



TONGA

June 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TONGA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 13, 2016 consideration of the staff report that concluded the Article IV consultation with Tonga.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 13, 2016, following discussions that ended on March 11, 2016, with the officials of Tonga on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 26, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- A **Statement by the Executive Director** for Tonga.

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IMF Executive Board Concludes 2016 Article IV Consultation with Tonga

On June 13, the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV consultation¹ with [Tonga](#).

The Tongan economy has been rebounding since a contraction in FY2013.² Growth accelerated from 2.1 percent in FY2014 to 3.7 percent in FY2015, supported by construction, tourism, strong remittances, and strong private credit growth, notwithstanding weather-related disruptions to agricultural production. Inflation declined to -0.3 percent at end-February 2016, reflecting lower global food and fuel prices. The country's external position remains strong, with reserves supported by strong remittances, donor aid, and low global fuel prices.”

Real GDP is projected to grow at 3.1 percent in FY2015/16, driven by agriculture and construction sectors, as well as private consumption. Over the medium term, growth would stay around 2.5–3.0 percent, supported mainly by construction activities related to the preparation for the South Pacific Games (SPG). Low inflation is projected to continue over the medium term in line with global commodity prices.”

The balance of risks is tilted toward the downside. A protracted period of slower growth in advanced and emerging market economies, particularly in Australia and New Zealand, could lead to lower aid, remittances, and tourism receipts. On the domestic side, a large increase in current spending and potential cost overruns related to SPG could weaken fiscal sustainability and raise public debt. Slippages in the reform process could affect donor aid and create a fiscal financing gap, while natural disasters could take a toll on the economy.”

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

² Fiscal year in Tonga runs from July 1 to June 30.

Executive Board Assessment³

The Executive Directors welcomed Tonga's improved macroeconomic performance and favorable outlook. However, they noted that given the country's small size, remoteness, and exposure to natural shocks, it remains vulnerable to risks. Directors agreed that policy priorities ahead should focus on building buffers and implementing structural reforms to strengthen the economy's resilience, safeguard macroeconomic and financial stability, and boost potential growth.

Directors emphasized the importance of addressing fiscal risks and gradually building buffers. They welcomed the authorities' commitment to rein in the wage bill and avoid cost overruns. They also encouraged continued reliance on concessional financing for capital spending, including grant financing for the South Pacific Games. Directors saw a need for further improvements in debt management as well as broader reforms to increase revenue and raise the efficiency of public spending to create the fiscal space needed for investment in infrastructure and human capital.

Directors considered the current accommodative monetary policy stance to be appropriate. However, they encouraged the authorities to be ready to mop up excess liquidity should signs of overheating emerge. Directors also encouraged the central bank to improve its monetary policy framework by introducing a policy interest rate, developing monetary and macro-prudential policy instruments, and announcing a new lower indicative reference rate for inflation to help anchor inflation in the medium term. They underscored that maintaining gross international reserves at the current level would help safeguard external stability. Directors welcomed the continued progress made by the central bank in upgrading its supervisory, regulatory, and legal frameworks for the financial sector, and called for further steps to expand its oversight over nonbanks.

Directors emphasized that structural policies should aim at raising growth potential by expanding opportunities for private sector development. They supported the efforts to enhance financial inclusion and to promote private credit, but highlighted the need to exercise caution in the application of government lending schemes. Directors encouraged the authorities to develop a broader reform strategy to improve the business climate and to make further progress in natural disaster preparedness. They also underscored the need to improve the quality and timeliness of data and encouraged the effective use of technical assistance from the Fund and development partners.

³ At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the view of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>

Tonga: Selected Economic Indicators, FY2011–FY2017 1/

Nominal GDP FY2015: US\$435.4 million
 Population (2014): 103.8 thousands
 GDP per capita FY2015: US\$4182
 Major exports: root crops, vanilla, squash, fish

	FY2011	FY2012	FY2013	FY2014	Est. FY2015	Proj. FY2016	Proj. FY2017
	(Annual percent change)						
Output and prices							
Real GDP 2/	2.7	0.9	-3.1	2.1	3.7	3.1	2.3
Consumer prices (period average)	6.0	3.3	0.7	2.3	0.1	-0.2	-0.4
Consumer prices (end of period)	7.1	2.3	0.2	1.5	0.2	-0.9	0.1
GDP deflator	5.8	2.4	0.5	1.0	1.5	1.1	0.9
	(In percent of GDP)						
Central government finance							
Total revenue and grants	26.3	27.4	25.2	27.5	28.2	27.3	27.4
Total revenue	19.5	18.0	19.6	20.0	21.4	23.7	24.1
Grants	6.8	9.4	5.6	7.5	6.7	3.6	3.4
Total expenditure and net lending	33.7	30.2	26.5	25.7	29.3	30.4	29.1
<i>Of which:</i> Current expenditure	22.7	23.5	24.9	25.0	25.8	27.8	26.4
Capital expenditure	9.6	5.6	1.6	0.9	2.4	1.7	1.9
Overall balance	-7.4	-2.8	-1.3	1.7	-1.1	-3.1	-1.6
External financing (net)	8.4	5.1	0.2	0.3	0.6	1.4	1.3
Domestic financing (net)	-1.1	-2.4	1.0	-2.0	0.5	1.7	0.4
	(Annual percent change)						
Money and credit							
Total liquidity 3/	3.1	7.0	5.2	7.3	9.3	10.3	8.6
<i>Of which:</i> Broad money (M2)	3.3	7.2	6.1	7.2	9.0	10.6	8.8
Domestic credit	-12.3	-14.2	2.5	7.8	15.4	13.2	12.4
<i>Of which:</i> Private sector credit	-9.9	-5.2	-7.5	0.7	8.6	9.4	12.5
Interest rates (end of period)							
Average deposit rate	2.5	2.4	1.98	2.09	2.35	...	...
Average lending rate	12.7	10.0	9.44	8.66	8.23	...	...
	(In millions of U.S. dollars)						
Balance of payments							
Exports, f.o.b.	13.6	16.7	15.0	17.9	17.9	16.3	16.2
Imports, f.o.b.	-203.4	-203.4	-187.4	-187.6	-216.5	-217.2	-238.1
Services (net)	4.7	-7.7	0.3	1.3	-2.0	0.7	-5.3
Investment income (net)	12.9	12.1	11.4	4.7	4.5	3.8	4.6
Current transfers (net)	96.0	123.8	140.3	128.6	144.7	183.4	191.0
<i>Of which:</i> Remittances	68.3	77.2	107.4	102.7	107.7	125.1	127.4
Current account balance	-76.1	-58.5	-20.4	-35.1	-51.4	-13.0	-31.5
(In percent of GDP)	-18.0	-12.4	-4.5	-7.9	-11.8	-3.1	-7.1
Overall balance	34.6	23.1	2.4	11.2	-16.2	16.0	3.4
Terms of trade (annual percent change)	-4.0	-3.0	1.1	-3.3	-0.8	2.8	0.0
Gross official foreign reserves							
In millions of U.S. dollars	122.1	145.2	147.6	158.7	142.5	158.6	162.0
(In months of next year's goods and services imports)	5.2	6.5	7.1	6.9	6.2	6.2	5.7
Debt (in percent of GDP)							
Public debt (external and domestic)	43.6	48.7	51.4	45.8	49.0	48.7	48.2
External debt (public)	36.0	41.8	45.3	42.1	44.2	43.1	42.4
Debt service ratio	28.9	1.4	1.7	1.7	1.8	1.7	1.6
Exchange rates							
Nominal effective exchange rate (2005=100)	100.3	106.5	105.4	103.3	103.0	...	...

Real effective exchange rate (2005=100)	101.9	108.1	105.5	103.4	101.7	...	...
Memorandum items:							
Remittances (in percent of GDP)	16.1	16.3	23.9	23.2	24.7	29.6	28.8
Tourism (in percent of GDP)	7.9	8.3	9.7	10.0	8.9	9.8	10.1
FDI (in percent of GDP)	1.6	-0.3	1.2	2.6	2.7	2.8	2.9
Nominal GDP (millions of T\$)	774.8	800.6	779.3	803.6	846.1	881.9	910.7
Population (thousands)	103.0	103.3	103.5	103.9	104.1	104.4	104.6

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.



TONGA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

May 26, 2016

KEY ISSUES

Outlook and risks. Since FY2013, Tonga has been on a growth path supported by the reconstruction in the aftermath of the 2014 Cyclone Ian, tourism, and remittances, and benefiting from low global fuel prices. In the medium term, growth is projected to be driven by economic activity in preparation to the Sixteenth South Pacific Games (the SPG) in 2019, while inflation is expected to remain low. International reserves are expected to remain at a comfortable level, supported by strong donor inflows, high remittances, and low costs of fuel imports. After weakening in FY2016 as a result of strong wage growth, the fiscal position is projected to improve gradually in the medium-term. Main risks to the outlook stem from a protracted period of slower growth in advanced and emerging economies, natural disasters, and fiscal pressure to raise government wages or as a result of cost overruns for the SPG and shortfalls in donor aid.

Challenges. The main challenge for Tonga in the medium term is to improve its growth potential and to create jobs for the young population, which would require expanding opportunities for private sector development. Given Tonga's vulnerabilities stemming from its small size, remoteness, narrow export base, dependence on fuel imports, and exposure to natural disasters, ensuring macroeconomic and financial stability will remain a key challenge.

Key policy advice. Tonga needs to improve resilience to shocks by building buffers and to undertake structural reforms to support private sector development and economic diversification. The key policy recommendations are: (i) contain wage growth and build sound fiscal position by gradually increasing the primary balance to ensure fiscal sustainability; (ii) maintain gross reserves at the current level to bolster resilience to shocks; (iii) lower the current inflation reference rate; (iv) strengthen monetary policy framework, including by introducing a policy interest rate and associated instruments, and develop macroprudential tools to better manage liquidity and credit cycle; and (v) enhance business-enabling structural reforms and improve efficiency of the public sector to raise growth potential.

Approved By
Hoe Ee Khor (APD)
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Discussions took place in Nuku'alofa during February 29–March 11, 2016. The team comprised Elena Loukoianova (head), Agnes Isnawangsih (APD), Anna Unigovskaya (MCD), and Tubagus Feridhanusetyawan (Fiji Resident Representative). Mr. Marzunisham Omar and Mr. Mardini Eddie (OED) participated in key discussions. Johannes Wolf (AsDB) also joined selected discussions. Staff met Prime Minister Honorable 'Akilisi Pohiva, Minister of Finance and National Planning Honorable Dr. 'Asiake 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. Anh Van Le and Antoinette Kanyabutembo assisted in the preparation of this report.

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CONTEXT

1. Setting. Tonga is a small remote open economy in the South Pacific with a narrow production base and low connectivity, resulting in high transportation costs, limited economies of scale, and high fixed costs (Figure 1).¹ As a result of the large number of workers abroad, Tonga is one of the highest-level recipients of remittances as a share of GDP among all developing countries. Tonga's high dependence on remittances, foreign aid, tourism, and energy imports pose challenges to its development, which is also affected by a protracted period of slower growth in advanced and emerging market countries, particularly in Australia and New Zealand, as well as natural disasters² and El Niño-related weather events. With limited resources, the government's recent challenges have been to support reconstruction in the aftermath of Cyclone Ian in 2014, which caused damages estimated at 11 percent of GDP, and to secure sufficient funding for the South Pacific Games (SPG) planned for 2019.³

2. Political developments. Prime Minister (PM) 'Akilisi Pohiva⁴ has been in office since January 2015, following general elections in which his pro-democracy party "Democratic Party of the Friendly Islands" obtained nine out of 26 seats in the Legislative Assembly.⁵ Under his leadership, the government prepared the second Tonga Strategic Development Framework (TSDF II) for 2015–25 with the focus on governance, inclusion, and private sector development. The Minister of Finance and the Governor of the National Reserve Bank of Tonga (NRBT) have stayed in their posts. The head of state in Tonga, a constitutional monarchy, King Tupou VI, was crowned in July 2015 following his accession to the throne in 2012.

3. Traction. The authorities have made progress on key policy advice outlined in the last Article IV consultation. In the 2015 staff report, staff emphasized the importance of improving the primary fiscal balance over the medium term. The authorities have focused on raising revenues and improving PFM, and followed the policy of zero non-concessional borrowing. They also have been moving cautiously on the implementation of a levy on foreign exchange (FX) transactions and raising the departure fee. However, more needs to be done in the fiscal area to tame wage growth to ensure progress on fiscal consolidation. International reserves have been maintained at a comfortable level. The authorities are considering lowering the inflation reference rate and express their interest in further developing their monetary policy framework and macroprudential operational tools with technical assistance from the IMF. The authorities have made significant progress in structural reforms especially in the area of utilities and labor market, public enterprise

¹ The population has remained broadly constant at around 100,000, despite a high birthrate, reflecting large-scale emigration to Australia, New Zealand, and the United States, as well as a low life expectancy of estimated 72.6 years in 2014. (World Bank, *World Development Indicators*).

² Severe cyclones occurred in 1982, 1991, and 2014.

³ Capital costs of the SPG are currently estimated at T\$93 million, or 9 percent of estimated GDP in FY2019. The government seeks donor support to cover capital costs of the SPG.

⁴ He is the first commoner to become a PM in Tonga.

⁵ Of the Legislative Assembly's 26 members, 17 members are elected by popular vote, and nine are chosen by 33 nobles.

reform, formalization of the informal sector, bankruptcy regime, an energy bill, and exports promotion via regional trade agreements.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

4. Recent developments. Tongan economy has been rebounding since a contraction in FY2013.⁶ Growth accelerated from 2.1 percent in FY2014 to 3.7 percent in FY2015, supported by construction, tourism, strong remittances, and strong private credit, and notwithstanding weather-related disruptions to agricultural production. Inflation declined from 0.2 percent (y/y) at end-June 2015 to -0.3 percent at end-February 2016, reflecting declining global food and fuel prices, well below the NRBT inflation reference range of 6 to 8 percent. The domestic component of inflation, however, edged up to reflect higher prices of locally produced food (Figure 2). External position remains strong, supported by strong remittances, donor aid, and low global fuel prices, with reserves at \$142 million at end-February 2016, equivalent to more than 6 months of imports. From end-FY2014 to February 2016, the NEER for the Tongan Pa'anga, which is pegged to a basket of currencies,⁷ depreciated by 3.6 percent, while the REER depreciated by 6.1 percent.

5. Outlook. The FY2016 real GDP growth is projected to remain relatively strong at 3.1 percent, driven by a recovery in agriculture and an increase in construction activity in preparation for the SPG. Domestic demand will be supported by lower fuel prices, remittances, and aid inflows, and inflation will remain low. In the medium-term, growth is projected to fluctuate between 2.3 and 3 percent, supported by construction, tourism, and trade in the run-up to the SPG, before converging to its historical average of about 1.8 percent by FY2021. Reflecting the stronger demand generated by the SPG, inflation is expected to increase to three percent in FY2019. The outlook for the external sector is positive with projected low global commodity prices, increasing remittances, and improving tourism receipts. Although the current account is expected to widen in the run up to the SPG, reserves will be maintained at a comfortable level and external debt will remain stable provided that expected donor financing for SPG is realized.

6. Risks. The overall balance of risk is tilted to the downside. Protracted period of slower growth in advanced and emerging market economies, particularly in Australia and New Zealand, could weigh on Tonga via aid, remittances, and tourism channels. On the domestic front, a resurgence of strong credit growth could threaten financial stability, even though the banking sector remains well capitalized and highly liquid. Large increases in current expenditure, particularly the wage bill, could lead to higher public debt, jeopardizing debt sustainability. Slippages in delivery of policy reforms could affect the level of development partners' budget support, leading to lower aid. Cost overrun related to the SPG could make it necessary to mobilize additional resources, potentially resorting to non-concessional borrowing and raising the public debt. Natural disasters and weather-related events are also a high risk and could take a toll on the economy. On the upside,

⁶ Fiscal year in Tonga runs from July 1 to June 30.

⁷ The value of local currency is determined by a weighted basket of currencies comprised of the US, Australian, and New Zealand dollars, and the Japanese yen with the US dollar as the intervention currency, and the monthly maximum adjustment limit set at 5 percent.

Tonga would continue to benefit as a net energy and food importer, if oil and food prices remain low (Appendix I).

Authorities Views

7. The authorities concurred with staff assessment of the economic outlook and risks for Tonga. They projected only marginally higher growth than the staff in the run up to the SPG, noting a strong impact on growth of construction projects undertaken by local churches and a major school anniversary celebration later in 2016. Regarding the risks, they viewed a delay in receipt of budget support, natural disasters, and an increase in public debt, including as a result of excessive wage growth, as the main risks.

POLICY DISCUSSIONS

The discussions focused on measures (i) to increase resilience of Tonga's economy to shocks, including from climate change and natural disasters, (ii) to preserve macroeconomic and financial stability, and (iii) to improve Tonga's long-term growth prospects.

A. Fiscal Policy

8. The fiscal deficit is projected to widen in FY2016 on the back of a high wage bill growth and lower grants. The overall balance reverted from a 1.7 percent surplus in FY2014 to a 1.1 percent deficit in FY2015, and staff projects a further increase in the deficit to 3.1 percent in FY2016. Revenues are projected to increase strongly on the back of administrative improvements in tax collection and increased excises and customs revenue. However, a decline in budget support grants, together with a shift towards a higher share of loan-financing by donors, and a strong increase in current spending led by wages, will result in a widening of the deficit.⁸ The projected deficit is higher than implied by FY2016 budget, reflecting a delay in the implementation of the FX levy and the departure fee, and notwithstanding under-implementation of

Tonga: FY2016 Budget and Staff Projections

	Est.	Budget	Proj.
	FY2015	FY2016	FY2016
	(In percent of GDP)		
Total revenue and grants	28.6	33.3	27.3
Total revenue	21.4	24.5	23.7
Current revenue	21.4	24.5	23.6
Tax revenue	18.3	20.2	20.4
Nontax revenue	3.1	4.4	3.2
Capital revenue	0.0	0.0	0.1
Grants (in cash)	7.2	8.7	3.6
Project grants	4.5	6.5	1.5
Budget support	2.7	2.2	2.0
Total expenditure and net lending	29.3	35.2	30.4
Current expenditure	25.8	30.9	27.8
Capital expenditure	2.4	3.4	1.7
Total lending minus repayments	1.1	0.9	0.9
Overall balance (incl. grants)	-0.6	-2.0	-3.1
External financing	0.6	1.0	1.4
Domestic financing	0.1	0.9	1.7
Primary balance (incl. grants)	0.2	-1.1	-2.2
Primary balance (excl. grants)	-5.9	-9.8	-5.8
Memorandum items:			
Nominal GDP (in millions of pa'anga)	846.1	881.9	881.9
Grants in-kind (in percent of GDP)	7.9	9.7	9.7
Total external public debt outstanding (in percent of GDP)	44.2	43.1	43.1

Sources: Tongan authorities; and IMF staff estimates.

