INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/253

TUVALU

August 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TUVALU

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 2014 Article IV consultation with Tuvalu, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on August 25, 2014, following discussions that ended on May 28, 2014, with the officials of Tuvalu on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 5, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Press Release** summarizing the views of the Executive Board as expressed during its August 25, 2014 consideration of the staff report that concluded the Article IV consultation with Tuvalu.
- A **Statement by the Executive Director** for Tuvalu.

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

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International Monetary Fund
Washington, D.C.

TUVALU

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

August 5, 2014

KEY ISSUES

Overview. Large revenues from fishing licenses, together with substantial foreign aid, facilitated a sizable budget surplus in the past two years but also an expansionary budget in 2014. The large increase in budget spending is set to cause some inflationary pressure. More importantly, the likely difficulties in unwinding the budget expansion and potential liabilities arising from weaknesses in state-owned banks and public enterprises make fiscal sustainability a major concern over the medium to long run.

Outlook and risks. Growth prospects are generally positive owing to several large infrastructure projects financed by development partners that are planned to be implemented over the medium term. Inflation is expected to rise moderately, reflecting rapidly growing government expenditure and substantial public sector wage increases. Near-term risks mainly stem from elevated banking sector vulnerabilities, while, over the medium to long run, growth prospects may be hampered by the dominance of inefficient public enterprise in the economy, uncertainty in the fisheries sector, and weak competitiveness.

Policies. Policy discussions focused on fiscal sustainability and resource revenue management, financial stability, and structural reforms to engender sustained, inclusive growth. Key recommendations include:

- Unwind the large budget expansion in 2014, conduct fiscal consolidation, and, over the medium term, introduce a fiscal framework that targets a structural fiscal surplus;
- Establish a regulatory framework and conduct a complete diagnosis of the banking system as soon as feasible;
- Develop a reform plan for public enterprises, with a focus to clearly define and cost social responsibilities and enhance transparency and accountability; and
- Continue to implement reforms toward inclusive growth, including through an improved business environment, enhanced vocational training, and greater efforts to explore job opportunities both at home and abroad.

Approved By
Brian Aitken
and Vikram Haksar

Discussions took place in Funafuti during May 21–28, 2014. The team comprised Mr. Yu (Head), Ms. Jung (both APD), Ms. Sian (SEC), Mr. Yang (Resident Representative), Ms. Pan (World Bank), Ms. Olsson, and Mr. Lototele (both ADB). Mr. Yoon and Mr. Moon (both OED) participated in the discussions

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CONTEXT

1. **Tuvalu is one of the smallest and most isolated countries in the world**. With a population of some 11,000 people living on 26 square kilometers, Tuvalu is more than 3,000 kilometers away from its nearest major external market (New Zealand). The country faces tremendous challenges stemming from its remoteness, lack of scale economies, weak institutional capacity, and, above all, climate change and rising sea levels, which threaten the country's very existence. (Appendix III)

2. **Income is relatively high, but the economy is fragile.** Fishing revenues and foreign aid, as well as remittances, have significantly raised living standards—absolute poverty is rare, access to primary education is effectively universal, and per capita income is among the highest in the group of small Pacific island countries. Nevertheless, fishing revenues and foreign aid are highly volatile and uncertain (Appendix IV), and could experience a secular decline over the medium to long run, while remittances have not recovered to the level prevailing before the global financial crisis mainly as a result of limited human capacity, pointing to weak competitiveness (Appendix V). The authorities have limited policy space to maneuver—fiscal policy is the only macro policy lever given the use of the Australian dollar as the legal currency; there is little scope for diversifying the small economy that is dominated by inefficient public enterprises; and the lending capacity of banks is constrained by severe asset quality problems. These factors make it all the more important to develop a sound fiscal policy framework, address weaknesses in banks and public enterprises, and foster a favorable business environment for the private sector.

3. **Tuvalu holds large assets abroad and also owes substantial debt.** The Tuvalu Trust Fund (TTF), originally capitalized by development partners in 1987, aims to provide additional funding for budget support. Holdings are global, but Australian assets are weighted heavily. The TTF is not fully sovereign and cannot be drawn down freely: when its market value exceeds a "maintained value" indexed to Australian CPI, the TTF Board—representing both development partners and Tuvalu government—can decide to transfer the excess to the budget. TTF's market value dropped markedly during the global financial crisis, but has since recovered steadily to more than $A 140 million (3.5 times of GDP). The Consolidated Investment Fund (CIF) serves as a fiscal buffer and deposit account for development partners' grants, and can be drawn down freely at the authorities' discretion. Thanks to large fiscal surpluses achieved in the past two years, CIF has been built up to more than $A 15 million (38 percent of GDP). Meanwhile, Tuvalu's public debt has reached 41 percent of GDP by end-2013, with external debt—including public enterprise debt on commercial terms—accounting for 35 percent of GDP. The debt is projected to rise sharply to 56.9 percent in 2014 on account of a new loan agreement taken on by a fishing joint venture to finance the expansion of its fishing capacity—the loan could, as usual, be guaranteed by the government.

4. **The authorities are cognizant of the challenges and have developed a broad reform agenda**. A policy reform matrix (PRM), formulated in consultation with development partners, has been fleshed out in an effort to enhance governance and social development, facilitate private sector growth, and safeguard macroeconomic stability. (Appendix II) Significant progress has been

made in the first two phases of the PRM to enhance public financial management, while measures undertaken to rationalize social spending and strengthen public enterprises have witnessed limited success. The authorities are designing the third phase of PRM in close consultation with development partners.

5. Tuvalu has entered into an electoral cycle. The general elections are expected to be held by March 2015.

BACKGROUND

A. Recent Developments

6. Growth has been weak while inflation picked up moderately. Real GDP growth has been volatile averaging only 1 percent in the past decade. Activity has benefited from increased competition in the retail sector and a recent boom in the fisheries sector, while banking weaknesses constrain the financial support for the private sector, and the poorly managed public enterprises strain government finances and worsen the country's business climate. Inflation rose to 3 percent by end-2013, largely reflecting a pickup in nonfood inflation. It benefited from lower global food and commodity prices, as well as trade diversification and increased retail competition, but prices rose on account of a weakening Australian dollar.

7. The balance of payments has been supported by large fishing-related receipts and official aid. Owing to the introduction of the Vessel Day Scheme and the establishment of fishing joint ventures with Asian companies, both fishing exports and fishing license fees have more than doubled in just a few years, with each accounting for about half of GDP now.[1] Foreign aid, including both budget support and off-budget project financing, has also hovered at around half of GDP. However, remittances, which used to be one of the most important sources of foreign exchange inflows, have shrunk dramatically since the global financial crisis, to 10 percent of GDP compared to the pre-crisis levels of nearly 20 percent. Imports, which closely correlate with fiscal spending, have been generally stable.

8. The budget achieved a substantial surplus for the second consecutive year in 2013. Fishing license fees reached a record high in 2013 because of improved negotiating power under the Vessel Day Scheme and increased revenues under the bilateral treaty with the U.S. government. Tax revenue outperformed the budget target largely as a result of improved compliance following a tax audit of public enterprises and the favorable performance of a fishing joint venture as well as a VAT rate increase. These developments were further reinforced by higher-than-expected foreign grants. Current spending was generally restrained, and on-budget capital spending was small, reflecting the government's weak implementation capacity. As a whole, the fiscal surplus reached 26.3 percent of GDP.[2]

[1] The Tuvaluan government holds around 50 percent of the joint venture's shares.
[2] Extrabudgetary spending supported by project financing from development partners have been around 25 percent of GDP.

9. Vulnerabilities of banks and public enterprises have further aggravated structural weaknesses. In the unsupervised state-owned dual-bank system, asset quality remains poor as half of the loan portfolio is nonperforming, which is caused to a large extent by government-sponsored programs implemented a few years ago and public enterprise borrowing. Although both banks, i.e. the National Bank of Tuvalu (NBT) and Development Bank of Tuvalu (DBT), have restricted their exposure to public enterprises and made substantial provisions, an accurate estimate of capital adequacy is impeded by the lack of a regulatory framework. The DBT—accounting for about10 percent of banking sector assets—has made substantial losses, with its net capital depleted from $A 2.5 million (7.2 percent of GDP) to $A 0.7 million (1.7 percent of GDP) in the past three years. The DBT further experienced a sharp drop in deposits in 2013 as depositors were concerned with its capacity to service obligations. Meanwhile, non-bank public enterprises, with some being insolvent already, accumulated losses of more than 3 percent of GDP in the past few years, leaving this sector's total capital below 0.5 percent of GDP. (Appendix VI) The immense losses incurred by public enterprises represent deficiencies in governance and the cost of social responsibilities.

10. There is no sign of significant exchange rate misalignment. The real effective exchange rate depreciated over the past year and has returned to its 10-year average on the back of a weakening Australian dollar. However, the economy's competitiveness remains weak, with remoteness causing high transportation cost and isolation, and the lack of scale increasing transaction cost. The large budget expansion could exert inflationary pressure and cause real exchange rates to appreciate, undermining competitiveness. (Box 1)

B. Outlook and Risks

11. Near-term risks mainly stem from banking sector vulnerabilities, while fiscal sustainability remains a major concern over the medium to long run. Several infrastructure projects financed by grants from development partners (amounting to more than 40 percent of GDP) are expected to come on stream in the next three years, and may boost growth to 2.5 percent, while weak capacity and competitiveness will continue to impede growth over the long run.[3] Macroeconomic and financial risks are elevated. In the near term, the impaired balance sheet of the DBT could further weaken its lending capacity, constitute a drag on growth in the private sector, and, more importantly, threaten macro-financial stability and undermine business confidence. Over the medium to long run, maintaining fiscal sustainability remains the most important challenge—the debt sustainability analysis suggests a high risk of debt distress under the baseline; fishing revenues are highly uncertain and face downside risks; and contingent liabilities, mostly associated with state-owned banks and public enterprises, are substantial.

12. The external account may deteriorate over time. The large inflows of foreign grants would be offset by rising imports as a result of increased budget spending and public investment. With the depletion of the CIF, foreign exchange reserves are projected to decline from 9 months of

[3] The spending on these large projects would be extrabudgetary.

imports to 5 months over the medium term. The balance of payments is subject to significant risks. Fishing license fees will likely remain buoyant over the medium term, but may decline over the long run because of climate change and overfishing. Remittances by seafarers and seasonal workers might weaken if the risk of protracted slower growth in advanced and emerging economies materializes or China's economy further slows, affecting growth and job opportunities in the Pacific region. The impact of U.S. tapering is uncertain—the tapering could cause the Australian dollar to further depreciate and improve Tuvalu's competitiveness, but a disorderly tapering may increase volatility in Australia's asset markets where the TTF is invested, generating fluctuations in the TTF's market value and likely transfers to Tuvalu's budget.

Authorities' Views

13. The authorities generally agreed with the staff's views on the economic outlook. They indicated that the weak growth may result from a lack of large projects, and expect growth to pick up in the next few years as several large projects start to be implemented. They also anticipated balance of payments pressure in light of the uncertainty in fishing-related receipts.

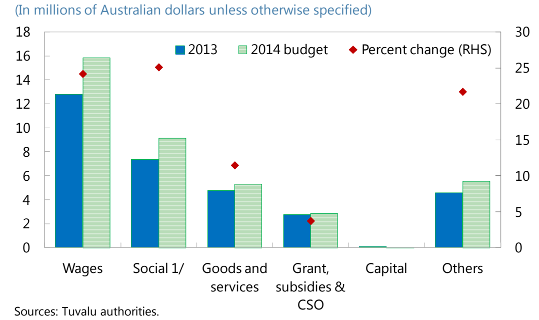
POLICY DISCUSSIONS

The key policy agenda is to develop a medium-term fiscal framework that anchors a sustainable fiscal policy; address risks in the banking sector by establishing a regulatory framework; enhance the efficiency of public enterprises, and foster inclusive growth and competitiveness via continued structural reforms.

A. Fiscal Policy and Public Financial Management

14. Despite sound fiscal performance in the past two years, a dramatic expansion of budget spending in 2014 has substantially increased risks to fiscal sustainability. The 2014 budget continues to target a surplus, with a large temporary increase of foreign grants and TTF transfers financing a more than 20 percent expansion of spending, which is mostly one-off increases of current expenditure and includes a 25 percent rise in civil servant salary and a potentially costly revival of the Tuvalu Cooperative Society (TCS), which would supplement the supply of necessities to outer islands by private retailers[4]. The large salary increase has also induced public enterprises to increase employee wages by the same magnitude, adding to their operational costs.

