



Asia & Pacific SMALL STATES MONITOR

August 2014

Quarterly Bulletin | Issue 02/2014

In this issue of the *Asia & Pacific Small States Monitor*...

...we highlight the challenges facing Asia and Pacific small states associated with natural disasters and climate change. The most recent event was the severe flood that hit Solomon Islands in April.

The IMF will hold a seminar on coping with natural disasters and climate change, co-sponsored by the World Bank Group, during the upcoming UN Conference on Small Island Developing States in Samoa. IMF Deputy Managing Director Min Zhu will attend.

Given that stronger macroeconomic policy frameworks and growth can bolster resilience to shocks, we also feature new Asia and Pacific Department (APD) research on: estimating fiscal multipliers in small states; and the role of tourism in promoting growth in Palau. We also include a note on monetary policy in Tonga and discuss the IMF's new "Staff Guidance Note on Fund's Engagement with Small Developing States" (prepared by the IMF Strategy, Policy, and Review Department), which provides operational guidance on the IMF's engagement with small developing countries.

Patrizia Tumbarello, Chief of the Pacific Islands Unit, APD

"Small developing countries cannot internalize the costs of natural disasters and climate change on their own."

Hon. Rick Houenipwela, Minister of Finance and Treasury of Solomon Islands, during the May 2014 IMF mission

Flooding in Solomon Islands (*Solomon Island Times*)



Contents

- **Asia and Pacific Small States: Developments and Outlook**
Page 2
- **Upcoming and Recent Events**
Page 3
- **Special Topics**
Pages 4-6
 - **Fiscal Multipliers in the Asia-Pacific Small States**
 - **Climate Change and Natural Disasters in the Asia-Pacific Small States**
 - **Palau: Promoting Tourism and Growth**
- **Country Notes—Bhutan, Kiribati, Palau, Solomon Islands, and Tonga**
Pages 7-9
- **Perspective from the Field: Monetary Policy Challenges in Tonga**
Pages 9-10
- **The Fund's Engagement with Small Developing States**
Page 11
- **Asia and Pacific Small States: Recent Economic Developments (Figures)**
Pages 12-13
- **Photos from Recent IMF Missions and Asia-Pacific Small State Events**
Page 14

Prepared by: Shari Boyce (Project Coordinator), Sergei Dodzin, Ezequiel Cabezón, Fazurín Jamaludin, and Yiqun Wu (all Pacific Islands Unit), and Rosanne Heller (Editorial Officer)

The analysis and policy considerations expressed in this publication are those of the IMF staff and do not represent official IMF policy or the views of IMF Executive Directors or their national authorities.

Please send questions to
APDsmallstates@imf.org and
ptumbarello@imf.org.

Growth Developments

Recent economic performance in the APD small states was uneven in the first few months of 2014 ([Figure 1](#)).

- Most tourism-oriented economies experienced a robust increase in arrivals, partly reflecting country-specific factors such as the resumption of direct flights to Palau from emerging Asia and postcyclone recovery in Fiji and Samoa, as well as a steady increase in tourist arrivals from Asia (especially China) in Fiji and Maldives. Fiji is preparing for a return to a democratically elected government and the run-up to the elections has contributed to increased confidence in the economy.
- But natural disasters hit four APD small states in the first few months of 2014 (see [Special Topic](#)): Tonga and Fiji in January (Cyclone Ian); Vanuatu in March (Cyclone Lusi); and Solomon Islands in April (flash floods). These have undermined short-term growth to different degrees as noted in the country notes on [Solomon Islands](#) and [Tonga](#).
- Among commodity exporters ([Bhutan](#), Solomon Islands, and Timor-Leste) and other APD small states, growth remains uneven: robust activity in Bhutan was driven mainly by hydropower-related construction activities; Solomon Islands experienced a continuing decline of logging stocks and a short-term disruption of gold production; and Timor-Leste's ongoing depletion of oil reserves has led to a tighter budget constraint and lower government spending in the non-oil sector. In the other small states, growth is being supported by externally financed infrastructure projects. In Tuvalu, for example, donor-financed energy projects are supporting outer island development, and large airport and road rehabilitation projects are expected to bring foreign investments of about 40 percent of GDP in the medium term.

Outlook

- In 2014, growth in APD small states is expected to pick up slightly to about 2½ percent. However, the small Pacific island countries with GDP growth projected at about 2 percent on average will continue to underperform other small states in other regions.
- Investment in infrastructure and steady growth in emerging Asia, Australia, and New Zealand will underpin APD small states' short- and medium-term performance. APD small states urgently need structural reforms to bridge infrastructure gaps, strengthen productivity, and lift potential growth. In the near term, elections on September 17 in Fiji and later this year in Solomon Islands, introduce some uncertainty to the outlook.

APD Small States: Real GDP Growth

(Year-on-year percent change)

	2012	2013	2014	2015
		Est.	Proj.	Proj.
Bhutan	6.5	5.0	6.4	7.6
Fiji	1.7	3.6	3.8	2.5
Kiribati	2.8	2.9	3.0	2.7
Maldives	0.9	3.7	4.2	4.5
Marshall Islands	3.2	0.8	3.2	1.7
Micronesia	0.4	0.6	0.6	0.6
Palau	5.5	-0.2	1.8	2.2
Samoa	2.9	-0.3	1.6	1.9
Solomon Islands	3.8	3.0	0.1	3.5
Timor-Leste ¹	7.7	5.4	6.6	6.8
Tonga	0.7	0.3	1.4	3.4
Tuvalu	0.2	1.3	2.2	2.5
Vanuatu	1.8	2.8	3.5	4.5
APD small states ²	2.5	2.0	2.6	3.1
Small Pacific Island Countries ²	2.3	1.5	2.1	2.5
Small states (excl. APD) ²	1.7	2.2	2.7	3.0

1/ Non-oil GDP.

2/ Simple average.

Sources: IMF, World Economic Outlook database; IMF staff reports; and IMF, staff estimates and projections. Data for Bhutan, Micronesia, the Marshall Islands, Palau, Samoa, and Tonga are reported on a fiscal year basis.





GLOBAL
CHOICES

UN Conference on
Small Island Developing States

Apia, Samoa | 2014
1-4 September

~ IMF Feature Event ~

“Coping with Natural Disasters:

Building Macro-Fiscal Resilience in Small Island Developing States”

September 2, 2014 | 3-4:30 pm, Faleata Sports Complex (CR 3), Apia, Samoa

Welcoming Remarks by the Honorable Tuilaepa Sailele Malielegaoi,
Prime Minister and Minister of Finance, Samoa

Presenters:

Min Zhu, IMF Deputy Managing Director

Rachel Kyte, World Bank Group Vice President and Special Envoy for Climate Change

Panelists:

Honorable Keith Mitchell, Prime Minister of Grenada

Stephen Groff, Vice President, Asian Development Bank

Justin Ram, Director of Economics, Caribbean Development Bank

Upcoming Events on Small Islands/States

- **UN Conference on Small Island Developing States**

September 1-4, 2014 in Apia, Samoa

<http://www.sids2014.org>

- **South-Pacific Governors' Meeting**

December 4-6, 2014 in Fiji

Recent Events on Small States

- **The 45th Pacific Islands Forum Meeting**

July 29-August 1, 2014 in Koror, Palau

<http://www.palaupif.com/>

- **PFTAC Steering Committee Meeting**

July 14, 2014 in Nadi, Fiji

<http://www.pftac.org/events/14>

- **2014 Forum Economic Ministers Meeting**

July 8-10, 2014 in Honiara, Solomon Islands

<http://www.forumsec.org/pages.cfm/economic-governance/forum-economic-ministers-meeting-femm/2014-femm.html>

- **2014 Pacific Day at the New Zealand Embassy, Washington D.C.**

June 18, 2014 in Washington D.C., U.S.A.

