assuming that loan-to-assets ratio is fixed at 79 percent (June 08 level).

Sources: Tongan authorities; and IMF staff estimates.

...suggesting some space for banks to expand private credit.

Tonga: Loan-to-Deposit and Excess Reserve Ratio
(In percent)



Sources: Tongan authorities; and IMF staff estimates.

1/ Ratio to non-government deposits; 2/ Credit to private sector by the banks.

Table 1. Tonga: Selected Economic Indicators, 2009/10–2015/16 ^{1/}

				Prel.	Est.	Proj.	
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
(Annual percent change)							
Output and prices							
Real GDP 2/	4.2	2.0	0.5	-2.7	2.1	2.5	2.9
Consumer prices (period average)	1.7	6.0	3.3	0.7	2.3	0.4	1.2
Consumer prices (end of period)	2.7	7.1	2.3	0.2	1.5	0.6	1.7
GDP deflator	3.5	6.1	2.5	0.3	2.3	0.4	1.2
(In percent of GDP)							
Central government finance							
Total revenue and grants	27.3	26.7	27.9	25.6	29.2	30.6	26.8
Total revenue	20.4	19.8	18.4	19.9	19.8	21.8	20.8
Grants	6.9	6.9	9.5	5.7	9.4	8.8	6.0
Total expenditure and net lending	32.7	34.2	30.7	26.9	28.1	32.5	28.4
Of which: Current expenditure	26.1	23.0	23.9	25.3	26.7	27.8	25.2
Capital expenditure	2.6	9.8	5.7	1.6	1.3	3.5	3.2
Overall balance	-5.4	-7.5	-2.8	-1.3	1.1	-1.8	-1.5
External financing (net)	3.5	8.6	5.2	0.2	-0.7	3.8	2.8
Domestic financing (net)	1.9	-1.1	-2.4	1.0	-0.4	-1.9	-1.3
(Annual percent change)							
Money and credit							
Total liquidity 3/	5.1	3.1	7.0	5.2	7.3	4.0	4.9
Of which: Broad money (M2)	5.6	3.3	7.2	6.1	7.2	4.0	5.0
Domestic credit	-11.5	-12.3	-16.8	-0.5	8.1	3.8	4.3
Of which: Private sector credit	-15.6	-9.9	-5.2	-7.5	0.7	3.0	3.3
(In millions of U.S. dollars)							
Balance of payments							
Exports, f.o.b.	7.9	10.8	17.9	13.8	15.0	15.0	17.3
Imports, f.o.b.	-130.4	-152.6	-179.3	-175.5	-175.6	-195.9	-213.1
Services (net)	-9.2	4.7	-7.7	0.3	1.3	3.3	5.5
Investment income (net)	11.9	12.9	12.1	11.4	4.7	5.4	6.1
Current transfers (net)	96.3	98.6	116.4	117.2	126.6	149.0	147.7
Of which: Remittances	69.5	68.3	77.2	107.4	102.7	113.4	123.3
Current account balance	-23.4	-25.5	-40.7	-8.6	-6.2	-23.3	-36.5
(In percent of GDP)	-6.4	-6.1	-8.8	-1.9	-1.4	-5.0	-7.5
Overall balance	19.8	33.3	19.8	4.1	8.7	8.5	7.1
Gross official foreign reserves							
In millions of U.S. dollars	87.5	120.8	140.6	144.7	153.4	161.8	168.9
(In months of next year's goods and services)	5.0	5.6	6.6	7.3	7.0	6.9	6.9
External debt (in percent of GDP)							
External debt	32.2	36.6	42.6	46.0	42.9	44.6	45.0
Debt service ratio	1.3	1.2	1.4	1.8	1.8	1.7	1.7
Exchange rates							
Nominal effective exchange rate (2005=100)	99.7	100.3	106.5	105.4	103.3	...	...
Real effective exchange rate (2005=100)	99.0	101.9	108.1	105.5	103.4	...	...
Memorandum items:							
Remittances (in percent of GDP)	19.0	16.4	16.6	24.3	23.2	24.4	25.3
Tourism (in percent of GDP)	7.1	8.0	8.5	9.8	10.0	10.5	10.9
FDI (in percent of GDP)	3.3	4.9	1.1	3.6	2.6	2.6	2.6
Nominal GDP (millions of T\$)	704.9	762.9	786.2	767.8	802.2	825.4	858.8
Population (thousands)	102.8	103.0	103.3	103.5	103.8	104.1	104.3

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

1/ Fiscal year beginning July.

2/ Including preliminary data.

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

Table 2. Tonga: Summary of Government Operations, 2009/10–2015/16

						Budget	Proj.	
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2014/15	2015/16
(In millions of pa'anga)								
Total revenue and grants	192.1	203.8	219.4	196.8	234.2	246.9	252.8	230.5
Total revenue	143.6	151.0	144.4	153.0	158.8	169.3	180.2	178.6
Current revenue	143.6	149.1	144.2	152.3	158.8	169.3	179.4	177.8
Tax revenue	116.2	133.0	126.9	132.7	136.7	141.4	151.5	155.0
<i>Of which:</i> Taxes on income/profits	28.1	38.3	25.3	30.3	25.0	29.9	38.9	34.6
Sales tax and consumption tax	72.4	81.9	87.8	86.9	96.3	95.5	96.5	103.1
Nontax revenue	27.3	16.1	17.4	19.6	22.1	27.9	27.9	22.8
Capital revenue	0.0	2.0	0.2	0.7	0.0	0.0	0.8	0.8
Grants (in cash)	48.6	52.8	75.0	43.8	75.3	77.6	72.6	51.9
Project grants	35.2	30.7	37.9	32.0	41.7	46.0	46.0	32.1
Budget support	13.4	23.6	37.1	11.8	33.6	31.6	26.6	19.8
Total expenditure and net lending	230.2	261.1	241.5	206.7	225.4	244.7	267.9	243.7
Total expenditure	202.3	249.9	232.4	206.7	225.4	244.7	257.9	243.4
Current expenditure	183.8	175.6	187.8	194.1	214.6	228.6	229.1	216.0
Wages and salaries	82.7	91.8	83.6	84.5	95.5	101.9	101.9	103.1
Capital expenditure	18.4	74.4	44.7	12.6	10.8	16.1	28.9	27.4
Total lending minus repayments	27.9	11.2	9.0	0.0	0.0	0.0	10.0	0.3
Current balance (excl. project grants)	-15.7	-5.2	-9.5	-41.8	-55.7	-59.3	-20.4	-38.2
Overall balance (incl. grants)	-38.0	-57.3	-22.1	-10.0	8.7	2.2	-15.2	-13.2
Primary balance (incl. grants)	-32.5	-50.8	-15.6	-2.9	15.8	-7.0	-7.9	-4.3
Primary balance (excl. grants)	-81.0	-103.6	-90.6	-46.6	-59.5	-68.6	-70.4	-56.2
Total financing	38.0	57.3	22.1	10.0	-8.6	13.8	15.2	13.2
External financing	24.7	65.5	41.2	1.9	-5.7	11.3	31.2	24.2
Domestic financing	13.3	-8.2	-19.1	8.0	-3.0	2.5	-16.1	-11.0
(In percent of GDP)								
Total revenue and grants	27.3	26.7	27.9	25.6	29.2	29.9	30.6	26.8
Total revenue	20.4	19.8	18.4	19.9	19.8	20.5	21.8	20.8
Current revenue	20.4	19.5	18.3	19.8	19.8	20.5	21.7	20.7
Tax revenue	16.5	17.4	16.1	17.3	17.0	17.1	18.4	18.1
<i>Of which:</i> Taxes on income/profits	4.0	5.0	3.2	3.9	3.1	3.6	4.7	4.0
Sales tax and consumption tax	10.3	10.7	11.2	11.3	12.0	11.6	11.7	12.0
Nontax revenue	3.9	2.1	2.2	2.6	2.8	3.4	3.4	2.7
Capital revenue	0.0	0.3	0.0	0.1	0.0	0.0	0.1	0.1
Grants (in cash)	6.9	6.9	9.5	5.7	9.4	9.4	8.8	6.0
Project grants	5.0	4.0	4.8	4.2	5.2	5.6	5.6	3.7
Budget support	1.9	3.1	4.7	1.5	4.2	3.8	3.2	2.3
Total expenditure and net lending	32.7	34.2	30.7	26.9	28.1	29.6	32.5	28.4
Current expenditure	26.1	23.0	23.9	25.3	26.7	27.7	27.8	25.2
Wages and salaries	11.7	12.0	10.6	11.0	11.9	12.3	12.3	12.0
Capital expenditure	2.6	9.8	5.7	1.6	1.3	2.0	3.5	3.2
Total lending minus repayments	4.0	1.5	1.1	0.0	0.0	0.0	1.2	0.0
Current balance (excl. project grants)	-2.2	-0.7	-1.2	-5.4	-6.9	-7.2	-2.5	-4.5
Overall balance (incl. grants)	-5.4	-7.5	-2.8	-1.3	1.1	0.3	-1.8	-1.5
Primary balance (incl. grants)	-4.6	-6.7	-2.0	-0.4	2.0	-0.8	-1.0	-0.5
Primary balance (excl. grants)	-11.5	-13.6	-11.5	-6.1	-7.4	-8.3	-8.5	-6.5
Total financing	5.4	7.5	2.8	1.3	-1.1	1.7	1.8	1.5
External financing	3.5	8.6	5.2	0.2	-0.7	1.4	3.8	2.8
Domestic financing	1.9	-1.1	-2.4	1.0	-0.4	0.3	-1.9	-1.3
Memorandum items:								
Nominal GDP (in millions of pa'anga)	704.9	762.9	786.2	767.8	802.2	825.4	825.4	858.8
Wage and salaries (in percent of recurrent expenditure 1/)	53.1	59.5	54.6	51.3	52.1	55.4	55.2	53.7
Total external public debt outstanding (in percent of GDP)	32.2	36.6	42.6	46.0	42.9	44.6	44.6	45.0

Sources: Tongan authorities; and IMF Staff estimates.

1/ Recurrent expenditure excludes one-off expenditure.

Table 2a. Summary of Central Government Operations, 2009/10–2015/16 ^{1/}

	2009/10	2010/11	2011/12	2012/13	2013/14	Proj.	
						2014/15	2015/16
(In millions of pa'anga)							
Revenue	192.1	201.9	219.2	196.1	234.2	252.0	229.7
Taxes	116.2	133.0	126.9	132.7	136.7	151.5	155.0
Of which: Taxes on income/profits	28.1	38.3	25.3	30.3	25.0	38.9	34.6
Sales tax and consumption tax	72.4	81.9	87.8	86.9	96.3	96.5	103.1
Trade taxes	14.9	12.7	13.6	14.7	15.3	15.9	17.0
Social contributions	...	...	...	...	...	...	...
Grants (in cash)	48.6	52.8	75.0	43.8	75.3	72.6	51.9
Project grants	35.2	30.7	37.9	32.0	41.7	46.0	32.1
Budget support	13.4	23.6	37.1	11.8	33.6	26.6	19.8
Other revenue	27.3	16.1	17.4	19.6	22.1	27.9	22.8
Expenditure	202.3	248.0	232.3	206.0	225.4	257.1	242.6
Expense	184.1	176.0	187.8	194.2	214.7	229.2	216.1
Compensation of employees	89.7	100.9	91.0	95.0	105.4	121.8	114.1
Use of goods and services	69.4	50.8	66.2	76.1	85.3	80.7	75.2
Consumption of fixed capital	...	...	...	...	...	...	...
Interest	5.6	6.5	6.5	7.1	7.1	7.3	8.9
Of which: To nonresidents	3.9	4.3	4.8	5.3	5.7	6.0	6.9
Subsidies	1.6	0.4	0.5	0.3	0.4	0.4	0.4
Grants	1.1	1.9	2.7	1.8	1.9	2.2	2.0
Social benefits	10.2	7.3	10.1	6.7	7.1	8.1	7.5
Other expense	6.7	8.3	10.8	7.2	7.6	8.7	8.0
Net acquisition of nonfinancial assets	18.2	71.9	44.4	11.8	10.7	28.0	26.5
Acquisitions of nonfinancial assets	18.2	73.9	44.6	12.5	10.7	28.8	27.34
Disposals of nonfinancial assets	0.0	2.0	0.2	0.7	0.0	0.8	0.8
Consumption of fixed capital	...	...	...	...	...	...	...
Gross operating balance	8.0	25.8	31.4	1.8	19.5	22.8	13.6
Net lending/borrowing and interest	-4.6	-39.7	-6.6	-2.9	15.8	2.1	-4.0
Net lending (+)/borrowing (-)	-10.2	-46.1	-13.1	-10.0	8.7	-5.2	-12.9
Net acquisition of financial assets	27.9	11.2	9.0	-5.7	0.0	26.1	11.3
Domestic net lending	27.9	11.2	9.0	0.0	0.0	10.0	0.3
Change in cash balances (+ = increase)	0.0	0.0	0.0	-5.7	0.0	16.1	11.0
Net incurrence of financial liabilities	38.0	57.3	22.1	4.3	-8.6	31.2	24.2
(In percent of GDP)							
Revenue	27.3	26.5	27.9	25.5	29.2	30.5	26.7
Taxes	16.5	17.4	16.1	17.3	17.0	18.4	18.1
Of which: Taxes on income/profits	4.0	5.0	3.2	3.9	3.1	4.7	4.0
Sales tax and consumption tax	10.3	10.7	11.2	11.3	12.0	11.7	12.0
Trade taxes	2.1	1.7	1.7	1.9	1.9	1.9	2.0
Social contributions	...	...	...	...	...	...	...
Grants (in cash)	6.9	6.9	9.5	5.7	9.4	8.8	6.0
Project grants	5.0	4.0	4.8	4.2	5.2	5.6	3.7
Budget support	1.9	3.1	4.7	1.5	4.2	3.2	2.3
Other revenue	3.9	2.1	2.2	2.6	2.8	3.4	2.7
Expenditure	28.7	32.5	29.5	26.8	28.1	31.2	28.3
Expense	26.1	23.1	23.9	25.3	26.8	27.8	25.2
Compensation of employees	12.7	13.2	11.6	12.4	13.1	14.8	13.3
Use of goods and services	9.8	6.7	8.4	9.9	10.6	9.8	8.8
Consumption of fixed capital	...	...	...	...	...	...	...
Interest	0.8	0.8	0.8	0.9	0.9	0.9	1.0
Of which: To nonresidents	0.5	0.6	0.6	0.7	0.7	0.7	0.8
Subsidies	0.2	0.0	0.1	0.0	0.0	0.0	0.0
Grants	0.2	0.3	0.3	0.2	0.2	0.3	0.2
Social benefits	1.4	1.0	1.3	0.9	0.9	1.0	0.9
Other expense	1.0	1.1	1.4	0.9	0.9	1.1	0.9
Net acquisition of nonfinancial assets	2.6	9.4	5.7	1.5	1.3	3.4	3.1
Acquisitions of nonfinancial assets	2.6	9.7	5.7	1.6	1.3	3.5	3.2
Disposals of nonfinancial assets	0.0	0.3	0.0	0.1	0.0	0.1	0.1
Consumption of fixed capital	...	...	...	...	...	...	...
Gross operating balance	1.1	3.4	4.0	0.2	2.4	2.8	1.6
Net lending (+)/borrowing (-)	-1.4	-6.0	-1.7	-1.3	1.1	-0.6	-1.5
Net acquisition of financial assets	4.0	1.5	1.1	-0.7	0.0	3.2	1.3
Domestic net lending	4.0	1.5	1.1	0.0	0.0	1.2	0.0
Change in cash balances (+ = increase)	0.0	0.0	0.0	-0.7	0.0	1.9	1.3
Net incurrence of financial liabilities	5.4	7.5	2.8	0.6	-1.1	3.8	2.8
Memorandum items:							
Nominal GDP (in millions of pa'anga)	704.9	762.9	786.2	767.8	802.2	825.4	858.8
Total external public debt outstanding (in percent of GDP)	32.2	36.6	42.6	46.0	42.9	44.6	45.0