Expenditure Breakdown
(In millions of Australian dollars unless otherwise specified)



Sources: Tuvalu authorities.
1/ Includes Tuvalu Medical Treatment Scheme, scholarship programs and Special Development Expenditure.

[4] Tuvalu Cooperative Society (TCS) is owned by Tuvaluan people and used to be the main wholesaler and retailer. With increasing competition from private retailers, the TCS was forced to terminate most of its operations after incurring large losses. The TCS currently holds arrears of $A 2.5 million against external suppliers and domestic banks.

With on-budget foreign grants returning to historical average levels, the budget would move into a deficit from 2015 onwards and fully deplete the fiscal buffers over the medium term unless the spending increase is unwound.

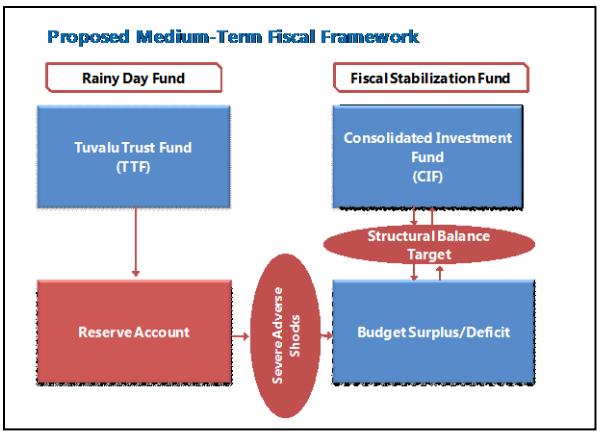
15. Medium-term fiscal risks arise from several sources. First, tax revenue might shrink as the tariff rates that apply to regional trade are cut under the Pacific Island Countries Trade Agreement (PICTA).[5] Second, there is a risk that fishing revenue might decline after its recent rapid increase as overfishing and climate change adversely impact fishing resources. Finally, vulnerabilities in banks and public enterprises may pose substantial liabilities to the government—bringing the capital of insolvent non-bank public enterprises to positive would cost at least 4 percent of GDP, while the cost of addressing banking vulnerabilities needs to be assessed under a regulatory framework. The government' guarantee of public enterprise debt, notably including external loans borrowed by the fishing joint ventures, also constitutes contingent liabilities.

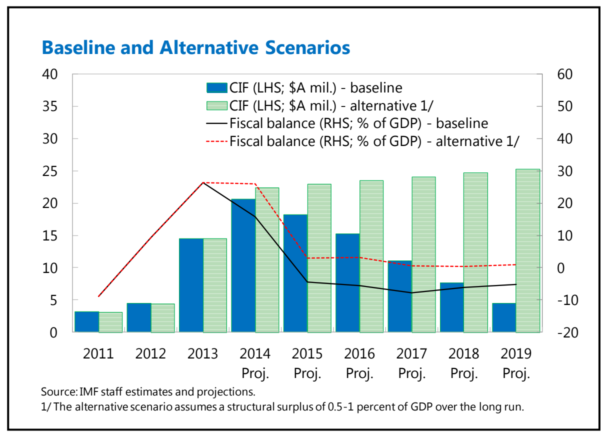
16. To enhance fiscal sustainability, consolidation efforts are needed. Tax administration should be further strengthened, including through legal actions on non-compliance, and a tax policy review would be necessary given the uneven cost-benefit among different taxes. However, given the narrow economic base, the scope for further increases in tax revenue is limited, and most of the fiscal consolidation would more likely be achieved via expenditure control in the near term. To put the fiscal policy on a sustainable footing, the government expenditure should be scaled down from the 2014 budget level at 93 percent of GDP to about 80 percent of GDP in the next three years when the impact of budget spending cut on growth would be offset by the implementation of large infrastructure projects financed by development partners. To achieve this target, spending should be largely frozen—which would bring down its share in GDP to 84 percent within three years—while a few rapidly growing expenditures should be cut back. For example, although rolling back civil servants' salary increase may be difficult, expenditures on goods and services as well as grants and subsidies—all budgeted to grow by double digits—should be put under tight scrutiny on the back of the newly introduced procurement mechanism and the PRM framework, and be reined in to the extent feasible. Moreover, reviving TCS would require additional financial support, which could cost 10 percent of GDP to clear arrears and regain market share. The authorities should explore more cost effective policies to supply necessities to the outer islands. Additionally, there is considerable room to improve the cost effectiveness of social programs such as the scholarship program and Tuvalu Medical Treatment Scheme (TMTS), which finances overseas treatment of Tuvaluan patients. Last but not least, the government should refrain from providing guarantees for public enterprise borrowing given the already high risk of debt distress.

17. Beyond fiscal consolidation, a new medium-term fiscal framework is needed to ensure fiscal sustainability, address procyclicality and build buffers in view of the daunting challenges facing Tuvalu. Under this framework, the transfers between the budget, the CIF, and the TTF should follow a clear rule anchored by a structural balance target:

[5] Under PICTA, tariff rates for the trade among Pacific island countries will be cut to zero by 2015, and this rate cut would be deferred to 2017 for the least developed countries including Tuvalu.

- Targeting a structural balance would reduce expenditure fluctuation as a result of revenue volatility. Given the weak capacity, staff suggests a simple approach to estimate the structural revenue, where fishing license fees are adjusted to reflect their moving average. As fishing license fees have been increasing markedly, targeting a structural balance would imply saving a portion of these fees for the time being. Staff estimates that, with the CIF already built up to a comfortable level, a structural surplus of 0.5-1 percent of GDP is needed to maintain fiscal buffers and bring down the risk of debt distress from high to moderate over the medium and long run.
- To help achieve the structural balance target, the CIF should be transformed into a fiscal stabilization fund that follows a clear rule of accumulation and withdrawal—temporary windfalls from fishing revenues should be saved in the CIF and it can be drawn down when there is a revenue shortfall.
- The TTF should serve as a rainy day fund, with the returns on investment saved in a reserve account for use in the event of severe adverse shocks.





18. Marked progress has been made in strengthening public financial management. Notably, a central procurement unit has been established, and associated regulations adopted. The authorities also published a budget manual outlining the budget process and policies, strengthened the monitoring of outer island budget operations, and started releasing monthly reports of budget execution, which significantly enhanced transparency and facilitated budget control.

19. Nevertheless, there is scope to further strengthen public financial management to improve transparency and safeguard fiscal resources. The budget process needs to be anchored by a sustainable medium-term fiscal framework that incorporates development objectives. The management of fishing license fees should be streamlined, with a focus to reconcile the treasury receipts and the sale of licenses by the Fisheries Department. Introducing a commitment control system would further improve budget management. Over the medium term, a wage-setting mechanism is necessary to ensure that public sector wage increases are in line with productivity gains in the economy.

Authorities' Views

20. The authorities shared staff's views on fiscal sustainability risks. They worry about the lack of transparency in the TMTS and its potential overspending, and intend to contain its cost by establishing a comprehensive database and closely following patients' treatment schedules. They also agreed to carefully estimate the cost of reviving the TCS and consider alternative options as needed. On debt sustainability, they generally concur with staff assessment, but indicate that the contingent liabilities from fishing joint ventures are not a key concern as the joint ventures have a favorable outlook and the probability for the government to assume their debt obligation is small.

21. The authorities agreed with the staff's proposal on introducing a medium-term fiscal framework. They share the concern about revenue volatility, and support the suggestion to have the fiscal policy anchored by a structural balance and make the TTF a rainy day fund, with its investment returns saved in a reserve account for large adverse shocks.

22. The authorities are committed to further enhancing public financial management. They are developing the IT system to better reconcile fishing license fees between the Treasury and Fisheries Department. They will also aim to further improve public financial management when implementing the third phase of PRM.

B. Financial Stability

23. Given substantial vulnerabilities in the banking sector, there is an urgent need to establish a framework of banking supervision and resolution. The NBT's financial risk appears under control given the sound profitability as indicated by a return on assets of around 3 percent and comfortable capital equivalent to 24 percent of total assets, although these need to be verified under a prudent regulatory framework. The rapid deterioration of the DBT's financial position points to a looming solvency issue. This would imply spillover risks across the banking system, which may be limited by the DBT's small market share and relatively simple financial linkages, and perhaps more importantly, result in large government liabilities: the budget would need to allocate resources to repay the bank's borrowing guaranteed by the government (1.4 percent of GDP). Moreover, fresh capital may eventually need to be injected into the banking system should an assessment based on prudent standards suggest—given the underdeveloped private sector and its limited financial capacity as well as the unsuccessful experience of privatizing public enterprises, introducing private capital could be challenging, and resorting to budget resources would still be likely. Going forward, the priority is to implement a banking supervisory and regulatory framework—in particular, a Bank Commission needs to be established and supervisors employed as soon as feasible with due regard to controlling administrative costs. Given Tuvalu's limited capacity and the need for arm's-length supervision, development partners' support for this initiative will be crucial.[6] The financial condition of the banking sector and its implications for the economy, e.g. the cost of a possible

[6] The mission suggested that the authorities contact the Pacific Financial Technical Assistance Centre (PFTAC) for technical assistance as soon as feasible.

recapitalization, should be assessed urgently on the basis of prudential standards, and a banking resolution framework needs to be set up.

Authorities' Views

24. The authorities are cognizant of the need to strengthen the banking sector. They are considering establishing the Bank Commission as stipulated by the law, and agreed with staff's views on the need to strengthen the banking sector, albeit with more focus on expanding banking services.

C. Public Enterprise Reform

25. Progress has been made in enhancing the governance of public enterprises, but they remain broadly inefficient. Staff welcomes the improved financial reporting, enforcement of the Public Enterprise Act, and progress made in merging and privatization efforts. Nonetheless, given their responsibilities to implement social policies, the poorly managed public enterprises are far from operating on a commercial basis and are mostly making losses despite receiving large government subsidies. The situation of the Tuvalu Electricity Corporation (TEC) is particularly worrisome as fuel grants by development partners are to be phased out by end-2014, which would add to fiscal burdens in subsidizing this corporation and make Tuvalu increasingly susceptible to fluctuating oil prices in the global market. A recent review conducted by a third party suggests that tariff adjustments may be inevitable to make the TEC financially viable.

26. A reform plan is needed to put public enterprises on a sustainable footing. The reform package should aim to enhance the enterprises' commercial orientation and financial soundness. In particular, there is a need to clearly define and cost their social responsibilities, which, together with strengthened accounting and auditing practices, would enhance their transparency and accountability. With respect to the TEC, electricity tariff rates should be reviewed periodically and allowed to adjust to appropriately reflect operational cost and fuel price movements, and government social policies should be directed at protecting the most affected poor.

Authorities' Views

27. The authorities are committed to advancing public enterprise reform with assistance by development partners. They are working with the Asian Development Bank on public enterprise reform through privatization and merging, and are seeking additional technical assistance in reviewing the operation of the Telecommunication Corporation.

D. Promoting Inclusive Growth

28. The reform momentum should continue with a focus on promoting macroeconomic stability and growth. The completion of the PRM I and II is commendable. Continued reform via the initiation of PRM III is important and should focus on strengthening the fiscal framework and addressing structural weaknesses, notably in the banking and public enterprise sectors. Rebalancing resources toward basic and vocational education, improving gender equality in accessing training opportunities, and enhancing infrastructure would help deliver better development outcomes and strengthen competitiveness. Greater efforts are also needed to foster domestic job market and explore employment opportunities for the labor force abroad, including through the seasonal worker scheme in other countries of the Pacific region.

Authorities' views

29. The authorities are committed to continued reforms. Building upon the achievements made under the first two phases of PRM, the authorities are working closely with development partners on the design of PRM III, which may be launched in a few months and will continue to focus on fiscal sustainability and public financial management as well as structural issues to foster private sector development.