⁸ The decline in project grants is linked to under-implementation of projects, and thus, is deficit-neutral. Following a change in risk rating under Joint Debt Sustainability Analysis by the IMF and the WB in 2014 from high to moderate, the WB and the ADB changed their financial support to Tonga from 100-percent grants to 50:50 ratio of grants to loans.

projects constrained by capacity.⁹ The deficit will be financed by foreign loans, domestic bonds, and drawdown of government deposits. A larger share of loan-financing in overall donor funding will contribute to a higher deficit in FY2016. In the medium-term, spending pressures, arising from wages and preparations for the SPG, will continue. However, provided wages are held in check and grant-financing is secured to finance the SPG, the deficit is projected to decline.

9. Discussions were focused on the need to protect fiscal and debt sustainability. The current public debt of Tonga is around 49 percent of GDP. The authorities have been careful not to incur new non-concessional debt in line with the new debt management strategy. Debt sustainability analysis (DSA) conducted by staff suggests that public and external debt are sustainable under the baseline scenario, but there are significant risks emanating from (i) the high wage pressure, (ii) shortfalls in donor financing of the SPG and cost overruns, and (iii) natural disasters. Should these risks materialize, fiscal deficits would widen, potentially necessitating non-concessional borrowing and raising the debt level. Tonga's overall risk of debt distress under the DSA is classified as moderate.¹⁰

10. Staff suggested measures to mitigate the risks. These include:

- *Restraining the wage growth* to the level consistent with inflation in order to lower the share of wages in current spending and the GDP (14 percent in FY2016). A new formula for COLA, which is under development, could become a useful annual target starting from FY2017. A broader civil service reform informed by the results of the recent remuneration review should be undertaken in parallel to ensure that employment in government is rationalized and pay scales adequately reflect responsibilities, while the quality of public services is maintained.
- *Rationalize public spending on the SPG and seek donor grants for capital spending.* Estimates of financing of capital spending on the SPG range from T\$78 to T\$93 million. The authorities are in the process of identifying donors for the SPG. Some donors expressed interest (for example China and PNG), but their commitments are yet to be confirmed. Given the risks to debt sustainability, staff supports the authorities' intention to seek grant financing where possible.
- *Building fiscal buffers* to mitigate the effects of natural disasters and to finance the operating costs of the SPG. Given the uncertainty regarding the potential revenue from the departure fee and the FX levy, contingency measures are needed to secure sufficient funding. In addition, maintaining fiscal reserves at three months of current spending is prudent for unexpected contingencies, such as natural disasters. Fiscal consolidation that would be needed to build buffers is estimated at about 1.1 percent of GDP per annum in the next three years. Savings

⁹ The FX levy was slated to be imposed in FY2016 on financial institutions by taxing financial institutions on the spread on the purchase and sale of foreign exchange. However, a delay in the implementation of FX levy occurred amid lack of clarity about its modalities and concerns about possible Fund jurisdictional implications of the FX Levy, which has resulted in Tonga's parliament passing amendments to the underlying law. In the end, the levy was implemented at a rate of ½ seniti per Pa'anga on the Pa'anga value of the spread, where "spread" is the difference between the actual transaction rate and the midpoint rate quoted by the NRBT, beginning June 1, 2016. Fund staff will monitor whether the operation of FX levy gives rise to jurisdictional concerns. For departure fee, the plan was to raise it from T\$65 by T\$100, but concerns about its impact on tourist arrivals have led to a delay in its implementation. Together the two measures were expected to raise T\$7.5 million per year.

¹⁰ See *Staff report for the 2016 Article IV Consultation—Debt Sustainability Analysis—Update*.

derived from the rationalization of spending in the context of the ongoing expenditure review should be used for accumulating fiscal buffers.

11. Moreover, building resilience is contingent on broader structural reform efforts to increase the revenue and to raise the efficiency of public spending. The government is focused on collection of remaining tax arrears, reviewing tax exemptions, and broadening the tax base. Further improvements in tax administration will be contingent on continued efforts at risk-based supervision, stricter enforcement, improved efficiency as a result of a reorganization of tax administration along the functional lines, and implementation of Automated System for Customs Data (ASYCUDA) in customs with the assistance from PFTAC. In the area of PFM, efficiency gains could be derived from implementation of the reform program for the procurement system, better accounting and reporting (revising the chart of accounts to improve line ministry reporting), and improved commitment controls (enhancing the IFMIS) and budget reporting functions, all of which will support better governance.¹¹ Staff welcomes the recent establishment of an Audit Oversight Committee of the Cabinet with the goal to improve timeliness and ensure a follow-up on audit recommendations as well as an on-going initiative to implement e-government. With the assistance of the ADB, the authorities are conducting a reform of public enterprises to improve their governance and financial results. Altogether, fiscal structural reforms will help create fiscal space for much needed growth enhancing investment in infrastructure and human capital.

Authorities Views

12. The authorities broadly agreed with staff assessment of fiscal outlook and risks. They saw excessive wage growth and spending on natural disasters as the main risks to fiscal outlook. They agreed with the need to rein in the wage bill, noting that they started reducing vacancies already this year. However, they were not ready to commit to a specific target for wage growth, indicating that this decision should await the completion of the organizational effectiveness review that is underway. The authorities reiterated their commitment to seek grant-financing for the SPG. They emphasized their efforts to lower debt burden by refinancing expensive debt to the Retirement Fund Board by using government bonds and negotiating debt relief with Bank of China. They agreed with the need to build fiscal buffers, noting existing provisions in place to respond to natural disasters (see below). In addition, they noted the need to secure resources to service large debt to China starting in FY2019, and the establishment of a sinking fund for this purpose.

B. External Stability

13. The staff emphasized the need to maintain adequate level of international reserves. The current reserve cover, at about 6 months of imports, is adequate according to staff analysis, which weighs economic costs of external shocks against the costs of holding reserves¹² although it is above the NRBT's target range of 3–4 months of import cover. Exchange rate is in line with fundamentals and there are no signs of deteriorating competitiveness (Box 1). However, should pressure on reserves emerge, the NRBT should be ready to depreciate the Pa'anga against the

¹¹ Progress is being made in these areas with the assistance of PFTAC, the WB and the ADB.

¹² See Box 2 of the Staff Report for the 2015 Article IV Consultation. The analysis by the staff remains valid to date.

basket of currencies in order to safeguard external stability. More restrained fiscal policy could also be needed to alleviate potential external pressures.

Authorities Views

14. The authorities agreed with staff's exchange rate assessment and on the need to maintain sufficient reserves, but questioned whether the current level of reserves is excessive.

Given large developmental needs of Tonga, they thought that the opportunity cost of holding reserves could be higher than estimated by staff. They expected the reserves to come down in the coming years as investment projects scale up.

C. Monetary Policy

15. Monetary policy stance remained accommodative with growth of broad money and private credit accelerating, and no change in monetary policy is warranted at this time. Broad money (M2) growth increased to 18.2 percent (y/y) in February 2016, from 9 percent (y/y) in June 2015, reflecting accumulation of surplus liquidity in the banking sector and inflows from abroad; and private credit growth increased to 14.6 percent (y/y) in February 2016 from 8.6 percent in June 2015. The credit growth was supported mainly by the implementation of the government-managed loan-subsidy scheme, lower lending rates, a boom in construction, and an increase in commercial loans, and has not been a concern so far. The resumption of credit growth needs to be monitored closely to ensure that risks do not build up. The authorities expressed concerns about the excess reserves of banks, noting that monetary policy tools have not been effective in addressing them. In staff's view, monetary tightening is not needed at this time, and strong credit growth is not yet a concern, since it started from a low level last year, and there are no signs of overheating. Monetary tightening, however, will be needed should signs of overheating emerge, particularly if inflation were to spike up. Raising the reserve requirement or selling government bonds could be used for this purpose.

16. In the medium-term, the authorities are looking for ways to improve the monetary policy framework. For this, the NRBT is considering introducing a short-term policy interest rate to guide lending and deposit rates. Staff encouraged the NRBT to follow best international practices by setting the neutral policy interest rate above the long run inflation rate and to seek TA from the IMF on the design and implementation of the framework.

17. Staff and the authorities agreed on the need to move away from the current reference range to a lower, more realistic reference rate of inflation. Ever since the reference range of 6-8 percent was introduced in 2011, inflation has fallen well below the range, undermining its usefulness as a guide for monetary policy. Pursuing an inflation range in the context of a fixed exchange rate regime, a weak monetary policy transmission mechanism, and sensitivity to external price shocks has been challenging. Staff advised to set a reference rate at four percent, to be more consistent with historic inflation and better aligned to the medium-term inflation outlook (while preserving a margin to accommodate future domestic and external price shocks). Any changes in reference rate should be publicly explained.

Authorities Views

18. The authorities concurred with staff assessment of monetary policy stance. At present they viewed raising reserve requirement as a first defense against overheating. In the medium-term they wished to expand their monetary policy toolkit to improve monetary policy flexibility and requested technical assistance from the IMF in this area. They have been receptive to the proposal to move to a new inflation reference rate, however, they were noncommittal to specific action deadlines.

D. Financial Stability and Macroprudential Policies

19. Financial sector is highly profitable and stable, but vigilance is needed. Tonga's banks have strong capital positions and are highly liquid, although their level of NPLs remains elevated.¹³ Interest spreads have been declining, perhaps reflecting increasing competition in the banking sector and better access to credit information. Credit-to-GDP ratio is still under 30 percent, a low level by international comparisons, and credit growth is consistent with financial deepening. The authorities, however, monitor banks closely, and are willing to explore macro-prudential tools, including loan-to-deposit ratio, loan-to-value ratio, caps on credit to specific sectors, and caps on net interest margin, to prevent a buildup of systemic financial risks. Although the risks from the government subsidy scheme with Tonga Development Bank (TDB) are minimal at this stage, lax lending standards could potentially become a problem. The non-banking financial institutions (NBFIs) sector remains small and is currently effectively unsupervised (although it has been brought under the supervision of the NRBT recently), which could become a concern in the future.

20. The authorities are making effort to strengthen financial stability by upgrading the NRBT supervisory, regulatory, and legal framework. Efforts have focused on strengthening regulations including amending the NRBT Act, and the Banking Act (formerly Financial Institutions Act), and improving the legal framework for all types of financial institutions. Work is ongoing to finalize the Banking Act, as well as other financial sector legislation, which would allow the NRBT to start supervising NBFIs, strengthen the autonomy and accountability of the NRBT, reform its governance framework, provide the NRBT with the powers to issue binding regulations, and entrust the NRBT with clear enforcement actions. Adopting the Banking Act in the near future would improve banking resolution regime, which is currently based on the Company Act. The NRBT continues receiving TA on risk-based supervision for the banking sector from the PFTAC, which would further improve supervising and regulatory capacity of the NRBT.

21. De-risking of global banks has not yet become an issue for Tonga, but the situation needs to be monitored. While some money transfer operators have closed down their operations, World Bank data indicate that remittances inflows have been stable and the transaction costs decreased between 2014 and 2015. At the same time, all Tongan banks have been able to continue normal correspondence banking activities with banks abroad.

¹³ There are five banks operating in Tonga. However, the NRBT prohibited one bank from deposit-taking after its capital position and liquidity weakened last year.

Authorities Views

22. The authorities concurred with staff assessment of financial sector risks. They are committed to further improving financial sector supervision and regulation, with TA from PFTAC, and extending supervision to nonbanks. They are concerned about the potential effect of de-risking on banking activity and foreign remittances, and are monitoring developments in the region in order to take actions, if necessary.

E. Financial Deepening, Structural Reforms, and Climate Change

23. The authorities are promoting access to finance to support inclusive growth. The NRBT is currently implementing SMEs finance project and conducting Demand Side Survey to study determinants of credit demand. Mandated credit reporting and extension of credit bureau coverage to non-bank credit providers, such as utilities, aim to reduce costs of due diligence and thereby support access to finance. Revision of the Land Act would help improve development of collateral for personal and business loans and reduce impediments for access to finance. Measures to promote collateral, credit information databases,¹⁴ and deposit insurance, are also expected to support financial stability.

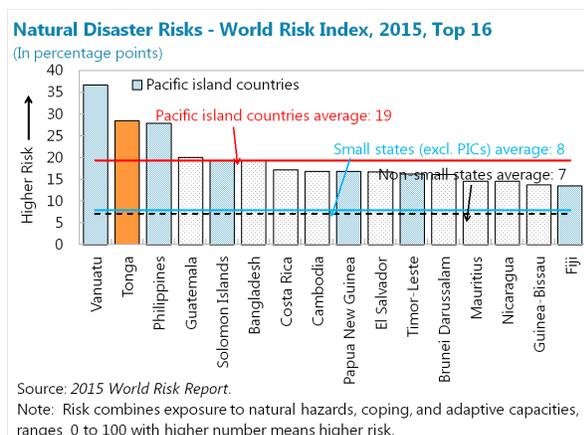
24. Government on-lending scheme via TDB has been part of the effort to increase credit to private sector. The scheme involve lending of government funds to small enterprises in selected sectors, such as agriculture, fisheries, education, and microfinance for women at low interest rate, currently 1 to 4 percent per year, and a fixed fee. Although the evaluation of the scheme has yet to be undertaken, anecdotal evidence suggest that accessing funding via TDB has been difficult for small businesses with no credit history or collateral. Therefore, staff recommended to simplify this scheme for small businesses and to consider adopting a comprehensive microfinance approach for informal sector and unbanked population.

25. Raising Tonga's growth potential remains an overarching goal and will require improving opportunities for private sector development and FDIs. The government has made significant progress in bringing structural reforms up to date, including in regulated utilities and labor market (recently becoming a member of the ILO), public enterprise reform, and is developing legislation to facilitate formalization of the informal sector, including revising the foreign investment act and work permit rules. The authorities continue efforts to adopt the receivership bill and develop bankruptcy policy and legislation based on this bill. They also work to develop a new National Energy Act, which would facilitate competition in the power generation sector, based on a revised Tonga Energy Road Map 2010-20 and continue promoting exports via regional trade agreements. Tonga is a member of the Pacific Island Countries Trade Agreement (PICTA), the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA,) and the World Trade Organization (WTO). Still, more needs to be done, as the share of private sector in the economy is low, and FDIs in FY2015 is estimated at a low 2.7 percent of GDP. Staff also recommended to

¹⁴ Currently, the credit bureau is located in Fiji for a number of the Pacific islands (www.databureau.com), though it would be more effective to move it to Tonga.

prepare a comprehensive private sector development strategy to guide reform implementation in the medium term.

26. Progress is being made in natural disaster preparedness. Tonga is ranked second on the risk of natural disaster based on the World Bank Risk Index. The authorities are undertaking several initiatives to enhance its resilience in the context of the TSDF II programs targeting (i) rural electrification, (ii) energy efficiency, (iii) Disaster Risk Management training and improving communication with districts and communities, and (iv) completion of specialized hazard maps and detailed analysis. More broadly, they have measures in place to improve ex post and ex ante resilience to shocks within a multi-pillar framework at the national level.¹⁵ They have funding arrangements in place to respond in case disaster struck, including *ex ante* cash emergency fund of T\$5 million, with an additional T\$1.5 million donor funded emergency financing for rapid response assistance. *Ex post* arrangements include flash appeal, bilateral and multilateral donor assistance for relief and reconstruction, and capital budget realignment. Additional measures that could be considered include funding through a contingency budget, as well as sovereign catastrophe risk and traditional disaster insurance. At the same time, comfortable gross international reserves supported by favorable external environment and moderate public debt should provide Tonga with some self-insurance in the medium term. A risk scenario in the DSA, integrating projected fiscal costs of future natural disasters into the macro-framework, demonstrates that external debt will remain sustainable, albeit at an elevated level.¹⁶



¹⁵ See the multi-pillar framework on strengthening ex ante and ex post resilience in Caberon, Hunter, Tumbarello, Washimi, and Wu, "Enhancing Macroeconomic Resilience to Natural Disasters and Climate Change in the Small States of the Pacific," IMF Working Paper, WP/15/125.

¹⁶ See "Staff Report of the 2016 Article IV Consultation--Debt Sustainability Analysis Update", IMF.

Tonga: Strengthening Ex-Ante and Ex-Post Resilience

	Risk Management	Measures Taken and On-going
Ex-Ante		
Risk Assessment	Assess vulnerability Incorporate disaster costs into national budget planning	-Maintaining an emergency fund of minimum T\$5 million for rapid response -Enhance PFM systems
Self Insure	Build buffers	- Maintaining funding through contingency budget - Maintaining adequate gross international reserves and moderate public debt
Risk Reduction	Enhance preparedness - Invest in smart infrastructure - Enhance debt management capacity	- Rural electrification program - Energy efficiency - Disaster risk management training and improving communication with districts and communities - Completion of specialized hazard maps and detailed analysis
Risk Transfer	Regional pooling	Participate in sovereign catastrophe risk insurance and traditional disaster insurance
Ex-Post		
Coping	Emergency response and reconstruction	Maintaining financial tools and arrangements such as capital budget realignment, bilateral and multilateral donor assistance for relief and reconstruction, flash appeals

Authorities Views

27. The authorities agreed that improving business environment and financial inclusion are key to raising growth potential. In this context, they noted strong pressure from the government and legislature to facilitate more bank lending to the private sector, including by imposing caps on interest rates. Although banks' interest rate spreads have been declining, average lending rate at 8 percent remains high. Staff warned against imposing interest controls as those could undermine banks' financial position and lead to less, rather than more credit. Moreover, stimulating more credit growth risks undermining financial stability, at time when credit growth is already strong. Regarding preparedness for natural disasters, the authorities noted that existing arrangements with donors (primarily Australia and New Zealand) for emergency assistance and their support of reconstruction effort in the aftermath of the disasters have been crucial for Tonga's economy.

OTHER ISSUES

28. Data issues. While broadly adequate for surveillance purposes, data quality and timeliness remain a concern, complicating monitoring of economic conditions and policy formulation (see the Statistical Issues in the Information Annex).¹⁷ Notwithstanding some progress—national accounts statistics by expenditure have been produced, the balance of payments (BOP) statistics is now in line with BPM6, and the central government budget migrated to GFSM 2001—improvements are needed in many areas, including labor market, household survey, population census, government finance statistics (GFS), compilation of financial soundness indicators (FSIs), and financial access survey (FAS). In this regard, weak capacity and understaffing at the statistics office is a concern, which the authorities are planning to address through technical assistance from the IMF and PFTAC.

STAFF APPRAISAL

29. The performance of Tonga’s economy has improved and the economic outlook is favorable, but there are downside risks. In FY2015 growth strengthened, inflation declined, gross reserves remained at comfortable level, and private credit accelerated. Overall competitiveness of the economy has improved with tourist arrivals increasing and the REER depreciating. Positive growth outlook is expected to continue in FY2016 and the medium-term, with strong external inflows and low fuel prices supporting domestic demand. However, as noted above, there are serious external and domestic policy risks which could cloud the outlook.

30. Fiscal position is expected to improve in the medium-term, and fiscal policy should be aimed at addressing fiscal risks and building buffers. Staff welcomes the authorities’ commitments to rein in the wage bill, and recommends setting up a limit on annual wage growth in line with average inflation. A broader civil service reform is needed in the medium-term to ensure the efficiency of wage spending. Given the risk to debt sustainability, staff supports the authorities’ intension to seek grant financing to cover the costs of the SPG, although strict control over expenditure will be required to prevent cost overruns, and to lower the debt burden via debt relief and refinancing. In addition to fiscal buffers for unexpected contingencies, such as natural disasters, the authorities should build fiscal buffers to cover the operational costs of the SPG. Contingency measures may be needed, if revenue from new taxes to finance the SPG (FX levy and departure fee) falls below projections. Staff encourages the authorities to closely monitor the implementation of the FX levy to ensure its compliance with Tonga’s obligations under Article VIII.