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

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

Table 3. Tonga: Depository Corporations Survey, 2009/10–2015/16 ^{1/}

	2009/10	2010/11	2011/12	2012/13	2013/14	Proj.	
						2014/15	2015/16
(In millions of pa'anga; end of period)							
Net foreign assets	143.1	195.9	240.4	252.6	268.5	286.1	292.3
Claims on nonresidents	188.5	224.3	267.9	277.7	299.8	310.1	322.3
NRBT	171.9	206.0	254.2	268.6	284.0	295.1	306.3
Other depository corporations	16.6	18.3	13.8	9.1	15.8	15.0	16.0
Liabilities to Nonresidents	-45.4	-28.4	-27.5	-25.1	-31.2	-24.0	-30.0
NRBT	-29.5	-22.0	-17.5	-18.1	-18.2	-16.0	-18.0
Other depository corporations	-15.9	-6.4	-10.0	-7.0	-13.0	-8.0	-12.0
Net domestic assets	153.3	109.6	80.3	78.7	87.4	97.4	110.0
Net domestic credit	277.7	243.7	202.8	201.7	218.1	226.3	236.0
Net claims on government	-28.1	-31.4	-58.9	-44.4	-54.4	-70.5	-81.7
Claims on public nonfin. corps.	15.5	13.6	13.7	16.8	41.7	59.0	72.0
Claims on private sector	290.3	261.5	247.9	229.3	230.9	237.8	245.7
Other items, net	-124.4	-134.1	-122.5	-123.0	-130.8	-128.9	-126.0
Total liquidity	296.4	305.4	326.9	343.8	368.9	383.4	402.3
Broad money (M2)	284.4	293.7	314.9	334.1	358.3	372.6	391.3
Narrow money	90.0	96.8	119.4	149.4	167.7	171.5	175.5
Quasi money	194.4	196.9	195.6	184.7	190.7	201.1	215.8
Securities other than shares 2/	12.0	11.8	11.9	9.7	10.5	10.8	11.0
(Annual percentage change)							
Net foreign assets	21.2	36.9	22.7	5.1	6.3	6.5	2.2
Net domestic assets	-6.5	-28.5	-26.7	-2.0	11.0	11.5	13.0
Net domestic credit	-11.5	-12.3	-16.8	-0.5	8.1	3.8	4.3
Claims on private sector	-15.6	-9.9	-5.2	-7.5	0.7	3.0	3.3
Total liquidity	5.1	3.1	7.0	5.2	7.3	4.0	4.9
Broad money (M2)	5.6	3.3	7.2	6.1	7.2	4.0	5.0
(In millions of U.S. dollars)							
Net foreign assets	73.5	116.1	137.3	138.8	150.1	162.2	166.4
Claims on nonresidents	96.8	133.0	153.1	152.6	167.5	175.8	183.5
NRBT	88.2	122.1	145.2	147.6	158.7	167.3	174.4
ODCs	8.5	10.9	7.9	5.0	8.8	8.5	9.1
Liabilities to nonresidents	-23.3	-16.8	-15.7	-13.8	-17.5	-13.6	-17.1
Memorandum items:							
Velocity (GDP/average M2)	2.5	2.6	2.5	2.3	2.2	2.2	2.2
Loan to deposit ratio	107.6	94.0	84.2	73.5	69.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.7	1.8	1.8	1.8	...	...

Sources: Tongan authorities; and IMF staff estimates.

^{1/} Comprises the National Reserve Bank of Tonga (NRBT) and other depository corporations (ODCs), including the Tonga Development Bank (TDB).^{2/} Comprises bills and promissory notes issued by financial sector and held outside the sector.

Table 4. Tonga: Balance of Payments Summary, 2009/10–2015/16
(In millions of U.S. dollars, unless otherwise indicated)

	2009/10	2010/11	2011/12	Prel. 2012/13	Est. 2013/14	Proj. 2014/15	2015/16
Trade balance	-122.5	-141.7	-161.5	-161.6	-160.6	-180.9	-195.9
Exports, f.o.b.	7.9	10.8	17.9	13.8	15.0	15.0	17.3
Imports, f.o.b.	-130.4	-152.6	-179.3	-175.5	-175.6	-195.9	-213.1
Services (net)	-9.2	4.7	-7.7	0.3	1.3	3.3	5.5
Receipts	39.4	60.6	72.4	81.8	64.2	69.3	74.1
Payments	-48.7	-55.9	-80.1	-81.5	-62.9	-66.0	-68.7
Investment income (net)	11.9	12.9	12.1	11.4	4.7	5.4	6.1
Receipts	16.6	24.1	23.4	24.2	21.8	23.4	25.0
Payments	-4.7	-11.2	-11.3	-12.7	-17.1	-18.0	-18.9
Current transfers (net)	96.3	98.6	116.4	117.2	126.6	149.0	147.7
Official transfers (net) 1/	17.4	20.8	33.2	18.1	30.9	35.3	24.4
Private transfers (net)	78.9	77.8	83.1	99.1	95.8	113.6	123.4
Current account balance	-23.4	-25.5	-40.7	-8.6	-6.2	-23.3	-36.5
(In percent of GDP)	-6.4	-6.1	-8.8	-1.9	-1.4	-5.0	-7.5
Capital account balance	16.4	5.6	7.4	3.5	7.2	2.0	17.1
Financial account balance	26.8	53.3	27.5	20.6	14.6	29.7	26.5
FDI (net)	12.2	20.3	5.0	16.0	11.6	12.1	12.7
Other investment (net)	14.6	33.0	22.5	4.6	3.0	17.6	13.8
Overall balance 2/	19.8	33.3	19.8	4.1	8.7	8.5	7.1
Memorandum items:							
Gross official foreign reserves	87.5	120.8	140.6	144.7	153.4	161.8	168.9
<i>In months of next year's goods and services import</i>	5.0	5.6	6.6	7.3	7.0	6.9	6.9
Exchange rate							
Pa'anga per U.S. dollar (period average)	1.9	1.8	1.7	1.7	1.8	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.7	1.8	1.8	1.8	...	...
Nominal GDP (in millions of US\$)	365.4	416.4	463.9	442.9	442.6	464.6	487.9
Commodity price indexes (2005 = 100)							
Food	142.1	165.0	177.8	176.6	174.0	161.6	151.3
Fuel	70.4	91.5	104.5	104.5	100.5	85.2	75.1

Sources: Tongan authorities; and IMF staff estimates.

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

2/ Change in gross official foreign reserves.

Table 5. Tonga: Medium-Term Scenario, 2010/11–2019/20 ^{1/}

	2010/11	2011/12	Prel. 2012/13	Est. 2013/14	2014/15	2015/16	Proj. 2016/17	2017/18	2018/19	2019/20
(Annual percentage change)										
Output and prices										
Real GDP	2.0	0.5	-2.7	2.1	2.5	2.9	2.0	2.0	3.0	2.4
Consumer prices (end of period)	7.1	2.3	0.2	1.5	0.6	1.7	2.0	2.4	3.8	3.5
Consumer prices (period average)	6.0	3.3	0.7	2.3	0.4	1.2	1.9	2.2	3.1	3.6
GDP deflator	6.1	2.5	0.3	2.3	0.4	1.2	1.9	2.2	3.1	3.6
(In percent of GDP)										
Central government finance										
Total revenue and grants	26.7	27.9	25.6	29.2	30.6	26.8	25.5	26.8	26.8	26.7
Total revenue	19.8	18.4	19.9	19.8	21.8	20.8	21.0	20.8	20.8	20.8
Of which: tax revenue	17.4	16.1	17.3	17.0	18.4	18.1	18.3	18.1	18.1	18.1
Grants	6.9	9.5	5.7	9.4	8.8	6.0	4.5	6.0	6.0	5.9
Total expenditure and net lending	34.2	30.7	26.9	28.1	32.5	28.4	26.5	27.5	27.2	26.9
Current expenditure	23.0	23.9	25.3	26.7	27.8	25.2	24.8	25.4	24.6	24.7
Capital expenditure	9.8	5.7	1.6	1.3	3.5	3.2	1.6	2.0	2.6	2.2
Net lending	1.5	1.1	0.0	0.0	1.2	0.0	0.0	0.0	0.0	0.0
Overall balance (incl. grants)	-7.5	-2.8	-1.3	1.1	-1.8	-1.5	-0.9	-0.6	-0.4	-0.1
External financing (net)	8.6	5.2	0.2	-0.7	3.8	2.8	1.6	1.6	0.4	0.0
Domestic financing (net)	-1.1	-2.4	1.0	-0.4	-1.9	-1.3	-0.6	-0.9	-0.1	0.1
Primary balance (incl. grants)	-6.7	-2.0	-0.4	2.0	-1.0	-0.5	0.1	0.3	0.6	0.8
Primary balance (excl. grants)	-13.6	-11.5	-6.1	-7.4	-8.5	-6.5	-4.4	-5.7	-5.4	-5.2
(In millions of U.S. dollars)										
Balance of payments										
Exports, f.o.b.	10.8	17.9	13.8	15.0	15.0	17.3	19.7	21.6	23.2	25.0
(Annual percent change)	36.3	65.4	-22.6	8.4	0.0	15.0	14.0	10.0	7.0	8.0
Imports, f.o.b.	-152.6	-179.3	-175.5	-175.6	-195.9	-213.1	-220.9	-233.5	-240.8	-254.2
(Annual percent change)	17.0	17.6	-2.2	0.1	11.5	8.8	3.6	5.7	3.1	5.6
Services (net)	4.7	-7.7	0.3	1.3	3.3	5.5	7.9	9.2	10.6	15.7
Investment income (net)	12.9	12.1	11.4	4.7	5.4	6.1	6.9	7.8	7.2	7.1
Transfers (net)	98.6	116.4	117.2	126.6	149.0	147.7	148.9	165.1	179.7	195.6
Of which: Remittances	68.3	77.2	107.4	102.7	113.4	123.3	131.6	138.0	150.1	163.6
Current account balance	-25.5	-40.7	-8.6	-6.2	-23.3	-36.5	-37.5	-29.8	-20.1	-10.9
(In percent of GDP)	-6.1	-8.8	-1.9	-1.4	-5.0	-7.5	-7.4	-5.6	-3.6	-1.9
Capital account balance	5.6	7.4	3.5	7.2	2.0	17.1	16.3	16.2	1.7	1.7
Financial account balance	53.3	27.5	20.6	14.6	29.7	26.5	21.3	22.6	17.3	15.8
FDI (net)	20.3	5.0	16.0	11.6	12.1	12.7	13.4	14.0	14.7	15.5
Other investment (net)	33.0	22.5	4.6	3.0	17.6	13.8	7.9	8.6	2.6	0.3
Overall balance	33.3	19.8	4.1	8.7	8.5	7.1	0.1	9.1	-1.2	6.7
Gross international reserves (end of period)										
In millions of U.S. dollars	120.8	140.6	144.7	153.4	161.8	168.9	169.0	178.1	177.0	183.6
In months of next year's goods and services imports	5.6	6.6	7.3	7.0	6.9	6.9	6.6	6.7	6.3	6.3
External debt (in percent of GDP)										
Public sector external debt	36.6	42.6	46.0	42.9	44.6	45.0	44.2	43.6	41.5	39.9
Debt service ratio	1.2	1.4	1.8	1.8	1.7	1.7	1.6	1.5	2.6	2.9
Memorandum items:										
Private transfers (net, in millions of U.S. dollars)	77.8	83.1	99.1	95.8	113.6	123.4	130.7	138.5	151.7	166.8
(In percent of imports of goods and services)	37.3	32.0	38.6	40.2	43.4	43.8	44.7	44.8	47.2	49.3
Nominal GDP (millions of pa'anga)	762.9	786.2	767.8	802.2	825.4	858.8	892.0	929.4	986.7	1047.2

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

^{1/} Fiscal year beginning July.

Table 6. Tonga: Financial Soundness Indicators, 2007/08–2013/14 ^{1/}

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	(In percent)						
Financial sector							
Total loans/GDP	54.8	53.3	43.4	36.1	34.1	30.5	34.0
Banks							
Net domestic credit			(Year-on-year percent change)				
Public non-financial corporations	27.6	-1.1	229.0	-12.0	3.1	19.7	148.4
Private sector	17.1	-3.7	-15.6	-9.9	-5.2	-7.5	0.7
			(In percent)				
Risk-weighted capital adequacy ratio	17.0	22.1	18.9	23.9	30.5	35.9	39.8
Net interest income to average assets	4.7	4.7	4.5	3.9	3.8	3.8	3.6
Non-performing loans	9.5	20.5	15.3	15.2	15.3	13.9	12.7
Loan loss reserves to gross loans	4.7	13.3	14.8	15.0	6.2	7.0	4.7

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

^{1/} Data as of end of fiscal years.