<http://csis.org/event/pacific-day-2014>

- **2014 Pacific Update, Crawford School of Public Policy**

June 16-17, 2014, Canberra, Australia

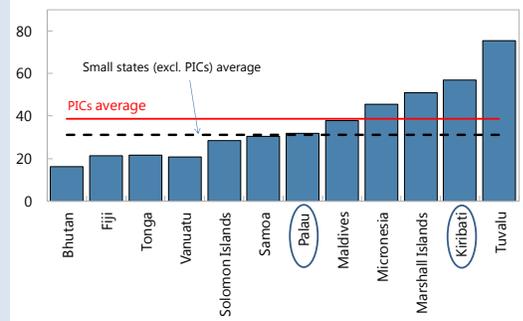
<https://crawford.anu.edu.au/events/3983/2014-pacific-update>

Owing to their small population size, geographical dispersion, and lack of economies of scale, the government sector in the APD small states plays a large role in supporting growth and employment. The importance of the government is even greater in the most remote and dispersed Pacific island countries (PICs). Moreover, some Pacific islands (Kiribati, the Marshall Islands, Micronesia, Palau, and Tuvalu) do not have a central bank and some could face a significant loss of fiscal resources (the Marshall Islands, Micronesia, and Palau) when Compact grants from the United States expire after 2023. Therefore, assessing the impact of fiscal policy on growth is critical for helping governments design fiscal policies that take into account output dynamics and ensure long-term fiscal sustainability. Fiscal multipliers allow us to measure the impact of fiscal policy on growth.

A recent APD analysis provides an operational framework that incorporates two-way links between the government sector and the overall economy and assesses the magnitude of fiscal multipliers in two APD small states.² It is based on a dynamic model that connects government spending, taxation, government employment, and wage setting with foreign demand, private sector production and employment, and demand for domestic and foreign goods. The framework is calibrated and linked to the country economic sectoral accounts and other country data rather than based on estimates from cross country regressions. It allows answering policy questions, such as: What would be the growth impact of a change in public wages versus a change in other government expenditures? What would be the size of private sector growth needed to offset the impact of fiscal consolidation? This study estimated fiscal multipliers with regard to changes in different components of government spending, such as a change in the wage bill and changes in other components of public spending.

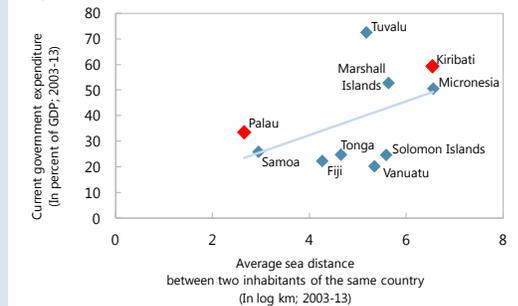
The analysis suggests that fiscal multipliers in small states tend to be low, reflecting high level of spending on imports. The government spending multipliers range from 0.44 to 0.47 in Kiribati and from 0.14 to 0.16 in Palau, depending on whether the fiscal impulse is due to a change in nominal wages or to government spending net of nominal wages.³ This range is consistent with the theoretical and empirical literature that suggests that the stimulus effect of fiscal policy is smaller in small open economies⁴, and also with the estimates obtained for small island states in Eastern Caribbean Currency Union (ECCU).⁵ The results of the paper suggest that increasing the rate of return of public spending (i.e., quality of spending) is essential to stimulate growth both in the short and the long run.

Current Government Expenditure, 2013
(In percent of GDP)



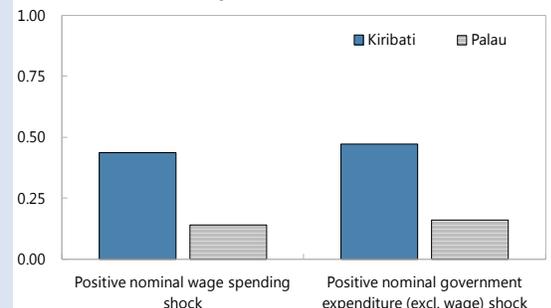
Sources: IMF, WEO; and IMF staff estimates.

Current Government Expenditure and Geographic Dispersion



Sources: IMF, WEO; and IMF staff estimates.

Short-Run Fiscal Multipliers¹



Source: IMF staff estimates.

¹ Referred to as impact multipliers in the literature.

¹ Prepared by Sergei Dodzin (Asia and Pacific Department) and Xuefei Bai (former Special Appointee in APD from the People's Bank of China), based on "Growth and Fiscal Multipliers in Small States: The Case of Pacific Island Countries," forthcoming in the IMF book "Raising Potential Growth and Enhancing Resilience in APD Small States."

² The framework is calibrated for Kiribati and Palau and can be extended to other small states.

³ The larger size of the multiplier in Kiribati relative to Palau is the result of the larger share of domestic goods and services in government workers' expenditure basket (equivalent to 50-60 percent); in Palau, the share is 20-30 percent.

⁴ Spilimbergo, Symansky, and Schindler, 2009, "Fiscal Multipliers," IMF Staff Position Note, SPN/09/11. The range is from 1 to 1½ for spending multipliers in large countries, 0.5-1 for medium-size countries, and less than 0.5 for small open economies.

⁵ Gonzalez-Garcia, Lemus, and Mrkaic, "Fiscal Multipliers in the ECCU," IMF Working Paper 13/117.

Natural disasters and climate change are interrelated and affect many Asian and Pacific developing island states to different degrees. Low-lying atolls—such as those in Kiribati, Maldives, the Marshall Islands, and Tuvalu—are the most

vulnerable to rising sea levels, although climate change also negatively affects agricultural income in high-elevation islands (especially in rural areas) by increasing water salinity. Over the last five decades, some PICs have been more affected by natural disasters than the average of small states in other regions (see text chart) and these events have increased through time. Going forward, rising temperatures are widely predicted to raise the frequency of extreme weather events in the Pacific, intensifying the risk of natural disasters. Higher-elevation islands would also be hard-hit, given their concentration near coastlines of population, socioeconomic activity, and infrastructure.