E. Other Issues

30. Article XIV/VIII. At the time of joining the Fund in 2010, Tuvalu availed itself of the transitory provisions of Article XIV, Section 2. While the exchange control regulations are quite restrictive and prescribe approval requirements from the NBT or the Finance Minister for most payments or transfers, staff's understanding is that in practice, no approval is required and payments and transfers for current international transactions are administered liberally. Staff continues to conduct a comprehensive review of the exchange system to assess jurisdictional implications. Staff has recommended that the regulations be updated in line with current practice so that Tuvalu can accept the obligations of Article VIII, Sections 2, 3, and 4, although the authorities have indicated that they have no current plans to do so.

31. Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). Tuvalu is currently strengthening its anti-money laundering framework, based on the 2006 AML/CFT law and benefitting from technical assistance. Tuvalu became an observer to the Asia/Pacific Group on Money Laundering (APG) in 2014.

32. Capacity building in government statistics remains a daunting task. Progress is being made in a few areas such as budget execution reporting and balance of payments statistics. However, the statistical office is understaffed, and weaknesses in national accounts statistics impede economic analysis. Going forward, there is an urgent need to increase resources allocated to statistical work and to strengthen training and technical assistance provided by development partners including PFTAC.

STAFF APPRAISAL

33. Tuvalu has made significant strides in implementing reform policies. Tax administration, particularly the compliance of public enterprises, and public financial management have been strengthened. Progress has also been made in enhancing the monitoring and auditing of public enterprises and removing civil servants from Board positions. Nevertheless, important challenges remain.

34. Now is the time to build on the favorable budget outcome of the last two years to further enhance fiscal sustainability. With the buildup of fiscal buffers, the budget is in a strong position to reinforce fiscal soundness. Fiscal consolidation, particularly unwinding the 2014 budget expansion, is crucial to put the budget on a sustainable footing. Introducing a medium-term fiscal framework that targets a structural surplus would profoundly strengthen Tuvalu's capacity to manage revenue volatility, and creating more savings in the TTF would build resilience against adverse shocks.

35. There is considerable room to rationalize social spending. It will be prudent to institutionalize the referral committee and closely scrutinize the medical expenses under the TMTS. Staff also encourages the authorities to explore alternative health plans with burden sharing by individuals, for example negotiating health insurance for its citizens, which can be purchased using citizens' savings at the Tuvalu National Provident Fund. For the scholarship program, targeting the total number of students studying abroad instead of new students would make the resource allocation more predictable and facilitate budget management.

36. There is an urgent need to address the heightened banking risks. The increasing losses and liquidity pressure experienced by the DBT may lead to a solvency problem. The authorities need to develop a contingency plan for the bank's possible failure, most importantly a resolution framework and an estimate of associated fiscal costs. Meanwhile, measures need to be undertaken to contain losses incurred by the bank. A complete review of the banking system should be conducted, and a regulatory framework should be established as soon as feasible.

37. Given the dominance of public enterprises, their financial viability is crucial to the health of banks and fiscal sustainability. The Public Enterprise Reform and Management Unit (PERMU), which is supposed to play a critical role in developing a reform package, should be well staffed. At the current conjuncture, priority should be given to clearly defining public enterprises' social responsibilities and enhancing their transparency and accountability via strengthened accounting and auditing practices.

38. Prudent macroeconomic policies and continued structural reforms are essential to enhancing competitiveness and building resilience. Although there is no sign of significant overvaluation, Tuvalu's competitiveness remains weak, as indicated by the falling remittances from seafarers. In this context, government spending and wage increase should be restrained to reduce inflationary pressure and real exchange rate appreciation. Over a longer horizon, providing sound education and vocational training opportunities, for example, by upgrading training programs at the Tuvalu Maritime Training Institute and allowing access by women, is key to improving employment and competitiveness. The implementation of the PRM has begun to bear fruit, and reforms in the next phase should continue to aim at containing fiscal risks, addressing structural weaknesses in banks and public enterprises, and enhancing the business environment for the private sector.

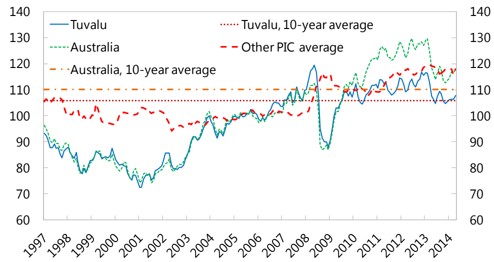
39. Data shortcomings, particularly in the national accounts, hamper surveillance. Additional resources need to be allocated to the statistical work necessary for surveillance and policymaking.

40. Staff recommends that the next Article IV consultation take place on a 24-month cycle.

Box 1. Tuvalu: External Sector and Exchange Rate Assessment[1]

Tuvalu's real effective exchange rate (REER) has returned to its historical level. The REER has depreciated by about 8 percent since its recent peak in early 2013. The real depreciation was mainly driven by the weakening of the Australia dollar, the legal currency in Tuvalu. Historically, Tuvalu's REER has moved closely with that of Australia, but has been less appreciated since the global crisis.

International Comparison: Real Effective Exchange Rate
(Index, 2005 = 100)

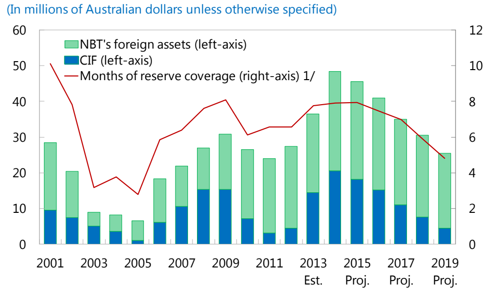


Sources: IMF, INS; IMF, APD-CORE; and IMF staff calculations.

There is no sign of significant exchange rate misalignment, but loose policies could increase the risk of overvaluation over the medium term. Benefiting from lower global food and commodity prices, as well as increased trade diversification and retail competition, inflation in Tuvalu has been below trading partners' inflation. However, the expected sizable increase in public sector wages would boost domestic demand, widen the trade deficit, and exert upward pressure on inflation and real exchange rate appreciation.

Reserves appear sufficient, but would decline in the medium term.[2] The significant increase in the CIF as a result of fiscal surplus in 2012 and 2013 is estimated to push reserves up to around nine months of imports. In the medium term, however, the fiscal balance is expected to move into a widening deficit on the back of stagnated fishing license fees and a loose control on expenditure, which will cause the CIF to be fully depleted by 2020 and a rise of imports. As a consequence, import cover will decline to five months. Although the reserve cover appears sufficient by traditional cover, an estimate based on risk metrics suggests it should be kept at above seven months of imports.

Tuvalu: International Reserves
(In millions of Australian dollars unless otherwise specified)



Source: Tuvalu authorities.
1/ Ratio of international reserves to next year's imports of goods and services, in months.

Tuvalu's competitiveness remains weak. Remoteness causes high transportation costs and isolation, and the lack of scale increases transaction cost. Moreover, insufficient human capital impedes Tuvaluans to explore overseas job opportunities, with declining remittances pointing to structural weaknesses. In this connection, improving the business climate and taking an innovative approach to exploring growth opportunities, including strengthening education and training, are particularly important in the long run.

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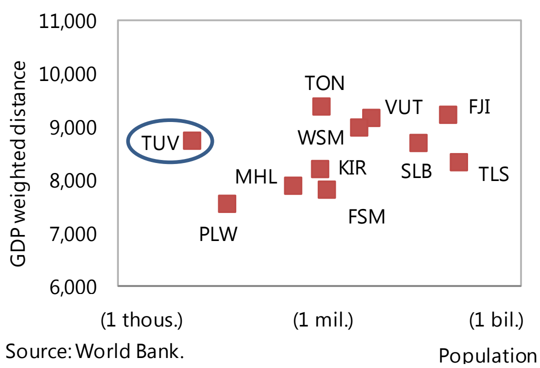
1 Prepared by Sung Eun Jung.

2 Reserves are defined as the sum of CIF and liquid foreign assets held by the National Bank of Tuvalu.

Figure 1. Tuvalu: The Setting in a Cross-Country Context

Tuvalu is one of the most remote islands in the South Pacific and among the least populated.

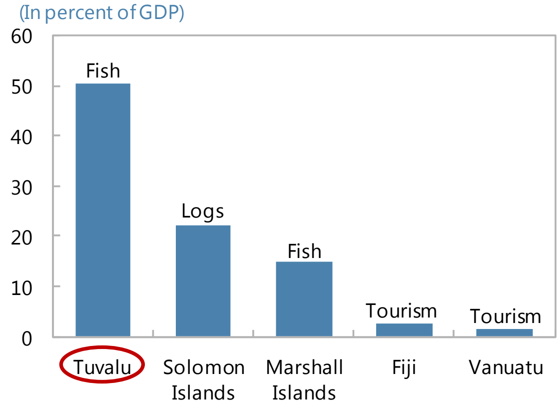
Population versus GDP-Weighted Distance[1/]



Source: World Bank.
1/ Distance to all countries weighted by GDP.

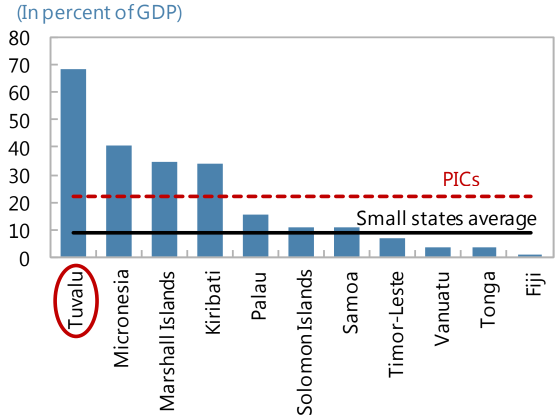
Fishing is the most important industry.

Main Exports of Goods and Services, 2012
(In percent of GDP)



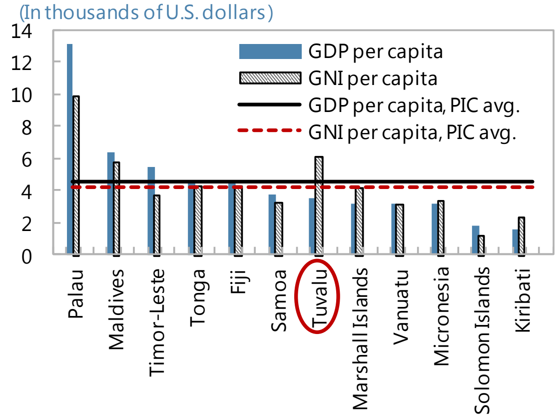
Tuvalu heavily relies on foreign aid.

External Grants, 2012
(In percent of GDP)



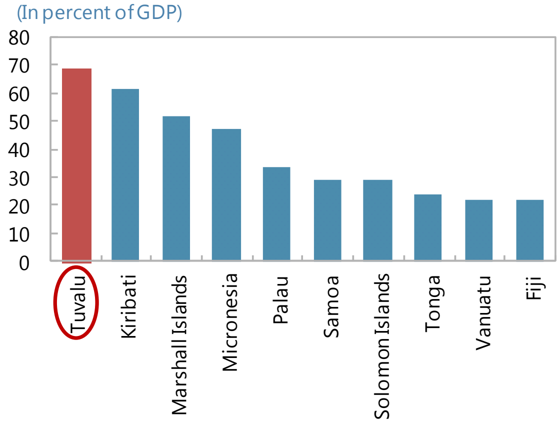
Gross national income is relatively high because of fishing revenue.

Per Capita Income, 2012
(In thousands of U.S. dollars)



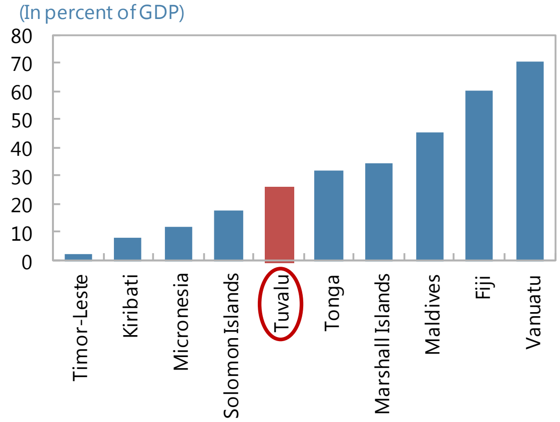
The public sector dominates…

Current Government Expenditure, 2012
(In percent of GDP)



…while the private sector remains rudimentary.