31. Continued progress with fiscal structural reforms along with good debt management will be important to maintain fiscal sustainability and to secure fiscal space for growth-enhancing spending in the medium-term. In line with the new debt management strategy, the government should adhere to the policy of no non-concessional borrowing and seek opportunities to lighten the debt burden. Structural reforms should aim at broadening the tax base, and improving tax administration and PFM, leveraging technical assistance from development partners

¹⁷ Tonga has been participating in the Enhanced General Data Dissemination System (e-GDDS) since May 30, 2006.

and the IMF (PFTAC). Fiscal space as a result of these reforms could be used for growth-enhancing investment in infrastructure and human capital.

32. The authorities should maintain gross reserve buffers at the current level to safeguard external stability. Staff estimates that reserves at around 6 months of imports are appropriate for Tonga given its vulnerability to external shocks and fiscal risks, and the exchange rate is broadly in line with fundamentals. The authorities, however, should stand ready to depreciate the Pa'anga against the basket of currencies in order to safeguard external stability should external pressures emerge. More restrained fiscal policy would also be needed to alleviate potential external pressures.

33. The current accommodative stance of monetary policy is appropriate in light of low inflation and strong external position, but vigilance is needed to guard against macro-financial risks. The recent acceleration in the growth of private credit is not a concern as it is coming from a low level and is consistent with financial deepening, given the low rate of banking penetration in Tonga. However the NRBT should stand ready to mop up excess liquidity in the banks should signs of overheating emerge. The banking sector remains stable and profitable. However, the NRBT should continue supervising banks closely and adopt macro-prudential tools as needed to avoid buildup of systemic risks. Global de-risking has not yet affected Tonga in a major way, but risks associated with it should be monitored. To support financial stability more broadly, staff encourages the authorities' ongoing efforts at upgrading Tonga's supervisory, regulatory, and legal frameworks. The IMF stands ready to continue providing TA to the NRBT in the area of financial sector legislation.

34. Staff supports the NRBT's plan to strengthen its monetary policy framework. Staff welcomes the authorities' intention to move away from the current inflation reference range, which lost its usefulness as a guide for monetary policy, to a new indicative reference rate of inflation, set to be consistent with inflation outlook in the medium-term. Staff also sees merit in introducing a policy interest rate to guide lending and deposit rates and strongly encourages the NRBT to follow best international practices in setting the policy interest rate and developing the monetary instruments. In this regard, staff welcomes the NRBT's TA request to MCM on enhancing monetary policy framework, improving FX reserve management, and introducing macroprudential policies and instruments.

35. Raising Tonga's growth potential, requires improving opportunities for private sector development. Staff commends the government's initiative to improve financial access to support inclusive growth, however warns against excessive reliance on administrative methods of credit allocation. While supporting private sector via government lending schemes, such as in TDB, could be beneficial, caution is needed to ensure that public resources are applied effectively, and international experience should be studied in this regard. Staff notes progress on reforms to improve the business climate, including in the areas of regulation of utilities, labor market, and foreign investment and encourages the authorities to prepare a comprehensive private sector development strategy to guide reform implementation in the medium term. Such strategy should encompass the areas of governance, transparency, business climate, access to external markets, as well as investing in transport, communications, human capital (health and education), and tourism, building on the TSDf II. Additionally, to ensure sustainability of the growth, a comprehensive

national strategy along the lines presented by staff is needed build Tonga's resilience to climate change shocks. Such strategy should encompass measures, including ongoing under TSD II, to mitigate the risks and to cope once a disaster strikes. Staff welcomes efforts that are already underway to address climate change shocks.

36. Improving economic data remains a high priority. Given the importance of data timeliness and quality for formulation of sound macroeconomic policies, staff encourages the authorities to strengthen capacity of the Tonga Department of Statistics, including through improving staffing, and seek technical assistance from the IMF's Statistics Department and PFTAC on (i) the System of National Accounts, including developing quarterly GDP and moving compilation to SNA 2008, (ii), external sector statistics, (iii) GFS, and (iv) FSIs.

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

Box 1. Tonga: Exchange Rate and Competitiveness ^{1/}

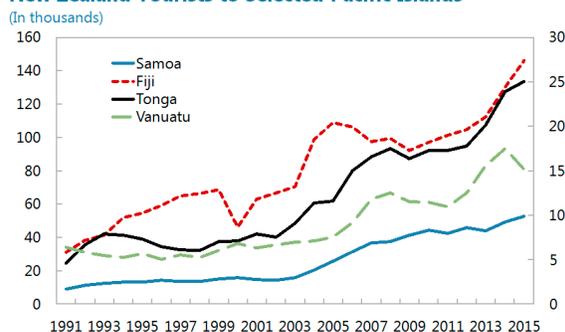
Tonga's real effective exchange rate is broadly in line with medium-term fundamentals. Other indicators suggest that the economy remains competitive.

Exchange rate

- Tonga's real effective exchange rate (REER) is broadly in line with medium-term fundamentals. The current account approach suggests an overvaluation by around 2.2 percent and current account gap of -0.2 percent. REER and nominal effective exchange rate (NEER) have been depreciating since September 2011 suggesting an improvement in external competitiveness.

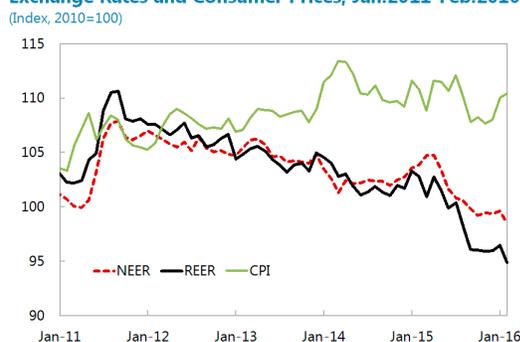
Other indicators

New Zealand Tourists to Selected Pacific Islands



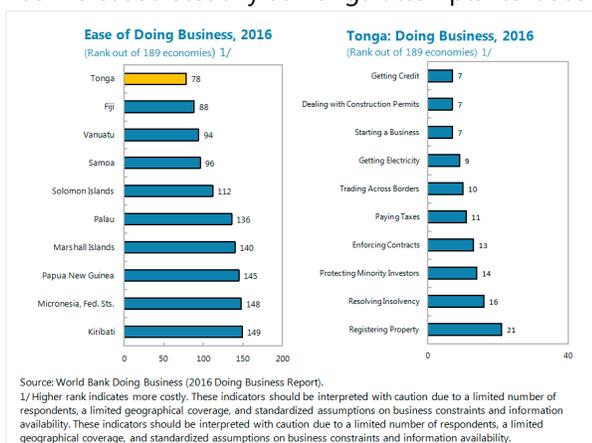
Source: Statistics New Zealand.

Exchange Rates and Consumer Prices, Jan.2011-Feb.2016



Sources: Authorities; and IMF staff estimates.

- Reserves.** Gross international reserves remain adequate at about 6 months of the prospective imports in FY2016, which is marginally above the target of 5.6 months of imports calculated using the IMF reserve adequacy template.
- Exports.** Exports recovered quickly from a slump during the global financial crisis and have grown moderately in recent years. In the medium term, exports are projected to grow at about two/three percent, in line with the overall economic growth. Continued lower commodity prices are projected to negatively affect exports, but higher demand for agricultural products (squash and root crops) will compensate for this.
- Number of tourists.** The number of tourists has increased steadily as Tonga attempts to become an attractive tourist destination.
- Costs of doing business.** Tonga remains competitive compared with other PICs, according to the World Bank's Doing Business 2016 report. Relative strengths include getting credit and electricity, dealing with construction permits, and starting a business. There is room for improvement in terms of registering property and resolving insolvency.



Source: World Bank Doing Business (2016 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. 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.

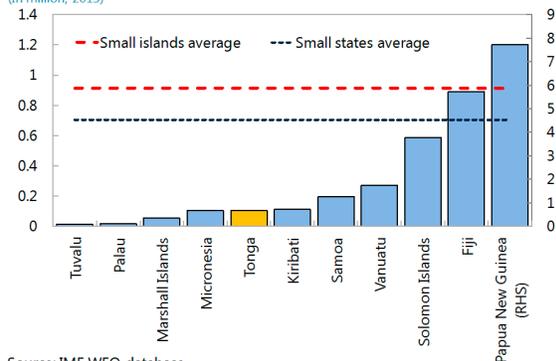
^{1/} Prepared by Agnes Isnawangsih and Anh Lee (both APD).

Figure 1. Tonga: Stylized Facts

As a small Pacific island country, ...

PICs: Population

(In million, 2015)

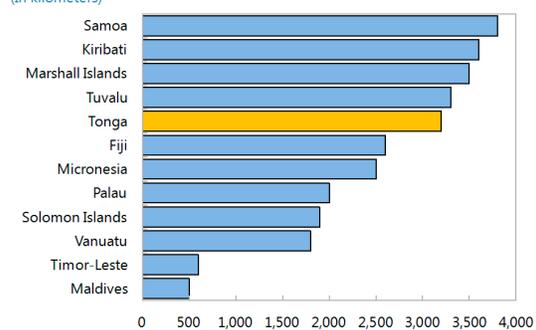


Source: IMF WEO database.

..Tonga faces geographical challenges.

PICs: Distance to the Closest Continent

(In kilometers)

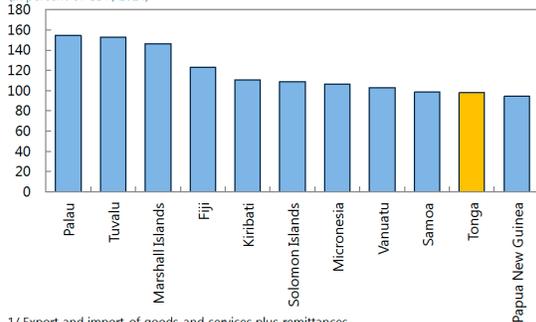


Sources: South Pacific Applied Geoscience Commission

Compare to its peers, Tonga has less trade ...

PICs: Trade Activities 1/

(In percent of GDP, 2014)

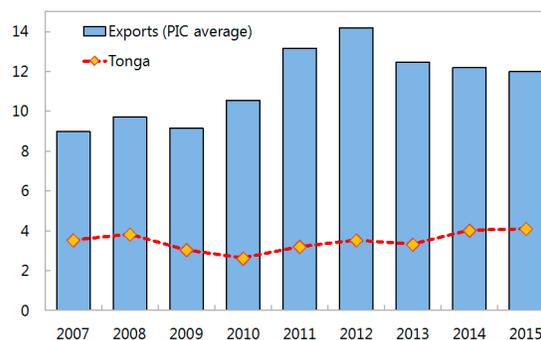


1/ Export and import of goods and services plus remittances. Sources: IMF WEO database; and IMF staff estimates.

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

PICs: Exports

(In percent of GDP)

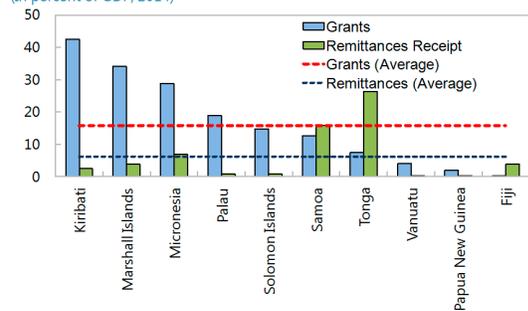


Sources: Country authorities; and IMF staff estimates.

Tonga is dependent on remittances and grants...

PICs: Grants and Remittances

(In percent of GDP, 2014)



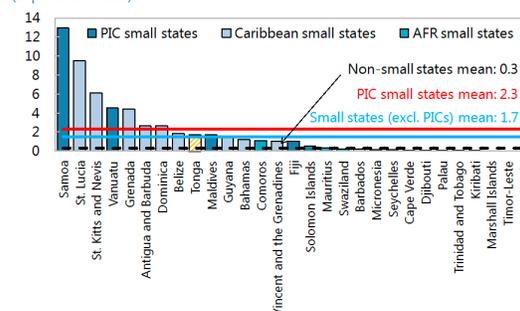
Notes: Grants exclude allocations in kind. Remittance data for Fiji and Tuvalu are only available until 2013.

Sources: Country authorities; and IMF staff estimates.

...and is susceptible to natural disaster.

Average Annual Damage and Losses¹

(In percent of GDP)



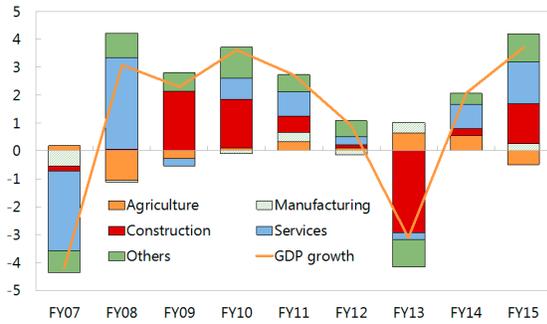
1/ During 1980-2014.

Sources: EM-DAT; and IMF staff estimates.

Figure 2. Tonga: Recent Economic Developments

GDP growth had recovered in FY2014 and improved in FY2015 supported by construction, tourism, and remittances ...

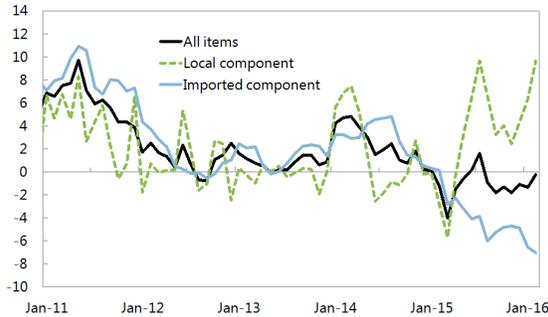
Tonga: Contribution to Growth by Sector
(In percent)



Sources: Tongan authorities; and IMF staff estimates.

Headline inflation remained low due to lower global food and commodity prices...

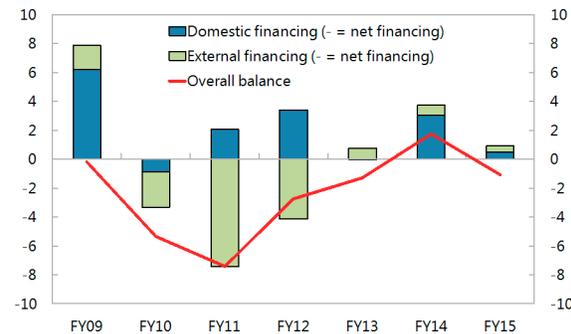
Tonga: Inflation, Jan.2011-Feb.2016
(In percent, year-on-year change)



Sources: Tongan authorities; and IMF staff estimates.

After a period of improvement, the fiscal position weakened in FY2015...

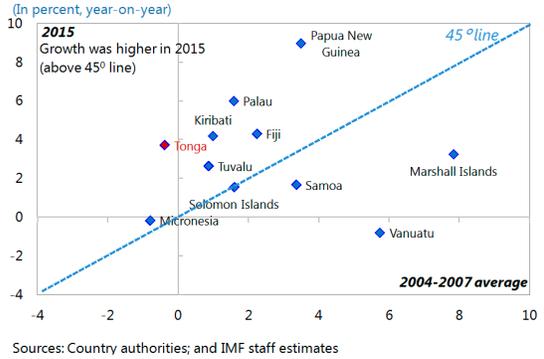
Tonga: Fiscal Balance
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

...exceeding its pre global financial crisis level.

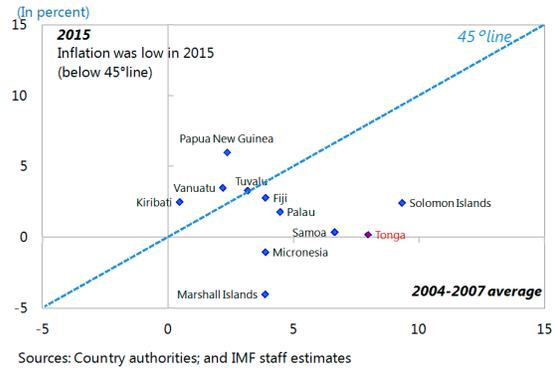
PICs: Real GDP Growth



Sources: Country authorities; and IMF staff estimates

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

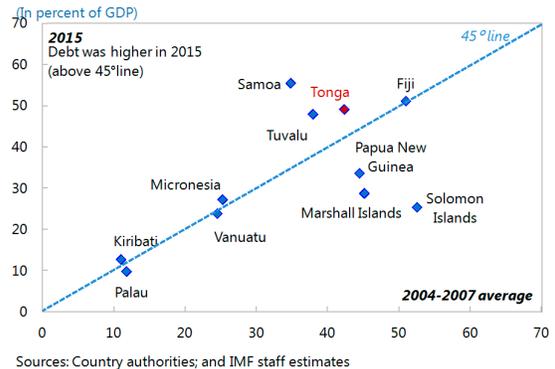
PICs: Inflation



Sources: Country authorities; and IMF staff estimates

...and total government debt remains elevated.

PICs: Government Debt



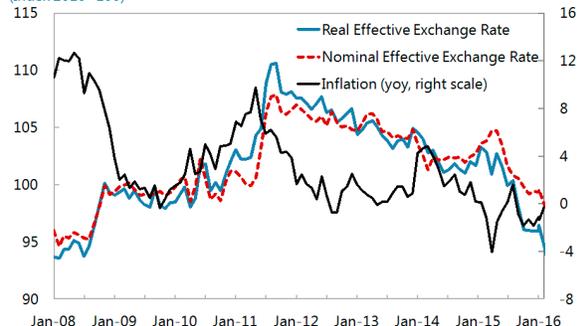
Sources: Country authorities; and IMF staff estimates

Figure 3. Tonga: External and Monetary Developments

Nominal and real effective exchange rates have been depreciating recently ...

Tonga: Effective Exchange Rates, Jan. 2008-Feb.2016

(Index 2010=100)

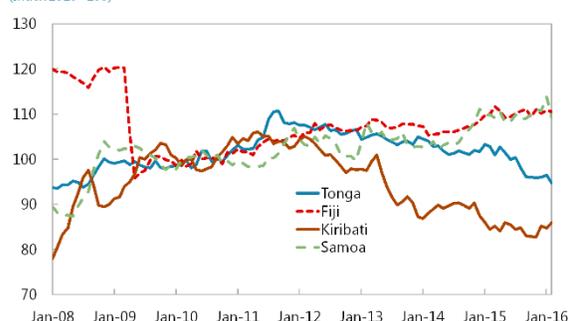


Sources: Authorities data; and IMF, Information Notice System database.

...but remain less volatile than some of Tonga's peers.