Table 7. Tonga: Millennium Development Goals, 1990-2013

	1990	1995	2000	2005	2008	2009	2010	2011	2012	2013
Goal 1: Eradicate extreme poverty and hunger										
Employment to population ratio, 15+, total (%)	..	..	..	..	..	..	..	..	..	..
GDP per person employed (constant 1990 PPP \$)	..	..	..	..	..	..	..	..	..	..
Income share held by lowest 20%	..	..	..	..	..	..	..	..	..	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	..	..	..	..	..	..	..	..
Poverty gap at \$1.25 a day (PPP) (%)	..	..	..	..	..	..	..	..	..	..
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	..	..	..	..	..	..	..	..	..	..
Prevalence of undernourishment (% of population)	..	..	..	..	..	..	..	..	..	..
Vulnerable employment, total (% of total employment)	..	..	..	..	..	..	..	..	..	..
Goal 2: Achieve universal primary education										
Literacy rate, youth female (% of females ages 15-24)	99	..	..	..	..	..	..	100	..	..
Literacy rate, youth male (% of males ages 15-24)	99	..	..	..	..	..	..	99	..	..
Persistence to last grade of primary, total (% of cohort)	..	..	95	91	..	..	..	..	..	..
Primary completion rate, total (% of relevant age group)	..	..	..	..	..	..	..	..	99	..
Total enrollment, primary (% net)	92	..	89	..	93	..	..	..	90	..
Goal 3: Promote gender equality and empower women										
Proportion of seats held by women in national parliaments (%)	3	..	6	..	..	..	..	4	4	4
Ratio of female to male enrollments in tertiary education (%)	..	67	69	99	..	..	..	..	..	..
Ratio of female to male primary enrollment (%)	..	..	..	..	88	..	..	99	99	..
Ratio of female to male secondary enrollment (%)	..	97	99	..	97	..	..	89	..	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	36	..	39	..	..	..	..	..	..
Goal 4: Reduce child mortality										
Immunization, measles (% of children ages 12-23 months)	86	94	95	99	99	99	99	99	95	99
Mortality rate, infant (per 1,000 live births)	..	..	13	..	16	15	22	11	11	10
Mortality rate, under-5 (per 1,000)	27	..	..	..	26	22	..	13	13	12
Goal 5: Improve maternal health										
Adolescent fertility rate (births per 1,000 women ages 15-19)	...	23	25	24	20	21	20	19	18	..
Births attended by skilled health staff (% of total)	92	..	95	98	..	98	99	..	..	..
Contraceptive prevalence (% of women ages 15-49)	33	41	31	..	27	..	32	..	..	..
Maternal mortality ratio (national estimate, per 100,000 live births)	..	205	81	..	76	114	37	..	..	..
Pregnant women receiving prenatal care (%)	..	..	..	..	99	..	98	..	..	..
Unmet need for contraception (% of married women ages 15-49)	..	..	..	..	..	..	..	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases										
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	..	..	..	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	38	..	28	..	..	..	17	..	..	..
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	..	..	..	..	..	..
Prevalence of HIV, male (% ages 15-24)	..	..	..	..	..	..	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	..	..	..	..	..	..	..
Tuberculosis case detection rate (% of all forms)	64	..	88	..	..	..	63	..	..	..
Goal 7: Ensure environmental sustainability										
CO2 emissions (kg per PPP \$ of GDP)	0.3	..	0.3	..	0.4	..	0.3	..	..	..
CO2 emissions (metric tons per capita)	0.8	..	1.2	..	1.7	..	1.5	..	..	..
Forest area (% of land area)	12.5	..	12.5	..	5.3	..	12.5	12.5	12.5	..
Improved sanitation facilities (% of population with access)	96	..	..	..	..	92	92	92	91	..
Improved water source (% of population with access)	100	..	..	100	99	99	99	99	99	..
Marine protected areas, (% of territorial water)	..	9.4	2.8	9.4	9.4	9.4	3.0	..	3.0	..
Goal 8: Develop a global partnership for development										
Internet users (per 100 people)	0.0	..	2.4	4.9	8.1	10.0	12.0	25.0	34.9	35.0
Mobile cellular subscriptions (per 100 people)	0.0	..	0.2	29.6	49.0	51.2	52.2	52.6	53.4	54.6
Telephone lines (per 100 people)	4.6	..	9.9	..	24.8	29.9	29.8	28.7	28.6	29.4
Other										
Fertility rate, total (births per woman)	4.6	4.4	4.3	4.1	4.0	4.0	3.9	3.9	3.8	..
GNI per capita, Atlas method (current US\$)	1,220	2,010	2,030	2,470	3,200	3,330	3,490	3,740	4,220	4,490
GNI, Atlas method (current US\$) (billions)	0.1	0.2	0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.5
Gross capital formation (% of GDP)	18	26	22	22	26	27	29	36	33	..
Life expectancy at birth, total (years)	70	70	71	71	72	72	72	72	72	..
Literacy rate, adult total (% of people ages 15 and above)	99	..	..	..	..	..	..	99	..	..
Population, total (millions)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Trade (% of GDP)	99	73	62	76	71	77	73	79	80	..

Source: World Bank, World Development Indicators database.

Appendix I. Risk Assessment Matrix¹

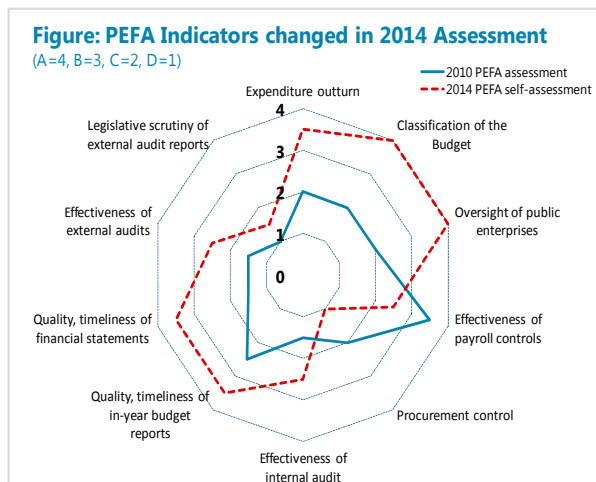
Source	Likelihood	Impact	Policy Response to Minimize Impact
EXTERNAL RISKS			
Protracted period of slower growth in advanced economies			
An economic slowdown in key advanced countries (New Zealand, Australia, and the U.S.) hosting Tongan overseas workers could weaken remittance inflows. Tonga's exports would be also significantly affected.	High	Medium/High	Preserve fiscal and external policy space to cope with adverse shocks in the short term. In the longer term, boost public investment, and pursue structural reforms to improve the investment climate and reduce dependence on aid and remittances.
Growth slowdown and financial risks in China			
Tonga would be affected indirectly through China's trade links with New Zealand/Australia, and directly through a slowdown in Chinese official development assistance	Low/Medium	Low/Medium	
DOMESTIC RISKS			
Slippages in the execution of policy reform			
Slippages in the reform process could derail critical reforms agreed with development partners. Such an outcome could affect grant flows for budget support, resulting in a significantly larger gross financing gap.	Low	High	Take early remedial actions, including stronger commitment to ensure fiscal prudence, renewed reform efforts, and streamlining the Games, to redress impaired confidence and re-energize support by the donors.
Cost overrun relating to the 2019 South Pacific Games			
Underestimating the true cost of construction works could make it necessary to mobilize additional resources and might necessitate corrective fiscal consolidation in the long run.	Medium	High	
Natural disasters (regional)			
Natural disasters similar to the recent cyclone could take significant toll on Tonga, such as damages to infrastructure and production base.	Low/medium	High	Prepare for future disaster by: (i) building fiscal space and international reserve buffers, (ii) designing a catastrophic insurance scheme; and (iii) using toolkits provided by global financial safety nets.

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Appendix II. Public Financial Management Reform¹

A well-functioning Public Financial Management (PFM) system contributes to economic stability and growth by improving the use of public resources and strengthening governance. In the case of Tonga, where foreign aid plays an important role in economic development, effective PFM also provides assurance to donor countries that aid is used in a transparent and efficient manner.

PFM in Tonga has improved in the past decade, but considerable weakness still exists. In the 2007 Public Expenditure and Financial Accountability (PEFA) assessment, Tonga received 7 ratings of “A/B” of the 27 applicable performance indicators. This number increased to 12 in the 2010 assessment. The latest 2014 self-assessment showed further progress in improving some weak PFM areas and maintaining the areas that performed well. The table below compares the ratings of performance indicators from the 2010 PEFA assessment and 2014 PEFA self-assessment. Areas including revenue out-turn compared to budget, measures for tax assessment and taxpayer registration, and transparency of taxpayer obligations and liabilities continue to perform well. At the same time, areas including oversight of fiscal risks from public enterprises, composition of expenditure out-turn compared to budget, and quality and timeliness of in-year budget reports have been improved from ratings of “C/D” to “A/B”.



Nonetheless, some PFM areas continue to be weak, such as the implementation of the three-year rolling medium-term budgeting framework, effectiveness of tax collection, and internal and external audit. In particular, performance in two areas has deteriorated since the 2010 assessment. They are processes for public procurement (from “C” to “D”) and effectiveness of payroll controls (from “B+” to “C+”).

The government of Tonga attaches high importance to PFM reform, which is considered critical to long-term growth. In October 2014, the Cabinet endorsed the PFM reform Roadmap which aims to improve critical PFM areas based on the 2014 assessment. The Roadmap proposes a total of 77 phased actions to be completed before 2019 and emphasizes the following priority areas:

- strengthening the effectiveness of tax collection and internal audit;
- enhancing and upgrading the Government Integrated Financial Management Information System (IFMIS);
- better integrating planning, budgeting, and aid management functions; and

¹ Prepared by Fei Liu (SEC) and Ronald Lee Hackett (PFTAC).

- ensuring adequate staff capacity in all PFM units in line ministries and public agencies, through new recruitment or strengthening capacity of existing staff.

The Roadmap recognizes the importance of effective communication with stakeholders and proper sequencing of the reform actions. However, potential areas of weakness exist:

- the timing for the IFMIS upgrade is ambitious, and the Roadmap appears more focused on equipment updates than on business process redesign to improve internal management;
- actions may not be adequate to address the effectiveness of payroll controls, a PFM area which has deteriorated in the 2014 assessment; and
- the discussion of devolution of PFM responsibilities needs to be managed carefully to avoid unintended consequences (for example, less coordinated budgeting and lack of consistency)

Table. Comparison between 2010 PEFA and 2014 Self-assessment

	2014 Self-Assessment	
	Strong (A or B) Performance	Weak (C or D) Performance
2010 PEFA Strong Performance	<ul style="list-style-type: none"> • PI-1: Aggregate expenditure out-turn compared to original approved budget • PI-3: Aggregate revenue out-turn compared to original approved budget • PI-4: Stock and monitoring of expenditure payment arrears • PI-6: Comprehensiveness of information included in budget documentation • PI-7: Extent of unreported government operation • PI-11: Orderliness and participation in the annual budget process • PI-13: Transparency of taxpayer obligations and liabilities • PI-14: Effectiveness of measures for taxpayer registration and tax assessment • PI-17: Recording and management of cash balances, debt and guarantees • PI-20: Effectiveness of internal controls for non-salary expenditure • PI-22: Timeliness and regularity of accounts reconciliation 	<ul style="list-style-type: none"> • PI-18: Effectiveness of payroll controls

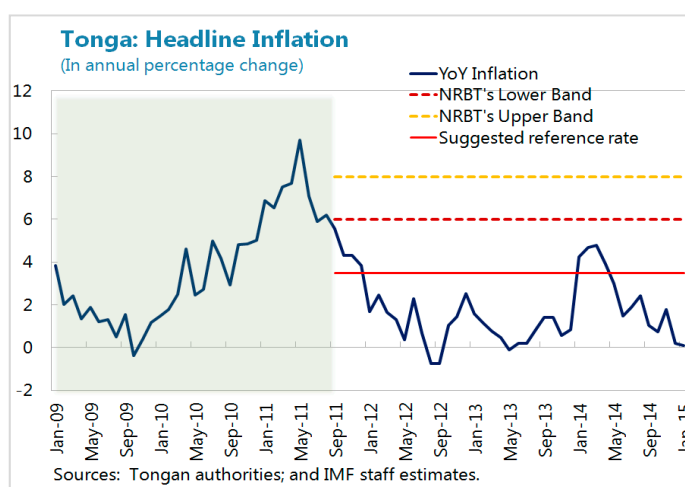
Table. Comparison between 2010 PEFA and 2014 Self-assessment

		2014 Self-Assessment	
		Strong (A or B) Performance	Weak (C or D) Performance
Weak Performance		<ul style="list-style-type: none"> • PI-2: Composition of expenditure out-turn compared to original approved budget • PI-5: Classification of the budget • PI-9: Oversight of aggregate fiscal risk from other public sector entities • PI-24: Quality and timeliness of in-year budget reports • PI-25: Quality and timeliness of annual financial statements 	<ul style="list-style-type: none"> • PI-10: Public access to key fiscal information • PI-12: Multi-year perspective in fiscal planning, expenditure policy and budgeting • PI-15: Effectiveness in collection of tax payments • PI-16: Predictability in the availability of funds for commitment of expenditures • PI-19: Competition, value for money and controls in procurement • PI-21: Effectiveness of internal audit • PI-23: Availability of information on resources received by service delivery units • PI-26: Scope, nature and follow-up of external audit • PI-27: Legislative scrutiny of the annual budget law • PI-28: Legislative scrutiny of external audit reports

Appendix III. Moving to Inflation Point Reference System¹

The NRBT uses an inflation reference range of 6 to 8 percent, which has remained unchanged since 2011, despite a fall in Tongan inflation after the global financial crisis. Actual inflation has been consistently below the reference range since then, raising questions about the usefulness of the range. The NRBT could introduce an inflation reference rate along the following lines:

- Introducing an inflation reference rate.** A benchmark for inflation would be useful for facilitating internal policy discussions and coordination, including with the Ministry of Finance and National Planning (MOFNP). A reference rate rather than range would be more suitable for this purpose. The rate could be set equal to the medium-term inflation forecast (e.g., use IMF staff's forecast of 3.5 percent), which should be reviewed periodically to ensure consistency with economic fundamentals.
- Policy coordination and discussion.** The central bank could use the reference rate in their assessment of economic developments and outlook during their periodic review of monetary policy setting. The central bank should share their assessment with the Ministry of Finance and National Planning (MOFNP) and discuss policy coordination.
- Improve communication.** The rationale for choosing an inflation reference rate and the use of it should be clearly communicated to the public. The NRBT could also mention that the inflation reference rate reflects what the NRBT sees as consistent with medium-term fundamentals of the Tongan economy. The NRBT's Monetary Policy Statement could also explain deviation from the reference rate, as well as the authorities' intended policy reaction.



¹ Prepared by Yasuhisa Ojima (APD).

Appendix IV. Impediments to Credit Growth¹

Despite accommodative monetary policy and ample liquidity in the banking sector, credit to the private sector has declined since the global financial crisis and remained weak in recent years. To implement effective policies for reviving credit growth, it is important to identify whether banks are reluctant to lend (supply-side constraint) or whether firms and households are unwilling to borrow (demand-side constraint). In Tonga, both demand- and supply-side constraints seem to limit credit growth, but supply-side constraints might be easier to address by policymakers.

- ***Demand-Side Constraints.*** A moderate growth outlook, limited investment opportunities and low expected returns are important constraints to credit demand in Tonga. High interest rates and unattractive lending conditions also reduce borrowing. Although lending rates for both households and businesses have gradually fallen in recent years, they remain elevated at roughly 8 percent. The requirement to pledge land as collateral entails risks that small borrowers are unwilling to take. Furthermore, many businesses and households still struggle to service past debt obligations. The availability of alternative funding sources might also have reduced the demand for bank credit. While Tonga does not have a corporate bond market, lending by micro-finance institutions, retirement funds, credit cooperatives and money lenders has gained in importance in recent years.
- ***Supply-Side Constraints.*** Several commercial banks in Tonga experienced large loan losses during the global financial crisis, and focused on repairing their balance sheets in the following years, thus limiting their ability to expand lending. Partially as a result of this experience, lending practices by banks have become more conservative after the crisis. Banks typically require borrowers to pledge collateral or to make an equity contribution to the business project. Small borrowers often lack the means to contribute equity to the project. Land tends to be the only asset that could qualify as collateral, but a lengthy land registration process and a limited secondary market for land reduce the value of land as collateral to banks. Furthermore, information provided by Tonga's credit bureau is perceived as incomplete, complicating the process of screening borrowers. As a result, banks tend to concentrate on extending credit to larger established businesses, and shy away from lending to SMEs.

¹ Prepared by Eva Christiane Kneer (APD).