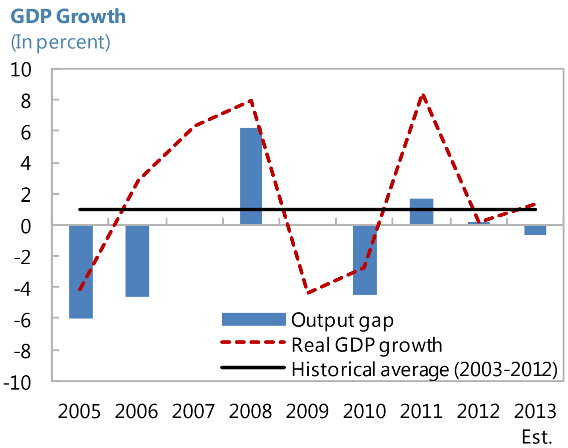
Domestic Credit to Private Sector, 2012
(In percent of GDP)



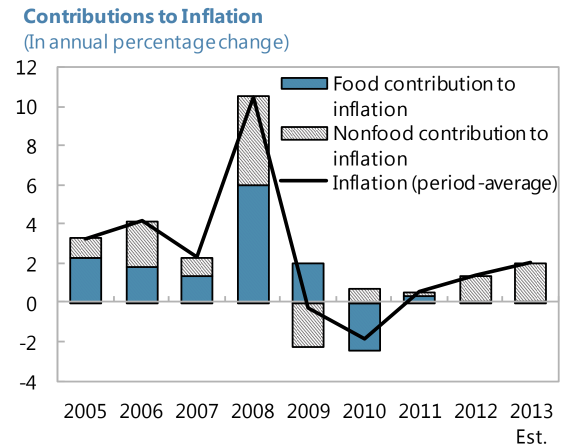
Sources: IMF, WEO; IMF, APD-LISC; and IMF staff estimates.

Figure 2. Tuvalu: Economic Developments

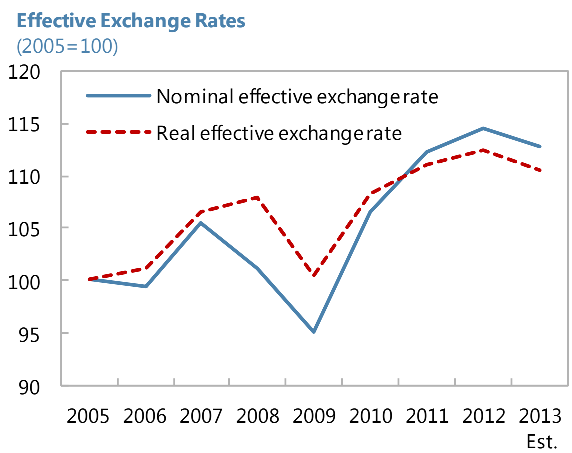
Growth has been generally weak.



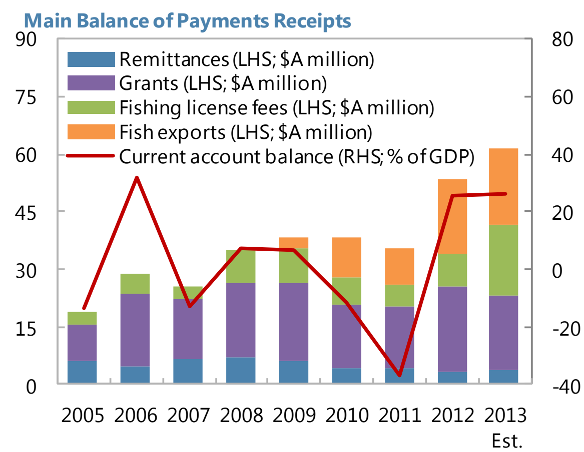
Inflation has picked up moderately...



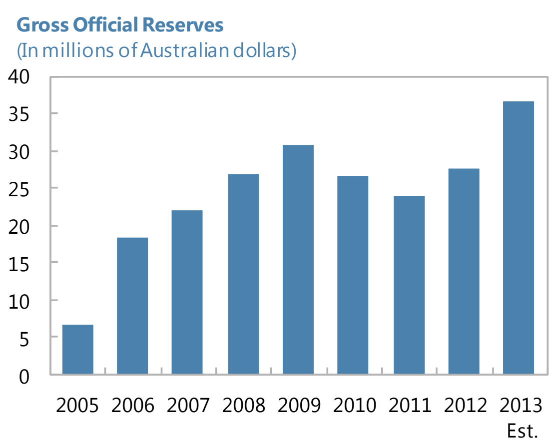
...on a weakening Australian dollar.



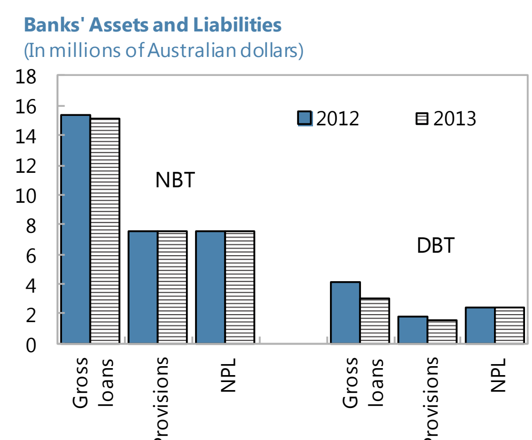
The balance of payments benefited from booming fishing receipts and large foreign grants.



Official reserves have been built up as a result of a large fiscal surplus.



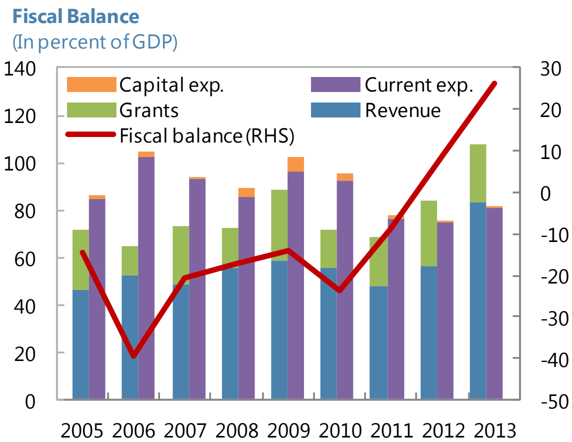
The banking sector suffers from large nonperforming loans.



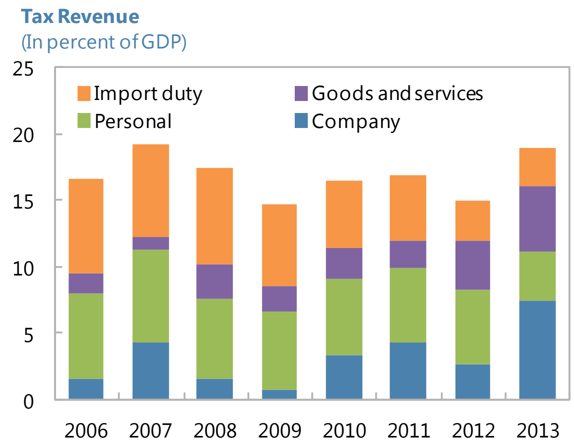
Sources: Tuvalu authorities; TTFAC reports; NBT; DBT; and IMF staff estimates.

Figure 3. Tuvalu: Fiscal Developments

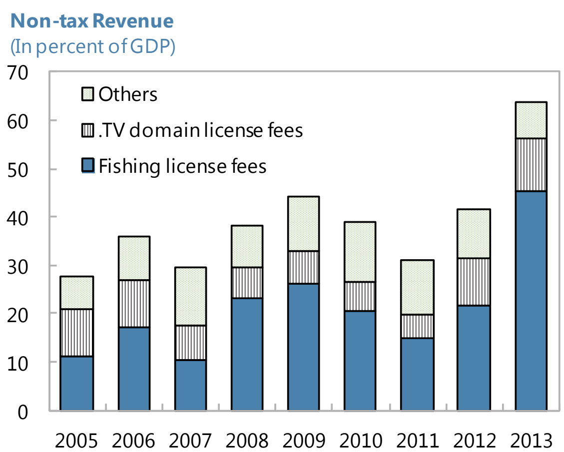
The budget has continued to run a surplus.



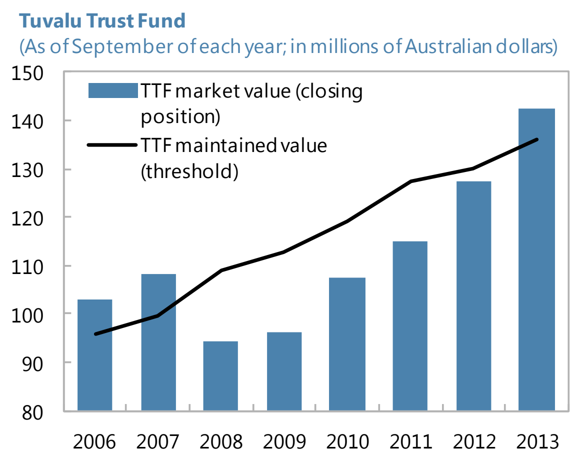
Tax revenue increased as a result of improved compliance…



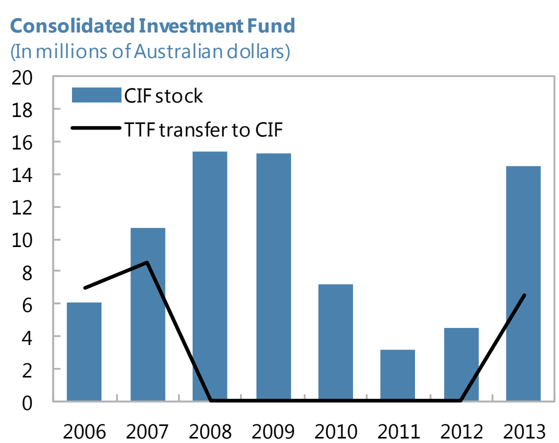
…and non-tax revenue was largely boosted by fishing license fees.



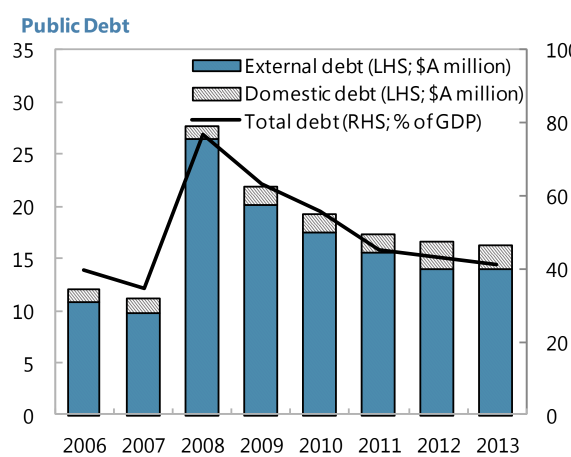
The Tuvalu Trust Fund has recovered markedly…



…so has the Consolidated Investment Fund.



Public debt remained largely stable.



Sources: Tuvalu authorities; TTFAC reports; World Bank; and IMF staff estimates.