PICs: Real Effective Exchange Rates, Jan.2008-Feb.2016

(Index 2010=100)

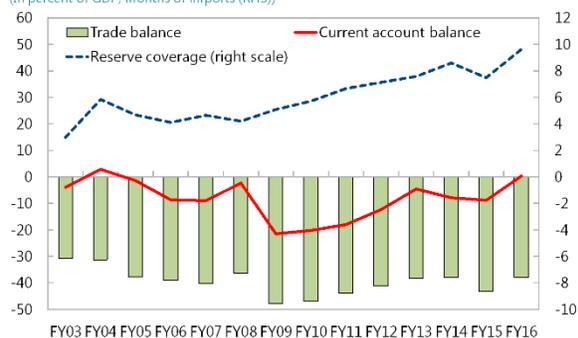


Source: IMF INS database.

International reserves remained large due to continued inflow of foreign aids and remittances...

Tonga: Balance of Payments

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

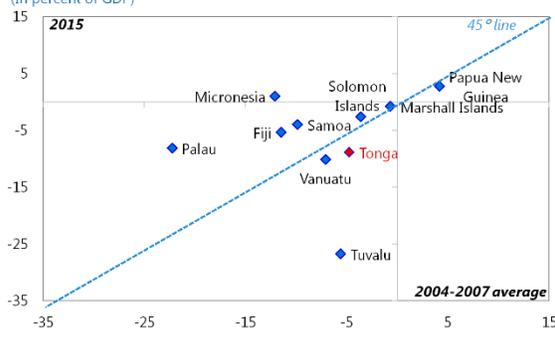


Sources: Tongan authorities; and IMF staff estimates.

...and current account deficit narrowed due to lower imports price.

PICs: Current Account Balance

(In percent of GDP)

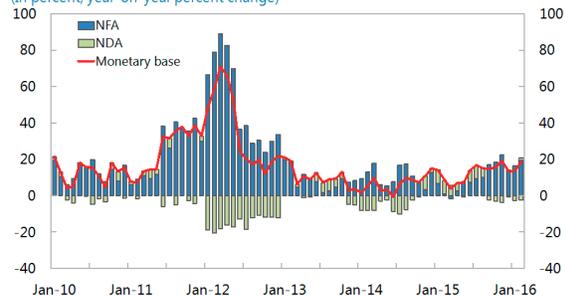


Sources: Country authorities; and IMF staff estimates

Monetary stance has been accommodative,...

Tonga: Monetary Base, Jan.2010-Feb.2016

(In percent, year-on-year percent change)

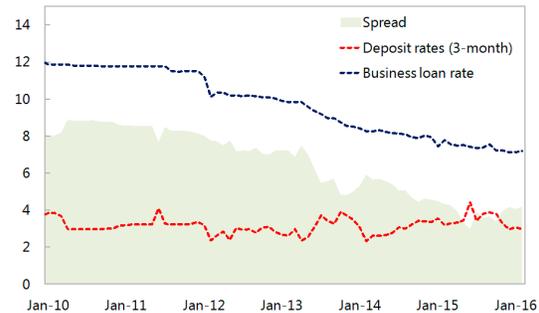


Sources: Tongan authorities; IMF, Integrated Monetary Database; and IMF staff estimates.

...mitigating the credit crunch and leading to lower interest margin.

Tonga: Interest Rates, Jan. 2010-Feb.2016

(In percent)

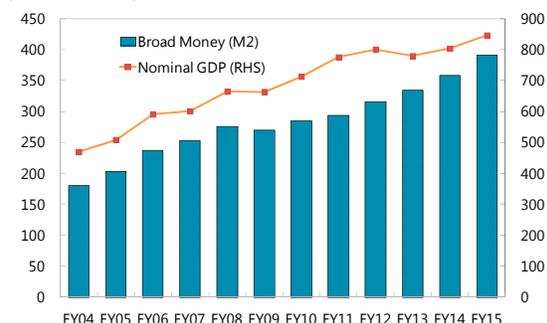


Sources: Tongan authorities; and IMF staff estimates.

Figure 4. Tonga: Financial Intermediation

Domestic liquidity has grown in tandem with nominal GDP...

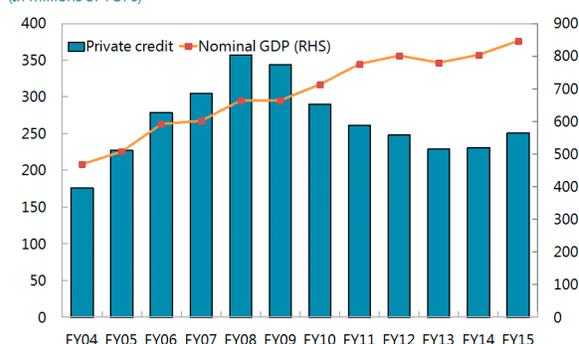
Tonga: Domestic Liquidity
(In millions of TOPs)



Sources: Tongan authorities; and IMF staff estimates.

...while private credit remained rather low since the global financial crisis in 2008.

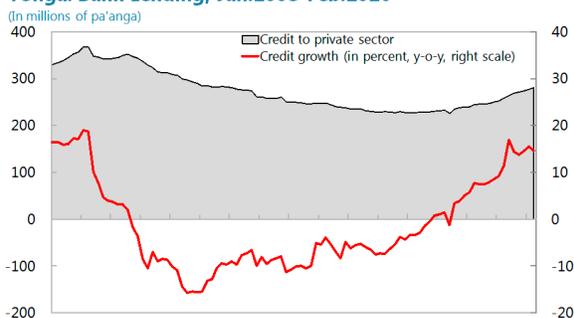
Tonga: Credit to Private Sector
(In millions of TOPs)



Sources: Tongan authorities; and IMF staff estimates.

In 2014-15 credit growth started to pick up...

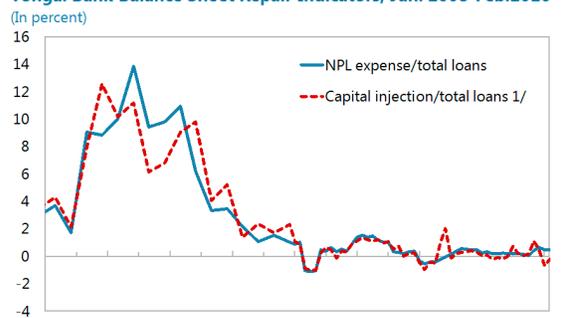
Tonga: Bank Lending, Jan.2008-Feb.2016



Sources: Tongan authorities; IMF, *Integrated Monetary Database*, and IMF staff estimates.

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

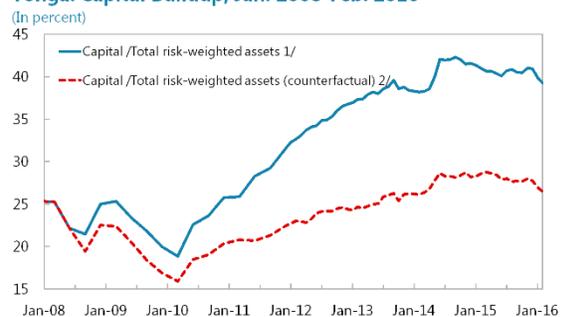
Tonga: Bank Balance Sheet Repair Indicators, Jan. 2008-Feb.2016



Source: Tongan authorities; and IMF staff estimates.
1/ Capital injection is estimated by the following formula: Capital (t) = Capital (t-1) - NPL Expense (t) + Capital injection (t).

...and bank capital ratios recovered...

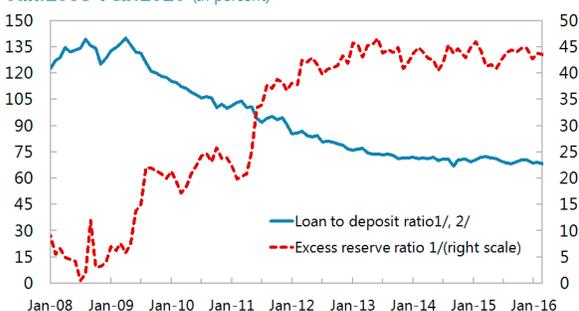
Tonga: Capital Buildup, Jan. 2008-Feb. 2016



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

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

Tonga: Loan-to-Deposit and Excess Reserve Ratio, Jan.2008-Feb.2016



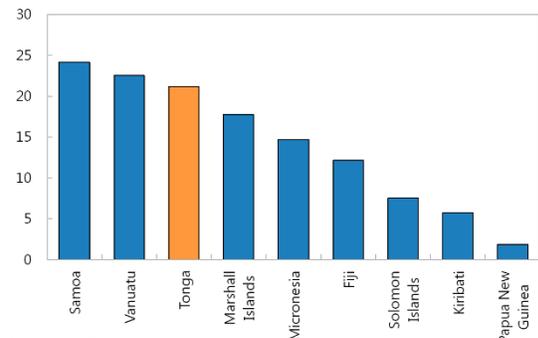
Sources: Tongan authorities; and IMF staff estimates.
1/ Ratio to non-government deposits; 2/ Credit to private sector by the banks.

Figure 5. Tonga: Financial Access

Financial access is appropriate compared with the peers as shown in number of bank branches,

Commercial Bank Branches, 2014

(per 100,000 adults)

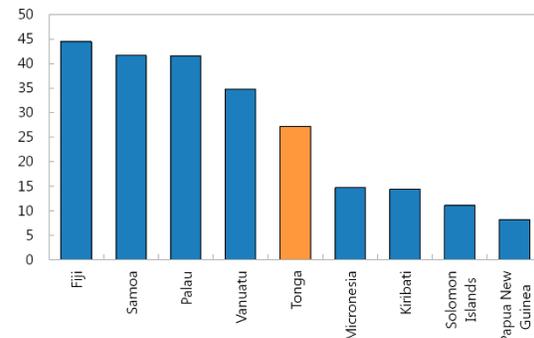


Source: IMF, Financial Access Survey.

...ratio of ATM to adults...

Number of ATM, 2014

(per 1000 adults)

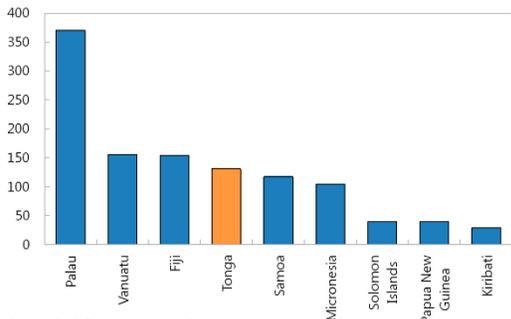


Source: IMF, Financial Access Survey.

...and number of bank loans...

Commercial Bank Loan Accounts, 2014

(per 1000 adults)

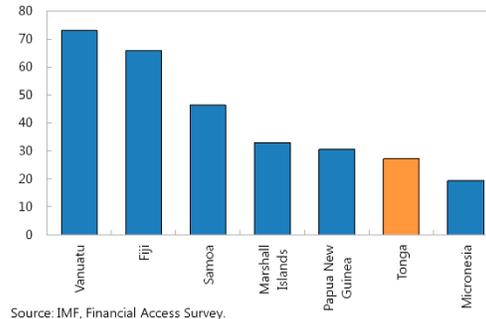


Source: IMF, Financial Access Survey.

...while value of loans is low.

Commercial Bank Loans, 2014

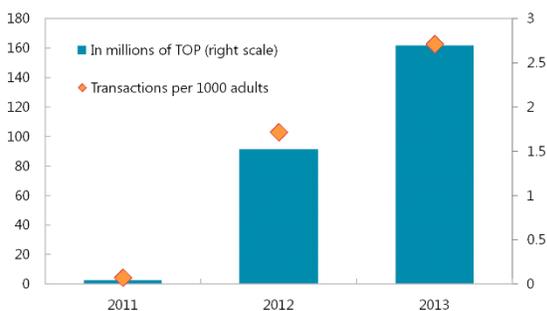
(In percent of GDP)



Source: IMF, Financial Access Survey.

However, there has been improvement in mobile money transactions...

Tonga: Mobile Money Transactions



Source: IMF, Financial Access Survey.

...and private loans started to pick up in 2014.

Tonga: Commercial Bank Loans Growth, Jan.2011-Feb.2016

(In percent, year-on-year)



Sources: National Reserves Bank of Tonga; and IMF, International Financial Statistics.

Table 1. Tonga: Selected Economic Indicators, FY2011–17 1/

Nominal GDP FY2015: US\$435.4 million

Population (2014): 103.8 thousands

GDP per capita FY2015: US\$4182

Major exports: root crops, vanilla, squash, fish

	FY2011	FY2012	FY2013	FY2014	Est. FY2015	Proj. FY2016	FY2017
(Annual percent change)							
Output and prices							
Real GDP 2/	2.7	0.9	-3.1	2.1	3.7	3.1	2.3
Consumer prices (period average)	6.0	3.3	0.7	2.3	0.1	-0.2	-0.4
Consumer prices (end of period)	7.1	2.3	0.2	1.5	0.2	-0.9	0.1
GDP deflator	5.8	2.4	0.5	1.0	1.5	1.1	0.9
(In percent of GDP)							
Central government finance							
Total revenue and grants	26.3	27.4	25.2	27.5	28.2	27.3	27.4
Total revenue	19.5	18.0	19.6	20.0	21.4	23.7	24.1
Grants	6.8	9.4	5.6	7.5	6.7	3.6	3.4
Total expenditure and net lending	33.7	30.2	26.5	25.7	29.3	30.4	29.1
Of which: Current expenditure	22.7	23.5	24.9	25.0	25.8	27.8	26.4
Capital expenditure	9.6	5.6	1.6	0.9	2.4	1.7	1.9
Overall balance	-7.4	-2.8	-1.3	1.7	-1.1	-3.1	-1.6
External financing (net)	8.4	5.1	0.2	0.3	0.6	1.4	1.3
Domestic financing (net)	-1.1	-2.4	1.0	-2.0	0.5	1.7	0.4
(Annual percent change)							
Money and credit							
Total liquidity 3/	3.1	7.0	5.2	7.3	9.3	10.3	8.6
Of which: Broad money (M2)	3.3	7.2	6.1	7.2	9.0	10.6	8.8
Domestic credit	-12.3	-14.2	2.5	7.8	15.4	13.2	12.4
Of which: Private sector credit	-9.9	-5.2	-7.5	0.7	8.6	9.4	12.5
Interest rates (end of period)							
Average deposit rate	2.5	2.4	1.98	2.09	2.35	...	...
Average lending rate	12.7	10.0	9.44	8.66	8.23	...	...
(In millions of U.S. dollars)							
Balance of payments							
Exports, f.o.b.	13.6	16.7	15.0	17.9	17.9	16.3	16.2
Imports, f.o.b.	-203.4	-203.4	-187.4	-187.6	-216.5	-217.2	-238.1
Services (net)	4.7	-7.7	0.3	1.3	-2.0	0.7	-5.3
Investment income (net)	12.9	12.1	11.4	4.7	4.5	3.8	4.6
Current transfers (net)	96.0	123.8	140.3	128.6	144.7	183.4	191.0
Of which: Remittances	68.3	77.2	107.4	102.7	107.7	125.1	127.4
Current account balance	-76.1	-58.5	-20.4	-35.1	-51.4	-13.0	-31.5
(In percent of GDP)	-18.0	-12.4	-4.5	-7.9	-11.8	-3.1	-7.1
Overall balance	34.6	23.1	2.4	11.2	-16.2	16.0	3.4
Terms of trade (annual percent change)	-4.0	-3.0	1.1	-3.3	-0.8	2.8	0.0
Gross official foreign reserves							
In millions of U.S. dollars	122.1	145.2	147.6	158.7	142.5	158.6	162.0
(In months of next year's goods and services imports)	5.2	6.5	7.1	6.9	6.2	6.2	5.7
Debt (in percent of GDP)							
Public debt (external and domestic)	43.6	48.7	51.4	45.8	49.0	48.7	48.2
External debt (public)	36.0	41.8	45.3	42.1	44.2	43.1	42.4
Debt service ratio	28.9	1.4	1.7	1.7	1.8	1.7	1.6
Exchange rates							
Nominal effective exchange rate (2005=100)	100.3	106.5	105.4	103.3	103.0	...	...
Real effective exchange rate (2005=100)	101.9	108.1	105.5	103.4	101.7	...	...
Memorandum items:							
Remittances (in percent of GDP)	16.1	16.3	23.9	23.2	24.7	29.6	28.8
Tourism (in percent of GDP)	7.9	8.3	9.7	10.0	8.9	9.8	10.1
FDI (in percent of GDP)	1.6	-0.3	1.2	2.6	2.7	2.8	2.9
Nominal GDP (millions of T\$)	774.8	800.6	779.3	803.6	846.1	881.9	910.7
Population (thousands)	103.0	103.3	103.5	103.9	104.1	104.4	104.6

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, FY2011–FY2017

	FY2011	FY2012	FY2013	FY2014	FY2015	Budget	Proj.	
						FY2016	FY2016		FY2017
(In millions of pa'anga)								
Total revenue and grants	203.8	219.4	196.7	220.9	238.3	293.4	240.7	249.6
Total revenue	151.0	144.4	153.0	160.9	181.4	216.4	209.1	219.0
Current revenue	149.1	144.2	152.3	160.9	181.4	216.4	208.5	218.4
Tax revenue	133.0	126.9	132.7	139.2	154.9	177.9	180.1	188.3
<i>Of which:</i> Taxes on income/profits	38.3	25.3	30.3	28.8	34.7	36.8	34.9	36.1
Sales tax and consumption tax	81.9	87.8	86.9	95.1	103.5	115.2	123.3	128.5
Nontax revenue	16.1	17.4	19.6	21.7	26.5	38.5	28.4	30.1
Capital revenue	2.0	0.2	0.7	0.0	0.0	0.0	0.6	0.6
Grants (in cash)	52.8	75.0	43.8	60.0	57.0	77.0	31.6	30.6
Project grants	30.7	37.9	32.0	32.7	34.0	57.7	13.5	14.4
Budget support	23.6	37.1	11.8	27.3	22.9	19.2	18.1	16.2
Total expenditure and net lending	261.1	241.5	206.7	206.9	247.6	310.8	268.0	264.6
Total expenditure	249.9	232.4	206.7	208.2	238.3	303.3	260.5	257.1
Current expenditure	175.6	187.8	194.1	201.1	218.0	272.9	245.1	240.2
Wages and salaries	91.8	83.6	84.5	92.4	101.8	115.0	122.0	125.1
Capital expenditure	74.4	44.7	12.6	7.1	20.3	30.4	15.4	16.9
Total lending minus repayments	11.2	9.0	0.0	-1.3	9.3	7.5	7.5	7.5
Current balance (excl. project grants)	-5.2	-9.5	-41.8	-40.2	-36.6	-56.5	-7.3	-21.7
Overall balance (incl. grants)	-57.3	-22.1	-10.0	14.0	-9.3	-17.4	-27.3	-15.0
Primary balance (incl. grants)	-50.8	-15.6	-2.9	21.1	-2.1	-9.7	-19.6	-7.2
Primary balance (excl. grants)	-103.6	-90.6	-46.6	-40.2	-49.7	-49.7	-51.2	-37.8
Total financing	57.3	22.1	10.0	-14.0	9.3	17.4	27.3	15.0
External financing	65.5	41.2	1.9	2.4	4.7	9.2	12.4	11.7
Domestic financing	-8.2	-19.1	8.0	-16.3	4.6	8.2	14.9	3.3
(In percent of GDP)								
Total revenue and grants	26.3	27.4	25.2	27.5	28.2	33.3	27.3	27.4
Total revenue	19.5	18.0	19.6	20.0	21.4	24.5	23.7	24.1
Current revenue	19.2	18.0	19.5	20.0	21.4	24.5	23.6	24.0
Tax revenue	17.2	15.8	17.0	17.3	18.3	20.2	20.4	20.7
<i>Of which:</i> Taxes on income/profits	4.9	3.2	3.9	3.6	4.1	4.2	4.0	4.0
Sales tax and consumption tax	10.6	11.0	11.2	11.8	12.2	13.1	14.0	14.1
Nontax revenue	2.1	2.2	2.5	2.7	3.1	4.4	3.2	3.3
Capital revenue	0.3	0.0	0.1	0.0	0.0	0.0	0.1	0.1
Grants (in cash)	6.8	9.4	5.6	7.5	6.7	8.7	3.6	3.4
Project grants	4.0	4.7	4.1	4.1	4.0	6.5	1.5	1.6
Budget support	3.0	4.6	1.5	3.4	2.7	2.2	2.0	1.8
Total expenditure and net lending	33.7	30.2	26.5	25.7	29.3	35.2	30.4	29.1
Current expenditure	22.7	23.5	24.9	25.0	25.8	30.9	27.8	26.4
Wages and salaries	11.8	10.4	10.8	11.5	12.0	13.0	13.8	13.7
Capital expenditure	9.6	5.6	1.6	0.9	2.4	3.4	1.7	1.9
Total lending minus repayments	1.4	1.1	0.0	-0.2	1.1	0.9	0.9	0.8
Current balance (excl. project grants)	-0.7	-1.2	-5.4	-5.0	-4.3	-6.4	-0.8	-2.4
Overall balance (incl. grants)	-7.4	-2.8	-1.3	1.7	-1.1	-2.0	-3.1	-1.6
Primary balance (excl. grants)	-13.4	-11.3	-6.0	-5.0	-5.9	-5.6	-5.8	-4.2
Total financing	7.4	2.8	1.3	-1.7	1.1	2.0	3.1	1.6
External financing	8.4	5.1	0.2	0.3	0.6	1.0	1.4	1.3
Domestic financing	-1.1	-2.4	1.0	-2.0	0.5	0.9	1.7	0.4
Memorandum items:								
Nominal GDP (in millions of pa'anga)	774.8	800.6	779.3	803.6	846.1	881.9	881.9	910.7
Grants in-kind (in percent of GDP)	...	...	7.2	8.9	11.6	9.7	9.7	11.0
Total external public debt outstanding (in percent of GDP)	36.0	41.8	45.3	42.1	44.2	42.7	43.1	42.4

Sources: Tongan authorities; and IMF staff estimates.