Appendix V. Challenges to Growth¹

Tonga faces considerable challenges to achieving higher economic growth, many of which are shared with its Pacific island neighbors. Nations that move up from Tonga's level of income most often do so by exporting competitive manufactures or building industries to serve large domestic markets.² Neither are viable growth strategies for Tonga. The South Pacific islands countries, including Tonga, are the most distant in the world from markets (on a GDP-weighted basis).³ This, on its own, heightens frictional trade costs. With scale, such costs could be lowered but Tonga is also unable to exploit the economies of scale required to bring down production costs because of its small size—a population of 100,000. Small size and economic remoteness combine to produce more formidable barriers to growth than either would on its own. For example, it is hard to service Tonga by large container vessels, which are the standard in international shipping, thus increasing the cost of long-distance logistics.⁴

Despite the considerable challenges of size and location, there are viable growth strategies that countries such as Tonga can and have successfully pursued to support growth and shared prosperity. Industries that trade on the natural assets of the country, such as sustainable tourism, fisheries, agriculture and possibly seabed mining are areas of potential. Tourism in particular offers the prospect of growth in supporting industries including better use of domestic production base (e.g., agriculture), substituting for costly imported products. Tonga has already taken significant steps towards creating a conducive environment for growth. The figure below shows that Tonga performs better than the East Asia Pacific (EAP) average in 7 of the 10 measured areas, but significant constraints persist in registering property, investor protection and insolvency resolution.⁵

Tonga has made considerable infrastructure investments, including a new national fiber-optic cable, renewable energy capacity and road network in the capital island. At the same time, the most often-cited constraints to private sector development in Tonga remain, namely: i) risk and uncertainty; ii) high cost of doing business; and iii) lack of access to markets. Growth-enhancing initiatives include:

- First, there is scope to improve the predictability and certainty for business to support long-term planning by reducing ambiguity, discretion and gaps in law and regulation, by putting in place clear, unambiguous and appropriate legislation built on consultation and which is clearly communicated to the public. Areas of importance are in labor market regulation, trade taxation, discretionary tax exemptions and foundational law for formal credit markets to function properly. Work underway on the Foreign Investment Act and supporting legislative revisions will also be important.
- Second, using a combination of development partner-supported infrastructure investment, targeted policy reforms and effective regulation could reduce business costs such as energy and logistics.

¹ Prepared by David Knight (WB) and Johannes Wolf (ADB).

² Bulman, D. et al, 2014, Transitioning from Low-Income Growth to High-Income Growth, World Bank Policy Research Working Paper 7104.

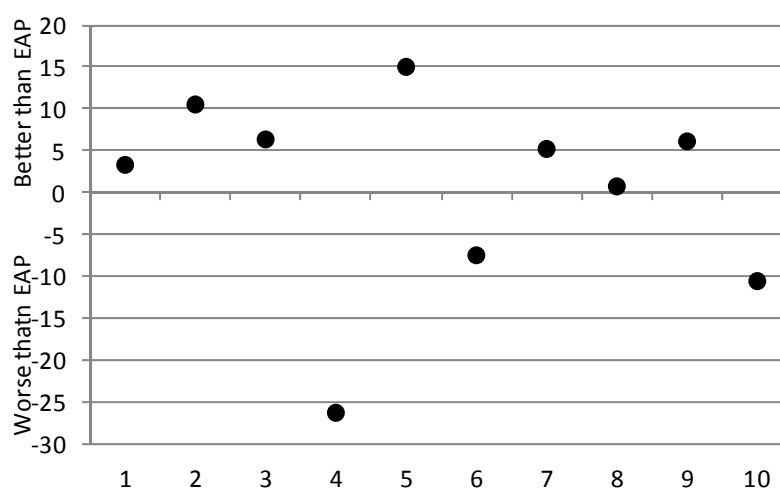
³ World Bank, 2014, East Asia and Pacific Economic Update October 2014, World Bank: Washington DC.

⁴ UNCTAD, 2014, Review of Maritime Transport, United Nations: New York and Geneva.

⁵ World Bank, 2014, Doing Business 2015: Going Beyond Efficiency, World Bank: Washington DC.

- Third, Tonga could seek to strengthen external partnerships that support improved market access and promote collective (regional) solutions to public goods provision and facilitate cross-border economic activity. Pro-development relationships with donor countries need to prioritize the economic benefit for Tonga by facilitating and lowering the barriers to much larger markets. Regional partnerships could aim to solve collective action problems by fostering strong cooperative action, which will yield greater benefits for all.

**Figure. Doing Business 2014/15:
Distance to Frontier Scores for Tonga Relative to EAP Average**



1. starting a business; 2. construction; 3. getting electricity; 4. registering property; 5. getting credit; 6. protecting investors; 7. paying taxes; 8. trading across borders; 9. enforcing contracts; 10. resolving insolvency

1/ These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.



TONGA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 7, 2015

Prepared By

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

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FUND RELATIONS¹

Membership Status

Joined September 13, 1985; Article VIII.

General Resources Account

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

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	6.58	100.00
Holdings	7.09	107.75

Outstanding Purchases and Loans

None

Financial Arrangements

None

Projected Obligations to Fund*

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

	Forthcoming				
	2015	2016	2017	2018	2019
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 Arrangement

The exchange rate arrangement is a pegged exchange rate within horizontal bands. Tonga has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 and maintains an exchange control

¹ As of March 15, 2015.

system that is free of restrictions on the making of payments and transfers for current international transactions. Since February 11, 1991, the value of the pa'anga is determined based on a weighted basket of currencies comprising the United States, Australian, and New Zealand dollars, with the U.S. dollar as the intervention currency. In July 2014, the Fijian dollar was added to the basket replacing the Japanese yen, and, in July 2010, 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.

Last Article IV Consultation

Staff discussions were held during April 2014. On July 23, 2014, the Executive Board of the IMF concluded the Article IV consultation with Tonga and considered and endorsed the staff report (IMF Country Report No. 14/240).

Technical Assistance

The Legal Department (LEG) provided assistance on AML/CFT issues for the Pacific islands countries, including Tonga, from 2002 through 2005. LEG also provided assistance on the National Reserve Bank of Tonga Act and Financial Institutions Act from 2013 to 2014. PFTAC has, on an on-going basis, provided assistance on budgetary management; tax administration; banking legislation and supervision; and balance of payments and national accounts statistics.

Resident Representative

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

PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2015–16¹

Background

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

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

Strategy 2015–16

PFTAC's TA strategy is guided by the APD regional strategy and is planned within the results framework for current PFTAC funding cycle.²

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 groups 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 to assist the authorities to implement high priority reforms identified in the Roadmap, including Treasury business process improvements (1.7); and planning for upgrading the government's FMIS (1.7). PFTAC will also support ADB projects aimed at developing an effective medium-term budget framework (1.6) including producing more accurate macroeconomic analysis; (5.1) and more rigorous cash/debt management (1.7). In the medium term, PFTAC would look to assist the authorities implement a follow-up PEFA assessment, probably in 2015 (1.1).

In the revenue area, the main focus remains on assisting the authorities to continue with implementation of the recommendations of the October 2011 PFTAC strategic revenue review. A PFTAC revenue administration mission conducted in October 2014 evaluated progress on these recommendations, the majority of which have now been implemented. Further PFTAC assistance

¹ As of March 2015.

² 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.

was provided to: (a) facilitate implementation of the new Small Business Tax which came into force on August 1, 2014 (2.2, 2.3) ; (b) provide advice on the management of consumption tax credits (2.4); and (c) prepare the Income Tax Amendment Bill for a new deep sea mining regime (2.2 2.3)– this legislation was recently passed. The existing corporate strategy has been updated and sets the foundation for the design of enhanced strategies and operational plans (2.8).

A number of additional PFTAC tax administration recommendations have been accepted by the authorities and a technical assistance plan agreed to – this will include the development of a compliance improvement strategy and the establishment of a risk management unit (2.4 2.5). Two new AusDFAT revenue advisors are in place and have made a significant contribution to improving core tax functions. The ADB, with the assistance of the Australian Government, is providing assistance in the upgrade of current IT systems (2.6) which will further streamline operations and reduce compliance costs for taxpayers. Tonga remains one of the regional leaders in implementing modern revenue administration practices confirmed by an upward shift reflected in the PFTAC baseline assessment tool.

In statistics, Tonga is relatively well advanced against the overall results framework; based on PFTAC advice, it produces National Accounts on two independent measures (4.1) with production of a range of income indicators (4.3). Balance of payments statistics are now being developed according to BPM6 standards (4.9). However, the quality of statistics and source data need to be strengthened. The Tonga Bureau of Statistics was assisted during 2011 and 2012 by an AusAID (now DFAT) funded resident advisor, with the result that direct PFTAC assistance was minimal during this period. PFTAC continued to coordinate with and be a resource for the resident advisor and to provide focused technical inputs in particular areas. Limited re-engagement with Tonga resumed during 2014 and will continue in 2015. Balance of payments and Government Finance Statistics support have been provided by IMF HQ.

In financial sector supervision, IMF/PFTAC over the past few years assisted the NRBT in with the deployment of standard prudential returns (3.1) and with establishing enhanced off-site analysis (3.3). These currently enable the NRBT to prepare regular off-site analysis and monitoring reports from the sector. Intensive support is being provided in FY2015/16 to develop on-site supervision techniques by providing technical advisory mentorship in performing the actual on-site examination of a number of commercial banks (3.4, 3.5) which includes examination preparedness, scoping, planning, execution, and report writing. The year 2015/16 will further see the introduction of a comprehensive credit union program aimed at overhauling the oversight of credit unions (3.9).

In the macroeconomic area, PFTAC continues to assist the Ministry of Finance and National Planning (MOFNP) to strengthen its capacity in macroeconomic monitoring and forecasting (5.1) in coordination with a resident macroeconomic adviser funded by the ADB. Staffs of National Reserve Bank of Tonga (NRBT) and MOFNP participated in a regional fiscal analysis and forecasting workshop held jointly by PFTAC and the Singapore Regional Training Institute in March 2014 (5.2); NRBT staff attended a regional seminar on monetary policy management, analysis and operation held jointly by the Bank of England's Centre for Central Bank Studies and PTAC in March 2014 (5.1) and also a regional workshop on long-term fiscal planning held jointly by the ADB and PFTAC in December 2014 (5.2).

WORLD BANK-IMF COLLABORATION¹

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

- **Article IV Consultation.** The World Bank participated in the 2009–15 Article IV missions, as well as joining several consultations and providing various analytical inputs to the Article IV Reports. This participation facilitated the discussions, especially in areas of mutual interest such as fiscal policy and structural reform. In addition, Bank and Fund staffs prepared jointly the Debt Sustainability Analysis appendix to the staff reports.
- **Economic Updates.** IMF analysis continues to provide a vital framework to the ongoing budget support program, with IMF assessments used as the basis for decisions regarding the appropriateness of the overall macroeconomic policy framework.
- **Structural Fiscal Reforms.** Bank and Fund staffs have worked successfully to provide technical assistance (TA) in public expenditure management and continue to collaborate on the ongoing analytical work on public expenditure, the medium-term macro-framework, and general structural issues.

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

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

¹ As of February 2015

- of services such as energy, water and telecommunications in order to reduce costs;
- (ii) strengthen the institutional framework for lending—including the enforcement of creditor rights to collateral—as a means to increase access to finance and lower the cost of borrowing;
- (iii) improve vital tourism infrastructure, including through the commercialization of Tonga Communication Corporation; and (iv) lower regulatory barriers to foreign investment.

World Bank Group cooperation with Tonga is set out in a Country Assistance Strategy presented to the Board in October 2010. Given the current depth of policy dialogue and Tonga's difficult position, the Bank is significantly scaling up both analytical and financial support for Tonga. Total IDA and Trust Fund commitments to Tonga over the past five years amount to US\$87 million, compared to US\$30 million between 1985—when Tonga became a member—and FY10.

A key focus of engagement has been around budget support operations. There have been annual World Bank budget support operations for each of the five years FY2011 to FY2015 to provide a total of US\$25.8 million to support fiscal, business-environment improving, public financial management and energy sector reforms as part of a World Bank-led multi-donor process.

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

The World Bank Group provided TA to the Ministry of Revenue and Ministry of Finance and National Planning during FY2015 to prepare a new Medium Term Debt Strategy. The World Bank Group is also providing ongoing assistance to the Ministry of Finance and National Planning to support the privatization of the International Dateline Hotel and to commercialize the operations of the Tonga Development Bank and support in the development of a new central procurement database.

The Bank and Fund teams will continue their close cooperation going forward, particularly in supporting the current program of budget support and to assist the Government in responding to ongoing economic difficulties. Table 1 details the specific activities planned by the two country teams over the February 2015–January 2017 period. It was also agreed that further details on collaboration, as necessary, will be agreed at the technical level as work progresses.

Table 1. Tonga: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas (February 2015–January 2017)

	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • Tonga COLA TA • Procurement IT systems TA • Social protection and disaster risk management TA • Possible new Development Policy Program • Tonga Agriculture & Fisheries Sector Plan TA • Seasonal Worker Program Evaluation 	<ul style="list-style-type: none"> • FY2015 • FY2015 • FY2015 • FY2016-17 • FY2016 • FY2016
Fund Work Program	<ul style="list-style-type: none"> • External Sector Statistics (follow-up) • PFM Roadmap (follow-up) • Financial Sector Supervision (follow-up) • 2015 Article IV Mission • 2015 Article IV Staff Report/Board Meeting • 2016 Article IV Policy Note • 2016 Article IV Mission • 2016 Article IV Staff Report/Board Meeting 	<ul style="list-style-type: none"> • FY2015 • FY2015 • FY2015 • February 2015 • April/May 2015 • February 2016 • March 2016 • May/June 2016

RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

The goal of the Asian Development Bank's (AsDB) Pacific Approach 2010–2014 of a sustained and resilient, improved standard of living aligns with the vision of the Tonga Strategic Development Framework 2009/2010–2014/2015 (TSDF) to create a society in which all Tongans enjoy higher living standards and a better quality of life. Similarly, the Pacific Approach, which serves as AsDB's country partnership strategy, aims to achieve its goal through inclusive and environmentally sustainable growth, which is consistent with the TSDF vision of equitable and environmentally sustainable private sector-led economic growth. AsDB's Country Operations Business Plan 2015–2017 for Tonga shares the same focus as the Pacific Approach and the TSDF.

The Pacific Approach focuses on the need to mitigate environmental impact and strengthen climate change resilience through development of renewable energy options; enhancing connectivity via multimodal networks and new technologies; and supporting urban development. Two key drivers of change to promote the focus of the Pacific Approach include improved private sector environment and public sector management. The priority outcome objectives of the TSDF supported by AsDB are: (i) a dynamic public and private sector partnership as the main engine of growth; (ii) appropriate, well-planned, and well-maintained infrastructure that improves the everyday lives of the people and lowers the cost of doing business; and (iii) integration of environmental sustainability, disaster-risk management, and climate change adaptation into planning and program implementation.

AsDB has approved 15 loans and 11 grants totaling US\$140.32 million from the Asian Development Fund (ADF) and other sources to Tonga since it joined AsDB in 1972. Sixty eight technical assistance (TA) projects (including supplementary financing) with a value of US\$22.12 million were also provided to improve capacity and strengthen institutional development in various sectors. Past AsDB investments have focused on finance and public sector development, and infrastructure development in transport, power, agriculture, and fisheries.

Active projects include five grant-financed projects and one TA project in the country portfolio. The grant-financed projects support connectivity through the Tonga-Fiji Submarine Cable project; service delivery through the Nuku'alofa Urban Sector Development project (with cofinancing from Australia) and the Outer Island Renewable Energy project (with cofinancing from Australia); and climate resilience through the Climate Resilience Sector project financed by the Strategic Climate Fund. The Cyclone Ian Recovery project (with cofinancing from New Zealand) approved in 2014 reconstructs education and energy infrastructure on the Ha'apai Island group damaged by cyclone Ian in January 2014. The ongoing TA project, with supplementary financing approved in 2014, focuses on corporate planning and establishing a medium-term budget framework. Tonga also benefits from a number of regional TA projects in private sector development, economic management, energy efficiency, and public financial management. The AsDB is active in the joint policy reform discourse with the Government of Tonga and other development partners.