Table 1. Tuvalu: Selected Social and Economic Indicators, 2010–2015 1/

Population (2013): 10,753	Poverty rate (2010): 26.3 percent
Per capita GDP (2013 est.): US$3,554	Life expectancy (2012): 65 years
Main export: Fish	Primary school enrollment (2006): 100 percent
Key export markets: Fiji, Australia, Japan	Secondary school enrollment (2001): 79.5 percent

	2010	2011	2012	2013	2014	2015
				Est.	Proj.	
			(Percent change)			
Real sector						
Real GDP growth	-2.7	8.5	0.2	1.3	2.2	2.5
Consumer price inflation (period average)	-1.9	0.5	1.4	2.0	3.3	3.1
			(In percent of GDP)			
Government finance						
Revenue and grants	71.9	69.0	84.3	107.5	116.0	87.6
Revenue	55.5	47.8	56.6	82.9	64.6	65.6
of which: Tax revenue	16.5	16.9	15.0	19.0	15.1	18.0
Fishing license fees	20.6	14.9	21.8	45.4	33.8	32.8
Grants 2/	16.4	21.2	27.8	24.6	51.4	22.1
Total expenditure	95.7	77.9	75.0	81.1	100.2	92.1
Current expenditure	92.5	76.1	75.0	81.0	100.1	91.9
of which: Wages and salaries	33.8	31.3	31.9	32.2	38.0	36.2
Capital expenditure and net lending	3.2	1.8	0.0	0.2	0.2	0.2
Overall balance	-23.8	-8.9	9.3	26.3	15.8	-4.4
Extra budgetary grants 3/	31.8	21.2	29.3	25.2	25.7	31.4
Tuvalu Trust Fund (stock, $A million)	108	119	131	141	146	145
Consolidated Investment Fund (stock, $A million)	7.2	3.2	4.5	14.5	20.6	18.2
			(Percent change, unless otherwise indicated)			
Money and credit						
Deposits	-8.3	8.6	9.7	29.3	9.5	…
Credit	0.9	15.1	-11.4	-7.7	0.8	…
Lending interest rate (in percent) 4/	10.6	10.6	10.6	10.6	10.6	…
			(In millions of Australian dollars, unless otherwise indicated)			
Balance of payments						
Current account balance	-4.1	-13.9	9.8	10.5	11.5	-16.3
(In percent of GDP)	-11.9	-36.5	25.3	26.4	27.7	-37.2
of which:						
Exports of goods	10.9	10.2	19.9	20.5	21.1	21.9
ow/ Fish	10.4	9.4	19.5	20.1	20.7	21.4
Imports of goods	-17.3	-17.6	-16.7	-19.1	-22.3	-35.8
Fishing license fees	7.2	5.7	8.4	18.0	14.1	14.3
Current transfers (net)	15.2	14.3	20.3	18.0	23.1	15.7
ow/Remittances	4.3	4.4	3.7	3.8	4.0	4.1
Capital and financial account balance	10.0	12.3	0.8	1.2	0.5	13.4
of which: .TV domain license fees	2.0	1.9	3.7	4.4	4.1	4.1
Capital transfers (net)	7.5	12.3	4.7	5.1	5.8	9.1
Gross official reserves 5/	26.6	24.1	27.5	36.5	48.5	45.6
(In months of next year's imports)	6.1	6.6	6.6	7.8	7.9	7.9
			(In percent of GDP, unless otherwise indicated)			
Debt indicators						
Gross public debt	55.6	45.3	43.0	41.1	56.9	48.6
External	50.6	40.7	36.4	35.3	52.0	44.6
Domestic	5.1	4.6	6.7	5.8	4.9	4.1
Exchange rates						
Australian dollars per U.S. dollar (period average)	1.1	1.0	1.0	1.0	…	…
Nominal effective exchange rate (2005=100)	111.2	119.1	122.7	123.7	…	…
Real effective exchange rate (2005=100)	108.3	111.0	112.4	110.6	…	…
Nominal GDP (In millions of Australian dollars)	34.7	38.1	38.5	39.7	41.7	43.8

Sources: Tuvalu authorities; PFTAC; SPC; ADB; World Bank; and IMF staff estimates and projections.

1/ Tuvalu uses the Australian dollar as its currency. It has no central bank.
2/ Includes transfer from the Tuvalu Trust Fund to the Consolidated Investment Fund.
3/ Estimated by staff based on balance of payments and fiscal data.
4/ Average of personal, business, overdraft, and housing loans.
5/ Defined as the sum of foreign assets of the National Bank of Tuvalu, the Consolidated Investment Fund, and SDR holdings.

Table 2. Tuvalu: Illustrative Medium-Term Baseline Scenario, 2010–2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Est.	Projections					
					(Percent change)					
Growth and inflation										
Real GDP growth	-2.7	8.5	0.2	1.3	2.2	2.5	2.5	1.9	2.0	1.9
CPI inflation (period average)	-1.9	0.5	1.4	2.0	3.3	3.1	3.0	2.9	2.8	2.8
					(In percent of GDP)					
Fiscal accounts										
Total revenue and grants	71.9	69.0	84.3	107.5	116.0	87.6	82.4	76.3	74.0	72.2
Revenue	55.5	47.8	56.6	82.9	64.6	65.6	59.9	59.0	57.3	56.0
Grants	16.4	21.2	27.8	24.6	51.4	22.1	22.5	17.3	16.8	16.3
Total expenditure and net lending	95.7	77.9	75.0	81.1	100.2	92.1	87.9	84.0	80.2	77.4
Overall balance (including grants)	-23.8	-8.9	9.3	26.3	15.8	-4.4	-5.5	-7.8	-6.1	-5.1
					(In millions of Australian dollars, unless otherwise indicated)					
Balance of payments										
Current account	-4.1	-13.9	9.8	10.5	11.5	-16.3	-10.5	-8.9	-4.6	-5.6
(In percent of GDP)	-11.9	-36.5	25.3	26.4	27.7	-37.2	-23.0	-18.7	-9.2	-10.9
of which:										
Exports	10.9	10.2	19.9	20.5	21.1	21.9	22.6	23.4	24.3	25.1
(In percent of GDP)	31.5	26.7	51.7	51.7	50.7	50.0	49.3	49.0	48.8	48.7
Imports	-17.3	-17.6	-16.7	-19.1	-22.3	-35.8	-28.5	-27.1	-25.9	-26.3
(In percent of GDP)	49.9	46.3	43.3	48.2	53.4	81.8	62.1	56.7	52.1	51.1
Capital and financial account	10.0	12.3	0.8	1.2	0.5	13.4	6.0	2.9	0.2	0.5
of which: Capital transfers	7.5	12.3	4.7	5.1	5.8	9.1	11.3	8.6	6.1	6.4
.TV domain license fees	2.1	2.4	3.7	4.4	4.1	4.1	4.1	4.2	4.2	4.2
Memorandum items										
Gross external public debt (percent of GDP)	50.6	40.7	36.4	35.3	52.0	44.6	37.9	32.1	25.5	20.3
External debt service ratio 1/	7.8	19.4	11.2	11.6	12.8	13.2	12.5	10.7	11.7	9.4
Gross official reserves (millions of U.S. dollars)	26.6	24.1	27.5	36.5	48.5	45.6	41.0	35.0	30.6	25.5
(In months of next year's imports)	6.1	6.6	6.6	7.8	7.9	7.9	7.5	7.0	5.9	4.8
Tuvalu Trust Fund (stock, $A million)	108.0	118.7	130.6	140.6	146.4	145.5	149.1	152.8	156.6	160.6
Consolidated Investment Fund (stock, $A million)	7.2	3.2	4.5	14.5	20.6	18.2	15.2	11.1	7.6	4.5

Sources: Data provided by the Tuvalu authorities and IMF staff estimates and projections.

1/ In percent of exports of goods and services.

Table 3. Tuvalu: Summary Operations of the General Government, 2010–15 (GFS 1986)

	2010	2011	2012	2013	2014 Budget	2014 Proj.	2015 Proj.
	(In millions of Australian dollars)						
Total revenue and grants	24.9	26.3	32.5	42.7	52.0	48.3	38.4
Revenue	19.3	18.2	21.8	32.9	31.0	26.9	28.7
Tax revenue	5.7	6.4	5.8	7.5	7.9	6.3	7.9
Personal income tax	2.0	2.1	2.2	1.5	1.8	1.6	1.6
Corporate income tax	1.2	1.6	1.0	3.0	2.8	1.5	1.6
Consumption & sales tax	0.1	0.1	0.6	1.2	1.2	1.3	1.9
Excise and others	0.8	0.8	0.8	0.7	0.8	0.7	0.8
Import duty	1.7	1.9	1.2	1.1	1.3	1.2	2.0
Nontax revenue	13.6	11.8	16.0	25.4	23.1	20.6	20.8
of which: Fishing license fees	7.2	5.7	8.4	18.0	14.0	14.1	14.3
Interest and dividends	1.9	1.5	0.9	0.2	0.7	1.3	1.3
.TV license fees	2.0	1.9	3.7	4.4	4.1	4.1	4.1
Grants 1/	5.7	8.1	10.7	9.8	21.0	21.4	9.7
Total expenditure and net lending	33.2	29.7	28.9	32.2	38.7	41.8	40.3
Current expenditure	32.1	29.0	28.9	32.1	38.7	41.7	40.2
of which: Wages and salaries	11.7	11.9	12.3	12.8	15.9	15.9	15.9
TMTS	2.2	2.1	2.3	2.6	2.3	2.8	3.0
Scholarship programs	…	…	1.8	1.8	2.3	2.3	2.3
Capital expenditure and net lending	1.1	0.7	0.0	0.1	0.0	0.1	0.1
Capital expenditure	1.1	0.7	0.0	0.1	0.0	0.1	0.1
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (incl. grants)	-8.3	-3.4	3.6	10.5	13.2	6.6	-1.9
Overall balance (excl. grants)	-13.9	-11.5	-7.1	0.7	-7.8	-14.8	-11.6
Structural balance 2/	-9.4	-2.3	3.8	2.6	…	3.5	-4.6
Financing	8.3	3.4	-3.6	-10.5	-13.2	-6.6	1.9
Foreign (net)	-0.8	-0.2	-0.1	-0.4	-0.4	-0.4	-0.4
Domestic (net)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
CIF (net, -=increase)	9.2	3.6	-3.5	-10.0	-12.8	-6.1	2.4
	(In percent of GDP)						
Total revenue and grants	71.9	69.0	84.3	107.5	124.7	116.0	87.6
Revenue	55.5	47.8	56.6	82.9	74.3	64.6	65.6
Tax revenue	16.5	16.9	15.0	19.0	18.9	15.1	18.0
Nontax revenue	39.1	30.9	41.5	63.9	55.3	49.5	47.6
of which: Fishing license fees	20.6	14.9	21.8	45.4	33.6	33.8	32.8
Interest and dividends	5.4	4.0	2.3	0.5	1.7	3.2	3.0
.TV license fees	5.8	4.9	9.6	11.0	9.7	9.7	9.3
Grants 1/	16.4	21.2	27.8	24.6	50.4	51.4	22.1
Total expenditure and net lending	95.7	77.9	75.0	81.1	93.0	100.2	92.1
Current expenditure	92.5	76.1	75.0	81.0	92.9	100.1	91.9
of which: Wages and salaries	33.8	31.3	31.9	32.2	38.0	38.0	36.2
TMTS	6.4	5.6	6.1	6.5	5.5	6.8	6.9
Scholarship programs	…	…	4.7	4.5	5.6	5.6	5.3
Capital expenditure and net lending	3.2	1.8	0.0	0.2	0.1	0.2	0.2
Capital expenditure	3.2	1.8	0.0	0.2	0.1	0.2	0.2
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (incl. grants)	-23.8	-8.9	9.3	26.3	31.7	15.8	-4.4
Overall balance (excl. grants)	-40.2	-30.1	-18.4	1.8	-18.7	-35.6	-26.5
Structural balance 2/	-27.1	-6.1	9.8	6.4	…	8.3	-10.5
Financing	23.8	8.9	-9.3	-26.3	-31.6	-15.8	4.4
Foreign (net)	-2.4	-0.5	-0.1	-1.0	-1.0	-1.0	-0.9
Domestic (net)	-0.3	-0.1	0.0	-0.1	0.0	-0.1	-0.1
CIF (net, -=increase)	26.4	9.4	-9.2	-25.3	-30.7	-14.7	5.5
Memorandum items:							
Extra budgetary grants 3/	31.8	21.2	29.3	25.2	…	25.7	31.4
Public debt (in percent of GDP)	55.6	45.3	43.0	41.1	…	56.9	48.6
Stock of CIF ($A million)	7.2	3.2	4.5	14.5	20.6	20.6	18.2
Nominal GDP ($A million)	34.7	38.1	38.5	39.7	41.7	41.7	43.8

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

1/ Includes transfer from the Tuvalu Trust Fund to the Consolidated Investment Fund.

2/ Defined as the overall balance minus deviation from a normal level of fishing license fees, calculated on the basis of backward and forward averages.

3/ Estimated by staff based on balance of payments and fiscal data.