1/ Recurrent expenditure excludes one-off expenditure.

Table 3. Tonga: Depository Corporations Survey, FY2011–17 1/

	FY2011	FY2012	FY2013	FY2014	FY2015	Proj.	
						FY2016	FY2017
(In millions of pa'anga, end of period)							
Net foreign assets	195.9	240.4	252.6	268.5	283.2	305.5	308.0
Claims on nonresidents	224.3	267.9	277.7	299.8	316.7	345.0	347.5
NRBT	206.0	254.2	268.5	284.0	300.0	328.6	331.1
Other depository corporations	18.3	13.8	9.1	15.8	16.8	16.4	16.4
Liabilities to Nonresidents	-28.4	-27.5	-25.1	-31.2	-33.5	-39.5	-39.5
NRBT	-22.0	-17.5	-18.0	-18.2	-19.5	-20.2	-20.2
Other depository corporations	-6.4	-10.0	-7.0	-13.0	-14.0	-19.3	-19.3
Net domestic assets	109.6	86.6	91.3	100.4	120.1	139.2	174.8
Net domestic credit	243.7	209.1	214.3	231.1	266.8	302.0	339.6
Net claims on government	-31.4	-58.9	-44.4	-54.4	-50.0	-35.1	-31.8
Claims on public nonfin. corps.	13.6	13.7	16.8	41.7	47.5	45.9	45.9
Claims on private sector	261.5	247.9	229.3	230.9	250.7	274.3	308.5
Other items, net	-134.1	-122.5	-123.0	-130.8	-146.7	-162.8	-164.8
Total liquidity	305.4	326.9	343.8	368.9	403.3	444.7	482.8
Broad money (M2)	293.7	314.9	334.1	358.3	390.4	431.6	469.4
Narrow money	96.8	119.4	149.4	167.7	182.1	185.2	188.4
Quasi money	196.9	195.6	184.7	190.7	208.3	246.4	281.0
Securities other than shares 2/	11.8	11.9	9.7	10.5	12.9	13.1	13.4
(Annual percentage change)							
Net foreign assets	36.9	22.7	5.1	6.3	5.5	7.9	0.8
Net domestic assets	-28.5	-20.9	5.4	9.9	19.7	15.9	25.5
Net domestic credit	-12.3	-14.2	2.5	7.8	15.4	13.2	12.4
Claims on private sector	-9.9	-5.2	-7.5	0.7	8.6	9.4	12.5
Total liquidity	3.1	7.0	5.2	7.3	9.3	10.3	8.6
Broad money (M2)	3.3	7.2	6.1	7.2	9.0	10.6	8.8
(In millions of U.S. dollars)							
Net foreign assets	116.1	137.3	138.8	150.1	134.6	147.4	150.7
Claims on nonresidents	133.0	153.1	152.6	167.5	150.5	166.5	170.1
NRBT	122.1	145.2	147.6	158.7	142.5	158.6	162.0
ODCs	10.9	7.9	5.0	8.8	8.0	7.9	8.0
Liabilities to nonresidents	-16.8	-15.7	-13.8	-17.5	-15.9	-19.1	-19.3
Memorandum items:							
Velocity (GDP/average M2)	2.6	2.5	2.3	2.2	2.2	2.0	1.9
Loan to deposit ratio	94.0	84.2	73.5	69.9	70	...	...
Pa'anga per U.S. dollar (end of period)	1.7	1.8	1.8	1.8	2.1	...	...

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, FY2011–17

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

	FY2011	FY2012	FY2013	Prel. FY2014	Est. FY2015	Proj. FY2016 FY2017	
Trade balance	-189.7	-186.6	-172.4	-169.7	-198.6	-200.9	-221.9
Exports, f.o.b.	13.6	16.7	15.0	17.9	17.9	16.3	16.2
Imports, f.o.b.	-203.4	-203.4	-187.4	-187.6	-216.5	-217.2	-238.1
Services (net)	4.7	-7.7	0.3	1.3	-2.0	0.7	-5.3
Receipts	60.6	72.4	81.8	64.2	58.4	61.3	64.4
Payments	-55.9	-80.1	-81.5	-62.9	-60.4	-60.5	-69.6
Investment income (net)	12.9	12.1	11.4	4.7	4.5	3.8	4.6
Receipts	24.1	23.4	24.2	21.8	22.5	22.7	24.5
Payments	-11.2	-11.3	-12.7	-17.1	-18.0	-18.9	-19.8
Current transfers (net)	96.0	123.8	140.3	128.6	144.7	183.4	191.0
Official transfers (net) 1/	20.7	35.3	28.3	17.6	21.1	38.6	43.7
Private transfers (net)	75.3	88.5	112.0	111.0	123.6	144.8	147.3
Current account balance	-76.1	-58.5	-20.4	-35.1	-51.4	-13.0	-31.5
(In percent of GDP)	-18.0	-12.4	-4.5	-7.9	-11.8	-3.1	-7.1
Capital account balance	44.7	56.4	25.5	14.2	20.0	14.3	16.6
Financial account balance	17.6	27.7	-2.7	16.2	14.2	14.7	18.4
FDI (net)	6.6	-1.6	5.3	11.7	11.7	12.0	12.8
Other investment (net)	11.0	29.3	-8.0	4.5	2.5	2.6	5.6
Overall balance 2/	34.6	23.1	2.4	11.2	-16.2	16.0	3.4
Memorandum items:							
Gross official foreign reserves	122.1	145.2	147.6	158.7	142.5	158.6	162.0
<i>In months of next year's goods and services</i>	5.2	6.5	7.1	6.9	6.2	6.2	5.7
Exchange rate							
Pa'anga per U.S. dollar (period average)	1.8	1.7	1.7	1.8	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.7	1.8	1.8	1.8	2.1	...	...
Nominal GDP (in millions of US\$)	422.9	472.3	449.5	443.4	435.4	422.3	442.5
Commodity price indexes (2005 = 100)							
Food	165.5	178.5	176.9	173.9	155.6	137.1	132.5
Fuel	91.5	104.5	104.5	100.2	73.5	42.8	37.9

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, FY2011–21 1/

	FY2011	FY2012	FY2013	FY2014	Est.		Proj.				
					FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
(Annual percentage change)											
Output and prices											
Real GDP	2.7	0.9	-3.1	2.1	3.7	3.1	2.3	2.5	2.9	1.8	1.8
Consumer prices (end of period)	7.1	2.3	0.2	1.5	0.2	-0.9	0.1	3.0	3.0	3.0	2.5
Consumer prices (period average)	6.0	3.3	0.7	2.3	0.1	-0.2	-0.4	1.6	3.0	3.0	2.7
GDP deflator	5.8	2.4	0.5	1.0	1.5	1.1	0.9	1.6	3.0	3.0	2.7
(In percent of GDP)											
Central government finance											
Total revenue and grants	26.3	27.4	25.2	27.5	28.2	27.3	27.4	28.6	28.8	29.7	29.6
Total revenue	19.5	18.0	19.6	20.0	21.4	23.7	24.1	24.6	24.7	25.2	25.3
Of which: tax revenue	17.2	15.8	17.0	17.3	18.3	20.4	20.7	21.0	21.1	21.6	21.7
Grants	6.8	9.4	5.6	7.5	6.7	3.6	3.4	4.0	4.1	4.4	4.2
Total expenditure and net lending	33.7	30.2	26.5	25.7	29.3	30.4	29.1	29.5	29.6	29.8	29.7
Current expenditure	22.7	23.5	24.9	25.0	25.8	27.8	26.4	26.1	26.0	25.9	25.9
Capital expenditure	9.6	5.6	1.6	0.9	2.4	1.7	1.9	2.5	2.8	3.3	3.1
Net lending	1.4	1.1	0.0	-0.2	1.1	0.9	0.8	0.8	0.7	0.7	0.7
Overall balance (incl. grants)	-7.4	-2.8	-1.3	1.7	-1.1	-3.1	-1.6	-0.8	-0.7	-0.2	-0.1
External financing (net)	8.4	5.1	0.2	0.3	0.6	1.4	1.3	2.1	0.8	0.8	0.3
Domestic financing (net)	-1.1	-2.4	1.0	-2.0	0.5	1.7	0.4	-1.2	-0.1	-0.6	-0.2
Primary balance (incl. grants)	-6.6	-1.9	-0.4	2.6	-0.2	-2.2	-0.8	0.0	0.0	0.6	0.6
Primary balance (excl. grants)	-13.4	-11.3	-6.0	-5.0	-5.9	-5.8	-4.2	-4.0	-4.0	-3.8	-3.6
(In millions of U.S. dollars)											
Balance of payments											
Exports, f.o.b.	13.6	16.7	15.0	17.9	17.9	16.3	16.2	16.6	17.1	17.5	18.0
(Annual percent change)	39.9	22.9	-10.6	19.5	0.0	-8.9	-0.5	2.4	3.0	2.5	2.7
Imports, f.o.b.	-203.4	-203.4	-187.4	-187.6	-216.5	-217.2	-238.1	-266.2	-275.3	-276.1	-280.0
(Annual percent change)	16.9	0.0	-7.8	0.1	15.4	0.3	9.6	11.8	3.4	0.3	1.4
Services (net)	4.7	-7.7	0.3	1.3	-2.0	0.7	-5.3	-7.1	-2.6	4.9	-2.2
Investment income (net)	12.9	12.1	11.4	4.7	4.5	3.8	4.6	5.8	6.7	6.4	6.7
Transfers (net)	96.0	123.8	140.3	128.6	144.7	183.4	191.0	202.6	205.3	216.1	221.7
Of which: Remittances	68.3	77.2	107.4	102.7	107.7	125.1	127.4	132.4	137.7	143.8	149.8
Current account balance	-76.1	-58.5	-20.4	-35.1	-51.4	-13.0	-31.5	-48.3	-48.9	-31.2	-35.8
(In percent of GDP)	-18.0	-12.4	-4.5	-7.9	-11.8	-3.1	-7.1	-10.5	-10.1	-6.2	-6.8
Capital account balance	44.7	56.4	25.5	14.2	20.0	14.3	16.6	18.6	16.9	18.1	17.6
Financial account balance	17.6	27.7	-2.7	16.2	14.2	14.7	18.4	25.9	21.1	21.9	20.2
FDI (net)	6.6	-1.6	5.3	11.7	11.7	12.0	12.8	13.4	14.1	14.8	15.5
Other investment (net)	11.0	29.3	-8.0	4.5	2.5	2.6	5.6	12.5	7.1	7.2	4.7
Overall balance	34.6	23.1	2.4	11.2	-16.2	16.0	3.4	-3.8	-10.9	8.9	1.9
Gross international reserves (end of period)											
In millions of U.S. dollars	122.1	145.2	147.6	158.7	142.5	158.6	162.0	158.2	147.4	156.3	158.2
In months of next year's goods and services imports	5.2	6.5	7.1	6.9	6.2	6.2	5.7	5.3	5.0	5.2	5.0
External debt (in percent of GDP)											
Public sector external debt	36.0	41.8	45.3	42.1	44.2	43.1	42.4	43.2	41.9	41.0	39.6
Debt service ratio	28.9	1.4	1.7	1.7	1.8	1.7	1.6	1.5	2.9	3.2	3.6
Memorandum items:											
Private transfers (net, in millions of U.S. dollars)	75.3	88.5	112.0	111.0	123.6	144.8	147.3	153.0	159.1	166.2	173.1
(In percent of imports of goods and services)	29.1	31.2	41.7	44.3	44.6	52.1	47.9	44.5	44.7	46.6	47.6
Nominal GDP (millions of pa'anga)	774.8	800.6	779.3	803.6	846.1	881.9	910.7	948.4	1004.9	1053.2	1101.5

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

1/ Fiscal year beginning July.

Table 6. Tonga: Financial Soundness Indicators, FY2009–15 1/

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
	(In percent)						
Financial sector							
Total loans/GDP	52.5	42.9	35.5	33.5	30.5	33.9	35.2
Banks							
Net domestic credit	(Year-on-year percent change)						
Public non-financial corporations	-1.1	229.0	-12.0	3.1	19.7	148.4	14.0
Private sector	-3.7	-15.6	-9.9	-5.2	-7.5	0.7	8.6
	(In percent)						
Risk-weighted capital adequacy ratio	22.1	18.9	23.9	30.5	35.9	39.8	39.0
Net interest income to average assets	4.7	4.5	3.9	3.8	3.8	3.6	3.7
Non-performing loans	20.5	15.3	15.2	15.3	13.9	12.7	10.0
Loan loss reserves to gross loans	13.3	14.8	15.0	11.6	11.0	7.8	...
Sources: National Reserve Bank of Tonga; and IMF, <i>International Financial Statistics</i> .							
1/ Data as of end of fiscal years.							

Table 7. Tonga: Millennium Development Goals, 1990–2015 1/

	Base					Degree of Achievement
	1990	1990-95	2005-10	2011-14	2015	
Goal 1: Eradicate extreme poverty and hunger						
Proportion of people living below National Poverty Line (%)	...	...	22.5	...	...	Below target
Income share held by lowest 20%	...	...	6.6	...	...	Below target
GDP per person employed (constant 1990 PPP \$)	...	...	...	...	...	Below target
Employment to population ratio, 15+, total (%)	...	...	...	...	...	Below target
Prevalence of underweight, weight for age (% of children under 5)	...	...	...	1.9	...	On target
Prevalence of undernourishment (% of population)	...	...	...	...	...	On target
Goal 2: Achieve universal primary education						
Total enrollment, primary (% net)	92.3	92.6	98.9	84.6	...	On target
Persistence to last grade of primary, total (% of cohort)	...	...	90.4	...	...	On target
Literacy rate, adult total (% of people ages 15 and above)	...	...	99.0	99.4	...	On target
Goal 3: Promote gender equality and empower women						
Ratio of female to male primary enrollment (%)	1.0	1.0	1.0	1.0	...	On target
Ratio of female to male secondary enrollment (%)	1.0	1.0	1.1	1.0	...	On target
Ratio of female to male enrollments in tertiary education (%)	...	...	...	...	...	On target
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	...	...	...	...	...	Below target
Proportion of seats held by women in national parliaments (%)	0.0	0.0	0.0	0.0	0.0	Below target
Goal 4: Reduce child mortality						
Mortality rate, under-5 (per 1,000)	21.9	18.9	17.4	17.1	16.7	On target
Mortality rate, infant (per 1,000 live births)	18.7	16.2	15.0	14.7	14.4	On target
Immunization, measles (% of children ages 12–23 months)	86.0	94.0	68.0	67.0	...	On target
Goal 5: Improve maternal health						
Maternal mortality ratio (national estimate, per 100,000 live births)	...	...	36.4	...	...	On target
Births attended by skilled health staff (% of total)	...	92.0	98.4	98.0	...	On target
Contraceptive prevalence (% of women ages 15–49)	...	...	31.5	34.1	...	Below target
Adolescent fertility rate (births per 1,000 women ages 15–19)	25.5	23.7	17.6	15.4	...	Below target
Pregnant women receiving prenatal care (%)	...	...	97.9	...	...	Near target
Unmet need for contraception (% of married women ages 15–49)	...	...	...	...	...	Below target
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Prevalence of HIV, total (% of population ages 15–49)	...	...	...	...	...	On target
Condom use at last high-risk sex	...	...	...	...	...	Near target
Proportion of population aged 15–24 years with comprehensive knowledge of HIV/AIDS	...	...	...	...	...	Off target
Incidence of tuberculosis (per 100,000 people)	36.0	37.0	17.0	14.0	...	On target
Tuberculosis case detection rate (% of all forms)	67.0	57.0	63.0	88.0	...	On target
Incidence and prevalence associated with obesity	...	...	...	...	...	Below target
Goal 7: Ensure environmental sustainability						
Forest area (% of land area)	12.5	12.5	12.5	12.5	...	Near target
CO2 emissions (kg per PPP \$ of GDP)	0.2	0.2	0.2	0.2	...	On target
CO2 emissions (metric tons per capita)	0.8	1.0	1.1	1.0	...	On target
Marine protected areas, (% of territorial water)	0.0	9.4	9.4	9.4	...	Near target
Improved water source (% of population with access)	98.6	98.6	99.2	99.6	99.6	Near target
Improved sanitation facilities (% of population with access)	94.4	93.7	91.6	91.0	91.0	Near target
Goal 8: Develop a global partnership for development						
Aid per capita (current US\$)	...	...	...	...	...	On target
Telephone lines (per 100 people)	4.6	6.9	29.8	11.3	...	Near target
Mobile cellular subscriptions (per 100 people)	0.0	0.3	52.2	64.3	...	Near target
Internet users (per 100 people)	0.0	0.1	16.0	40.0	...	Near target

Sources: World Bank, *World Development Indicators*; and Tonga Millennium Development Goals Final Report.