Natural disasters and climate change also pose severe macro-critical challenges. Apart from their devastating human costs, these events damage

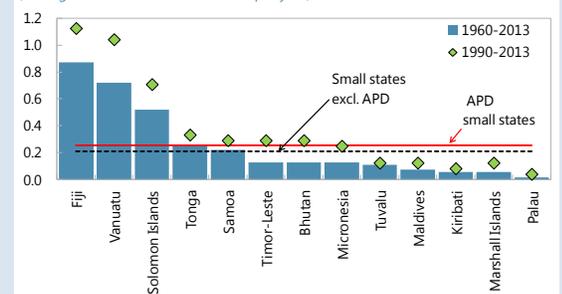
growth prospects and worsen countries' fiscal positions. Key factors in the low potential growth rates of small PICs have been the loss of already-low human and physical capital and the heavy cost of rebuilding in the wake of natural disasters. IMF preliminary analyses suggest that natural disasters reduce medium-term growth in small PICs and worsen their underlying fiscal position.² [World Bank Group estimates](#) indicate that the current average annual loss caused by natural disasters across 15 PICs is 1.7 percent of regional GDP. Similar challenges are faced by the Caribbean island countries.³

In the context of IMF surveillance, dealing with natural disasters in Asia-Pacific small states requires a multi-pillar strategy. This includes enhancing resilience by building buffers (adequate official reserves, low debt levels, and strong fiscal and external positions), continuing participation in sovereign insurance mechanisms,⁴ and having reliable access to prompt financing on terms consistent with stability considerations that reduce the need for policy adjustments. As reported in an [IMF Board paper on small states](#), fostering ex ante resilience in the face of natural disasters requires integrating natural disaster risks into macroeconomic policy frameworks to determine the size of the buffers needed (or self-insurance) and of the outside insurance; ensuring sufficient flexibility to help redeploy spending rapidly, and sufficient external buffers to help mitigate potential balance of payments shortfalls. After the disaster, an efficient response requires improving transparency to ensure effective use of disaster assistance; strengthening coordination among development partners and authorities;⁵ and pursuing growth-enhancing structural reforms. While building fiscal and external buffers is essential to foster resilience and catalyze donor support, PICs cannot address fully climate change needs without external assistance.

IMF policy advice on coping with natural disasters is also supported by the provision of technical assistance (TA) and training. For example, TA on public financial management can help improve the platform from which PICs seek natural disasters and climate change assistance. Indeed, capacity issues are also a constraint with respect to accessing global funding sources, with these challenges likely to divert capacity from other aspects of core policy management⁶.

The IMF offers financing to meet a broad range of urgent balance of payments needs, including those arising from natural disasters. This assistance can be accessed through the [Rapid Financing Instrument](#), which is available to all member countries, and the [Rapid Credit Facility](#), which provides rapid financing with limited conditionality and on concessional terms. Both lending facilities are designed for members that do not require a full-fledged economic program (e.g., because of the transitory and limited nature of the shock) or where such a program is not feasible because the need is urgent or policy implementation capacity is limited.

APD Small States: Occurrence of Natural Disasters per Year
(Average number of natural disasters per year)



Sources: Center for Research on Epidemiology of Disasters, International Disaster Database; and IMF staff estimates.

¹ Prepared by Leni Hunter, Ezequiel Cabezon, and Yiqun Wu (Asia and Pacific Department).

² Cabezon, Hunter, Tumbarello, Wu, "Macroeconomic Implications of Natural Disasters in APD Small States," forthcoming, IMF Working Paper.

³ Acevedo, 2014, [IMF Working Paper 14/125](#); Laframboise and Loko, 2012, [IMF Working Paper 12/245](#).

⁴ The World Bank's Pacific Catastrophe Risk Insurance Pilot was launched in January 2013 and offers immediate funding to PICs in the wake of severe natural disasters. In January 2014, Tonga became the first country to benefit from a payout under the pilot.

⁵ The Pacific Islands Forum (PIF) Secretariat and the [Asian Development Bank](#) are also heavily involved in natural disasters climate change issues in the Pacific. The [Nauru case study](#), conducted by the PIF, cited the difficulties in quantifying the extent of external financing made available for climate change, and in distinguishing this financing from existing development assistance.

⁶ The IMF also provides TA to all members interested in environmental tax reforms. Fiscal policies should be center stage in the effort to get energy prices to reflect the harmful and environmental side effects associated with energy use, notably climate change, according to a new [report](#) by the IMF and outlined in a [speech](#) by IMF Managing Director Christine Lagarde at the [Center for Global Development](#), July, 31 2014.

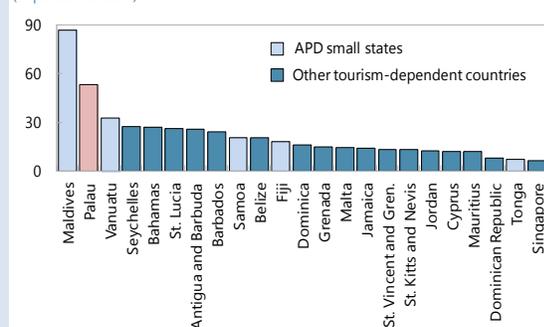
Palau is the second most tourism-dependent economy in the world, after Maldives. As a world-class diving destination, Palau hosts more than 100,000 tourists annually—about five times its total population. The number of tourists increased steadily from 1999 to 2012, helping boost GDP per capita to US\$13,193 in 2012 from US\$8,500 in 2000. Tourism receipts accounted for more than half of GDP in 2013, or about 75 percent of total exports of goods and services. Tourism-related taxes represented 15 percent of total tax revenue. The sector employs more than 40 percent of the labor force.

The linkages with Asia are strong and increasing. Eighty percent of tourists come from Taiwan Province of China, Japan, and Korea (unlike other Pacific islands that depend more on tourism from Australia and New Zealand), and tourists from China have grown rapidly over the last five years. Palau’s business cycle is thus synchronized with the Asian business cycle.

Palau’s heavy reliance on tourism brings many opportunities but also some vulnerabilities. Owing to its narrow production base, Palau’s GDP volatility is even greater than other small states. As tourism activity consumes a high level of fuel and food imports (over 30 percent of GDP), Palau is also vulnerable to global commodity price fluctuations. Moreover, in 2013, the appreciation of the U.S. dollar, Palau’s legal tender, made Palau’s tourist attractions more expensive for Asian tourists. In addition, natural disasters—including those related to climate change or environmental damage and accidents—could erode tourism and growth.