Table 4. Tuvalu: Summary Operations of the General Government, 2010–15 (GFS 2001)

	2010	2011	2012	2013	2014 Budget	2014 Proj.	2015 Proj.
	(In millions of Australian dollars)						
Total revenue and grants	24.9	26.3	32.5	42.7	52.0	48.3	38.4
Revenue	19.3	18.2	21.8	32.9	31.0	26.9	28.7
Tax revenue	5.7	6.4	5.8	7.5	7.9	6.3	7.9
Nontax revenue	13.6	11.8	16.0	25.4	23.1	20.6	20.8
of which: Fishing license fees	7.2	5.7	8.4	18.0	14.0	14.1	14.3
Interest and dividends	1.9	1.5	0.9	0.2	0.7	1.3	1.3
.TV license fees	2.0	1.9	3.7	4.4	4.1	4.1	4.1
Grants 1/	5.7	8.1	10.7	9.8	21.0	21.4	9.7
Expenditure	33.2	29.7	28.9	32.2	38.7	41.8	40.3
Expense	32.1	29.0	28.9	32.1	38.7	41.7	40.2
Wages and salaries	11.7	11.9	12.3	12.8	15.9	15.9	15.9
Purchase of goods and services	8.0	7.5	7.7	8.5	9.8	11.6	9.2
Transfers 1/	5.2	4.5	6.3	7.9	8.3	9.6	10.7
Interest payments	0.3	0.3	0.1	0.1	0.1	0.1	0.2
Other expense	6.8	4.7	2.5	3.0	4.5	4.5	4.2
Net acquisition of nonfinancial assets	1.1	0.7	0.0	0.1	0.0	0.1	0.1
Gross operating balance	-7.1	-2.7	3.6	10.5	13.3	6.6	-1.9
Net lending / borrowing (overall balance)	-8.3	-3.4	3.6	10.5	13.2	6.6	-1.9
Net financial transactions	8.3	3.4	-3.6	-10.5	-13.2	-6.6	1.9
Net acquisition of financial assets	9.2	3.6	-3.5	-10.0	-12.8	-6.1	2.4
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	9.2	3.6	-3.5	-10.0	-12.8	-6.1	2.4
Net incurrence of liabilities	-0.9	-0.2	-0.1	-0.4	-0.4	-0.5	-0.5
Domestic	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	-0.8	-0.2	-0.1	-0.4	-0.4	-0.4	-0.4
	(In percent of GDP)						
Total revenue and grants	71.9	69.0	84.3	107.5	124.7	116.0	87.6
Revenue	55.5	47.8	56.6	82.9	74.3	64.6	65.6
Tax revenue	16.5	16.9	15.0	19.0	18.9	15.1	18.0
Nontax revenue	39.1	30.9	41.5	63.9	55.3	49.5	47.6
of which: Fishing license fees	20.6	14.9	21.8	45.4	33.6	33.8	32.8
Interest and dividends	5.4	4.0	2.3	0.5	1.7	3.2	3.0
.TV license fees	5.8	4.9	9.6	11.0	9.7	9.7	9.3
Grants 1/	16.4	21.2	27.8	24.6	50.4	51.4	22.1
Expenditure	95.7	77.9	75.0	81.1	93.0	100.2	92.1
Expense	92.5	76.1	75.0	81.0	92.9	100.1	91.9
Wages and salaries	33.8	31.3	31.9	32.2	38.0	38.0	36.2
Purchase of goods and services	23.2	19.8	20.1	21.3	23.6	27.9	21.0
Transfers 1/	15.0	11.7	16.3	19.9	20.0	23.0	24.5
Interest payments	0.8	0.8	0.3	0.2	0.3	0.3	0.5
Other expense	19.7	12.5	6.4	7.4	10.9	10.9	9.7
Net acquisition of nonfinancial assets	3.2	1.8	0.0	0.2	0.1	0.2	0.2
Gross operating balance	-20.6	-7.1	9.4	26.5	31.8	15.9	-4.3
Net lending / borrowing (overall balance)	-23.8	-8.9	9.3	26.3	31.7	15.8	-4.4
Net financial transactions	23.8	8.9	-9.3	-26.3	-31.6	-15.8	4.4
Net acquisition of financial assets	26.4	9.4	-9.2	-25.3	-30.7	-14.7	5.5
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	26.4	9.4	-9.2	-25.3	-30.7	-14.7	5.5
Net incurrence of liabilities	-2.7	-0.5	-0.2	-1.1	-1.0	-1.1	-1.0
Domestic	-0.3	-0.1	0.0	-0.1	0.0	-0.1	-0.1
Foreign	-2.4	-0.5	-0.1	-1.0	-1.0	-1.0	-0.9
Memorandum items:							
Extra budgetary grants 2/	31.8	21.2	29.3	25.2	…	25.7	31.4
Public debt (in percent of GDP)	55.6	45.3	43.0	41.1	…	56.9	48.6
Stock of CIF ($A million)	7.2	3.2	4.5	14.5	20.6	20.6	18.2
Nominal GDP ($A million)	34.7	38.1	38.5	39.7	41.7	41.7	43.8

Sources: Tuvalu authorities; PFTAC; and IMF staff estimates and projections.

1/ Includes medical treatment scheme and scholarships, as well as Community Service Obligations (CSO).

2/ Estimated by staff based on balance of payments and fiscal data.

Table 5. Tuvalu: Balance of Payments, 2010–19

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Est.	Projections					
	(In millions of Australian dollars, unless otherwise indicated)									
Current account balance	-4.1	-13.9	9.8	10.5	11.5	-16.3	-10.5	-8.9	-4.6	-5.6
Trade	-6.4	-7.4	3.2	1.4	-1.1	-13.9	-5.9	-3.7	-1.6	-1.2
Exports, f.o.b.	10.9	10.2	19.9	20.5	21.1	21.9	22.6	23.4	24.3	25.1
of which: Fish	10.4	9.4	19.5	20.1	20.7	21.4	22.1	22.9	23.7	24.5
Imports, f.o.b.	-17.3	-17.6	-16.7	-19.1	-22.3	-35.8	-28.5	-27.1	-25.9	-26.3
Services	-24.0	-30.2	-23.1	-26.6	-29.5	-32.8	-35.2	-33.6	-28.6	-30.3
Credit	4.4	4.2	4.3	4.4	4.6	4.9	5.1	5.3	5.5	5.7
Debit	-28.4	-34.4	-27.4	-31.0	-34.1	-37.7	-40.3	-38.9	-34.1	-36.0
Net income	11.0	9.4	9.4	17.6	19.0	14.7	14.4	14.3	14.3	14.3
Credit	12.7	10.6	12.4	22.4	24.0	20.0	19.9	20.1	20.3	20.5
Debit	-1.7	-1.2	-3.1	-4.8	-5.0	-5.3	-5.5	-5.8	-6.0	-6.2
Net transfers	15.2	14.3	20.3	18.0	23.1	15.7	16.2	14.0	11.4	11.7
Credit	17.4	16.7	22.4	20.4	25.5	18.2	18.9	16.8	14.3	14.7
Debit	-2.2	-2.4	-2.2	-2.3	-2.4	-2.6	-2.7	-2.8	-2.9	-3.0
Capital and financial account	10.0	12.3	0.8	1.2	0.5	13.4	6.0	2.9	0.2	0.5
Capital account	9.6	14.7	8.4	9.5	9.8	13.2	15.4	12.8	10.3	10.6
of which: Capital tranfers	7.5	12.3	4.7	5.1	5.8	9.1	11.3	8.6	6.1	6.4
.TV domain license fees	2.0	1.9	3.7	4.4	4.1	4.1	4.1	4.2	4.2	4.2
Financial account	0.4	-2.3	-7.6	-8.3	-9.3	0.2	-9.5	-9.9	-10.1	-10.1
Direct investment (net)	0.6	-0.1	1.6	0.7	0.7	0.8	0.8	0.9	0.9	0.9
Portfolio investment (net)	-1.9	0.0	-1.4	-1.4	-1.5	-1.6	-1.6	-1.7	-1.8	-1.8
Other (net) 2/	1.7	-2.3	-7.9	-7.6	-8.6	1.0	-8.7	-9.0	-9.2	-9.2
Errors and omissions	-9.1	-0.1	-8.7	-2.7	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-3.3	-1.7	1.9	9.0	12.0	-2.9	-4.6	-6.0	-4.4	-5.1
Financing										
Change in official reserves (-=increase in reserves)	3.3	1.7	-1.9	-9.0	-12.0	2.9	4.6	6.0	4.4	5.1
Memorandum items:										
Current account balance (percent of GDP)	-11.9	-36.5	25.3	26.4	27.7	-37.2	-23.0	-18.7	-9.2	-10.9
excluding official grants (percent of GDP)	-58.8	-77.5	-30.7	-22.1	-30.9	-76.1	-61.3	-51.1	-35.2	-36.6
Gross official reserves 1/	26.6	24.1	27.5	36.5	48.5	45.6	41.0	35.0	30.6	25.5
(in months of imports of goods and services)	6.1	6.6	6.6	7.8	7.9	7.9	7.5	7.0	5.9	4.8

Sources: Tuvalu authorities; PFTAC; and IMF staff estimates and projections.

1/ Defined as the sum of liquid assets of the National Bank of Tuvalu, the Consolidated Investment Fund, and SDR holdings.

2/ Includes financial transactions related to the joint venture company, Tuvalu Tuna FH Co.

Table 6. Tuvalu: Assets and Liabilities of the Banking Sector, 2007–13

	2007	2008	2009	2010	2011	2012	2013 Est.
	(In millions of Australian dollars)						
Assets	38.4	46.0	41.4	41.1	42.8	44.3	51.3
Cash	1.1	1.1	1.5	1.2	1.6	2.3	1.7
Deposits	10.2	12.8	13.8	14.9	16.7	18.0	20.0
Loans and advances 1/	23.7	27.0	19.8	20.7	20.8	19.5	18.1
of which: Government loans	4.9	3.6	1.7	2.1	0.3	0.3	0.0
Claims on other banks	0.6	2.2	1.1	1.6	1.0	1.8	8.6
Fixed assets	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Other assets	2.1	2.4	4.7	2.4	2.3	2.4	2.4
Liabilities	25.4	31.0	24.8	21.7	23.5	25.7	33.0
Deposits	21.4	24.1	22.3	20.4	22.2	24.3	31.5
of which: Government deposits	4.3	3.4	2.6	3.9	3.3	3.7	9.3
Demand deposits	7.1	9.7	7.9	7.6	7.6	10.2	18.3
Securities	…	…	…	…	0.1	0.1	0.3
Liabilities to other banks 2/	1.4	2.3	1.0	0.7	0.6	0.5	0.5
Other liabilities	2.6	4.6	1.6	0.6	0.6	0.7	0.8
Capital	13.0	15.0	16.6	19.4	19.2	18.6	18.2
of which: Paid-up capital	3.4	3.7	4.0	4.6	4.7	4.7	4.7
Retained earnings	2.3	3.1	3.9	5.7	5.1	4.5	4.4
Provision for credit impairment	7.3	8.2	8.6	9.1	9.5	9.4	9.1

Sources: National Bank of Tuvalu; and Development Bank of Tuvalu.

1/ Gross loans and advances.

2/ Development Bank of Tuvalu's loans from the European Investment Bank.