1/ Latest available data are reported for each time period.

Appendix I. Risk Assessment Matrix¹

Source	Likelihood	Impact	Policy Response to Minimize Impact
EXTERNAL RISKS			
<p>Structurally weak growth in key 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.</p>	High/Medium	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.
<p>Significant China slowdown Tonga would be affected indirectly through China's trade links with New Zealand/Australia, and directly through a slowdown in Chinese official development assistance</p>	Low/Medium	Medium	
<p>Persistently lower energy prices Tonga would on balance benefit from the lower energy prices. However, persistently lower oil prices would discourage certain investments, including in seabed mining and renewable energy.</p>	High	Low	
<p>Reduced financial services by global/regional banks ("de-risking") Stricter global regulatory requirements could further push MTO to close down, which could potentially increase the cost of inward remittances.</p>	Medium	Low	
DOMESTIC RISKS			
<p>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.</p>	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.
<p>Cost overrun relating to the 2019 South Pacific Games and wage pressure Excessive wage growth and/or 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.</p>	Medium/High	High	
<p>Natural disasters (regional) Natural disasters similar to the recent cyclone could take significant toll on Tonga, such as damages to infrastructure and production base.</p>	Low/medium	High	Prepare for future disaster by: (i) building fiscal space and maintaining international reserve buffers, (ii) participating in catastrophic insurance schemes; and (iii) following disasters, using programs and funds available through 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.

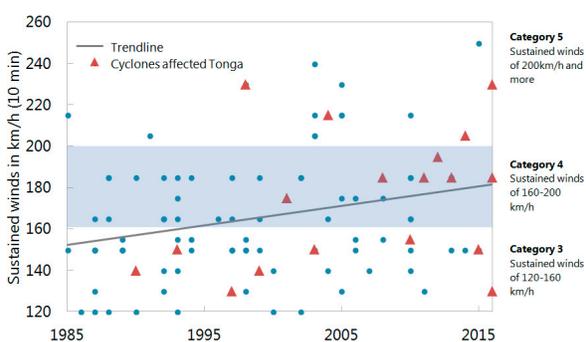
Appendix II. Frequency and Impact of Natural Disasters in Tonga¹

Tonga faces a high risk to natural disasters. Tonga, a small island close to equator, is exposed to cyclones, floods, earthquake, droughts, and sea-level rise. In the past five years, Tonga was affected by natural disasters more frequently than previously, with average sustained winds of cyclones passing through Tonga increasing. In early 2016, cyclone Ula battered northern islands of Tonga with minimum damage. In February, tropical cyclone Winston double hit Tonga within a week, leaving some minor damage and power outage. The United Nation University's World Risk Index ranked Tonga second of 171 countries in 2015, up one rank from 2014 on account of deteriorating adaptive capacities.

Type	Date	Total damage (in thousands of US\$)	Total affected (persons)	Total deaths (persons)
Storm	16-Mar-61	...	8000	2
Storm	04-Dec-73	500	...	3
Earthquake	23-Jun-77	1200	5505	1
Storm	27-Dec-77	1100	10005	...
Storm	03-Mar-82	21200	146512	6
Storm	30-May-82	1100	...	1
Storm	02-Apr-90	2500	3103	1
Storm	16-Mar-97	...	3000	...
Storm	26-Dec-98	...	3071	...
Storm	31-Dec-01	51300	16500	...
Earthquake	29-Sep-09	9500	...	9
Storm	25-Jan-11	3000	...	...
Storm	06-Jan-14	31000	4014	1

Source: EM-DAT database.

Strong Tropical Cyclones in the South Pacific, 1985-2016



Source: Meteorological Service of New Zealand, Regional Specialized Meteorological Center in Nadi, Fiji

Average losses from disasters in Tonga have been substantial. Across the Pacific, which is the most vulnerable region in per capita terms, Tonga is among the most affected by disasters over the past 20 years. According to data on the costs of recent disasters (for example, storms, floods, earthquakes, volcanic activity, etc.) from the EM-DAT database (see also table above), Tonga suffered damages and losses to property, crops, and livestock equivalent to about 1.9 percent of annual GDP over the period from 1996 to 2015. This is second only to Vanuatu, which experienced massive losses in 2014 after Cyclone Pam.

In addition to human cost and damages, natural disasters also lower long term growth, weaken fiscal position and the current account.

For damage and losses equivalent to 1 percent of GDP, growth drop by 0.7 percentage point in the year of the disaster, according the IMF recent research.² Actual damages and losses during 1980-2014 reduced trend growth by 0.7 percent. Additionally, post-cyclone incomes do not recover for 20 years, effectively pushing the GDP trajectory downwards, and that a 90th

Estimated Impact of Cyclone Ian

(In percent of GDP)

	FY 2014			FY 2015		
	Pre	Post	Difference	Pre	Post	Difference
Total expenditure and net lending	26.3	25.7	-0.6	26.8	29.3	2.5
Current account (in percent of GDP)	-5.4	-7.9	-2.5	-2.7	-11.8	-9.1

Sources: Tongan authorities; and IMF staff estimates.

¹ Prepared by Agnes Isnawangsih (IMF) and Johannes Wolf (AsDB).

² IMF Working Paper 15/125.

percentile event (i.e. wind speeds of up to 19.5 meters per second) can effectively undo 3.7 years of average development.³ Recent cyclone Ian in January 2014 is estimated to cost 45.4 million US\$ or 11 percent of GDP.⁴ Staff estimates a weakening of current account by 2.5 percent of GDP in FY2014 and 9.1 percent in FY2015 and an increase in total expenditure by 2.5 percent of GDP in FY2015.

³ S.M. Hsiang and A.S. Jina. 2014. The Causal Effect of Environmental Catastrophe on Long Run Economic Growth: Evidence from 6,700 Cyclones. NBER Working Paper. No. 20352. Cambridge, MA.

⁴ IMF 2014 Staff Report.



TONGA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 26, 2016

Prepared By

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

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FUND RELATIONS ¹

Membership Status

Joined September 13, 1985; Article VIII.

General Resources Account

	SDR Million	Percent Quota
Quota	13.80	100.00
Total holdings of currency	10.36	75.10
Reserve position in the Fund	3.44	24.90

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	6.58	100.00
Holdings	5.37	81.54

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 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

¹ As of April 20, 2016.

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 February 2015. On April 24, 2015, the Executive Board of the IMF concluded the 2015 Article IV consultation with Tonga and endorsed the thrust of the staff appraisal (IMF Country Report No. 15/107).

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. Tubagus Feridhanusetyawan is the resident representative.

PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2016–17¹

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. Since 2014, TA has been provided by the IMF in the compilation of National Accounts and in balance of payments (BOP) and government finance statistics (GFS). Support has also been provided to the National Reserve Bank of Tonga (NRBT) in off-site and on-site banking supervision.

Strategy 2016–17

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

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 be primarily to assist the authorities to implement high priority reforms identified in the Roadmap, including accounting and reporting improvements (1.7); and planning for upgrading the government's FMIS (1.7). PFTAC will also support the Government's efforts to develop 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 to implement a follow-up PEFA assessment, probably in 2018 (1.1).

In the revenue area, assistance was provided to facilitate: (a) the design and implementation of a compliance improvement strategy that guides operational activities towards mitigating major compliance risks; and (b) the implementation of a new function based organizational structure targeted towards streamlining operations and alleviating duplicated processes. Additional technical assistance to improve core tax functions is scheduled to take place in FY2017. Legal assistance to

¹ As of April, 2016.

review and benchmark the Revenue Services Administration Act against international best practice has been provided with enactment of proposed amendments scheduled to take place by end-2016.

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 and range of statistics and source data need to be strengthened. Engagement with the Tonga Department of Statistics (TDS) has strengthened since 2014, when PFTAC took over the provision of national accounts TA; from 2011 to early 2013, this was led by an AusAID (now DFAT) funded resident advisor, with limited PFTAC input. Recent work has focused on the use of tax returns to estimate GDP by production, which would support a future rebase and, potentially, quarterly GDP estimation. BOP and GFS support were provided by IMF HQ until 2015 but are now to be delivered by PFTAC, within its budget envelope.

In financial sector supervision, IMF/PFTAC over the past few years assisted the NRBT 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 support with performing actual on-site examinations of a number of commercial banks (3.4, 3.5) which includes examination preparedness, scoping, planning, execution, and report writing. PFTAC further reviewed the NRBT's complete set of Prudential Statements and drafted additional guidelines to ensure compatibility with the amendments made to the Financial Institution Act. 2015/16 will also see the introduction of a comprehensive credit union program aimed at overhauling the oversight of credit unions (3.9). In March 2016 the IMF Legal Department completed a desk review of the Financial Institutions Act.

In the macroeconomic area, technical assistance (TA) in 2015 was provided jointly by PFTAC and a secondee from the Reserve Bank of New Zealand, who was recruited by PFTAC and funded by the ADB, to build capacity for macroeconomic forecasting and analysis and link this analysis into budget processes. The TA focused on developing a forecasting framework for GDP (5.1) and the construction of a financial programming framework (5.2)—the Tonga Projection (TOP) Model. In October 2015 staff from the Ministry of Finance and National Planning (MFNP), the Tonga Department of Statistics (TDS) and the Ministry of Revenue and Customs (MORC) participated in a five day workshop on practical applications of the TOP Model. Subsequent collaboration by MFNP and MORC staff led to the development of a satellite revenue forecasting tool. The MORC tax tool uses the MFNP's industry-level GDP forecasts as well as historical tax collection data and internal information on tax trends, including the effects of compliance improvement and risk management activities, to forecast tax revenues at a more disaggregated level than the TOP Model. Staff also participated in a High Level Dialogue Meeting on Enhancing Resilience to Natural Disasters in Pacific Islands (5.4) and workshops on Strengthening Fiscal Frameworks in the Pacific Islands, Medium-Term Expenditure Planning for National Sustainable Development and Forecasting Tax Revenues (5.2).

WORLD BANK-IMF COLLABORATION¹

The IMF team led by Ms. Elena Loukoianova (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 provided support and analytical inputs to the Article IV mission, as with previous missions. In addition, Bank and Fund staffs prepared jointly the Debt Sustainability Analysis appendix to the staff report.
- **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 staff share a common view about Tonga's macroeconomic and structural reform priorities, which mainly aims at mitigating the risks to Tonga's external and fiscal sustainability and at promoting long-term growth. These include:

- **Sustainable fiscal management.** Construction costs for the South Pacific Games (SPG) 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 further improvements in 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 of services such as energy, water, and telecommunications in order to reduce costs;

¹ As of March 2016.

- (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 depth of policy dialogue and the difficult economic and fiscal position Tonga has been facing, the Bank has significantly scaled up both analytical and financial support for Tonga. Total IDA and Trust Fund commitments to Tonga over the past six years amount to nearly US\$140 million, compared to US\$30 million between 1985—when Tonga became a member—and FY2010.

A key focus of engagement has been around budget support operations. There have been annual World Bank budget support operations for each of the six years FY2011 to FY2016 to provide a total of US\$27.8 million to support fiscal, business-environment improving, public financial management, and energy sector reforms as part of a World Bank-led multi-donor process. A further two budget support operations are planned for FY2017 and FY2018, to complete the current programmatic series.

Other World Bank investments support connectivity for sustainable economic development, and include fiber-optic connectivity, transport sector reform, and aviation sector support, as well as support to climate change and disaster resilience-building.

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 2016–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 2016–January 2018)		
	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • Procurement IT systems TA • Social protection and disaster risk management TA • Second inclusive growth development policy operation • Credit registry TA • Business successes and failures • Fiscal anchor TA • Tax exemptions TA 	<ul style="list-style-type: none"> • FY2016 • FY2017 • FY2017 • FY2017 • FY2018 • FY2017 • FY2017
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 • June 2016

RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

The goal of the Asian Development Bank's (AsDB) Pacific Approach 2010–14 (extended until 2016) of a sustained and resilient, improved standard of living aligns with the vision of the Tonga Strategic Development Framework (TSDF) II, covering the period 2015–25, to create a more progressive Tonga supporting a higher quality of life for all. AsDB's Country Operations Business Plan 2016-18 for Tonga supports the focus of the Pacific Approach and the TSDF II.

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 national outcomes of the TSDF II supported by AsDB are: a more inclusive, sustainable and dynamic knowledge-based economy; more inclusive, sustainable, and balanced urban and rural development across island groups; responsive good-governance strengthening rule of law; sustainable and successful provision and maintenance of infrastructure and technology; and, effective land and environment management, with resilience to climate change and risk.

AsDB has approved 15 loans and 14 grants² totaling US\$146.08 million from the Asian Development Fund (ADF) and other sources to Tonga since it joined AsDB in 1972. Total of 69 technical assistance (TA) projects (including supplementary financing) with a value of US\$22.42 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, information and communication technology, agriculture, and fisheries.

Active projects include five grant-financed projects 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 co-financing from Australia) and the Outer Island Renewable Energy project (with co-financing from Australia, Denmark and the European Union); and climate resilience through the Climate Resilience Sector project financed by the Strategic Climate Fund. The Cyclone Ian Recovery project (with co-financing from New Zealand) approved in 2014 has climate- and disaster-proofed education and energy infrastructure on the Ha'apai Island group damaged by cyclone Ian in January 2014. There are no active country-specific TA projects but Tonga benefits from a number of regional TA projects in private sector development, economic management, energy efficiency, information and communication technology, and public financial management. The AsDB is active in the joint policy reform discourse with the Government of Tonga and other development partners, which is linked to budget support disbursements through AsDB's policy-based lending modality.

¹ As of March 2016.

² Includes financing from other sources including bilateral contributions, which are counted separately from AsDB financing in the number of grant approvals.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2010–15						
	2010	2011	2012	2013	2014	2015
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						
Number	0	3	0	4	2	3
Amount (in millions of US\$)	0.0	22.20	0.0	30.25	8.79	5.76
Technical assistance approvals						
Number	2	2	3	1	1	1
Amount (in millions of US\$)	0.52	1.18	1.38	1.33	0.68	0.30

STATISTICAL ISSUES

TONGA—STATISTICAL ISSUES APPENDIX As of April 20, 2016
I. Assessment of Data Adequacy for Surveillance
<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) on 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 (2012-13), 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 2009-10 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.</p>
<p>Government Finance Statistics: The FY2003 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 FY2015 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 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: Tonga compiles FSIs but has not reported them to the Fund yet.</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>	
<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) and international investment position (IIP) statistics on a quarterly basis in BPM6 format. These statistics are reported 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.</p> <p>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 NBRT since May 2014 and the International Investment Survey (IIS) has been carried out by the SD since 2014.</p> <p>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 to improve the 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, and 5) provision of sufficient resources for undertaking the IIS regularly.</p>	
<p>II. Data Standards and Quality</p>	
<p>The country has been participating in the GDDS since May 30, 2006.</p>	<p>No data ROSC is available.</p>

Tonga: Table of Common Indicators Required for Surveillance

As of April 20, 2016

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	Mar-16	Apr-16	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Mar-16	Apr-16	M	M	M
Reserve/Base Money	Feb-16	Mar-16	M	M	M
Broad Money	Feb-16	Mar-16	M	M	M
Central Bank Balance Sheet	Feb-16	Mar-16	M	M	M
Consolidated Balance Sheet of the Banking System	Feb-16	Mar-16	M	M	M
Interest Rates ²	Feb-16	Mar-16	M	M	M
Consumer Price Index	Feb-16	Mar-16	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2014/15	Mar-16	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2014/15	Mar-16	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	2014/15	Mar-16	A	A	A
External Current Account Balance	Q2/2015	Mar-16	Q	Q	Q
Exports and Imports of Goods and Services	Nov-2015	Jan-16	M	M	M
GDP/GNP	2014/15	Mar-16	A	A	A
Gross External Debt	2014/15	Mar-16	A	A	A
International Investment Position	Q2/2015	Mar-16	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

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION— DEBT SUSTAINABILITY ANALYSIS

May 26, 2016

Approved By
**Hoe Ee Khor and Peter
Allum (IMF) and IDA**

Prepared by:
International Monetary Fund and the International
Development Association

Risk of external debt distress	Moderate
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This is the second update of the debt sustainability analysis (DSA) conducted jointly by the IMF and the World Bank since 2014.¹ The results for external debt indicate that Tonga remains at a moderate risk of debt distress, and the highest risk to debt sustainability emanates from a combination of shocks to GDP, exports, the U.S. dollar deflator and grants. Analysis of public debt points to risks stemming from strong wage growth.

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 in April 2016, Factsheet URL: <http://www.imf.org/external/np/exr/facts/jdsf.htm>, 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. With the latest three-year average score of 3.47, Tonga is classified as a medium performer according to the World Bank Country Policy and Institutional Assessment (CPIA).

UNDERLYING ASSUMPTIONS

Compared with the DSA update in 2015, the underlying assumptions remain broadly stable (Table 1) with growth converging to 1.8 percent in the medium-term to factor in downside effects of periodic shocks from natural disasters. The following highlights the main changes:

- With the new global price outlook, the GDP and exports deflators have been revised downward, leading to lower nominal GDP and exports during the projection period.
- The fiscal balance deteriorates versus the previous DSA, reflecting higher wage spending and lower grants from development partners, and assuming more financing to Tonga in the form of loans.

Tonga: Key Macroeconomic Assumptions

	2014 DSA 2014-19 avg	2015 DSA 2015-20 avg	2016 DSA 2016-21 avg
Real GDP	2.26	2.44	2.40
GDP deflator (percent change)	2.66	2.06	0.84
Overall fiscal balance (percent of GDP)	-0.15	-0.90	-1.11
Primary balance (percent of GDP)	0.77	0.06	-0.30
Growth of exports of G&S (U.S. dollar terms)	5.58	7.90	4.62
Growth of imports of G&S (U.S. dollar terms)	5.86	6.03	4.76
Current account (percent of GDP)	-3.63	-5.16	-7.28

Sources: national authorities; and IMF staff estimates.

The current account deficit also worsens, assuming larger non-debt creating inflows (capital grants cash and in-kind) in the run-up to the South Pacific Games (SPG).

EXTERNAL DSA

Under the baseline scenario, all Tonga's external debt distress indicators remain below their country-specific policy-based indicative thresholds (Figure 1). The rise in debt service ratios from 2019 to 2029 reflects mostly repayments of the two external loans from China EXIM Bank. The bound tests demonstrate that with a combined shock to GDP, exports, the U.S. dollar GDP deflator and non-debt creating inflows, three debt ratios (PV of debt-to-GDP+remittances, PV of debt-to-exports+remittances and debt service-to-revenue) breach their respective thresholds, two of which significantly and on a more sustained basis, suggesting a moderate risk of debt distress.

