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IMF Executive Board Concludes 2017 Article IV Consultation with Tonga

On January 17, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the 2017 Article IV consultation¹ with Tonga. The decision was made without a Board meeting.² Over recent years, Tonga has enjoyed robust growth and macroeconomic stability. Growth continued to be strong at 2.7 percent in FY2017³ following 3.4 percent in FY2016, supported by construction, agriculture, tourism, strong remittances, and strong private credit growth. Inflation spiked in FY2017 because of a new import tax and an increase in domestic food prices. The country's external position weakened slightly owing to construction-related imports, with reserves supported by strong remittances and donor aid.

The outlook for the Tongan economy is favorable, despite external headwinds. Real GDP growth is projected at 3.4 percent in FY2018, driven by construction, agriculture, and tourism. Inflation is expected to decline, as the effect of the import tax subsides. The current account balance is projected to record a large deficit in FY2018, due to capital imports related to construction, which would be financed by donor aid through capital account. Public debt is

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

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

³ Fiscal year in Tonga runs from July 1 to June 30.

expected to increase slightly as percent of GDP. Reserves are expected to increase in FY2018 owing to strong remittance inflows.

The overall balance of risks is tilted to the downside. Risks from weaker global growth and the potential implementation of inward looking policies could negatively impact Tonga via reduced remittances, donor funds, and tourism. Pressures on correspondent banking relationships may also weigh on Tonga's outlook by increasing the cost of remittances. Domestic risks mainly relate to fiscal sustainability, which may be compromised should public sector employment reforms fail to contain wage growth, or grant disbursements and related infrastructure building be delayed. A potentially large burden on fiscal expenditure could result from costs of future natural disasters, especially if donor intervention falls short. On the upside, a higher-than-expected short-term fiscal expansion may provide a boost to GDP growth.

Executive Board Assessment

Tonga has continued to experience strong economic growth and moderating inflation. Economic growth is projected to remain high in FY2018, slowing to the historic average over the medium term, while inflation is expected to moderate. The authorities have been successful in developing the agriculture and tourism sectors, which retain potential, and growth has been supported largely by construction.

Risks to the outlook are tilted to the downside and stem from external and domestic sources. Risks associated with potentially weaker economic growth and inward looking policies globally may adversely affect the future path of grant financing, private remittances, and revenues from tourism. While the government's infrastructure strategy may provide a short-term boost to growth and increase future growth potential, the government needs to carefully manage its expenditures and avoid fiscal slippage resulting in non-concessional external borrowing. The external sector is moderately weaker than warranted by fundamentals and desirable policies. The CA balance is below its estimated norm, largely due to Tonga's reliance on grants and reflecting a significant share of imports. The exchange rate is estimated to be in line with fundamentals, with no sign of a deterioration in Tonga's competitiveness. Reserve adequacy has been strong in recent years, but is projected to decline due to increased prospective imports and

loan repayments. A more prudent fiscal policy would also help to bring the external position back in line with fundamentals.

Staff supports more prudent fiscal management, while recognizing the need to build capital stock in Tonga. The introduction of explicit fiscal anchors in the FY2018 Budget Document is welcome. At the same time, expected budget revenue are optimistic, even with the proposed tax revenue reforms. As advised in previous Article IV Consultations, the authorities should contain the large wage bill to ensure that fiscal sustainability is not compromised. In terms of own-financed capital expenditure, the authorities should aim at prioritizing those projects that are more likely to deliver long term returns, including project areas of education, health, and roads, and building resilience to natural disasters. The FX levy should be replaced by a non-distortionary tax and be phased out no later than its sunset clause in FY2020.

In the medium term, the authorities should maintain fiscal sustainability through prudent PFM and fiscal adjustment as needed to secure fiscal space for growth-enhancing spending. To steer the fiscal stance on a more sustainable path, the authorities should target a gradual adjustment of the primary balance to approximately one percent of GDP by FY2022 to maintain the external public debt broadly unchanged. The required adjustment is achievable through several revenue and expenditure measures. PFM should be further strengthened to ensure appropriate medium-term planning, accountability, and budget control and the efficient use of public funds. The stance of monetary policy is appropriate, and the NRBT should stand ready to adjust should risks emerge. The current stance is supporting credit growth, which is consistent with financial deepening. However, the NRBT should be ready to adjust monetary policy should signs of overheating emerge. The authorities' efforts in modernizing its monetary policy framework through the introduction of a policy rate and amendments of the NRBT Act are commendable. The NRBT should consider using more flexible monetary policy tools in addition to the RRs. Staff welcome the reforms to the NRBT Act and the Banking Act, the latter of which still needs to be finalized to enhance NRBT's supervisory powers. Loss of CBR may become an increasing source of concern, and given the importance of remittances, the potential impact should be minimized through compliance with relevant international standards with regards to the AML/CFT.

Macroprudential policies should be used to address systemic risks to financial stability. The banking sector remains stable and profitable. However, high credit growth merit continued monitoring. Staff encourages the authorities to develop macroprudential policies, such as limits to LTV ratio for property loans, loan diversification principles, and maximum LTD ratio. The NRBT should develop credit monitoring indicators to catch early signs of potential distress. Staff supports ongoing reforms aimed at raising Tonga's growth potential and reducing poverty. In line with the TSDF II, the authorities are appropriately focusing on investing in infrastructure, enabling business climate, enhancing private sector development, developing human capital, and improving access to finance. Bringing the informal economy into the formalized MSMEs would promote inclusiveness and help ensure economic growth benefits the broader population. Staff supports the focus on expanding export market access and increasing the value added of domestic production.