Appendix I. Tuvalu: Risk Assessment Matrix 1/

Sources of Risks	Likelihood	Potential Impact	Recommendation
Surges in global financial market volatility	H.	High. Elevated market volatilities will feed through to the market value of TTF that is primarily invested in Australia, making TTF's transfers to the budget more uncertain.	• Make TTF a rainy day fund, save most if not all investment returns, and smooth TTF transfers to the budget by targeting a longer-horizon benchmark.
Protracted period of slower growth in advanced and emerging economies	H.	Medium. Slower growth and reduced demand in the Pacific region would cause remittances by seafarers and seasonal workers to fall. But meanwhile, a weakening Australian dollar would help improve Tuvalu's competitiveness.	• Develop human capital to improve competitiveness • Foster domestic business climate to improve employment • Take an innovative approach to explore foreign employment opportunities
Growth slowdown in China	M.	Medium. Slower growth and reduced demand in the Pacific region would cause remittances by seafarers and seasonal workers to fall. But meanwhile, a weakening Australian dollar would help improve Tuvalu's competitiveness	• Develop human capital to improve competitiveness • Foster domestic business climate to improve employment • Take an innovative approach to explore foreign employment opportunities
Climate change	M-H.	High. The occurrence of extreme weather conditions could cause fluctuation in fishing revenues and large economic loss, while tuna stock tends to relocate and decline on variability of the ocean's conditions over the long run.	• Strengthen fiscal buffers (see above) • Build adaptive capacity to increase resilience, with assistance by development partners
Weak fiscal policy and lower foreign aid	M-H.	High. Fiscal buffers could be fully depleted, making the economy highly vulnerable to adverse shocks.	• Establish a transparent fiscal framework that addresses pro-cyclicality and saves for rainy days • Conduct fiscal consolidation and build fiscal buffers • Closely engage with development partners to mobilize foreign aid.
Poor governance of public enterprises and banks	H.	High. The weaknesses in public enterprises and banks pose challenges to growth and stability.	• Adopt public enterprise reforms to enhance transparency and accountability
Elevated banking risks/Insolvency of DBT	H.	High. Large NPLs impede lending, and pose substantial contingent liabilities to the budget. A possible insolvency of the DBT could cause spillover risks to the banking system and large fiscal cost.	• Establish a regulatory framework for banks • Assess fiscal cost of bank restructuring based on prudential standards • Develop a bank resolution framework

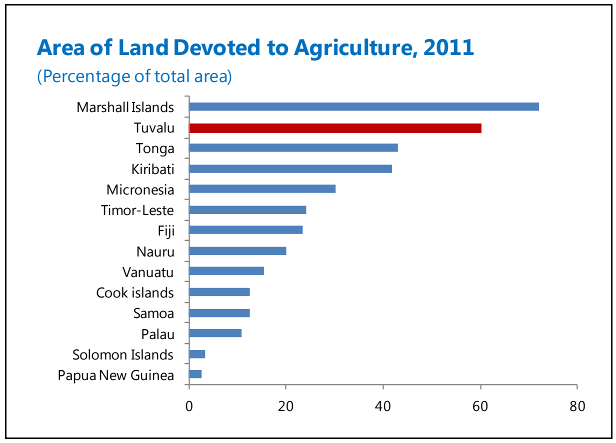
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). 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. Tuvalu—Policy Reform Matrix—Policies and Progress of Implementation

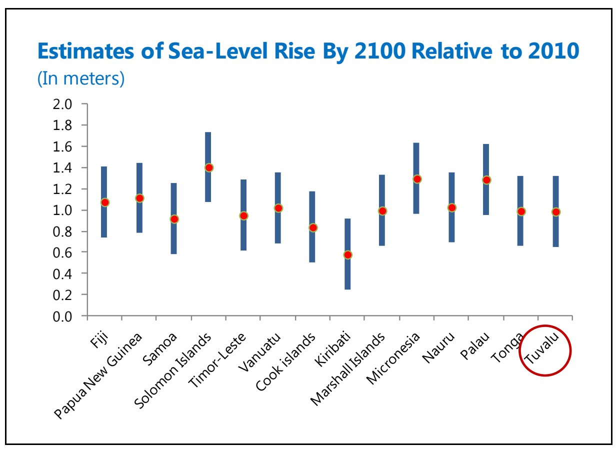
Policies	Objectives	Implementation as of 2014Q2
Produce annual reports for the Education and Health programs, and reduce cost of the overseas medical treatment scheme	Improve transparency and accountability of social programs, and contain their costs	A few reports have been produced, but others remain to be completed and the regularity of reporting remains to be improved. Some measures, albeit insufficient, have been introduced to reduce the cost of the overseas medical treatment scheme.
Conduct annual reporting and auditing for public enterprises	Strengthen governance and transparency of public enterprises	All public enterprises except the National Fishing Corporation of Tuvalu have been audited in 2012. The 2013 audit is in progress.
Remove public servants from Public Enterprise Boards	Reduce government intervention in Public Enterprises	The government requested voluntary resignation of public servants from Board positions, and all public servant Board members have now resigned.
Develop a budget manual	Enhance public financial management	The manual was drafted with the assistance of external advisors, and has been approved by the Cabinet. The Ministry of Finance and Economic Development is organizing training sessions for budget staff.
Increase VAT compliance to 75% of registered entities, including 100% of Public Enterprises	Strengthen tax administration	This has been achieved.
Conduct tax audit training and undertake at least 2 audits of large taxpayers	Strengthen tax administration	The external tax advisor has conducted intensive tax audit training for IRD staff. So far IRD has made more than two audits of large taxpayers
Increase VAT rate to 7% in 2013	Increase tax revenue and move toward common practices of other countries	The Regulation validating a 7% VAT rate has been passed and implemented.

Appendix III. Tuvalu—Climate Change—The Economic Impact on Pacific Islands Economies[1]

Climate change poses substantial challenges to small island economies in the Pacific.[2] Estimates suggest that sea levels in the Pacific could rise by as much as 1.2 meters to 1.7 meters before 2100, which would lead to significant declines in land area. Moreover, El Niño and La Niña events could also increase by over 40 percent in the Pacific, leading to a rise in the frequency and intensity of extreme weather events. This will particularly threaten the existence of Pacific island countries, where a concentration of population, socioeconomic activities, and major infrastructure along the low-lying coastal areas make them highly vulnerable to rising sea levels and extreme weather events.[3] In this context, Tuvalu, one of the lowest countries in the world with the highest point only 4.6 meters above sea level, is particularly susceptible.



Estimates suggest climate change could inflict losses to the Pacific region amounting to 2.2 to 3.5 percent of GDP per year. Given a 2-4 C° temperature increase, projected economic losses amount to US$1 billion in damages to water resources.[4] Agriculture could account for one-third to one-half of total economic losses caused by climate change. These effects would be acutely felt in Tuvalu where more than 60 percent of the total land area is devoted to agricultural production. Fisheries will also be affected by more acidic oceans and degraded fish habitats, which will lower the yields of some species and cause the location of fish resources to shift.



Building capacity against climate change would entail substantial investment. Currently, the Pacific island countries are far from being resilient to climate change, and substantial investments are needed to enhance the capacity to offset the impact of climate change. Building adaptive capacity such as climate-proofing critical infrastructure, enhancing existing early-warning systems for coastal inundation, and developing plans in coastal management—including coral-reef conservation and protection—are necessary to address a wide range of uncertain climate outcomes. The funding cost could average from 1.5 to 2.5 percent of GDP per year.

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[1] Prepared by Inderjit Sian.

[2] The Economics of Climate Change in the Pacific, 2013, Asian Development Bank, http://www.adb.org/publications/economics-climate-change-pacific.

[3] Climate Change – Small Island Developing States, 2005, UNFCCC.

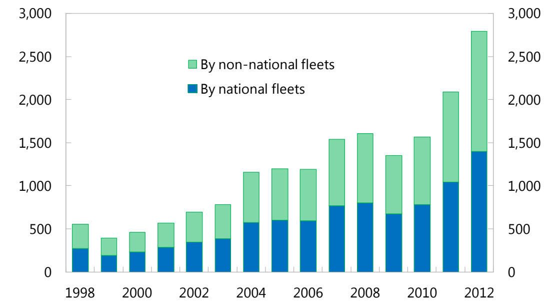
[4] Climate Change Impacts—Pacific Islands", the Global Mechanism and IFAD

Appendix IV. Tuvalu—Pacific Islands—Are Fishing Resources Renewable?[1]

The Pacific islands region is the home to some of the last healthy tuna populations in the world. The Western and Central Pacific Ocean (WCPO) contains the world's largest stock of tuna and accounts for more than half of the global tuna catch. The value of tuna catch in this region has almost doubled since 2010, reaching around US$2.8 billion.

Overfishing constitutes a key challenge to tuna population. The stock of tuna is at a historical low and may not be renewable under intense pressure from international fishing fleets. Since the 1960s, the global catch has increased from 20,000 tons per year to 4 million tons per year, and the tuna population plummeted. Studies estimate that the population of one key species, the Pacific bluefin, has dropped by 96 percent in recent decades because of overfishing, and the catch of bigeye tuna, another popular species in the market, needs to be reduced by at least 32 percent from the 2006-09 levels to ensure long-term sustainability.[2,3]

Value of Tuna Catch
(In millions of US dollars)



Source: Secretariat of the Pacific Community.

Climate change is expected to reduce the suitability of tuna spawning and forage habitats. In the long run, rising ocean temperatures will reduce primary and secondary production in the sea, which, together with weakening currents and nutrient transport, will reduce the population of tuna. In the short run, concentration areas of tuna tend to move—countries in the central Pacific, such as Kiribati and Tuvalu, experience higher catches during El Niño years, while countries in the western Pacific, such as Papua New Guinea and Solomon Islands enjoy higher catches during La Niña years. These movements will cause year-to-year fluctuations in the tuna catch by individual countries.

Restricting overfishing is a challenging task. The Vessel Day Scheme has vastly boosted fishing revenues in recent years, but its impact on fish resources has been unclear. Although the Pacific island countries attempt to preserve tuna resources by setting limits on the number of vessel days, the number of registered fishing vessels has continued to rise, and fishing technologies have become increasingly efficient and perhaps potentially harmful—the most popular fishing method in the region called purse seine fishing has caused a significant rise of juvenile catches.

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[1] Prepared by Sung Eun Jung.
[2] Harvey, Fiona (January 2013), "Overfishing causes Pacific bluefin tuna numbers to drop 96%". The Guardian (London: GMG). ISSN 0261-3077. OCLC 60623878.
[3] Policy Brief 14/2012, Secretariat of the Pacific Community http://www.spc.int/coastfish/en/publications/brochures/policy-briefs.html

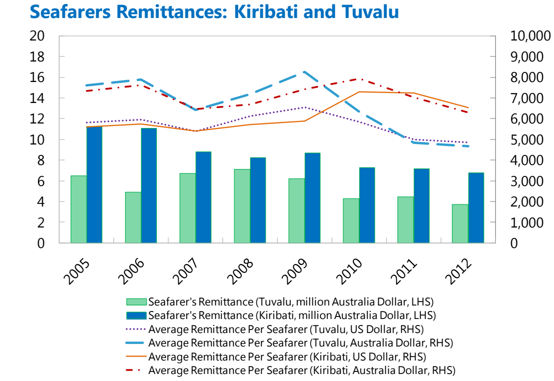
Appendix V. Tuvalu—Seafarers' Employment and Remittances in Kiribati and Tuvalu[1]

Seafaring provides an important source of employment and remittances for Kiribati and Tuvalu, but both employment and remittances associated with this traditional activity have exhibited clear downward trends in recent years. While remaining sizable, employment fell sharply during the global financial crisis. As of October 2013, there were about 1,008 Kiribati and 112 Tuvalu seafarers on board, compared to 1,452 and 361 respectively in 2006. Over the period, seafarer remittances fell by about 4 percent of GDP for Kiribati and 9 percent of GDP for Tuvalu. In 2012, remittances stood at 5.8 percent of GDP in Kiribati and 10 percent of GDP in Tuvalu. The depreciation of the U.S. dollar over the past few years has also had a negative impact on the Australian dollar value of seafarer remittances.

The recovery in world trade from the global financial crisis did not produce a corresponding recovery in seafarer employment for a number of structural reasons. The shipping industry serving global trade continues to suffer from low profitability and overcapacity, and increasing automation of ship operations has reduced the demand for seafarers. At the same time, seafarers from Kiribati and Tuvalu have become less competitive compared with those from South and Southeast Asian countries as transportation costs for Kiribati and Tuvalu seafarers traveling to their destinations have become relatively high.

Insufficient training in some cases impedes seafarer employment. While the Kiribati Marine Training Center is considered one of the best vocational training institutes in the region, training programs provided by the Tuvalu Maritime Training Institute are generally for traditional merchant vessels and have become inadequate for ships equipped with modern technologies. Moreover, while the close connection with the German merchant ships has traditionally provided an important source of employment and income, this concentration has increasingly aggravated external shocks to Kiribati and Tuvalu seafarers' employment and remittances.

Seafarers Remittances: Kiribati and Tuvalu



[1] Prepared by Xuefei Bai, Sergei Dodzin, and Jiangyan Yu.

Appendix VI. Tuvalu—Public Enterprises in Tuvalu[1]

The financial performance of public enterprises remains weak. The audited accounts for 2012 show that most public enterprises reported financial losses and revealed significant vulnerabilities in their financial position.[2] The impediments to public enterprise operations remain the same as those identified in the 2012 Article IV staff report, namely persistent inefficiencies in management practices, weak tariff structures, arrears on payments by the government, and limited scope to gain from economies of scale. As such, losses made by these enterprises—at more than 3 percent of GDP in the past few years—entail substantial potential liabilities of the government.