Additional risks arise from a potential shortfall of donor grants to finance the SPG and periodic spending to respond to natural disasters. To illustrate these risks, an alternative scenario has been prepared assuming about T\$100 million being borrowed to finance the capital costs of the games during FY2016–19, on the terms of China's EXIM Bank loan (2 percent interest, 20-year maturity, and 5-year grace period).² It is also assumed that natural disasters once every 4 years, leading to a decline in GDP by about 2 percentage points and to additional spending on recovery, amounting to about one percent of GDP in the following years. Although past recovery efforts have been generously grant-financed by donors, the assumption is that financing will diminish going forward. Compared to the baseline scenario, debt ratios will increase, narrowing their distance to thresholds

² The most recent projections of the costs of the SPG range from T\$80 million to T\$100 million. This is down from previous estimates to reflect the authorities' decision to utilize existing facilities rather than construct new accommodations.

significantly but not breaching them. Hence, the moderate risk rating remains under this alternative scenario.

PUBLIC SECTION DSA³

Under the baseline scenario, the present value of public debt is projected to remain below the benchmark throughout the projection period (Figure 2), steadily decreasing to below 20 percent of nominal GDP. However, in the scenarios in which the primary balance remains at the level of 2016 throughout the projected period, or the public wage bill grows at an average rate of the past three years (7 percent) during the projection period, public debt becomes unsustainable.

CONCLUSION

Compared to the DSA update of 2015,⁴ the risks to debt sustainability increased somewhat as demonstrated by the results of the most extreme shock simulations. Additional risks stem from the inability of the government to contain wage growth. However, the risk of external and public debt distress continues to be classified as moderate.

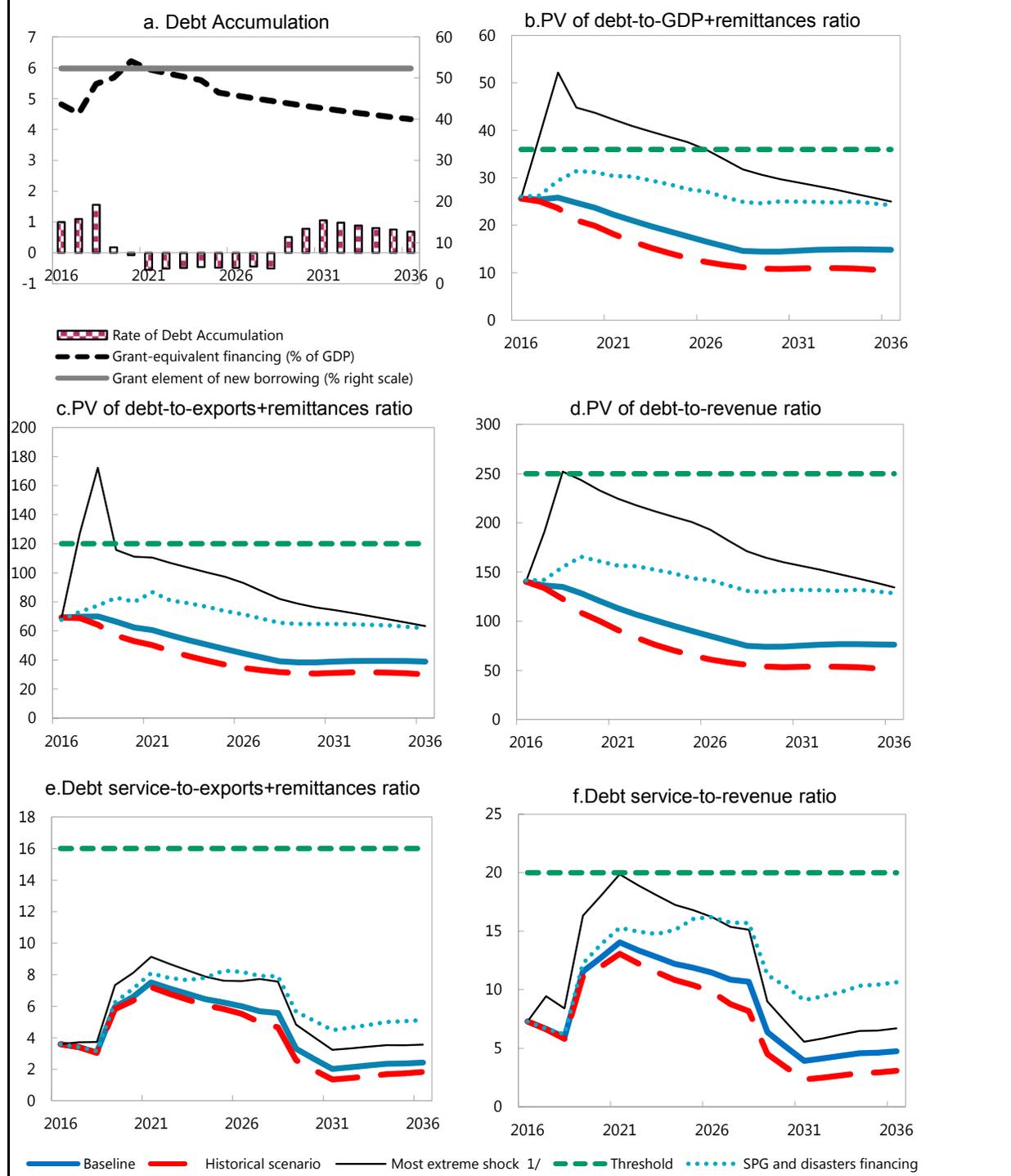
Authorities' views

The authorities broadly agreed with the staff assessment of debt sustainability risks. They strive to maintain robust debt policies. To that end, they have recently finalized the Debt Management Policy and are taking steps to alleviate debt burden, including negotiating debt forgiveness with the Bank of China (T\$8 million) and refinancing debt to the Pension Fund. They are concerned, however, that a higher share of loan financing by development partners (the World Bank and the Asian Development Bank) following Tonga's upgrade to a moderate level of risk of debt distress in 2014 could undermine debt sustainability. They agree with the staff that other risks emanate from the pressure to raise public sector wages and to finance the SPG, and that it is important to maintain fiscal buffers for contingencies, such as natural disasters.

³ 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 3.47. The Tonga fiscal year starts in July.

⁴ See [IMF Staff Report of the 2015 Article IV Consultation –Debt Sustainability Analysis Update](#).

Figure 1. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2016-2036 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 2026. In figure b. it corresponds to a Combination shock; in c. to a Combination shock; in d. to a Combination 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, 2016-2036 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 2026.

2/ Revenues are defined inclusive of grants.

Table 1. Tonga: DSA 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)	472	449	443	435	422	443	462	485	506	617	752	917
Real GDP (percentage change)	0.9	-3.1	2.1	3.7	3.1	2.3	2.5	2.9	1.8	1.8	1.8	1.8
GDP deflator (percentage change)	2.4	0.5	1.0	1.5	1.1	0.9	1.6	3.0	3.0	2.5	2.5	2.5
Fiscal												
Total revenue and grants	27.4	25.2	27.5	28.2	27.3	27.4	28.6	28.8	29.7	28.9	28.6	28.5
Foreign grants	9.4	5.6	7.5	6.7	3.6	3.4	4.0	4.1	4.4	3.7	3.5	3.3
Total expenditure	30.2	26.5	25.7	29.3	30.4	29.1	29.5	29.6	29.8	29.3	28.6	28.5
Interest payments	0.8	0.9	0.9	0.9	0.9	0.9	0.8	0.8	0.8	0.6	0.5	0.5
Overall balance	-2.8	-1.3	1.7	-1.1	-3.1	-1.6	-0.8	-0.7	-0.2	-0.5	0.0	0.0
Primary balance	-1.9	-0.4	2.6	-0.2	-2.2	-0.8	0.0	0.0	0.6	0.2	0.5	0.4
Net domestic financing	-2.4	1.0	-2.0	0.5	1.7	0.4	-1.2	-0.1	-0.6	0.2	-1.3	-1.1
Net external financing	5.1	0.2	0.3	0.6	1.4	1.3	2.1	0.8	0.8	0.2	1.3	1.1
Balance of payments												
Exports of goods and services	18.9	21.5	18.5	17.5	18.4	18.2	18.9	19.6	20.4	19.2	19.6	20.1
Imports of goods and services	60.0	59.8	56.5	63.6	65.8	69.5	74.5	73.3	70.6	67.8	67.1	67.5
Workers' remittances	16.3	23.9	23.2	24.7	29.6	28.8	28.7	28.4	28.5	28.6	28.7	28.9
Current account	-12.4	-4.5	-7.9	-11.8	-3.1	-7.1	-10.5	-10.1	-6.2	-5.9	-6.9	-7.1
Net foreign direct investment	-0.3	1.2	2.6	2.7	2.8	2.9	2.9	2.9	2.9	3.1	3.2	3.3
Gross official reserves	6.5	7.1	6.9	6.2	6.2	5.7	5.3	5.0	5.2	5.0	5.4	5.6
	(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.												

Table 2. Tonga: External Debt Sustainability Framework, Baseline Scenario, 2013–36 1/
(In percent of GDP, Unless Otherwise Indicated)

	Actual			Historical Average	Standard Deviation	Projections						2016-2021			2022-2036	
	2013.0	2014.0	2015.0			2016	2017	2018	2019	2020	2021	Average	2026	2036	Average	
External debt (nominal) 1/	45.3	42.1	44.2			43.1	42.4	43.2	41.9	41.0	39.6		34.0	32.4		
<i>of which: public and publicly guaranteed (PPG)</i>	45.3	42.1	44.2			43.1	42.4	43.2	41.9	41.0	39.6		34.0	32.4		
Change in external debt	3.4	-3.1	2.1			-1.1	-0.7	0.8	-1.3	-0.9	-1.4		-1.1	-0.2		
Identified net debt-creating flows	5.5	5.9	9.9			-1.1	3.3	6.5	6.0	2.5	3.2		2.0	3.3		
Non-interest current account deficit	3.9	7.2	11.1	11.1	6.4	2.4	6.4	9.8	9.4	5.5	6.2		5.3	7.0	6.1	
Deficit in balance of goods and services	38.3	38.0	46.1			47.4	51.3	55.6	53.7	50.2	50.2		48.3	47.5		
Exports	21.5	18.5	17.5			18.4	18.2	18.9	19.6	20.4	18.9		19.3	20.2		
Imports	59.8	56.5	63.6			65.8	69.5	74.5	73.3	70.6	69.1		67.6	67.7		
Net current transfers (negative = inflow)	-31.2	-29.0	-33.2	-28.1	3.6	-43.4	-43.2	-43.9	-42.3	-42.7	-42.1		-41.8	-40.2	-41.0	
<i>of which: official</i>	-6.3	-4.0	-4.9			-9.1	-9.9	-10.7	-9.5	-9.9	-9.2		-8.8	-8.5		
Other current account flows (negative = net inflow)	-3.2	-1.8	-1.7			-1.6	-1.7	-1.9	-2.0	-1.9	-1.9		-1.1	-0.3		
Net FDI (negative = inflow)	-1.2	-2.6	-2.7	-4.1	6.1	-2.8	-2.9	-2.9	-2.9	-2.9	-2.9		-3.1	-3.5	-3.2	
Endogenous debt dynamics 2/	2.8	1.4	1.5			-0.7	-0.3	-0.4	-0.5	-0.1	-0.1		-0.2	-0.3		
Contribution from nominal interest rate	0.7	0.7	0.7			0.8	0.7	0.7	0.7	0.6	0.6		0.4	0.3		
Contribution from real GDP growth	1.4	-1.0	-1.6			-1.4	-1.0	-1.0	-1.2	-0.7	-0.7		-0.6	-0.6		
Contribution from price and exchange rate changes	0.8	1.6	2.4			...	...	...	...	...	...		...	...
Residual (3-4) 3/	-2.1	-9.1	-7.8			0.0	-3.9	-5.8	-7.3	-3.4	-4.6		-3.1	-3.5		
<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/	...	...	34.1			33.2	32.8	33.3	31.8	30.4	28.6		21.3	19.1	
In percent of exports	...	...	194.6			180.9	180.0	175.8	162.5	149.1	151.6		110.6	94.6	
PV of PPG external debt	...	...	34.1			33.2	32.8	33.3	31.8	30.4	28.6		21.3	19.1	
In percent of exports	...	...	194.6			180.9	180.0	175.8	162.5	149.1	151.6		110.6	94.6	
In percent of government revenues	...	...	159.0			140.2	136.3	135.0	128.5	120.6	113.1		85.0	76.1	
Debt service-to-exports ratio (in percent)	7.5	9.2	9.8			9.4	8.8	7.7	14.6	15.8	18.8		14.9	5.9		
PPG debt service-to-exports ratio (in percent)	7.5	9.2	9.8			9.4	8.8	7.7	14.6	15.8	18.8		14.9	5.9		
PPG debt service-to-revenue ratio (in percent)	8.2	8.5	8.0			7.3	6.7	5.9	11.5	12.8	14.0		11.5	4.7		
Total gross financing need (Millions of U.S. dollars)	19.3	27.8	44.1			5.3	22.9	38.6	45.5	29.5	35.9		32.8	45.2		
Non-interest current account deficit that stabilizes debt ratio	0.4	10.3	9.0			3.5	7.1	9.0	10.7	6.4	7.6		6.4	7.3		
Key macroeconomic assumptions																
Real GDP growth (in percent)	-3.1	2.1	3.7	1.0	2.8	3.1	2.3	2.5	2.9	1.8	1.8		2.4	1.8	1.8	
GDP deflator in US dollar terms (change in percent)	-1.8	-3.4	-5.3	4.5	9.0	-6.0	2.4	1.8	2.2	2.3	2.3		0.8	2.2	2.2	
Effective interest rate (percent) 5/	1.6	1.6	1.6	1.7	0.6	1.7	1.6	1.6	1.6	1.6	1.5		1.6	1.2	0.9	
Growth of exports of G&S (US dollar terms, in percent)	8.6	-15.2	-7.0	9.4	26.9	1.7	3.8	8.5	8.7	8.6	-3.6		4.6	4.5	4.5	
Growth of imports of G&S (US dollar terms, in percent)	-5.1	-6.9	10.5	7.5	8.6	0.3	10.8	11.8	3.4	0.3	1.9		4.8	3.8	4.4	
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	52.3	52.3	52.3	52.3	52.3	52.3		52.3	52.3	52.3
Government revenues (excluding grants, in percent of GDP)	19.6	20.0	21.4			23.7	24.1	24.6	24.7	25.2	25.3		25.1	25.1	25.1	
Aid flows (in Millions of US dollars) 7/	25.2	33.1	29.3			15.1	14.9	18.4	19.9	22.4	22.4		23.5	31.6		
<i>of which: Grants</i>	25.2	33.1	29.3			15.1	14.9	18.4	19.9	22.4	22.4		23.5	31.6		
<i>of which: Concessional loans</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0		
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			4.8	4.5	5.5	5.7	6.2	6.0		5.1	4.3	4.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			81.0	81.1	80.0	79.7	79.2	79.2		79.5	82.3	80.5
Memorandum items:																
Nominal GDP (Millions of US dollars)	449.5	443.4	435.4			422.3	442.5	461.9	485.5	505.5	526.6		641.5	953.8		
Nominal dollar GDP growth	-4.8	-1.4	-1.8			-3.0	4.8	4.4	5.1	4.1	4.2		3.3	4.0	4.0	
PV of PPG external debt (in Millions of US dollars)	...	...	137.1			141.4	146.1	152.9	153.8	153.4	150.6		136.6	182.1	
(PVt-PVt-1)/GDPI-1 (in percent)	...	...	...			1.0	1.1	1.6	0.2	-0.1	-0.6		0.5	-0.5	0.7
Gross workers' remittances (Millions of US dollars)	107.4	102.7	107.7			125.1	127.4	132.4	137.7	143.8	149.8		183.6	275.6		
PV of PPG external debt (in percent of GDP + remittances)	...	...	27.3			25.6	25.4	25.8	24.8	23.7	22.3		16.6	14.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	80.7			69.2	69.7	69.9	66.3	62.3	60.5		44.5	38.9	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	4.1			3.6	3.4	3.1	6.0	6.6	7.5		6.0	2.4	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 3. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–36
(In percent)

	Projections							2036
	2016	2017	2018	2019	2020	2021	2026	
PV of debt-to-GDP+remittances ratio								
Baseline	26	25	26	25	24	22	17	15
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	26	25	24	21	20	18	12	10
A2. New public sector loans on less favorable terms in 2016-2036 2	26	26	27	26	26	25	23	25
A3. Costs of SPG + natural disasters	26	26	29	31	31	30	27	24
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	26	26	27	26	25	24	18	16
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	26	27	30	29	28	27	21	17
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	26	27	28	27	26	25	18	16
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	26	38	49	43	42	41	35	24
B5. Combination of B1-B4 using one-half standard deviation shocks	26	39	52	45	44	42	36	25
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	26	33	33	32	31	29	21	19
PV of debt-to-exports+remittances ratio								
Baseline	69	70	70	66	62	60	45	39
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	69	69	64	57	53	50	35	30
A2. New public sector loans on less favorable terms in 2016-2036 2	69	72	73	71	69	69	61	66
A3. Costs of SPG + natural disasters	68	73	77	83	80	87	71	62
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	69	70	70	66	62	60	44	39
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	69	81	96	93	88	86	66	53
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	69	70	70	66	62	60	44	39
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	69	129	163	115	110	110	93	63
B5. Combination of B1-B4 using one-half standard deviation shocks	69	127	172	116	111	110	93	63
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	69	70	70	66	62	60	44	39
PV of debt-to-revenue ratio								
Baseline	140	136	135	128	121	113	85	76
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	140	134	123	109	100	91	61	50
A2. New public sector loans on less favorable terms in 2016-2036 2	140	140	140	137	133	129	116	129
A3. Costs of SPG + natural disasters	141	142	155	166	161	156	142	128
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	140	143	146	139	131	123	92	83
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	140	145	157	150	142	135	107	87
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	140	147	154	146	137	129	97	87
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	140	186	231	223	214	206	177	123
B5. Combination of B1-B4 using one-half standard deviation shocks	140	191	252	244	233	225	193	134
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	140	194	190	181	170	160	120	107

Table 3. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–36 (Continued)
(In percent)

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
Debt service-to-exports+remittances ratio								
Baseline	4	3	3	6	7	8	6	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	4	3	3	6	6	7	6	2
A2. New public sector loans on less favorable terms in 2016-2036 2	4	3	3	6	7	8	7	4
A3. Costs of SPG + natural disasters	4	3	3	6	7	8	8	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	4	3	3	6	7	8	6	2
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	4	4	4	7	8	9	8	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	4	3	3	6	7	8	6	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	4	5	5	7	7	8	8	5
B5. Combination of B1-B4 using one-half standard deviation shocks	4	5	5	7	7	8	8	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	4	3	3	6	7	8	6	2
Debt service-to-revenue ratio								
Baseline	7	7	6	12	13	14	11	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	7	7	6	11	12	13	10	3
A2. New public sector loans on less favorable terms in 2016-2036 2	7	7	6	12	13	15	14	8
A3. Costs of SPG + natural disasters	7	7	6	12	14	15	16	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	7	7	6	13	14	15	12	5
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	7	7	6	12	13	14	12	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	7	7	7	13	15	16	13	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	7	7	7	13	14	16	15	9
B5. Combination of B1-B4 using one-half standard deviation shocks	7	7	7	14	16	17	17	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	7	9	8	16	18	20	16	7
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	50	50	50	50	50	50	50	50

Sources: Country authorities; and staff estimates and projections.