Improving macroeconomic statistics is a priority. Although data are broadly adequate for surveillance, data quality and timeliness affect the formulation of economic policy and assessment of macroeconomic conditions. Staff recognizes recent improvements in some of the datasets, but efforts are needed to improve main macroeconomic datasets including BOP, fiscal accounts, and national accounts statistics. Staff encourages the authorities to resume or initiate timely official reporting of all relevant datasets to the IMF.

At the authorities' suggestion, it is proposed that the next article IV consultation with Tonga be held on the 24-month cycle. Tonga satisfies all relevant criteria to be moved to the 24-month cycle.

Tonga: Selected Economic Indicators, FY2013–FY2019 1/							
	FY2013	FY2014	FY2015	FY2016	FY2017 Est.	FY2018 Proj.	FY2019 Proj.
Output and prices (percent change)							
Real GDP 2/	-3.1	2.1	3.7	3.4	2.7	3.4	3.0
Consumer prices (period average)	0.7	2.3	0.1	-0.6	7.2	5.3	2.5
Consumer prices (end of period)	0.2	1.5	0.2	0.2	10.3	2.5	2.5
GDP deflator	0.5	1.0	1.5	1.7	3.1	2.1	2.1
Central government finance (percent of GDP)							
Total Revenue	33.2	37.7	34.9	40.9	44.5	53.5	52.6
Revenue (excluding grants in-kind)	25.1	28.8	28.1	30.6	30.5	32.1	30.3
Grants in-kind	8.1	8.9	6.8	10.3	14.0	21.5	22.3
Total Expenditure	34.5	31.3	37.6	41.3	44.9	55.8	54.5
Expense	26.2	27.8	31.6	32.0	34.1	41.1	39.7
Transactions in Nonfinancial Assets (Net)	8.2	3.4	6.0	9.4	10.8	14.8	14.8
Overall balance	-1.2	6.4	-2.7	-0.4	-0.4	-2.3	-1.9
Net Acquisition of Financial Assets	-0.7	6.0	-1.9	1.8	0.3	1.5	1.6
External financing (net)	0.4	-0.2	-0.4	0.2	0.3	3.6	3.5
Domestic financing (net)	0.2	-0.1	1.2	2.0	0.5	0.2	-0.1
Money and credit (percent change, end of period)							
Total liquidity (M3)	5.2	7.3	9.3	16.7	18.8	11.7	11.3
Of which: Broad money (M2)	6.1	7.2	9.0	15.0	19.1	12.1	11.7
Domestic credit	2.5	7.8	15.4	8.8	5.8	16.6	14.1
Of which: Private sector credit	-2.7	0.7	10.6	18.0	18.9	13.0	12.0
Interest rates (end of period)							
Average deposit rate	2.0	1.9	2.0	2.1	2.3
Average lending rate	9.4	9.0	8.7	8.7	8.6
Balance of payments (US\$ millions)							
Exports, f.o.b.	14.9	17.9	19.4	24.1	25.3	26.4	27.0
Imports, f.o.b.	-187.4	-187.6	-207.7	-202.8	-235.1	-258.4	-281.2
Services (net)	-17.9	-10.6	-19.4	-9.1	-14.4	-17.3	-21.7
Investment income (net)	11.3	3.2	4.5	2.5	6.8	8.7	11.6
Current transfers (net)	135.3	147.1	137.9	129.7	166.0	190.5	207.5
Of which: Remittances	107.4	102.7	102.2	112.2	117.4	124.3	130.4
Of which: Official grants	25.4	37.8	27.0	33.0	53.1	69.6	80.5
Current account balance	-43.7	-30.0	-65.3	-55.6	-51.3	-50.1	-56.7
(In percent of GDP)	-9.7	-6.8	-15.0	-13.2	-12.0	-11.8	-12.9
Overall balance	2.4	11.2	-16.2	23.9	3.5	15.4	-8.5
Terms of trade (annual percent change)	-2.7	1.5	-3.6	2.0	3.1	-1.8	-0.5
Gross official foreign reserves							
Gross official foreign reserves (US\$ millions)	147.6	158.7	142.5	166.4	169.9	185.2	176.7
(In months of imports)	6.9	6.8	6.3	6.3	5.9	5.9	5.5
Debt (percent of GDP)							
Public debt (external and domestic)	49.2	47.1	51.4	51.8	48.0	49.2	50.3
External debt	44.0	41.9	45.2	44.0	41.8	43.2	44.6
Debt service ratio	1.4	1.5	1.6	1.6	1.6	1.5	3.8
Nominal effective exchange rate (2005=100)	105.4	103.3	103.0	98.8	99.1
Real effective exchange rate (2005=100)	105.5	103.4	101.7	96.4	101.8
Memorandum items:							
Remittances (percent of GDP)	23.9	23.2	23.5	26.6	27.4	29.4	29.7
Tourism (percent of GDP)	9.9	9.5	11.3	13.0	12.9	15.0	15.3
FDI (percent of GDP)	1.4	1.7	2.4	2.6	2.7	2.8	2.8
Nominal GDP (T\$ millions)	779.3	803.7	846.1	889.4	941.8	993.8	1045.1
GDP per capita (T\$ thousands)	7.5	7.7	8.1	8.5	9.0	9.5	9.9
Population (thousands)	103.5	103.9	104.1	104.3	104.6	104.8	105.1
Sources: Tongan authorities; and IMF staff estimates and projections.							
1/ Fiscal year beginning July.							
2/ Including preliminary data.							