¹ As of February 2015.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2009–14						
	2009	2010	2011	2012	2013	2014
Loan approvals						
Number	0	0	0	0	0	0
Amount (in millions of US\$)	0.0	0.0	0.0	0.0	0.0	0.0
Grant approvals ^a						
Number	1	0	3	0	4	2
Amount (in millions of US\$)	10.0	0.0	22.20	0.0	30.25	8.79
Technical assistance approvals ^b						
Number	2	2	2	3	1	1
Amount (in millions of US\$)	1.0	0.52	1.18	1.38	1.33	0.68
^a Includes financing from other sources including bilateral contributions, which are counted separately from AsDB financing in the number of grant approvals. ^b Supplementary financing of an ongoing technical assistance project is counted separately in the number of approvals.						

STATISTICAL ISSUES

<p style="text-align: center;">TONGA—STATISTICAL ISSUES APPENDIX (As of March 26, 2015)</p>
<p style="text-align: center;">I. Assessment of Data Adequacy for Surveillance</p>
<p>General: While economic statistics are broadly adequate for surveillance, data deficiencies continue to complicate the monitoring of economic conditions and policy formulation. The Statistics Department (SD) and the Ministry of Finance and National Planning (MOFNP) have received, on a regular basis, technical assistance (TA) in national accounts, government finance, and balance of payments (BOP) statistics from the 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.</p>
<p>National Accounts: The coverage of the national accounts data has widened in the past few years as a result of enhanced TA, but there is still room for improvement. With assistance from the AusAID (now DFAT)-funded resident advisor, the 2009-10 Household Income and Expenditure Survey (HIES) results were partially incorporated in national accounts statistics. Customs data were supplemented with quarantine office data in merchandise exports and in-kind donor-funded capital projects as well as loan financed projects. Labor market statistics are weak: employment statistics have not been compiled since 2003, although population census 2011 and HIES 2009 provide point-in-time data; and average earnings statistics are not available.</p>
<p>Price Statistics: The Consumer Price Index is based on a basket of goods and services from the 2009 HIES. TA was provided in 2008 on the development of an import price index, but trade data was not of sufficient quality to produce indexes. The compilation of detailed international merchandise trade data is currently hampered by technical problems.</p>
<p>Government Finance Statistics: The FY2002/03 Central Government Budget Statement introduced a presentation of fiscal data compiled according to the methodology of the 1986 Government Finance Statistics Manual. The budget presentation was migrated to GFSM 2001 with the FY 2014/15 budget. Improvements are still needed to ensure accurate and reliable fiscal data. Timeliness and ease and efficiency in reporting remain an issue. Source data are often available with a significant time lag and in-year sub-annual reporting requires considerable manual intervention. The financial accounting system has not been upgraded in some time and as a result is not capable of capturing all transactions with much of the government's financial business processes and data collection completed on a manual basis. For example, the budget is compiled manually; debt management is conducted outside of the financial accounts; aid revenue data is not included in the financial accounts; and payments and receipts are both processed and recorded on a manual basis. Reconciliation with monetary and balance of payments data requires enhancement and published data are often subject to significant revisions. Consolidated financial statistics for the general government are not published due to lack of source data and capacity and up until now, no data are reported for publication in the GFS Yearbook (GFSY). Tonga is participating in the three-year GFS-IMF project for the Asia-Pacific region funded by the government of Japan, and is committed to commence reporting for the GFSY.</p>
<p>Financial Sector Surveillance: Currently Tonga does not report FSIs to the Fund.</p>
<p>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 <i>IFS</i> and <i>IFS Supplement on Monetary and Financial Statistics</i>. Beginning with January 2012 data, the NRBT updated the data collection forms for other depository corporations. The new forms are fully aligned with the recommendations of the <i>Monetary and Financial Statistics Manual</i> with minor exceptions.</p>

External Sector Statistics: There are several issues with the external sector statistics that need to be improved (in particular the coverage and timeliness), where the SD could play a more proactive role. The SD compiles balance of payments (BOP) statistics on a quarterly basis, which are published on its website in BPM6 format. It submits BOP statistics to the Fund annually. Monthly trade figures, derived from customs data, are available with a three-month lag. The NRBT compiles monthly foreign exchange transactions statistics based on the Overseas Exchange Transactions Reporting System (OET) with a six-week lag.

OET have presented shortcomings in its classification. Large net errors and omissions have remained in the balance of payments due to under-reporting of components such as current and capital transfers and direct investment. To address those issues, new OET codes consistent with BPM6 have been implemented by the NRBT since May 2014 and the International Investment Survey (IIS) has been carried out by the SD since 2014.

The challenges to improve external sector statistics faced with the SD and the NRBT are 1) to improve coverage of items in financial account by enhancing IIS response rate and gathering more accurate banks' financial transactions data, 2) to obtain not captured data e.g. compensation of employees, remittances and acquisition of goods and services by overseas workers and incorporate them into BOP statistics, 3) to capture capital transfers accompanied by main construction projects and incorporate them into BOP statistics, and 4) to maintain adequate staff resources for compiling and disseminating balance of payments and IIP in accordance with the international standards.

II. Data Standards and Quality

The country has been participating in the GDDS since May 30, 2006.

No data ROSC is available.

Tonga: Table of Common Indicators Required for Surveillance

As of March 15, 2015

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	Dec-14	Feb-15	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Dec-14	Feb-15	M	M	M
Reserve/Base Money	Dec-14	Feb-15	M	M	M
Broad Money	Dec-14	Feb-15	M	M	M
Central Bank Balance Sheet	Dec-14	Feb-15	M	M	M
Consolidated Balance Sheet of the Banking System	Dec-14	Feb-15	M	M	M
Interest Rates ²	Dec-14	Feb-15	M	M	M
Consumer Price Index	Dec-14	Feb-15	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2013/14	Jan-15	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2013/14	Jan-15	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	2013/14	Jan-15	A	A	A
External Current Account Balance	Q4/2013	Nov-14	Q	Q	Q
Exports and Imports of Goods and Services	Q2/2014	Mar-15	Q	Q	Q
GDP/GNP	2012/13	Jul -14	A	A	A
Gross External Debt	2012/13	Jan-14	A	A	A
International Investment Position	Q4/13	Mar-15	Q	Q	A

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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



TONGA

April 7, 2015

STAFF REPORT OF THE 2015 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS UPDATE

Approved By
Paul Cashin and Mark Flanagan (IMF)
Satu Kahkonen (IDA)

Prepared by
International Monetary Fund
International Development Association

Risk of external debt distress	Moderate
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This debt sustainability analysis (DSA) updates the 2014 DSA conducted jointly by the IMF and the World Bank.¹ The results indicate that Tonga remains at a moderate risk of debt distress, and that its external debt sustainability continues to be susceptible to external shocks. The latter is illustrated by the finding that a significant depreciation or slowdown in exports generates the highest debt ratios among different stress tests.

A. Underlying Assumptions

Compared with the previous DSA, the underlying assumptions remain stable with marginal change (Table 1).² The following highlights the main assumptions:

- Real GDP growth for FY2012/13 is revised down to -2.7 percent, from last year's estimate of 0.3 percent. This reflects mostly a significant winding down of construction and related activities. The growth is estimated to have picked up in FY2013/14 to about 2 percent and 2½ percent in FY2014/15, in part driven by the reconstruction needs after Cyclone Ian that hit Tonga in January 2014. In the long term, real growth is expected to converge to the historical trend of 1½–2 percent, driven mostly by agriculture, construction, and tourism.
- The current account deficit is estimated at 1½ percent of GDP in FY2013/14 and projected to remain about 7 percent between FY2015/16–2016/17, driven mostly by higher imports to support the construction for the South Pacific Games. In the long term, exports of

¹ The last full DSA was prepared in June 2014 (SM/14/173, Sup.2). In line with the Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries (SM/13/292), a full DSA is expected to be prepared every three years, or whenever circumstances have changed significantly since the previous DSA, such as a change in the external risk rating or overall risk assessment. Light updates should be prepared in intervening years.

² The public sector comprises the central government and there is no local government in Tonga. The Country Policy and Institutional Assessment (CPIA) rating for Tonga remains at a medium level with a three-year average score of 3.45. The Tonga fiscal year starts in July. For example, FY2014/15 is from July 2014 to June 2015.

goods and tourism receipts are projected to increase gradually reflecting the authorities' continuous efforts in developing exports and tourism sector.

Tonga: Key Macroeconomic Assumptions (In percent)

	2014 DSA	2015 DSA
	2014-19 AVG	2015-20 AVG
Real GDP growth	2.26	2.44
GDP deflator (percentage change)	2.66	2.06
Overall balance (percent of GDP)	-0.15	-0.90
Primary balance (percent of GDP)	0.77	0.06
Growth of exports of G&S (U.S. dollar terms)	5.58	7.90
Growth of imports of G&S (U.S. dollar terms)	5.86	6.03
Current account (percent of GDP)	-3.63	-5.16

Sources: Country authorities; and IMF staff estimates.

- The repayments of two large external loans from China EXIM bank contracted in 2007 and 2010 have recently been rescheduled with an additional 5-year grace period. These loans account for about 60 percent of the outstanding external debt and bear 2 percent interest rate, and 20-year maturity with a total of 10-year grace period.

B. External DSA

Under the baseline scenario, Tonga's external debt and debt service indicators remain below the thresholds (Figure 1). The humps in debt services from 2019 to 2029 reflect mostly repayments of the two external loans from China EXIM bank.

C. Public Sector DSA

The present value of public debt is projected to remain below the benchmark, and steadily decreases to about 20 percent of nominal GDP throughout the projection period (Figure 2).

D. Sensitivity Analysis

Stress tests show that the risk of external debt distress is sensitive to a slowdown in exports or a large one-time currency depreciation. This reflects the small but open nature of Tonga's economy, where imports account for about 60 percent of GDP and remittances account for over 25 percent. Under the most extreme shock scenarios, almost all indicators of external debt remain below the thresholds, except the debt service-to-revenue ratio that breaches slightly the threshold in FY2018/19. This breach is considered a borderline case, where the

probability approach is applied to assess the risk.³ The results show several breaches of the thresholds (Figure 3), indicating a moderate risk of debt distress. While a large one-time depreciation also causes of the most extreme shock in public debt DSA, the present value of public debt in this scenario also decreases gradually to about 20 percent of nominal GDP in the long term.

E. Conclusion

There is no major change to the stock of debt, borrowing prospect, or the macroeconomic framework from the July 2014 DSA. The debt sustainability assessment remains broadly unchanged and the risk of external and public debt distress continues to be classified as moderate.

F. Authorities' Views

The authorities agreed with the staff's assessment. They recognized the importance of prudent debt management in safeguarding debt sustainability and building sound fiscal positions in bolstering resilience to shocks. The authorities are in the process of finalizing the Debt Management Strategy.⁴

³ The probability approach is applied to a borderline case, which is defined as one where the largest breach or near breach falls within a 10-percent band around the threshold. It incorporates a country's individual CPIA score and average GDP growth rate, whereas the traditional approaches uses one of the three discrete CPIA values (3.25 for weak performers, 3.50 for medium performers, and 3.75 for strong performers), and an average growth rate across LICs (for details see the Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries (SM/13/292)).

⁴ The objective of this strategy is to maintain sovereign debt within levels that are sustainable over time, while also ensuring that financing requirements are met at low cost with an acceptable degree of risk in the medium term.

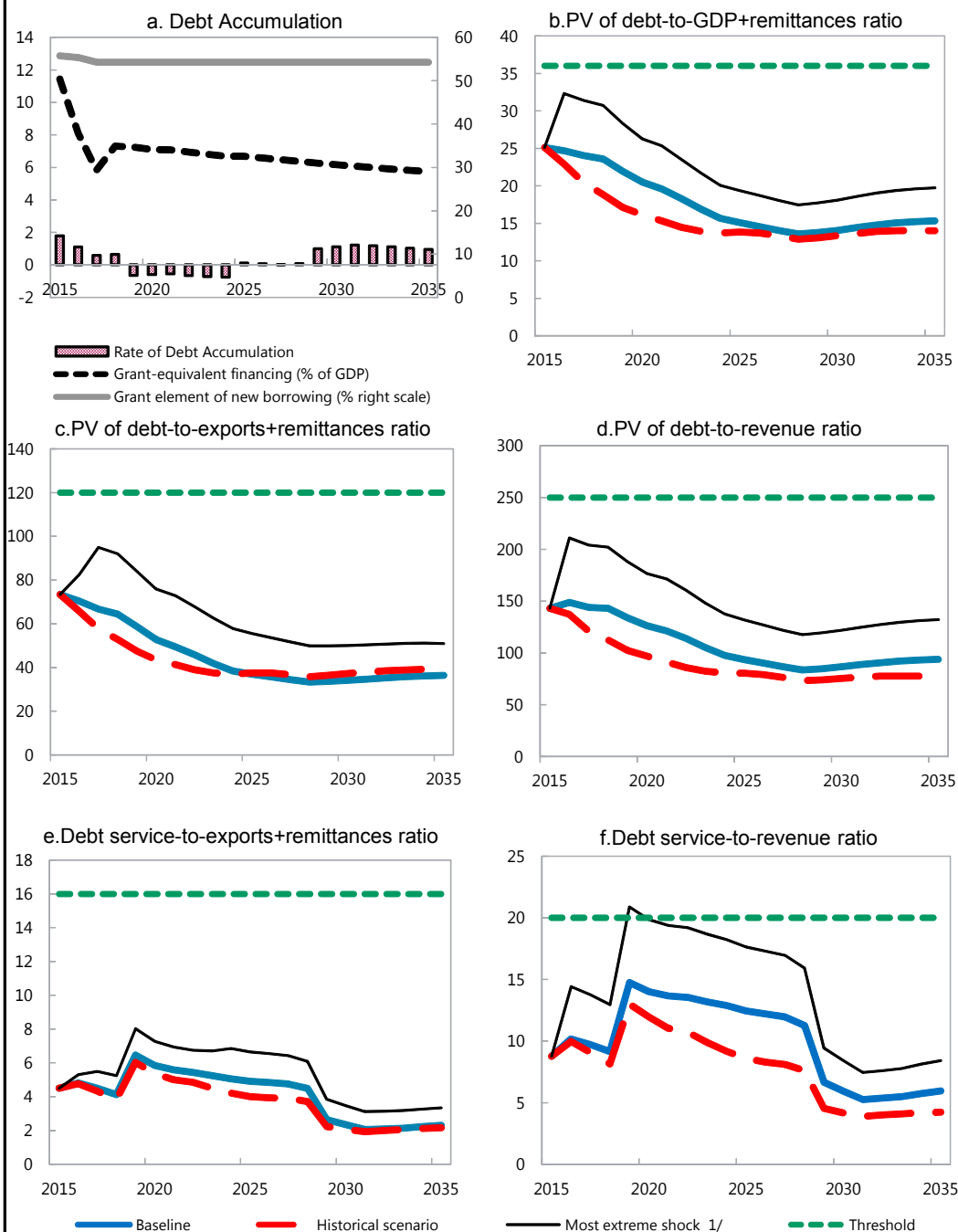
Table 1. Tonga: SDA Update: Key Variables 1/