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

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

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

4/ Includes official and private transfers and FDI.

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

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

Table 4. Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, 2013–36
(In percent of GDP, Unless Otherwise Indicated)

	Actual			Average	s/ Standard Deviation	s/ Standard Deviation	Estimate					Projections			
	2013	2014	2015				2016	2017	2018	2019	2020	2021	2016-21 Average	2026	2036	2022-36 Average
Public sector debt 1/	51.4	45.8	49.0				48.7	48.2	48.7	47.1	46.0	44.4		38.1	35.2
<i>of which: foreign-currency denominated</i>	45.3	42.1	44.2				43.1	42.4	43.2	41.9	41.0	39.6		34.0	32.4
Change in public sector debt	2.7	-5.5	3.2				-0.3	-0.5	0.5	-1.6	-1.1	-1.6		-1.2	-0.3
Identified debt-creating flows	3.4	-3.3	6.4				0.5	-0.5	-0.7	-1.7	-1.7	-1.8		-1.3	-1.2
Primary deficit	0.4	-2.6	0.2	0.8	2.9		2.2	0.8	0.0	-0.1	-0.6	-0.6	0.3	-0.3	-0.1
Revenue and grants	25.2	27.5	28.2				27.3	27.4	28.6	28.8	29.7	29.6		28.8	28.5
<i>of which: grants</i>	5.6	7.5	6.7				3.6	3.4	4.0	4.1	4.4	4.2		3.7	3.3
Primary (noninterest) expenditure	25.6	24.9	28.4				29.5	28.2	28.6	28.8	29.1	29.0		28.5	28.3
Automatic debt dynamics	4.0	-1.4	5.7				-1.8	-1.3	-0.7	-1.6	-1.1	-1.2		-1.0	-1.0
Contribution from interest rate/growth differential	1.7	-0.9	-1.4				-1.1	-0.8	-1.2	-1.6	-1.0	-1.0		-1.0	-1.0
<i>of which: contribution from average real interest rate</i>	0.1	0.1	0.2				0.4	0.3	0.0	-0.2	-0.2	-0.2		-0.3	-0.3
<i>of which: contribution from real GDP growth</i>	1.6	-1.0	-1.6				-1.5	-1.1	-1.2	-1.4	-0.8	-0.8		-0.7	-0.6
Contribution from real exchange rate depreciation	2.3	-0.5	7.1				-0.7	-0.5	0.4	-0.1	-0.1	-0.2		...	...
Other identified debt-creating flows	-0.9	0.8	0.5				0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Privatization receipts (negative)	0.0	0.8	0.5				0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Recognition of implicit or contingent liabilities	-0.9	0.0	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	-0.7	-2.2	-3.3				-0.8	-0.1	1.2	0.1	0.6	0.2		0.1	0.8
Other Sustainability Indicators															
PV of public sector debt	...	...	38.9				38.8	38.5	38.8	37.0	35.4	33.4		25.5	21.9
<i>of which: foreign-currency denominated</i>	...	...	34.1				33.2	32.8	33.3	31.8	30.4	28.6		21.3	19.1
<i>of which: external</i>	...	...	34.1				33.2	32.8	33.3	31.8	30.4	28.6		21.3	19.1
PV of contingent liabilities (not included in public sector debt)	...	...	...				...	...	...	...	...	...		...	...
Gross financing need 2/	3.2	0.0	2.9				4.8	3.5	2.2	3.6	4.5	4.5		3.8	1.9
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	138.1				142.2	140.5	135.5	128.3	119.4	112.9		88.5	77.0
PV of public sector debt-to-revenue ratio (in percent)	...	...	181.5				163.7	160.2	157.4	149.5	140.3	131.8		101.4	87.2
<i>of which: external 3/</i>	...	...	159.0				140.2	136.3	135.0	128.5	120.6	113.1		85.0	76.1
Debt service-to-revenue and grants ratio (in percent) 4/	11.1	9.6	9.4				9.6	9.7	7.5	12.5	17.0	17.1		14.3	7.1
Debt service-to-revenue ratio (in percent) 4/	14.3	13.1	12.4				11.1	11.1	8.7	14.6	20.0	20.0		16.3	8.0
Primary deficit that stabilizes the debt-to-GDP ratio	-2.3	2.9	-2.9				2.6	1.3	-0.5	1.6	0.5	1.0		0.9	0.2
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-3.1	2.1	3.7	1.0	2.8		3.1	2.3	2.5	2.9	1.8	1.8	2.4	1.8	1.8
Average nominal interest rate on forex debt (in percent)	1.6	1.6	1.6	1.7	0.6		1.7	1.6	1.6	1.6	1.6	1.5	1.6	1.2	0.9
Average real interest rate on domestic debt (in percent)	2.8	1.9	2.8	-1.0	4.8		2.9	2.6	1.4	0.0	0.0	0.2	1.2	0.5	0.5
Real exchange rate depreciation (in percent, + indicates depreciation)	5.3	-1.1	17.4	-0.9	10.6		-1.6	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	0.5	1.0	1.5	4.3	5.4		1.1	0.9	1.6	3.0	3.0	2.7	2.0	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	-15.6	-0.9	18.5	0.2	8.1		7.1	-2.2	4.1	3.4	2.8	1.4	2.8	0.8	2.5
Grant element of new external borrowing (in percent)	...	...	...	...	...		52.3	52.3	52.3	52.3	52.3	52.3	52.3	52.3	52.3

Sources: Country authorities; and staff estimates and projections.

1/ Central government; gross debt.

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 2016–36

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
PV of Debt-to-GDP Ratio								
Baseline	39	39	39	37	35	33	25	22
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	39	39	40	40	39	38	34	38
A2. Primary balance is unchanged from 2016	39	39	41	40	40	39	38	46
A3. Permanently lower GDP growth 1/	39	39	39	38	37	36	31	42
A4. High Wage Growth	39	38	39	39	39	39	55	159
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	39	41	44	43	43	41	38	44
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	39	40	42	41	39	37	29	24
B3. Combination of B1-B2 using one half standard deviation shocks	39	40	43	42	41	39	35	37
B4. One-time 30 percent real depreciation in 2017	39	52	52	49	46	43	30	24
B5. 10 percent of GDP increase in other debt-creating flows in 2017	39	44	44	42	41	38	30	26
PV of Debt-to-Revenue Ratio 2/								
Baseline	142	141	136	128	119	113	89	77
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	142	142	140	137	131	127	116	131
A2. Primary balance is unchanged from 2016	142	143	142	139	135	133	132	160
A3. Permanently lower GDP growth 1/	142	142	138	132	125	120	109	144
A4. High Wage Growth	142	140	137	134	131	134	193	558
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	142	148	152	148	141	138	132	153
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	142	146	148	141	131	124	100	86
B3. Combination of B1-B2 using one half standard deviation shocks	142	147	149	144	137	132	120	129
B4. One-time 30 percent real depreciation in 2017	142	190	181	169	155	145	105	83
B5. 10 percent of GDP increase in other debt-creating flows in 2017	142	160	154	146	137	130	106	90
Debt Service-to-Revenue Ratio 2/								
Baseline	10	10	8	13	17	17	14	7
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	10	10	8	13	18	18	16	11
A2. Primary balance is unchanged from 2016	10	10	8	13	18	18	16	12
A3. Permanently lower GDP growth 1/	10	10	8	13	17	18	16	11
A4. High Wage Growth	10	10	7	12	17	18	34	127
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	10	10	8	14	19	19	17	11
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	10	10	8	13	18	18	14	8
B3. Combination of B1-B2 using one half standard deviation shocks	10	10	8	13	18	19	16	10
B4. One-time 30 percent real depreciation in 2017	10	11	10	17	22	22	19	10
B5. 10 percent of GDP increase in other debt-creating flows in 2017	10	10	8	14	18	18	15	8

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.

**Statement by Marzunisham Omar, Executive Director for of Tonga, and Mardini Eddy, Senior
Advisor to the Executive Director of Tonga
June 13, 2016**

Mr. Omar and Mr. Eddie submitted the following statement:

On behalf of the Tongan authorities, we would like to express our sincere appreciation to the IMF mission team for the constructive and candid discussions during the 2016 Article IV Consultation. The discussions mainly centered on policies to further strengthen the resilience of Tonga's economy, preserve macroeconomic and financial stability, and improve long term growth prospects. The authorities broadly agree with the thrust of the staff assessment of the macroeconomic performance, the risks to the economic outlook, as well as the proposed reforms and policy recommendations to enhance Tonga's long-term growth prospects.

Recent Economic Developments and Outlook

Tonga's economic recovery from the devastating effects of Cyclone Ian in January 2014 continues to gather momentum. The National Reserve Bank of Tonga (NRBT) estimates economic growth of 3.3 percent for FY2016 (July 2015 to June 2016), from an estimated 3.7 percent in FY2015 and 2.1 percent in FY2014. The average growth rates over the past three years have been driven by reconstruction efforts following the cyclone's aftermath, as well as increased activity associated with the Coronation in July 2015 and the upcoming 150th Anniversary for Tupou College in June 2016. Growth is forecast to moderate to 1.9 percent in FY2017. Remittances remain a reliable source of income while the agriculture sector is expected to record higher export volumes with the production of new crops and emergence of new export markets.

Inflation picked up 1.4 percent (year-on-year) in March 2016, following seven consecutive months of deflation. However, the authorities expect that inflationary pressure will be moderate in the remaining months of FY2016 to record an annual deflation of 0.84 percent by June 2016. On the external front, foreign reserves have grown to record high of TOP323 million at end-April 2016, equivalent to 9 months of imports, significantly higher than the standard requirement of 3-4 months of import coverage, reflecting strong remittances and foreign aid. The narrowing of the current account deficit in FY2015 is attributable to the lower oil and import prices, however, moving forward the trade deficit is expected to widen further due to the projected increase in imports in preparation for the 2019 Pacific Games.

The authorities agree with staff's assessments of a positive outlook of the economy in the medium term. The hosting of the 2019 Pacific Games will be a boon to the services and tourism industry, as well as the construction sector, where a number of projects have been earmarked including the airport refurbishment, hotel renovation, construction of new resorts, as well as the resumption of projects delayed in 2014/2015. Tonga will also likely to benefit from the promising potential of the seabed mining industry in the next five years where exploration is under way for oil, and industrial metals such as gold, silver and copper. In terms of inflation, the authorities expect inflation to gradually pick up in FY2017, although inflation risks may rise in the near-term if the upturn in oil prices persists.

The authorities are in agreement with staff that the overall balance of risks to the economy is tilted to the downside. Tonga is vulnerable to a multitude of risks due to its small geographical size and location. On the external front, weak global growth especially for its main trading partners, may affect foreign aid, remittances and trade volumes while an upturn in global oil and food prices could lead to inflationary pressures. In addition, a major risk is natural disasters and volatile weather conditions, as evidenced by the hurricane and drought already experienced in 2016.

Fiscal Policy

The authorities remain committed to fiscal discipline, lowering the fiscal deficit and building fiscal buffers. The 2015/2016 budget theme was “Improved Government Delivery and Accountability”, to support the Tonga Strategic Development Framework 2015-2025 (TSDF II), through promoting enhanced good governance at all levels of the society. The authorities are guided by four key principles in their fiscal strategy, namely (i) delivering good governance; (ii) building inclusive and sustainable growth; (iii) alleviating poverty; and (iv) providing safe and better public infrastructure.

In the pursuit of fiscal prudence, the authorities recognize the need to improve the productivity and quality of the civil service, with a review of the productivity, efficiency and effectiveness of line ministries currently underway. The authorities are steadfast in their commitment to reform the civil service and contain the public sector wage bill, including cost of living adjustments (COLA). Steps have already been taken to eliminate half of the unfilled vacancies in the first three months of 2016, and the outstanding vacancies will be gradually abolished. A Remuneration Authority has been established to advise the government on the suitable level of COLA, and the authorities are also reviewing the Employment Relations Bill to review the civil and private sector employees’ wages.

The authorities concur with staff on the need for improvements in public financial management and the collection of government revenues. Measures have been adopted by the relevant departments to improve the collection of taxes and arrears, and corporate planning and budgeting, where the tax administration, working closely with PFTAC, is currently undergoing a structural review of its procedures.

The authorities are implementing a prudent fiscal and borrowing strategy of not incurring new concessional debt and will work closely with its development partners for budget support. With Tonga's expected moderate risk level of debt distress rating over the medium term and the present level of external debt, the authorities are committed to maintain external debt at a sustainable level and explore ways to mitigate the costs and risks in the debt portfolio. The authorities acknowledge staff's views for Tonga to safeguard its fiscal and debt sustainability and accumulate fiscal buffers, and gradually reduce its reliance on budget support. The Ministry of Finance and National Planning (MoFNP) recently produced its inaugural Medium Term Debt Strategy (MTDS), outlining alternative borrowing strategies which could help meet its debt objectives and achieve a more desired balanced composition of public debt. The authorities will, over the coming years, execute the various identified strategies.

Tonga will host the Pacific Games for the first time in 2019, and in preparation for the events, investment in sporting and related infrastructure will be implemented over the next few years. The authorities are confident in meeting the funding requirements for the Games and are presently working with its development partners to secure grant financing. Additionally, the Foreign Exchange Levy (Amendment) Act 2016 was passed on April 28, 2016 and will be effective from June 1, 2016, the revenue of which will help contribute to finance the Games' operational costs. A fee for airport departures is also likely to be levied beginning July 2016, for the same purpose.

Monetary and Financial Stability

The authorities share staff assessment that the current accommodative monetary policy stance is appropriate, and stand ready to take appropriate measures if there are signs of overheating. The current inflation reference range of 6-8 percent range is consistent with the previous experience of high inflation, given Tonga's exposure to volatilities in global commodity and food prices, as it imports most of its goods. Nonetheless, the authorities are keen to explore other monetary policy instruments to enhance its monetary policy framework, including macroprudential tools and liquidity management, and would welcome technical assistance from the Fund in these areas.

While staff assess that the current reserves cover of 6 months of imports is adequate, the authorities view the level as high, given the opportunity cost of maintaining the reserves in comparison to the various investment needs of the country. Nevertheless, the authorities acknowledge the need to maintain the current level of reserves given the country's ability to generate foreign currency receipts is not so robust, as it currently relies heavily on government donor funds and remittances while structural reforms required to boost the export and tourism sectors will take time to materialize. The outlook on payments, on the other hand, includes higher imports for the Games and the payment of principal loan amounts starting in 2019.

On financial stability, banks remain liquid, profitable and well-capitalized with risk-weighted capital ratio (RWCR) at 37 percent, well above the statutory minimum requirement of 15 percent. NPLs are currently around 10 percent, significantly lower than the 20 percent level in FY2009, and the authorities will continue work on lowering NPLs further. Credit growth is strong but as rightly pointed out by staff, this is based on a lower base and consistent with financial deepening. The authorities expect construction work and private lending in preparation for the Pacific Games to support credit growth in the next few years. Banks weighted lending rate stood at 7.94 percent in March 2016 compared to deposit rates of 2.23 percent, and interest spreads are gradually narrowing, although the authorities view the annual percentage rates as still being quite high. The authorities acknowledge the rising credit growth trend and excess liquidity in the banking system. As the loans to deposit ratio for the banking system of around 76 percent is below the benchmark of 80 percent, there is potentially still room for growth in prudent lending. Nonetheless, the authorities will continue to be vigilant and diligent in their surveillance and supervision, and will stand ready to address potential risks to preserve financial stability.

NRBT is making great advances in strengthening its supervisory, regulatory and legal framework. The authorities are presently working on the laws for the licensing and supervision of non-bank financial

institutions, including the microfinance institutions, money lenders, credit unions, as well as amendments to the Foreign Exchange Control Act and the Financial Institutions Act, which will be renamed as the Banking Act. Initiatives are also underway to improve financial access and financial inclusion, where Tonga is committed to the Maputo Accord 2015 under the Alliance for Financial Inclusion (AFI), which include developing and improving access to finance of the small to medium enterprises (SMEs), women and youth, and developing policies and regulations for SME finance, consumer protection and financial literacy. The authorities are also keen to highlight that the global de-risking situation has had some noticeable impact on the local financial players, and will closely monitor developments in correspondent banking relationships for the local banking and money transfer operators.

Structural Reforms

Tonga is moving progressively to achieve the goals of the TSDF II and to achieve a long-term vision of "A more progressive Tonga supporting a higher quality of life for all". The authorities concur with staff assessment on the calls to create a conducive and dynamic business environment to stimulate private enterprises and attract further foreign direct investment. A host of existing and new legislations are either under review or being considered, a number of which will facilitate the development of the private sector. The authorities are also cognizant of the need to review the Land Act to address existing gaps in the legislation and improve the usability of lands, for improving access to credit for example. Separately, the first National Agriculture Sector Plan was also endorsed by the Cabinet in December 2015. This five-year plan identifies measures to boost and modernize the agriculture industry across the board, where TOP36 million of government and Public Private Partnership (PPP) funds will be invested, and will also involve collaborations with the World Bank, International Fund for Agricultural Development (IFAD) and United Nations Development Programme (UNDP).

The decline in fuel prices over the past two years have benefitted the economy greatly. But being an oil importer, Tonga is vulnerable to volatilities in global commodity prices. To address the nation's long-term energy requirements, the authorities launched the Energy Roadmap in 2010, establishing an objective of achieving 50 percent renewable energy (RE) source by 2020. The vision involves the participation of seven ministries as well as the private sector. Several important steps have been undertaken, including developing legislations to enable RE projects and PPP schemes to move forward, restructuring the petroleum sector to be more efficient, and working with development partners. There is a good potential for greater use of renewable energy in Tonga including wind, ocean and solar energy, where 5.5 mW of solar energy is required to achieve the 50 percent RE target.

As noted by the World Bank Risk Index, Tonga is one of the world's most exposed to natural disaster country. Apart from the provision for an emergency fund allocated in the annual budget, additional efforts are required to mitigate the risks of natural disasters including climate proofing of infrastructures and monitoring ocean and weather patterns. The authorities are very much aware of the need to increase climate resiliency, and to that end, the Cabinet recently approved a climate change policy which will look at data management, research and information, as well as capacity building in this area. The authorities also wish to note that the existing arrangements with its close partners for

emergency assistance is a crucial element to address these challenges and is working with various parties including the European Union and the World Bank on climate resilience projects.

The authorities agree with staff assessment on the need to increase capacity in its data provision, and the importance of data quality and timeliness. In this respect, the authorities would like to express their appreciation for the technical assistance received from the Fund and PFTAC, and look forward to further technical assistance, especially on national accounts, external sectors and banking legislations.

Final Remarks

The Tongan authorities remain resolute in their commitment to implement broad-based structural reforms, and build buffers to meet potential headwinds with a view to achieve their long-term economic goals. The authorities will focus on the successful implementation of the policy recommendations, while maintaining adherence to the principle of good governance.

The authorities wish to acknowledge the support and assistance provided by the Fund including PFTAC, World Bank, Asian Development Bank, and other development partners, and look forward to continuing their long-standing cooperation and partnership with the Fund.