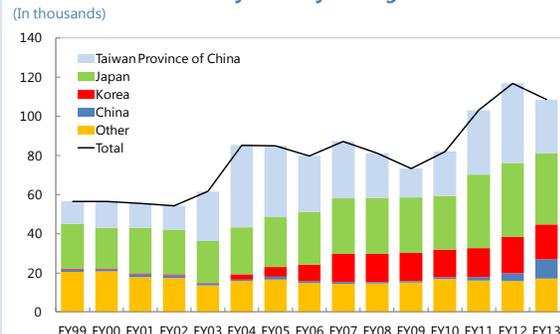
Identifying and addressing tourism-related challenges could enhance Palau’s competitiveness and thus improve its growth potential. Promoting diversification *within* the tourism industry could reduce the volatility of tourist arrivals and increase tourism revenue. For example, diversifying tourist attractions could encourage tourists to stay longer and spend more. Diversification *outside* the tourism industry could entail developing agriculture and aquaculture, to supply the tourism industry with domestic products, and expanding the service industry. The benefits of synergies between tourism and agriculture have long been recognized for the Pacific island countries (PICs), but progress in building these synergies has been slower than expected. Developing domestic supply chains and expanding the domestic share of tourism-related operations would help Palau enhance growth potential and limit growth volatility.² Diversifying the economy and promoting private sector development should be underpinned by structural reforms that open up the restrictive foreign investment regime and alleviate pressing infrastructure bottlenecks.

Tourism-Dependent Countries: Travel Receipts, 2012–13
(In percent of GDP)



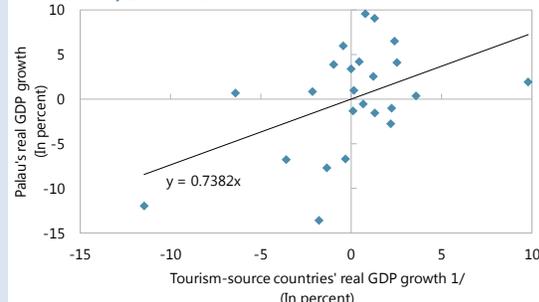
Source: IMF, *International Financial Statistics*.

Palau: Tourist Arrivals by Country of Origin
(In thousands)



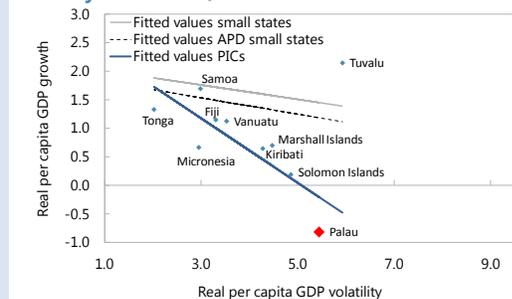
Sources: Palau Visitors Authority; and IMF staff calculations.

Palau and Tourism-Source Countries: Real GDP Growth Correlation, 1990–2013



1/ Includes Korea, Japan, and Taiwan Province of China.
Sources: IMF, WEO; and IMF staff estimates.

Small States—Asia and Pacific Region: Real per Capita GDP Volatility and Growth, 1990–2010



Sources: World Bank, *World Development Indicators*; IMF, WEO; and IMF staff calculations.

¹ Based on [Selected Issues Paper, Country Report No. 14/111](#), pages 14–26, by Ioana Hussiada (Asia and Pacific Department).

² Chen, Rauqueqe, Singh, Wu, and Yang, “Pacific Island Countries: in Search of a Trade Strategy,” forthcoming, IMF Working Paper.

Bhutan

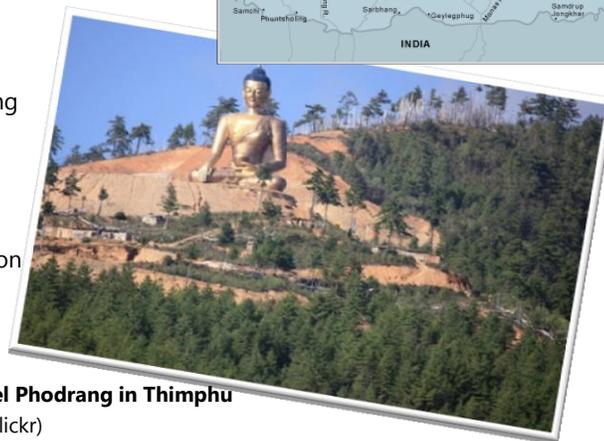
Context: Bhutan is a small, until recently fast-growing, lower middle-income country with deep economic ties to India and a peg to the Indian rupee. Growth in Bhutan was robust during the last Five-Year Plan (2008/09 to 2012/13), driven by the development of the hydropower sector (exporting electricity to India) and a credit-fueled private consumption boom.

Outlook and Risks: Growth is estimated to have slowed to 5 percent in FY 2013 from over 10 percent in FY2011, owing to policy efforts to moderate credit growth to contain overheating pressures. Risks are firmly tilted to the downside and stem from high debt levels and the possible surfacing of financial sector vulnerabilities following a prolonged period of rapid credit growth. There is also a risk of renewed external pressures if macroeconomic policies remain expansionary and credit growth rebounds strongly. Additionally, risks emanate from a potential slower-than-expected recovery in India though these risks are mitigated by the concentration of exports in the hydropower sector, which enjoys healthy demand from power-constrained India.

Policy Issues: The main near-term policy challenge is to revive growth while ensuring that external pressures do not reemerge. Fiscal policy should be tightened while preserving social and productive expenditure. On monetary policy, external flows should be fully sterilized and liquidity should be tightened to prevent credit growth from rebounding too strongly. Reserves have to be managed carefully to contain recurrent pressures on rupee reserves, including by aligning the currency composition of reserves with that of the structure of external liabilities and trade.

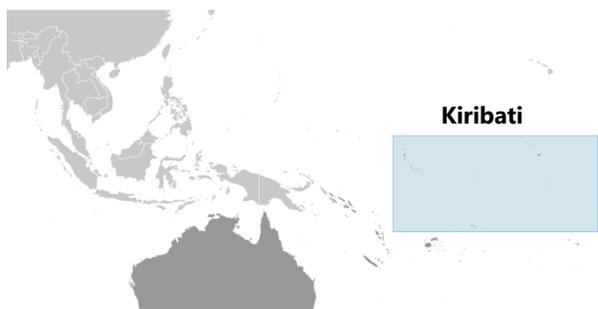
Source: [Bhutan—Staff Report for the 2014 Article IV Consultation](#).

See also: [Bhutan—Selected Issues, Country Report No. 14/179](#).



Lord Buddha, Kuensel Phodrang in Thimphu

(Source: Peter Ward, Flickr)



Kiribati

Context: Kiribati is one of the most remote microstates in the Pacific, with 33 islands spread over a vast ocean area. Given its narrow production and export base, Kiribati continues to rely heavily on revenues from fishing license fees, official transfers, and workers' remittances to finance its structural trade deficit. There has been some pickup in private sector activity since the start of the broad-based government reform program and with the commencement of the large, key donor-funded infrastructure projects, even though the public sector dominates the economy partly because of limited private sector opportunities.