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025	2030	2035
(Percent of GDP, unless otherwise indicated)												
Nominal GDP (US\$ millions)	464	443	443	465	488	508	529	557	579	685	839	1027
Real GDP (percentage change)	0.5	-2.7	2.1	2.5	2.9	2.0	2.0	3.0	2.4	1.7	1.7	1.7
GDP deflator (percentage change)	2.5	0.3	2.3	0.4	1.2	1.9	2.2	3.1	3.6	3.5	3.5	3.5
Fiscal												
Total revenue and grants	27.9	25.6	29.2	30.6	26.8	25.5	26.8	26.8	26.7	25.7	25.5	25.3
Foreign grants	9.5	5.7	9.4	8.8	6.0	4.5	6.0	6.0	5.9	4.6	4.4	4.3
Total expenditure	30.7	26.9	28.1	32.5	28.4	26.5	27.5	27.2	26.9	25.7	24.9	24.3
Interest payments	0.8	0.9	0.9	0.9	1.0	1.0	1.0	0.9	0.9	0.7	0.6	0.5
Overall balance	-2.8	-1.3	1.1	-1.8	-1.5	-0.9	-0.6	-0.4	-0.1	0.0	0.6	1.0
Primary balance	-2.0	-0.4	2.0	-1.0	-0.5	0.1	0.3	0.6	0.8	0.7	1.1	1.5
Net domestic financing	-2.4	1.0	-0.4	-1.9	-1.3	-0.6	-0.9	-0.1	0.1	-1.5	-2.7	-3.4
Net external financing	5.2	0.2	-0.7	3.8	2.8	1.6	1.6	0.4	0.0	1.5	2.1	2.4
Balance of payments												
Exports of goods and services	19.5	21.6	17.9	18.1	18.7	19.5	20.1	20.5	21.6	22.8	23.8	25.6
Imports of goods and services	55.9	58.0	53.9	56.4	57.8	57.5	58.4	57.7	58.5	60.0	60.8	61.2
Workers' remittances	16.6	24.3	23.2	24.4	25.3	25.9	26.1	27.0	28.3	30.6	29.5	28.7
Current account	-8.8	-1.9	-1.4	-5.0	-7.5	-7.4	-5.6	-3.6	-1.9	-2.3	-3.3	-3.0
Net foreign direct investment	1.1	3.6	2.6	2.6	2.6	2.6	2.7	2.6	2.7	2.9	2.7	2.2
Gross official reserves	6.6	7.3	7.0	6.9	6.9	6.6	6.7	6.3	6.3	6.3	6.3	6.4
(In months of next year's goods and services import)												

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

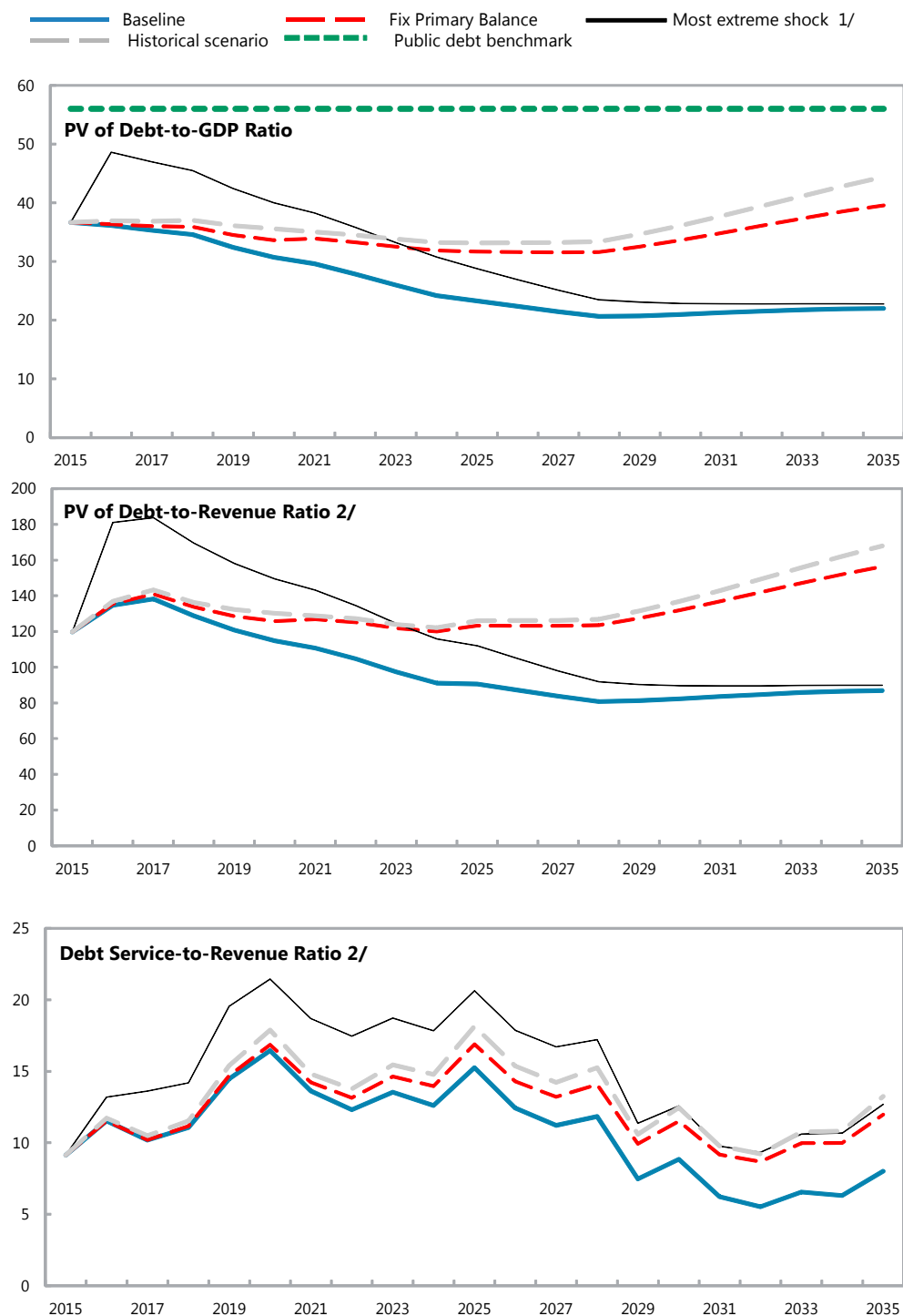
1/ Data on fiscal year basis, with fiscal year beginning in July.

Figure 1. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2015-2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b, it corresponds to a One-time depreciation shock; in c, to a Exports shock; in d, to a One-time depreciation shock; in e, to a Exports shock and in figure f, to a One-time depreciation shock

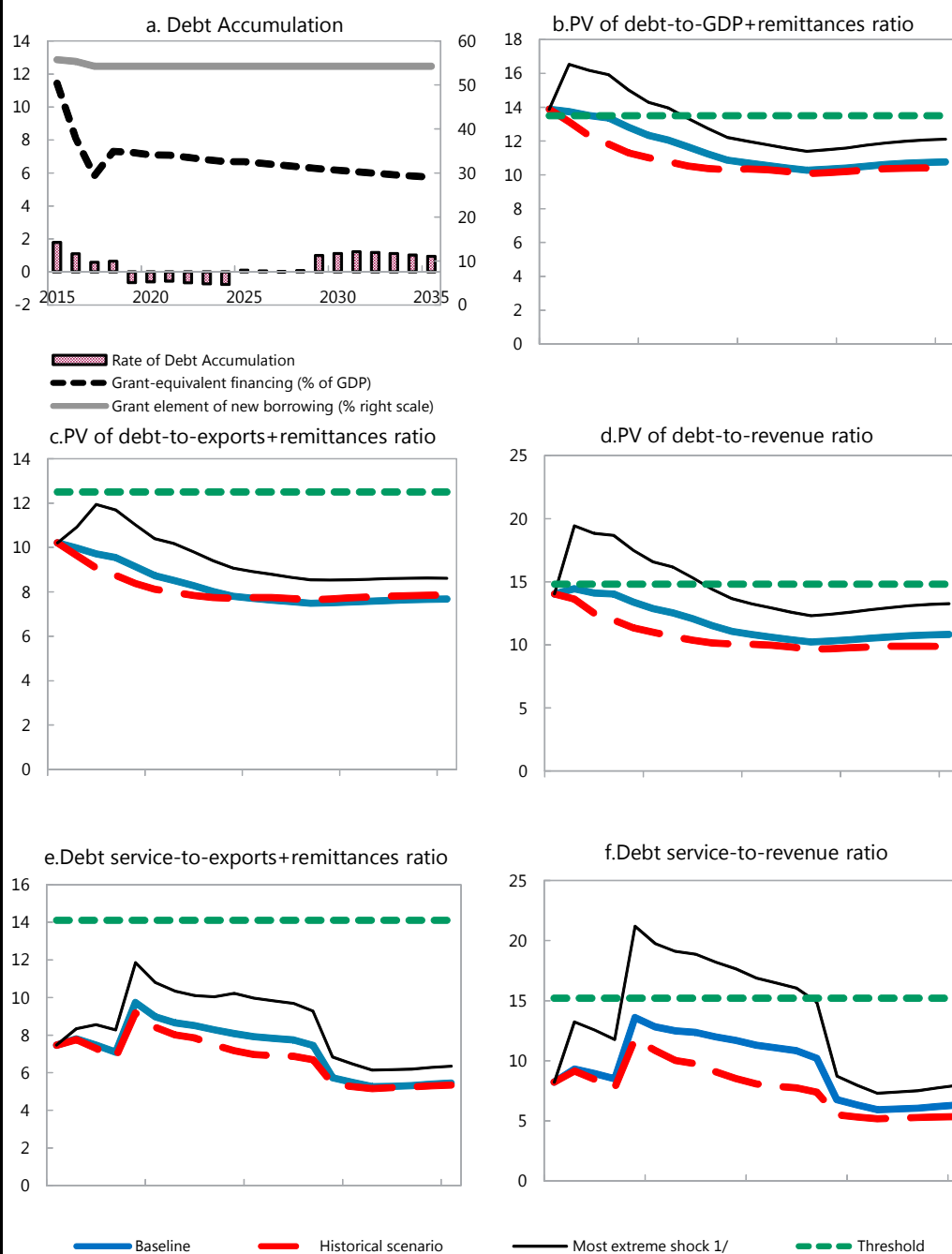
Figure 2. Tonga: Indicators of Public Debt Under Alternative Scenarios, 2015-2035 1/

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.

2/ Revenues are defined inclusive of grants.

Figure 3. Tonga: Probability of Debt Distress of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2015-2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. 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

Table 2. Tonga: External Debt Sustainability Framework, Baseline Scenario, 2012–2035 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical ^{6/} Standard ^{6/}		Projections									
	2012	2013	2014	Average	Deviation	2015	2016	2017	2018	2019	2020	2015–2020		2021–2035	
												Average	2025	2035	Average
External debt (nominal) 1/	42.6	46.0	42.9			44.6	45.0	44.2	43.6	41.5	39.9			34.2	39.2
<i>of which: public and publicly guaranteed (PPG)</i>	42.6	46.0	42.9			44.6	45.0	44.2	43.6	41.5	39.9			34.2	39.2
Change in external debt	6.1	3.3	-3.0			1.7	0.3	-0.7	-0.6	-2.1	-1.6			0.2	0.3
Identified net debt-creating flows	3.9	0.4	-1.2			1.4	3.7	3.9	2.1	-0.3	-1.7			-1.1	0.2
Non-interest current account deficit	8.2	1.0	0.6	5.3	3.1	4.3	6.8	6.7	5.0	3.0	1.3			1.9	2.5
Deficit in balance of goods and services	36.5	36.4	36.0			38.2	39.0	38.0	38.3	37.2	36.9			37.3	35.7
Exports	19.5	21.6	17.9			18.1	18.7	19.5	20.1	20.5	21.6			22.8	25.6
Imports	55.9	58.0	53.9			56.4	57.8	57.5	58.4	57.7	58.5			60.0	61.2
Net current transfers (negative = inflow)	-25.1	-26.5	-28.6	-28.8	3.4	-32.1	-30.3	-29.3	-31.2	-32.3	-33.8			-33.7	-31.4
<i>of which: official</i>	-7.2	-4.1	-7.0			-7.6	-5.0	-3.6	-5.0	-5.0	-5.0			-3.9	-3.7
Other current account flows (negative = net inflow)	-3.2	-9.0	-6.8			-1.8	-1.9	-2.0	-2.1	-1.9	-1.8			-1.7	-1.8
Net FDI (negative = inflow)	-1.1	-3.6	-2.6	-4.7	3.3	-2.6	-2.6	-2.6	-2.7	-2.6	-2.7			-2.9	-2.2
Endogenous debt dynamics 2/	-3.2	3.0	0.9			-0.4	-0.6	-0.2	-0.2	-0.6	-0.4			-0.2	-0.2
Contribution from nominal interest rate	0.5	1.0	0.9			0.7	0.7	0.6	0.6	0.6	0.6			0.4	0.5
Contribution from real GDP growth	-0.2	1.2	-1.0			-1.0	-1.2	-0.9	-0.8	-1.2	-1.0			-0.6	-0.6
Contribution from price and exchange rate changes	-3.6	0.8	1.0			...	...	...	...	...	...			...	...
Residual (3-4) 3/	2.1	3.0	-1.9			0.3	-3.3	-4.6	-2.8	-1.8	0.1			1.4	0.1
<i>of which: exceptional financing</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0
PV of external debt 4/	...	...	30.9			31.2	30.9	30.3	29.7	27.9	26.3			19.7	19.7
In percent of exports	...	...	172.5			172.2	165.1	155.5	147.8	136.1	121.8			86.8	77.2
PV of PPG external debt	...	...	30.9			31.2	30.9	30.3	29.7	27.9	26.3			19.7	19.7
In percent of exports	...	...	172.5			172.2	165.1	155.5	147.8	136.1	121.8			86.8	77.2
In percent of government revenues	...	...	155.8			143.1	148.7	144.0	143.0	133.9	126.3			93.7	93.9
Debt service-to-exports ratio (in percent)	6.9	8.7	10.2			10.6	11.3	10.5	9.5	15.0	13.5			11.5	5.7
PPG debt service-to-exports ratio (in percent)	6.9	8.7	10.2			10.6	11.3	10.5	9.5	15.0	13.5			11.5	4.9
PPG debt service-to-revenue ratio (in percent)	7.3	9.5	9.2			8.8	10.2	9.7	9.2	14.8	14.0			12.4	6.0
Total gross financing need (Millions of U.S. dollars)	39.4	-3.3	-1.0			16.9	30.9	31.2	22.5	19.2	9.1			11.3	18.1
Non-interest current account deficit that stabilizes debt ratio	2.2	-2.4	3.6			2.7	6.5	7.5	5.6	5.1	2.9			1.7	2.3
Key macroeconomic assumptions															
Real GDP growth (in percent)	0.5	-2.7	2.1	0.6	2.6	2.5	2.9	2.0	2.0	3.0	2.4	2.4	1.7	1.7	1.5
GDP deflator in US dollar terms (change in percent)	10.8	-1.9	-2.1	6.6	8.6	2.4	2.1	2.2	2.2	2.1	1.5	2.1	2.4	2.4	2.3
Effective interest rate (percent) 5/	1.5	2.2	1.9	1.7	0.6	1.6	1.5	1.5	1.5	1.4	1.4	1.5	1.2	1.3	1.2
Growth of exports of G&S (US dollar terms, in percent)	26.4	6.0	-17.2	9.5	24.7	6.5	8.4	8.3	7.6	7.0	9.6	7.9	5.1	4.2	5.1
Growth of imports of G&S (US dollar terms, in percent)	24.5	-0.9	-7.2	8.6	12.3	9.8	7.6	3.7	5.8	3.8	5.4	6.0	4.8	4.1	4.2
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	55.8	55.4	54.3	54.3	54.3	54.3	54.7	54.3	54.3	54.3
Government revenues (excluding grants, in percent of GDP)	18.4	19.9	19.8			21.8	20.8	21.0	20.8	20.8	20.8			21.1	21.0
Aid flows (in Millions of US dollars) 7/	44.2	25.2	41.6			62.9	47.6	35.3	44.3	46.1	46.9			57.8	71.4
<i>of which: Grants</i>	44.2	25.2	41.6			40.9	29.5	23.0	32.0	33.6	34.2			31.7	44.0
<i>of which: Concessional loans</i>	0.0	0.0	0.0			22.0	18.1	12.2	12.4	12.5	12.6			26.1	27.5
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			11.4	8.1	5.8	7.3	7.2	7.1			6.7	5.7
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			84.5	83.0	84.1	87.3	87.6	87.7			79.3	82.4
Memorandum items:															
Nominal GDP (Millions of US dollars)	463.9	442.9	442.6			464.6	487.9	508.3	529.5	556.7	578.6			685.4	1026.6
Nominal dollar GDP growth	11.4	-4.5	0.0			5.0	5.0	4.2	4.2	5.1	3.9	4.6		4.1	4.1
PV of PPG external debt (in Millions of US dollars)	...	...	138.3			146.2	151.2	154.0	157.3	153.8	150.3			134.6	201.5
(Pvt-Pvt-1)/GDPt-1 (in percent)	...	...	...			1.8	1.1	0.6	0.6	-0.7	-0.6	0.5		0.1	0.9
Gross workers' remittances (Millions of US dollars)	77.2	107.4	102.7			113.4	123.3	131.6	138.0	150.1	163.6			209.7	294.3
PV of PPG external debt (in percent of GDP + remittances)	...	...	25.0			25.1	24.7	24.1	23.6	21.9	20.5			15.1	15.3
PV of PPG external debt (in percent of exports + remittances)	...	...	75.1			73.4	70.3	66.7	64.4	58.7	52.8			37.0	36.4
Debt service of PPG external debt (in percent of exports + remittances)	...	...	4.4			4.5	4.8	4.5	4.1	6.5	5.9			4.9	2.3

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 3. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–2035
(In percent)

	Projections							2035
	2015	2016	2017	2018	2019	2020	2025	
PV of debt-to-GDP+remittances ratio								
Baseline	25	25	24	24	22	21	15	15
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	25	23	20	19	17	16	14	14
A2. New public sector loans on less favorable terms in 2015-2035 2	25	26	26	26	24	23	21	28
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	25	26	26	25	23	22	16	16
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	25	26	29	28	26	25	19	18
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	25	26	26	25	23	22	16	16
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	25	28	29	28	26	25	19	18
B5. Combination of B1-B4 using one-half standard deviation shocks	25	28	31	30	28	26	20	18
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	25	32	31	31	28	26	19	20
PV of debt-to-exports+remittances ratio								
Baseline	73	70	67	64	59	53	37	36
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	73	66	58	53	47	44	37	39
A2. New public sector loans on less favorable terms in 2015-2035 2	73	73	71	70	65	60	51	66
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	73	70	67	64	58	52	37	36
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	73	83	95	92	84	76	56	51
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	73	70	67	64	58	52	37	36
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	73	85	86	76	70	63	46	42
B5. Combination of B1-B4 using one-half standard deviation shocks	73	86	93	82	75	68	50	45
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	73	70	67	64	58	52	37	36
PV of debt-to-revenue ratio								
Baseline	143	149	144	143	134	126	94	94
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	143	137	121	112	102	97	80	77
A2. New public sector loans on less favorable terms in 2015-2035 2	143	154	153	155	148	143	128	169
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	143	157	158	156	145	136	102	102
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	143	159	171	170	159	151	117	107
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	143	155	157	155	144	135	101	101
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	143	164	171	170	159	151	117	107
B5. Combination of B1-B4 using one-half standard deviation shocks	143	168	185	184	173	164	128	116
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	143	211	204	202	188	177	132	132

Table 3. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–2035 (continued)
(In percent)

Debt service-to-exports + remittances ratio								
Baseline	4	5	4	4	6	6	5	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	4	5	4	4	6	5	4	2
A2. New public sector loans on less favorable terms in 2015-2035 2	4	5	5	4	7	6	5	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	4	5	4	4	6	6	5	2
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	4	5	5	5	8	7	7	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	4	5	4	4	6	6	5	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	4	5	5	4	7	6	6	3
B5. Combination of B1-B4 using one-half standard deviation shocks	4	5	5	5	7	6	6	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	4	5	4	4	6	6	5	2
Debt service-to-revenue ratio								
Baseline	9	10	10	9	15	14	12	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	9	10	9	8	13	12	9	4
A2. New public sector loans on less favorable terms in 2015-2035 2	9	10	10	9	15	15	14	10
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	9	11	11	10	16	15	14	7
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	9	10	10	10	15	15	14	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	9	11	11	10	16	15	14	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	9	10	10	10	15	15	14	7
B5. Combination of B1-B4 using one-half standard deviation shocks	9	11	11	10	16	15	15	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	9	14	14	13	21	20	18	8
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	52	52	52	52	52	52	52	52
Sources: Country authorities; and staff estimates and projections.								
1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.								
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the base								
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the st								
(implicitly assuming an offsetting adjustment in import levels).								
4/ Includes official and private transfers and FDI.								
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.								
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.								

Table 4. Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, 2012–2035

(In percent of GDP, unless otherwise indicated)

	Actual			Average ^{5/}	Standard Deviation ^{5/}	Estimate			Projections						
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-20 Average	2025	2035	2021-35 Average
Public sector debt 1/	49.6	52.1	46.6			50.0	50.2	49.2	48.4	46.1	44.3		37.8	41.5	
<i>of which: foreign-currency denominated</i>	42.6	46.0	42.9			44.6	45.0	44.2	43.6	41.5	39.9		34.2	39.2	
Change in public sector debt	5.2	2.6	-5.5			3.4	0.1	-0.9	-0.8	-2.3	-1.7		0.1	0.2	
Identified debt-creating flows	2.3	3.3	-4.1			-0.1	-0.6	-1.0	-1.2	-1.7	-1.5		-1.6	-2.6	
Primary deficit	2.0	0.1	-2.1	0.6	3.1	1.0	0.6	0.0	-0.2	-0.4	-0.6	0.1	-0.6	-1.5	-1.2
Revenue and grants	27.9	25.6	29.2			30.6	26.8	25.5	26.8	26.8	26.7		25.7	25.3	
<i>of which: grants</i>	9.5	5.7	9.4			8.8	6.0	4.5	6.0	6.0	5.9		4.6	4.3	
Primary (noninterest) expenditure	29.9	25.7	27.1			31.6	27.5	25.6	26.7	26.4	26.1		25.1	23.8	
Automatic debt dynamics	0.8	4.2	-2.0			-1.1	-1.2	-1.1	-1.0	-1.3	-0.9		-1.0	-1.2	
Contribution from interest rate/growth differential	-0.4	1.8	-0.9			-1.0	-1.4	-1.0	-1.0	-1.5	-1.2		-0.8	-1.0	
<i>of which: contribution from average real interest rate</i>	-0.1	0.5	0.2			0.1	0.0	0.0	-0.1	-0.1	-0.2		-0.2	-0.3	
<i>of which: contribution from real GDP growth</i>	-0.2	1.4	-1.1			-1.1	-1.4	-1.0	-0.9	-1.4	-1.1		-0.6	-0.7	
Contribution from real exchange rate depreciation	1.2	2.3	-1.1			0.0	0.1	-0.1	0.0	0.2	0.3		...	...
Other identified debt-creating flows	-0.6	-0.9	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	-0.6	-0.9	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	3.0	-0.7	-1.4			3.5	0.7	0.1	0.4	-0.6	-0.2		1.6	2.8	
Other Sustainability Indicators															
PV of public sector debt	...	...	34.5			36.7	36.2	35.3	34.6	32.4	30.7		23.3	22.0	
<i>of which: foreign-currency denominated</i>	...	...	30.9			31.2	30.9	30.3	29.7	27.9	26.3		19.7	19.7	
<i>of which: external</i>	...	...	30.9			31.2	30.9	30.3	29.7	27.9	26.3		19.7	19.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	4.0	3.2	-0.1			3.8	3.7	2.6	2.8	3.4	3.8		3.3	0.7	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	118.4			119.7	134.7	138.2	128.8	120.8	114.8		90.6	86.9	
PV of public sector debt-to-revenue ratio (in percent)	...	...	174.5			168.0	173.8	168.0	166.2	155.8	147.5		110.4	104.6	
<i>of which: external 3/</i>	...	...	155.8			143.1	148.7	144.0	143.0	133.9	126.3		93.7	93.9	
Debt service-to-revenue and grants ratio (in percent) 4/	7.0	12.1	6.8			9.1	11.5	10.2	11.1	14.5	16.5		15.3	8.0	
Debt service-to-revenue ratio (in percent) 4/	10.6	15.5	10.1			12.8	14.9	12.4	14.3	18.7	21.1		18.6	9.6	
Primary deficit that stabilizes the debt-to-GDP ratio	-3.2	-2.5	3.4			-2.4	0.5	1.0	0.6	1.9	1.1		-0.7	-1.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	0.5	-2.7	2.1	0.6	2.6	2.5	2.9	2.0	2.0	3.0	2.4	2.4	1.7	1.7	1.5
Average nominal interest rate on forex debt (in percent)	1.5	2.2	1.9	1.7	0.6	1.6	1.5	1.5	1.5	1.4	1.4	1.5	1.2	2.1	1.3
Average real interest rate on domestic debt (in percent)	0.3	2.9	0.7	-1.9	4.7	4.0	3.3	2.6	2.2	1.3	0.8	2.4	1.0	-16.3	-1.8
Real exchange rate depreciation (in percent, + indicates depreciation)	3.2	5.3	-2.4	-3.6	8.6	-0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.5	0.3	2.3	5.1	5.4	0.4	1.2	1.9	2.2	3.1	3.6	2.1	3.5	3.5	3.4
Growth of real primary spending (deflated by GDP deflator, in percent)	-9.8	-16.4	7.5	-1.8	6.6	19.7	-10.6	-5.0	6.2	2.0	1.4	2.3	1.5	1.6	0.9
Grant element of new external borrowing (in percent)	...	...	...	...	...	55.8	55.4	54.3	54.3	54.3	54.3	54.7	54.3	54.3	...

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Revenues excluding grants.

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

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

Table 5. Tonga: Sensitivity Analysis for Key Indicators of Public Debt, 2014–2034
(In percent)

	Projections							
	2015	2016	2017	2018	2019	2020	2025	2035
PV of Debt-to-GDP Ratio								
Baseline	37	36	35	35	32	31	23	22
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	37	37	37	37	36	36	33	44
A2. Primary balance is unchanged from 2015	37	36	36	36	34	34	32	40
A3. Permanently lower GDP growth 1/	37	36	36	36	34	33	28	37
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-2017	37	39	40	40	39	38	35	41
B2. Primary balance is at historical average minus one standard deviations in 2016-2017	37	38	39	38	36	34	26	25
B3. Combination of B1-B2 using one half standard deviation shocks	37	38	40	39	38	37	32	36
B4. One-time 30 percent real depreciation in 2016	37	49	47	45	42	40	29	23
B5. 10 percent of GDP increase in other debt-creating flows in 2016	37	42	41	40	38	36	28	26
PV of Debt-to-Revenue Ratio 2/								
Baseline	120	135	138	129	121	115	91	87
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	120	137	143	136	132	130	126	168
A2. Primary balance is unchanged from 2015	120	135	141	134	129	126	123	156
A3. Permanently lower GDP growth 1/	120	136	140	132	125	121	108	145
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-2017	120	142	155	148	143	140	133	161
B2. Primary balance is at historical average minus one standard deviations in 2016-2017	120	141	152	142	134	128	103	97
B3. Combination of B1-B2 using one half standard deviation shocks	120	141	153	145	139	135	123	141
B4. One-time 30 percent real depreciation in 2016	120	181	184	170	158	150	112	90
B5. 10 percent of GDP increase in other debt-creating flows in 2016	120	155	159	148	140	134	109	102
Debt Service-to-Revenue Ratio 2/								
Baseline	9	12	10	11	14	16	15	8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	9	12	10	12	15	18	18	13
A2. Primary balance is unchanged from 2015	9	12	10	11	15	17	17	12
A3. Permanently lower GDP growth 1/	9	12	10	11	15	17	17	11
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-2017	9	12	11	12	16	18	18	13
B2. Primary balance is at historical average minus one standard deviations in 2016-2017	9	12	10	12	15	17	16	9
B3. Combination of B1-B2 using one half standard deviation shocks	9	12	11	12	16	18	17	11
B4. One-time 30 percent real depreciation in 2016	9	13	14	14	20	21	21	13
B5. 10 percent of GDP increase in other debt-creating flows in 2016	9	12	11	12	16	18	16	9

Sources: Country authorities; and staff estimates and projections.

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

2/ Revenues are defined inclusive of grants.