Outlook and Risks: Consumer and business confidence has improved with the commencement of a road project in 2014 and the anticipated positive spillover. Increased spending related to the donor projects is expected to raise inflation to about 2.5 percent in 2014. Risks to the near-term outlook are balanced. While the positive impact of domestic public works may be larger than presently envisaged, a further softening in the external environment and volatile commodity prices present downside risks to growth. In addition, volatile fishing licenses represent a real risk to the stability of fiscal revenues. In the long term, the country's vulnerability to climate change and natural disasters presents risks to growth prospects.

Policy Issues: Kiribati's key economic challenges are to reduce large structural fiscal imbalances and increase growth and employment opportunities, while facing obstacles posed by remoteness, lack of scale, vulnerabilities to external shocks, and climate change. The significant fiscal consolidation envisaged by the authorities will help Kiribati's sovereign wealth fund (the Revenue Equalization Reserve Fund, or RERF) in real per capita terms. In the event of weaker fishing license fee revenues, a more ambitious adjustment in the non-fishing budget would be needed.

Source: [Kiribati—Staff Report for the 2014 Article IV Consultation](#).



Tarawa Coastline damaged by rising sea levels

(Source: E.W.A. Hong Kong SAR/Getty Images)

Maps: National Geographic and CIA World Factbook.

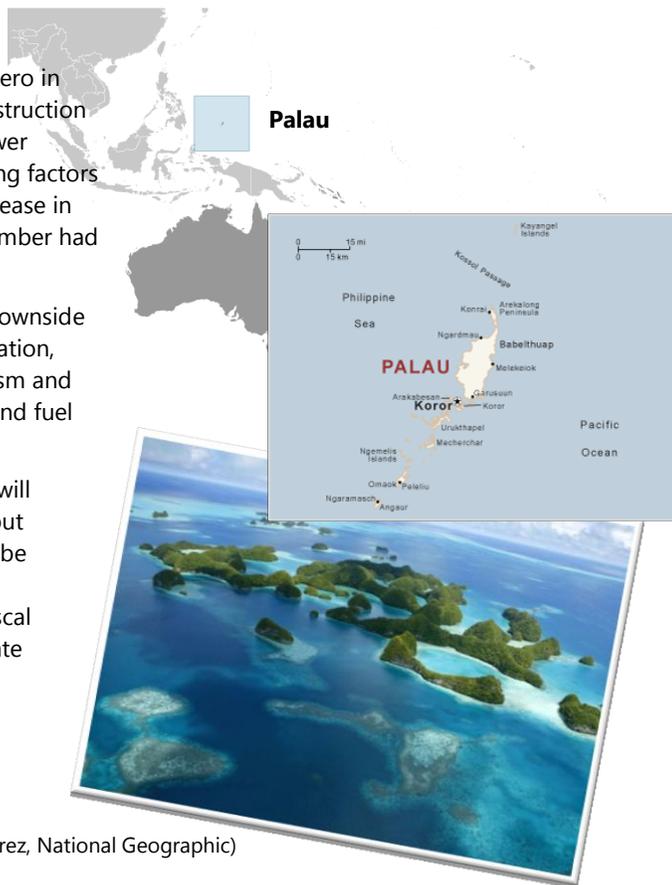
Palau

Context: After two years of strong expansion, growth was estimated at around zero in FY2013, lower than other Pacific island countries (PICs), owing to declines in construction and tourism. Construction activities slowed due to delayed capital grants and lower capital spending during the change in administration in early FY2013. Contributing factors to the decline in tourism include the cessation of some flights from Asia, the increase in tourism-related fees, and the U.S. dollar appreciation. Typhoon Haiyan last November had minimal impact on growth.

Outlook and Risks: The outlook points to a modest recovery, but is subject to downside risks. Financial market volatility and growth slowdown in Asia, U.S. dollar appreciation, and natural disasters, including those related to climate change, could hurt tourism and growth, weakening external and fiscal positions. Palau's heavy reliance on food and fuel imports also makes it susceptible to commodity price volatility.

Policy Issues: Given the absence of monetary and exchange rate policies, Palau will continue to rely on fiscal measures and structural reforms to address risks. Without substantial fiscal consolidation over the medium term, Palau's fiscal position will be unsustainable when the Compact grants expire in 2024. Successful fiscal consolidation is needed to build adequate fiscal buffers and ensure long-term fiscal sustainability and external stability. Improving the investment and business climate would help diversify the economy, reduce economic vulnerability, and support growth.

Source: [Republic of Palau—Staff Report for the 2014 Article IV Consultation](#).



Rock Islands

(Source: Stephen Alvarez, National Geographic)



Solomon Islands

Context: After four years of consecutive growth, unprecedented floods that hit Solomon Islands in early April 2014 have undermined economic activity. The flash floods caused loss of life and widespread damage to key infrastructure, water and sanitation systems, housing, and agricultural output. The country's only gold mine, a major driver of growth, was closed and is still not operating. On the other hand, performance under the IMF-supported Extended Credit Facility arrangement has been broadly satisfactory. Reserve buffers have been rebuilt and are at a comfortable level, well above the average of other small states.

Outlook and Risks: Economic growth prospects have worsened. Economic growth in 2014 is projected at near zero, despite reconstruction efforts, on account of the closure of the mine and other flood-related income losses. In 2015, activity is expected to increase by 3½ percent led by large foreign-financed infrastructure projects. With the continued decline in logging output, growth will need to be supported by increased productivity across a wide range of sectors. Risks to the outlook are on the downside with the upcoming parliamentary legislative elections adding an element of uncertainty.

Policy Issues: The authorities need to support economic activity through fiscal policy in the short term using fiscal buffers rebuilt in recent years, while strictly reprioritizing toward capital spending. The quality of public spending should be improved by advancing public financial management reform including by enhancing the transparency and accountability of scholarship and constituency funds. The current monetary stance is appropriate but the central bank should stand ready to tighten monetary policy if credit growth surges together with inflationary pressures.

Source: [Solomon Islands—Third Review Under the Extended Credit Facility Arrangement and Request for Modification of Performance Criteria](#).



Open-air market in Honiara
(Source: Global Education)

Maps: National Geographic and CIA World Factbook.

Tonga

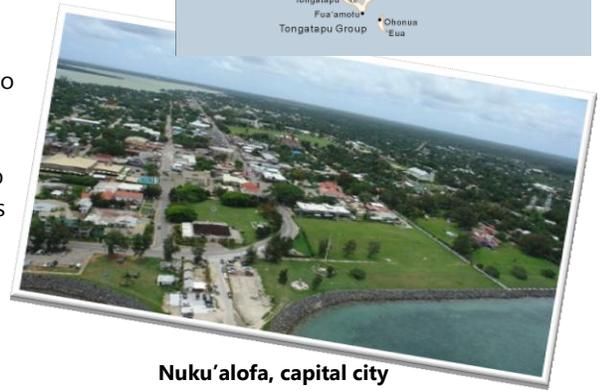
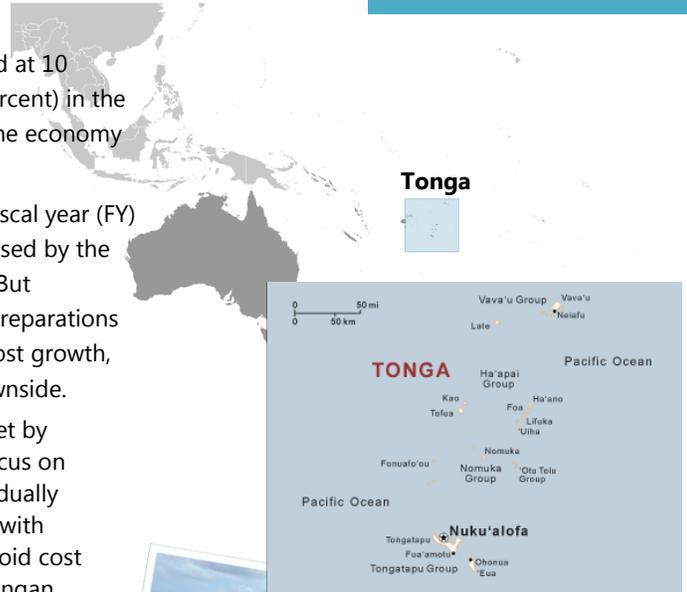
Context: A major cyclone hit Tonga in January 2014, causing damage estimated at 10 percent of GDP. The cyclone came on the heels of very sluggish growth (0-1 percent) in the previous 2 years owing to an unwinding of large public investment. However, the economy is rebounding. Risks to the inflation outlook and the external position are low.

Outlook and Risks: Real GDP growth is expected to recover to 1.4 percent in fiscal year (FY) 2013–14 (to June 30), and further to 3.4 percent in FY2014–15. The damage caused by the cyclone is expected to have reduced growth by about 1 percent in FY2013–14. But thereafter reconstruction activities would boost growth in the short term. The preparations for the 2019 South Pacific Games, hosted by Tonga, would also temporarily boost growth, but add to financing needs. Risks to the near-term outlook are tilted to the downside.

Policy Issues: The projected fiscal cost relating to the cyclone will be largely met by funding from development partners. In the near term, the authorities should focus on reconstruction activities, while a medium-term fiscal strategy should aim at gradually stabilizing and then reducing the debt-to-GDP ratio. Key would be to continue with revenue reform and wage restraint, to strengthen debt management, and to avoid cost overruns associated with the South Pacific Games. The deleveraging cycle of Tongan banks appears to be ending. Thus, the National Reserve Bank of Tonga should prepare to gradually tighten monetary conditions when signs of credit growth firm up. The authorities plan to lower the cost of credit through supportive measures, including by commercializing Tonga Development Bank. Robust safeguards should be put in place to ensure the soundness of the bank. Promotion of foreign direct investments should focus on business-enabling structural reforms, while the use of tax incentives should be minimized and well targeted.

Source: [Tonga—Staff Report for the 2014 Article IV Consultation](#).

See also the interview with the IMF mission chief for Tonga, Jack Joo Ree <http://www.radioaustralia.net.au/international/radio/program/pacific-beat/imf-gives-upbeat-forecast-for-tonga/1306190>.



Nuku'alofa, capital city
(Source: Tonganznet)

Maps: National Geographic and CIA World Factbook.

Perspective from the Field

Monetary Policy Challenges in Tonga¹

By Adam Gorajek, Head of the Economics Department at the National Reserve Bank of Tonga (NRBT) during May 2012-May 2014. This article is based on research conducted in the NRBT.

Overview

Tonga's recent experience suggests that monetary policy encounters the lower-bound constraint² more easily than in larger and more developed countries, which limits the effectiveness of monetary policy. What are the current challenges and potential long-term solutions for Tongan monetary policy?

Background

Monetary policy in Tonga has been accommodative over the last few years. Reserves held by commercial banks in excess of required reserves have been increasing since 2009, as reflected in the rise in the Exchange Settlement Account (ESA) balances at the National Reserve Bank of Tonga (NRBT). The rise in ESA balances has been driven by the NRBT's accumulation of foreign reserves under Tonga's fixed-exchange-rate regime. Normally, the NRBT would limit the increase in ESA balances, either by issuing short-term securities or raising the reserve requirement. However, given the weak economic outlook in 2009, the NRBT has allowed ESA balances to rise in order to support economic activity through lower interest rates and higher credit growth.

(Continued on Page 10)

Monetary Policy Challenges in Tonga (concluded)¹

Structural Challenges

Even so, banks' lending rates have fallen little since early 2010. The level of ESA balances was already high enough in early 2010 to cover even the most extreme levels of banks' daily cash outflows. This means that the balances, even then, did not actively constrain bank lending and further additions could not motivate banks to lower interest rates. Except for a brief period, the NRBT's standing facility rate was set at zero percent. The NRBT had already reached the lower bound of monetary policy.

At about 9 percent, the average bank lending rate seems too high to constitute a lower bound. But lending rates in Tonga cannot fall as much as in developed countries because lending is seen to be riskier and banks require compensation in the form of higher interest rates. Several factors contribute to the higher lending risks in Tonga:

- Tongan law prohibits banks from claiming freehold ownership of a borrower's property when the borrower defaults. Banks are restricted to leasehold ownership, for a period usually limited to 30 years from the mortgage start date. Mortgage collateral thereby depreciates over time. Banks also have difficulties diversifying assets owing to Tonga's small and narrow production base. General commercial rates are perceived to be high, with the ONDD, a Belgian public credit insurer, ranking commercial risks in Tonga among the highest, with institutional risks being a contributing factor.
- Tonga established a collateral registry in November 2011 but the registry data are reportedly questionable. Banks still cannot determine with confidence whether they are lending against genuine collateral. The information in Tonga's credit bureau is deficient and banks have little access to quality information on credit histories. The World Bank Group's International Finance Corporation scored Tonga 2 out of 6 for depth of credit information in 2013: the average score among small island states was 4.
- Resolving insolvencies in Tonga is unusually costly owing to the lack of insolvency-specific laws. The IFC accordingly ranked Tonga at 118 of 189 countries for ease of resolving insolvency.
- Foreign-owned banks, which account for 85 percent of Tonga's banking system, need NRBT approval to transfer funds to their head offices. The approvals are constant reminders that if Tonga's foreign reserves reach low levels again, the banks might be prevented from repatriating lending profits.

Policy Options Going Forward

Further increases in ESA balances would not be helpful. The NRBT could even drain some of the existing balances without lessening the degree of monetary policy stimulus. Draining the balances would also assist Tonga's financial market development, partly through increasing local familiarity with trading and holding debt securities. It would be critical not to drain balances to the point at which banks become liquidity constrained. The best way to stimulate economic growth now is with longer-term policies aimed at reducing local lending risks. The possibilities include, for example, helping improve the data in Tonga's collateral registry and credit bureau, supporting the introduction of insolvency laws, and helping enhance Tongans' personal financial management.

¹ This note reflects the views of the author and does not necessarily represent those of the NRBT or the IMF.