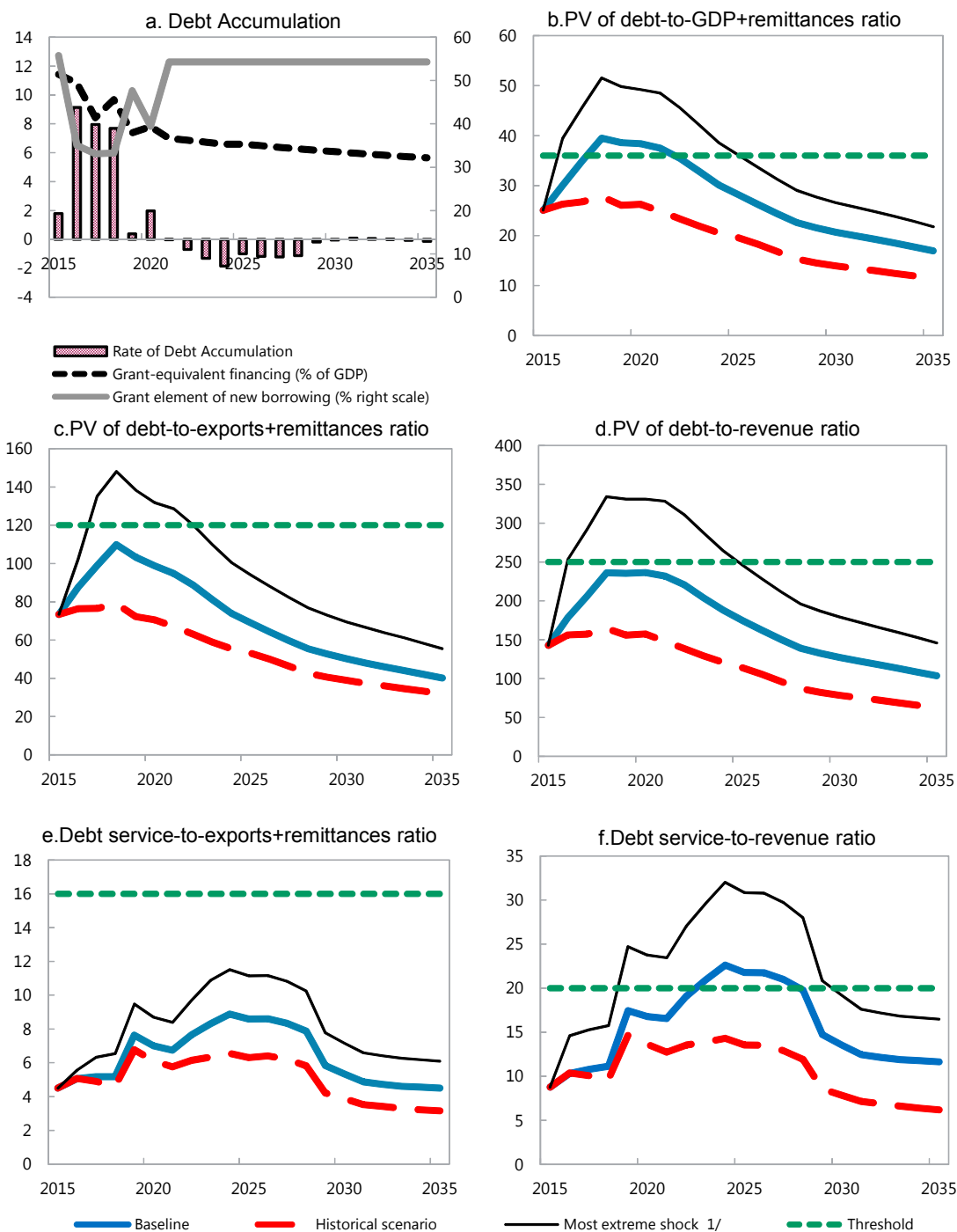
Appendix for the DSA update

The 2019 South Pacific Games: High-Cost Scenario

While the authorities' original plan is fiscally prudent, international experience suggests that cost overrun often occurs. To illustrate the impact of a cost overrun risk associated with hosting the 2019 South Pacific Games, staff simulated a DSA assuming a cost overrun financed by external debt amounts of US\$170 million, with 90 percent of the loan disbursed in the construction period from 2016 to 2018 and the remaining disbursed in the game year.¹ The hypothetical external loans are assumed to be provided on terms and conditions similar to the loans by China's EXIM bank in recent years (2 percent interest rate, 20-year maturity, and 5-year grace period). Two ratios—the present value of external debt to GDP plus remittances and debt service-to-revenue—would exceed their respective thresholds for 3-4 years under the baseline (Figure A1). Under stress tests of this customized scenario, four out of five debt and debt service indicators would exceed the relevant thresholds. In addition, the PV of public debt to GDP also exceeds the threshold under the most extreme shock scenario (Figure A2).

¹ The authorities estimate the cost of hosting the Games at US\$70 million, among which the operating cost (US\$20 million) is envisaged to be covered by the Games revenue and the capital cost (US\$50 million) by donations and franchises. The baseline scenario of the DSA uses the authorities' official costing and financing plan. However, historical experience suggests that cost overruns are common, and could create larger financing need.

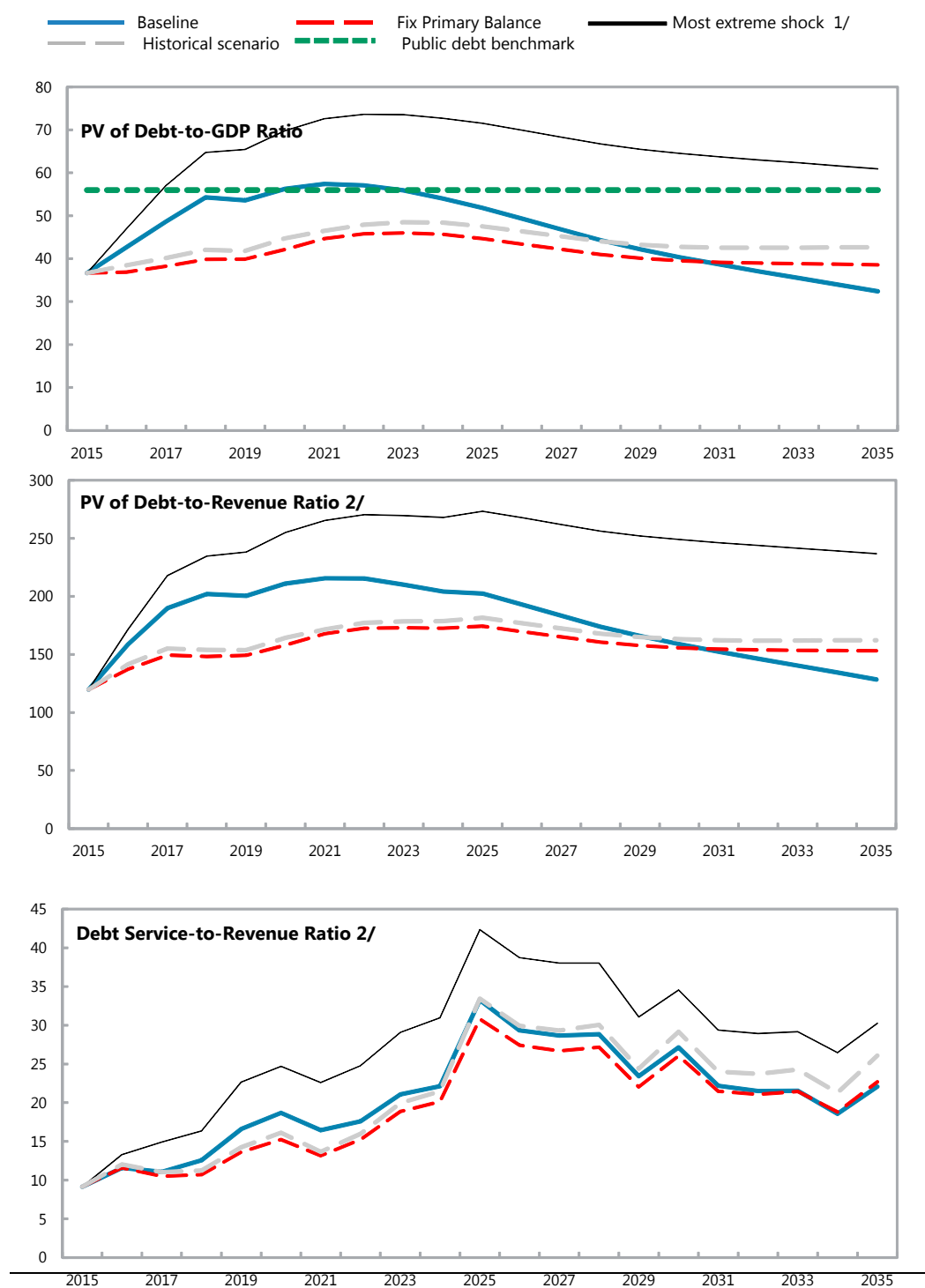
Figure A1. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios. 2015-2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure A2. Tonga: Indicators of Public Debt Under Alternative Scenarios, 2015–2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.

2/ Revenues are defined inclusive of grants.



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IMF Executive Board Concludes 2015 Article IV Consultation with Tonga

The Executive Board of the International Monetary Fund (IMF) has concluded the Article IV consultation¹ with Tonga and considered and endorsed the staff appraisal without a meeting on April 24, on a lapse-of-time basis.²

Tonga's economy is estimated to have grown by around 2 percent in fiscal year (FY) 2013/14 (year ending June), driven by agriculture and construction, following a contraction in 2012/13 mainly caused by the completion of a large capital project. Inflation has remained moderate at around 0-3 percent in recent years, reflecting low global food prices and, more recently, a sharp decline in oil prices. The external position has strengthened, following large grants and remittance inflows, which have bolstered international reserves.

Real GDP growth is expected to average 2–3 percent in FY2014/15–FY2019/20. Although the progress of reconstruction in the aftermath of 2014 Cyclone Ian is slower than expected, the coronation scheduled for July 2015 and preparations for the 2019 South Pacific Games will support economic activity over the next few years. Meanwhile, inflation is projected to remain low, reflecting the weak outlook for global commodity prices.

The balance of risks remains weighted to the downside. Spillovers from a protracted period of slower growth in advanced and emerging economies could weigh on Tonga, mainly due to its close economic ties with Australia and New Zealand. On the domestic side, potential cost overruns relating to the Pacific Games could make it necessary to mobilize additional fiscal resources.

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>.

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Executive Board Assessment

In concluding the 2015 Article IV consultation with Tonga, Executive Directors endorsed staff's appraisal, as follows:

Tonga's economy has rebounded and the outlook is favorable, while risks remain tilted to the downside. Growth is recovering and is expected to average 2–3 percent during the next five years, mainly supported by construction and tourism on the back of several large events (the coronation and the Pacific Games). Inflation is projected to remain low, reflecting the weak outlook for global commodity prices. International reserves are expected to stay comfortable at around 6 months of prospective imports largely, thanks to grants and remittances. The balance of risks is tilted to the downside. External risks involve spillovers from a protracted period of slower growth in advanced and emerging economies, which could weigh on Tonga, mainly through its close economic ties with Australia and New Zealand. On the domestic side, potential cost overruns related to the Pacific Games continue to pose downside risks.

The authorities should contain fiscal spending pressures in the near-term and build a sound fiscal position to bolster resilience to shocks over the medium term. Near-term fiscal pressures stem mostly from potentially large wage increases for civil servants, which can be contained by more efficient staff allocation in order to moderate the share of the wage bill in recurrent spending over the medium term. Controlling the spending program for the Pacific Games is also important to avoid cost overruns. The adoption of a roadmap for public financial management reform and the debt management strategy would lay the groundwork for a medium-term fiscal framework. Continued efforts to increase tax revenue by broadening the tax base and strengthening tax administration could create more room for priority social spending and public investment.

The current accommodative monetary policy stance is appropriate in view of the weak economy and low inflation, while large excess liquidity calls for better liquidity management to mitigate macro-financial risk. Preserving the current level of international reserves would help ensure external stability, and lowering the inflation reference rate would better anchor inflation expectations over the medium term. Although the presence of excess liquidity does not pose an imminent risk to financial sector soundness in the near term, the authorities should prepare to manage macro-financial risks by improving liquidity management and adopting macro-prudential tools. The progress in improving banks' balance sheets and strengthening the legal framework in the financial sector is welcome.

Structural reforms remain imperative to raising Tonga's potential growth. Progress in updating Tonga's strategic development framework (TSDF II) is welcome. Steadfast implementation of the authorities' reform plan is crucial to make growth more sustainable and inclusive. Implementing key initiatives, such as revising the Foreign Investment Act, would help improve the business climate and promote private sector development.

Implementing TA recommendations are important for successful reforms. Improving the quality of data statistics will also help policy formulation and facilitate private sector decisions. In view of limited resources, better coordination and prioritization of Tonga's prospective TA program is needed. The IMF/Pacific Financial Technical Assistance Center (PFTAC) would continue to provide the bulk of technical assistance, in coordination with other development partners.

Tonga: Selected Economic Indicators, 2009/10–2015/16 1/

	2009/10	2010/11	2011/12	Prel. 2012/13	Est. 2013/14	Proj.	
						2014/15	2015/16
(Annual percent change)							
Output and prices							
Real GDP 2/	4.2	2.0	0.5	-2.7	2.1	2.5	2.9
Consumer prices (period average)	1.7	6.0	3.3	0.7	2.3	0.4	1.2
Consumer prices (end of period)	2.7	7.1	2.3	0.2	1.5	0.6	1.7
GDP deflator	3.5	6.1	2.5	0.3	2.3	0.4	1.2
(In percent of GDP)							
Central government finance							
Total revenue and grants	27.3	26.7	27.9	25.6	29.2	30.6	26.8
Total revenue	20.4	19.8	18.4	19.9	19.8	21.8	20.8
Grants	6.9	6.9	9.5	5.7	9.4	8.8	6.0
Total expenditure and net lending	32.7	34.2	30.7	26.9	28.1	32.5	28.4
Of which: Current expenditure	26.1	23.0	23.9	25.3	26.7	27.8	25.2
Capital expenditure	2.6	9.8	5.7	1.6	1.3	3.5	3.2
Overall balance	-5.4	-7.5	-2.8	-1.3	1.1	-1.8	-1.5
External financing (net)	3.5	8.6	5.2	0.2	-0.7	3.8	2.8
Domestic financing (net)	1.9	-1.1	-2.4	1.0	-0.4	-1.9	-1.3
(Annual percent change)							
Money and credit							
Total liquidity 3/	5.1	3.1	7.0	5.2	7.3	4.0	4.9
Of which: Broad money (M2)	5.6	3.3	7.2	6.1	7.2	4.0	5.0
Domestic credit	-11.5	-12.3	-16.8	-0.5	8.1	3.8	4.3
Of which: Private sector credit	-15.6	-9.9	-5.2	-7.5	0.7	3.0	3.3
(In millions of U.S. dollars)							
Balance of payments							
Exports, f.o.b.	7.9	10.8	17.9	13.8	15.0	15.0	17.3
Imports, f.o.b.	-130.4	-152.6	-179.3	-175.5	-175.6	-195.9	-213.1
Services (net)	-9.2	4.7	-7.7	0.3	1.3	3.3	5.5
Investment income (net)	11.9	12.9	12.1	11.4	4.7	5.4	6.1
Current transfers (net)	96.3	98.6	116.4	117.2	126.6	149.0	147.7
Of which: Remittances	69.5	68.3	77.2	107.4	102.7	113.4	123.3
Current account balance	-23.4	-25.5	-40.7	-8.6	-6.2	-23.3	-36.5
(In percent of GDP)	-6.4	-6.1	-8.8	-1.9	-1.4	-5.0	-7.5
Overall balance	19.8	33.3	19.8	4.1	8.7	8.5	7.1
Gross official foreign reserves							
In millions of U.S. dollars	87.5	120.8	140.6	144.7	153.4	161.8	168.9
(In months of next year's goods and services imports)	5.0	5.6	6.6	7.3	7.0	6.9	6.9
External debt (in percent of GDP)							
External debt	32.2	36.6	42.6	46.0	42.9	44.6	45.0
Debt service ratio	1.3	1.2	1.4	1.8	1.8	1.7	1.7
Exchange rates							
Nominal effective exchange rate (2005=100)	99.7	100.3	106.5	105.4	103.3	...	...
Real effective exchange rate (2005=100)	99.0	101.9	108.1	105.5	103.4	...	...
Memorandum items:							
Remittances (in percent of GDP)	19.0	16.4	16.6	24.3	23.2	24.4	25.3
Tourism (in percent of GDP)	7.1	8.0	8.5	9.8	10.0	10.5	10.9
FDI (in percent of GDP)	3.3	4.9	1.1	3.6	2.6	2.6	2.6
Nominal GDP (millions of T\$)	704.9	762.9	786.2	767.8	802.2	825.4	858.8
Population (thousands)	102.8	103.0	103.3	103.5	103.8	104.1	104.3

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

1/ Fiscal year beginning July.

2/ Including preliminary data.

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