² A lower bound constraint is defined as a level of interest rate below which conventional monetary policy ceases to be effective.

References

- Davies, Matt and John Vaught, 2011, "[Interest Rates and Bank Profitability in the South Pacific](#)," PFTAC Regional Paper, July.
- , 2012, "Capital Requirements and Holdings in the South Pacific," PFTAC paper prepared for the 2012 South Pacific Central Bank Governors Meeting, December.
- International Monetary Fund, [Tonga: Staff Report for the 2013 Article IV Consultation](#).
- McCoy, Mary and Siotame Drew Havea, 2006, *Making Sense of Tonga: A Visitor's Guide to the Kingdom's Rich Polynesian Culture*, Training Group of the Pacific.
- Tonga Ministry of Finance and National Planning, 2013, "[Budget Statement 2013-14](#)," June.
- World Bank and the International Finance Corporation, 2013, "[Doing Business 2014](#)."

The Fund's Engagement with Small Developing States—Staff Guidance Note¹

The unique economic characteristics and constraints facing small developing states were presented in a March 2013 Fund Board paper [Macroeconomic Issues in Small States and Implications for Fund Engagement](#). While all small states have populations of under 1.5 million, they are a diverse group representing various income categories, but all of them face size-related constraints. The IMF has 33 members² that are considered small developing states. Three out of four small states are islands or widely dispersed multi-island states, such as in the Pacific region; others are landlocked, and some are located far from major markets.

Based on the findings of the Board paper, the Fund produced a note in May 2014 that provides operational guidance on Fund engagement with small developing countries; including on how small country size might influence the use of Fund facilities and instruments, program design, capacity building activities, and collaboration with other institutions and donors.

Five key thematic areas (G.R.O.W.TH.) are identified as central to the policy dialogue:

- **Growth and job creation.** Small states have experienced relative weak growth since the 1990s. An explicit focus on growth in both surveillance and program-related work is needed.
- **Resilience to shocks.** Small states experience higher macroeconomic volatility and more frequent natural disasters. Macroeconomic policy advice needs to be tailored to provide greater resilience to shocks.
- **Overall competitiveness.** Options to improve relative prices may include exchange rate adjustment (where possible) or measures supportive of internal devaluation (if not), and efforts to improve the business climate, including through regional initiatives.
- **Workable fiscal and debt sustainability options.** With many small states having very high debt burdens, reducing debt to manageable levels requires sustained fiscal consolidation with supporting policies and structural reforms. In cases where the amount of adjustment needed to restore debt sustainability is not feasible or adequate financing is not available, debt restructuring may be needed.
- **Thin financial sectors.** The promotion of deeper and more competitive, yet sound financial sectors contributes to economic growth in a stable macroeconomic environment and more effective policy mechanisms.

The guidance note also considers the special macroeconomic challenges faced by “micro” states, with populations of fewer than 200,000. In practice, many countries with populations larger than 1.5 million have characteristics of “smallness,” and this guidance note applies, in varying degrees, to these countries as well.

The guidance note is available at: <http://www.imf.org/external/np/pp/eng/2014/032414.pdf>.

¹ Prepared by Sarwat Jahan, (Strategy, Policy, and Review Department).

² The list of the 33 Small Developing States, according to the IMF definition, is presented below. These are IMF members with a population under 1.5 million excluding those defined as advanced market economies according to the World Economic Outlook, as well as fuel exporting countries classified by the World Bank Group as “high income” (Bahrain, Brunei Darussalam, and Equatorial Guinea).

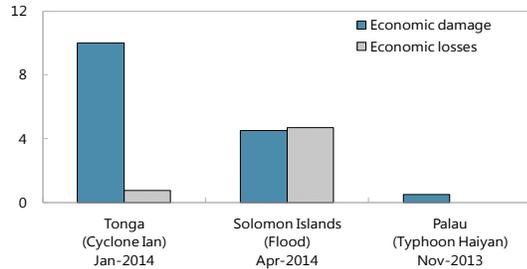
Antigua & Barbuda | The Bahamas | Barbados | Belize | Bhutan | Cape Verde | Comoros | Djibouti | Dominica | Fiji | Grenada
Guyana | Kiribati | Maldives | Mauritius | Micronesia | Montenegro | Palau | Republic of Marshall Islands | Samoa
São Tomé and Príncipe | Seychelles | Solomon Islands | St. Kitts and Nevis | St. Lucia | St. Vincent and the Grenadines
Suriname | Swaziland | Timor-Leste | Tonga | Trinidad & Tobago | Tuvalu | Vanuatu

Figure 1. APD Small States: Recent Economic Developments

APD small states continued to face challenges in recent months. Natural disasters caused damage and human and economic losses in some small states...

APD Small States: Economic Damage and Losses From Recent Natural Disasters

(In percent of GDP)

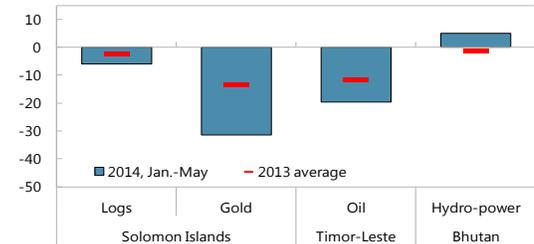


Sources: World Bank Group; and IMF staff estimates.

...floods in Solomon Islands further disrupted gold production while oil output in Timor–Leste continued falling because of depletion of oil reserves under production.

APD Small States: Commodity Production, January-May, 2014

(Year-on-year percent change)

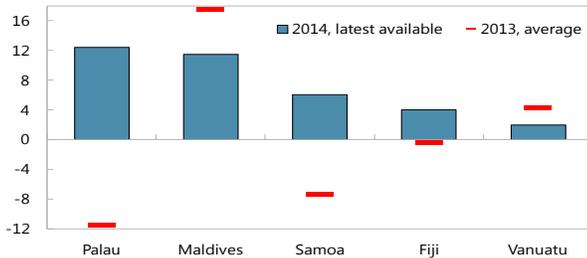


Note: For Bhutan it reflects year-on-year percent change of FY2014 over FY2013; and FY2013 over FY2012. The fiscal year starts in July.

Most tourism-oriented economies experienced robust increases in arrivals so far in 2014...

Tourism-intensive APD Small States: Tourist Arrivals, 2014, Latest Available

(Year-on-year percent change)



Note: January-June for Fiji and Maldives; January-May for Palau and Samoa; and January-March 2014 for Vanuatu.

...in part due to the appreciation of the Australian and New Zealand dollars since the beginning of this year.

Australia and New Zealand: Nominal Exchange Rate

(Index, January 2013=100)



Global food prices remained subdued...

Commodity Prices

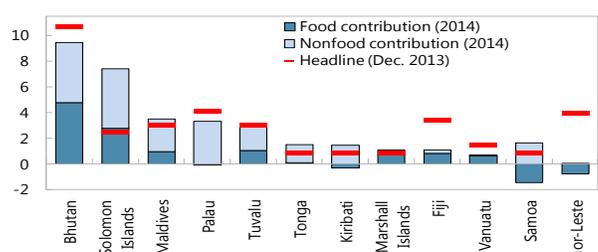
(January 2011=100)



...keeping inflation in check in most small states...

APD Small States: Inflation, 2014, Latest Available

(In percent)



Note: June 2014 for Fiji, Maldives, Palau, Samoa, Tonga, and Timor-Leste; May 2014 for Solomon Islands; and March 2014 for Bhutan, Kiribati, Marshall Islands, Tuvalu, and Vanuatu.

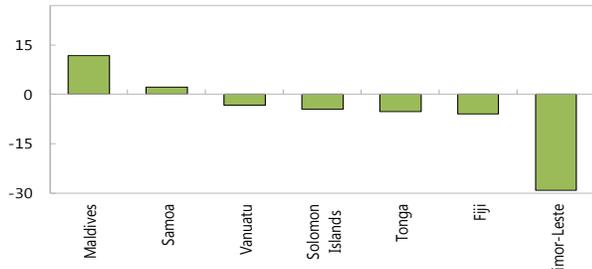
Note: Asia and Pacific developing (APD) small states include: Bhutan, Fiji, Kiribati, Maldives, Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Sources: Country authorities; EM-DAT International Disaster Database; and IMF staff estimates.

Figure 1. APD Small States: Recent Economic Developments (concluded)

...and helping contain the import bill.

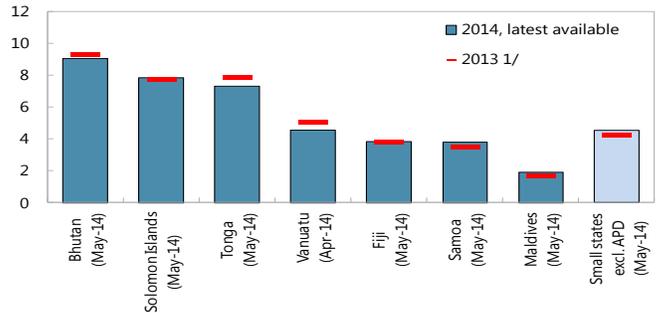
APD Small States: Imports of Goods, 2014, Latest Available
(Year-on-year percent change)



Note: January-May for Samoa and Solomon Islands; January-April for Fiji and Maldives; and January-March for Timor-Leste, Tonga, and Vanuatu.

The level of reserves remained broadly adequate and, in some cases, above comparators outside the APD region.

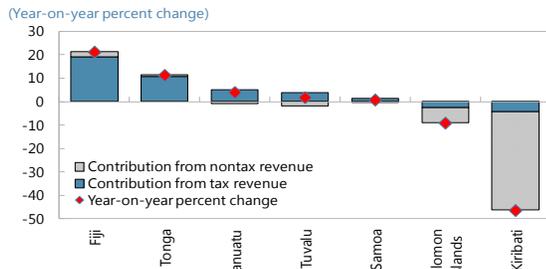
APD Small States: Reserves, 2014, Latest Available
(In months of next year's imports of goods and services)



1/ Indicates the same month as the latest available month in 2014.

Tax revenue was stable or increased, while nontax revenue declined, mainly in Kiribati because of lower fishing license fees, albeit from a very high base.

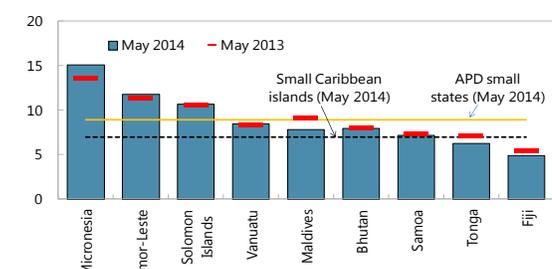
APD Small States: Fiscal Revenue excl. Grants, 2014, Latest Available
(Year-on-year percent change)



Note: January-May for Tuvalu and Vanuatu; January-April for Kiribati; and January-March for Fiji, Samoa, Solomon Islands, and Tonga.

Interest rate spreads were unchanged, but still higher than those of Caribbean comparators, reflecting PICs' structural impediments (e.g., use of land as collateral).

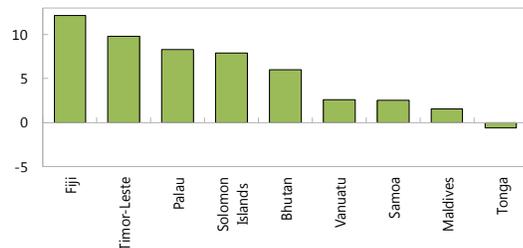
APD Small States: Interest Rate Spreads, May 2014
(In percent)



Note: March 2014 for Vanuatu. Spreads are computed as the difference between the average lending rate and the average deposit rate.

Private sector credit growth also varied across APD small states, still weak in some countries...

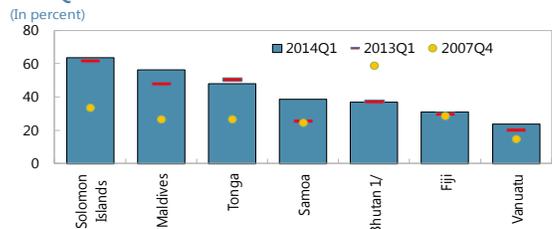
APD Small States: Private Credit Growth, 2014, Latest Available
(In percent; year-on-year change)



Note: May 2014 for Fiji, Maldives, Samoa, Solomon Islands, Timor-Leste, and Tonga; April 2014 for Vanuatu; and March 2014 for Bhutan and Palau.

...partly reflecting commercial banks' excess liquidity.

APD Small States: Nonloan Assets-to-Total Assets Ratio, 2014Q1
(In percent)



1/ December 2013 for Bhutan.

Note: Nonloan assets = total assets minus total loans. Nonloan assets include currency, deposits, securities, shares and equity, financial derivatives, other financial assets, and nonfinancial assets. The 2007Q4 data reflect the pre-crisis level.

Sources: Country authorities; and IMF staff estimates.

Photos from Recent IMF Missions and Small State Events



IMF Solomon Islands mission team with Denton Rarawa, Governor of the Central Bank of Solomon Islands and Vicki Plater, IMF Alternate Executive Director



IMF Palau mission team with the Palau authorities and members of the Palau National Congress



IMF Tonga mission team with Sione Ngongo Kioa, Governor of the National Reserve Bank of Tonga



Hoe Ee Khor, Deputy Director, Asia and Pacific Department, IMF



Hon. Maatia Toafa, Minister of Finance and Economic Development, Tuvalu (L), Wipada Soonthornsima, Deputy Division Chief, IMF Statistics Dept (C), and Scott Roger, PFTAC Coordinator (R)



Hon. Thomas Remengesau, President of Palau, and Patrizia Tumbarello, IMF Pacific Islands Unit Chief



Pacific islands senior officials and development partners at the PFTAC Steering Committee Meeting