An ambitious reform plan was enacted under the 2010 Public Enterprise Act (PEA), but progress has been slow in most areas. While progress was made in removing civil servants from Board positions, progress in other areas has been limited. Under the Act, the Public Enterprise Reform Monitoring Unit (PERMU) was established to monitor enterprises' compliance with the legislation, but the unit is effectively not in operation as the Director and supporting positions are presently vacant. Additionally, while the government compensates public enterprises' social services—for instance the provision of electricity and banking services to the outer islands—through allocations of Community Service Obligations (CSOs), the amounts are determined on the basis of negotiations between the recipients and the government rather than a clear defining and costing of social responsibilities assumed by public enterprises.

Certain public enterprises will face additional financial pressures. The recent wage increase for civil servants has induced public enterprises to raise salaries for their employees by a similar margin, adding to operational costs. The Tuvalu Electricity Corporation faces substantial challenges as fuel grants from Japan are to be phased out by end-2014—the corporation would make more losses and be more susceptible to global oil price movements.[3]

Public Enterprises	Year	Assets (Percent of GDP)	Solvency (Profit/Liabilites in Percent)
National Bank of Tuvalu (NBT)	2012	80	4
Development Bank of Tuvalu (DBT)	2012	6	-55
Tuvalu Telecommunications Corporations (TTC)	2012	6	-9
Vaiaku Lagi Hotel (VHL)	2012	0	-28
Tuvalu Electricity Corporation (TEC)	2012	15	8
Tuvalu Maritime Training Institue (TMTI)	2011	17	-2
Tuvalu Philatelic Bureau	2010	0	-35
National Fishhing Company of Tuvalu (NAFICOT)	N.A.	N.A.	N.A.

[1] Prepared by Inderjit Sian.

[2] The 2013 audited accounts are not available yet.

[3] It is estimated that tariff rates at the electricity company need to rise by around 50% for it to be profitable.

INTERNATIONAL MONETARY FUND

TUVALU

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 5, 2014

Prepared By

Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of June 30, 2014)

Membership Status: Joined June 24, 2010; Article XIV

General Resource Account:	**SDR Million**	**% Quota**
Quota	1.80	100.00
Fund holdings of currency (Exchange Rate)	1.37	76.00
Reserve Tranche Position	0.43	24.06

SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	1.69	100.00
Holdings	1.26	74.40

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to the Fund: None

Exchange Arrangements:

Tuvalu's legal tender is the Australian dollar. There is no central monetary institution. At the time of joining the Fund, Tuvalu availed itself of the transitory provisions of Article XIV, Section 2. While the exchange control regulations are quite restrictive and prescribe approval requirements from the NBT or the Finance Minister for most payments or transfers, staff's understanding is that in practice, no approval is required and payments and transfers for current international transactions are administered liberally. Staff continues to conduct a comprehensive review of the exchange system to assess jurisdictional implications. Staff has recommended that the regulations be updated in line with current practice so that Tuvalu can accept the obligations of Article VIII, Sections 2, 3 and 4, although the authorities have indicated that they have no current plans to do so.

The NBT is the only bank in Tuvalu handling foreign exchange transactions. The NBT buys and sells foreign exchange at rates determined daily by the NBT's board on the basis of rates quoted in the international markets plus specific spreads dependent on the specific foreign currency.

Article IV Consultation:

The previous Article IV consultation discussions were held in Funafuti in June 2012. The staff report (IMF Country Report No. 12/259) was discussed by the Executive Board on August 3, 2012.

Technical Assistance:

The Pacific Financial Technical Assistance Centre (PFTAC) has provided assistance on tax policy and administration (2007, 2008, 2010, and 2014); and financial sector supervision (2008). The Secretariat of the Pacific Community has provided assistance on national accounts statistics (2010, 2012). The IMF has provided assistance on balance of payments and government finance statistics under the JSA Project in the Asia and Pacific Region (2012, 2013, and 2014).

Resident Representative:

A Resident Representative office, covering Pacific islands and based in Fiji, was established in September 2010.

IMF-WORLD BANK COLLABORATION

The Bank and Fund country teams, currently led by Mr. Robert Utz (Lead Economist, EASPN) and Mr. Jiangyan Yu (Fund mission chief for Tuvalu), have maintained a close working relationship and dialogue on macroeconomic and structural issues. Since Tuvalu's decision to pursue membership of the Bretton Woods institutions in 2009, the Bank team has joined all IMF missions to Tuvalu since the country's membership mission, including Article IV missions.

The teams agree that Tuvalu's main macroeconomic challenges are to ensure fiscal sustainability, strengthen public service delivery, and create a more supportive environment for development. Based on this shared assessment, the teams identified the following structural reform areas, all of which are also addressed in the authorities' Policy Reform Matrix (PRM), as macro-critical:

i. Strengthening public financial management. In the absence of its own currency and monetary policy, a sustainable fiscal policy is key to maintaining macroeconomic stability. Rebuilding buffer assets which were nearly exhausted in the aftermath of the global financial crisis is crucial to ensuring sustainability. Maintaining adequate buffer assets will require a sound fiscal policy framework including saving of cyclical revenues. Moreover, budget reporting and monitoring need to be improved and economic and policy analysis capacity should be strengthened to better inform new spending initiatives.

ii. Reforming public enterprises. The government, with ADB support, has begun a comprehensive public enterprise reform program to improve current weak performance and profitability. Ensuring public enterprises are independently and professionally run, and are transparently subsidized for provision of essential but noneconomic activities will strengthen Tuvalu's business climate and lessen the drain on public resources.

iii. Exploring opportunities for poverty reduction, job creation, and private sector development. Tuvalu's geographic isolation, small size, and poor land quality have made it challenging to generate domestic private sector employment. Demand for Tuvaluan seafarers on the international maritime employment market is declining, due to rising competition from other countries, and existing labor migration schemes have not been well utilized. Adequate education and training need to be provided for Tuvaluans to better utilize overseas job opportunities and to reduce rising poverty.

iv. Strengthening public service delivery. The government of Tuvalu in the TKII and the medium term reform agenda identified improving service delivery in the health and education sectors as key objectives. Based on analysis from the Health and Education Medium Term Expenditure Framework and other analytical work, the authorities have begun to consider reforms to ensure appropriate allocation between primary and tertiary service delivery, and maximizing returns on scare resources.

v. The teams expect to sustain the close cooperation going forward. Table 1 details the specific activities implemented and planned by the two teams over the period July 2014–October 2016.

Table 1. Tuvalu: Bank and Fund Implemented/Planned Activities in Macro-Critical Areas, [July 2014–October 2016]

	Products	Expected/Actual Delivery Date
World Bank Work Program	• Joint participation in Article IV Mission • Systematic Country Diagnostic • Country Policy Institutional Assessment • Tuvalu Aviation Investment Program • Second Budget Support Operation • Pacific Regional Oceanscape Project • Energy Project • Telecom TA	• [Annual/Biennial] • [FY2015] • [Annual] • [FY2016] • [FY2015] • [FY2015] • [FY2015] • [FY2015]
IMF Work Program	• PFTAC: BOP statistics TA mission • PFTAC: national accounts TA mission • PFTAC: bank supervision TA mission • Staff visit	• [FY2015] • [FY2015] • [FY2015] • June 2015

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Partnerships

The Asian Development Bank (ADB) has partnered with the Government of Tuvalu since 1993. As of 31 December 2013, three loans with a total value of US$7.82 million, two policy-based grants for US$5.59 million, and over 20 technical assistance projects totaling US$6.51 million have been approved, largely supporting education and public sector management.

ADB's approach and operations in Tuvalu are aligned to the National Strategy for Sustainable Development, *Te Kakeega* 2005–2015, objectives of good governance and macroeconomic growth and stability.

ADB, together with development partners, remain committed to supporting government's roadmap for improving the management of public resources, exercising prudent public expenditure and fiscal management, strengthening corporate governance, and delivering better public services to the people of Tuvalu.

ADB participates as a team member of the International Monetary Fund Article IV Mission to Tuvalu, and liaises closely with the Pacific Financial Technical Assistance Centre—particularly on macroeconomic management and fiscal conditions.

ADB observes the biannual meetings of the Tuvalu Trust Fund Board and cooperates with civil society organizations in Tuvalu to strengthen the effectiveness, quality, and sustainability of its services.

ADB is also committed to undertaking joint missions with development partners to improve coordination and lessen demands on country capacity.

ADB Supported Projects and Programs

ADB's strategic directions in Tuvalu remains focused on strengthening public financial management, including public expenditure and fiscal management, corporate governance, and public enterprise reforms.

From November 1999 to July 2001, ADB worked closely with the government to implement the Island Development Program loan and technical assistance program. This focused on improving governance and economic management, enhancing employment opportunities through skills development, and improving services on the outer islands. The loan was closed in 2001 and rated successful. ADB also completed the upgrade of the Tuvalu Maritime Training Institute in 2010. Rated partly successful, the new structures and training facilities enable the institute to remain accredited with the International Maritime Organization, and will improve the education and skills of Tuvaluan seafarers so that they can compete for jobs overseas.

Tuvalu has benefitted from a number of ADB regional projects in the areas of economic management, governance, environment, renewable energy, private sector development, and education. Ongoing support for economic analyses is available under the Pacific Economic Management technical assistance with revenue and statistics technical support provided by the Pacific Financial Technical Assistance Centre. Regional cooperation offers many benefits and the collective efforts towards increased aviation safety and security requirements under the ADB-financed Pacific Aviation Safety Office and the Pacific Regional Audit Initiative are good examples of its potential.

Developing effective fiscal management to complement private sector development has been a long-standing goal of ADB to Tuvalu. The Improved Financial Management Program grant for $3.24 million was approved in December 2008 and disbursed in 2009 and 2011. The second program grant of $2.35 million, approved in November 2012 and disbursed in March 2013, achieved key public financial management objectives outlined in government's policy reform matrix.

ADB's technical assistance helped build the government's capacity to meet commitments under both programs. Overall, the performance of public enterprises has improved, however developing and implementing a more robust policy reform matrix and building on past successes is important for sustainable economic growth and more efficient and effective public services for the people of Tuvalu.

Future Directions

Tuvalu's growth strategy is set out in the National Strategy for Sustainable Development, *Te Kakeega*, 2005–2015. The strategy recognizes that strengthening public sector management and improving the private sector are key drivers for change in Tuvalu. This is consistent with the focus of ADB's Pacific Approach 2010–2014, approved in November 2009, as well as ADB's country operations business plan (COBP) 2014–2016 for Tuvalu, approved in July 2013.

ADB's operational strategy for 2014-2016 focuses on improving public financial management and supporting the process of public enterprise reform, with specific objectives to improve their governance, administration, and profitability.

A policy-based grant of US$2.2 million in 2015 and supporting technical assistance of $300,000 per annum is planned to help Tuvalu build on previous programs and ensure that the reform momentum created by earlier programs is sustained.[1]

Tuvalu will continue to benefit from regional projects in the areas of economic management and governance, climate change, education, and support from the Pacific Infrastructure Advisory Center in the energy and utilities sectors.

[1] As a Category A country, Tuvalu is eligible for grant assistance from the Asian Development Fund (ADF). The country allocation is indicative and is subject to a revised estimate of ADF commitment authority, country performance assessment outcomes, and the country's risk of debt distress.

PFTAC COUNTRY STRATEGY 2012–2014

Background

Tuvalu has faced a difficult macroeconomic environment in recent times which has resulted in pressures on fiscal sustainability. Growth has remained weak despite improved performance in the fishing and private retail sectors. Large revenue from fishing licenses, together with substantial donor financial support, facilitated a sizable budget surplus in 2013 but also an expansionary budget in 2014. The short-term outlook appears stable on the back of large donor-financed investments expected in the period ahead, but the balance of risk tilts towards the downside. Vulnerabilities in the SOE and financial sectors continue to pose challenges to macro stability.

Development partner budget support has enabled operations to continue while the authorities work with partners to develop a joint policy matrix to underpin future budget support. Tuvalu became an IMF and World Bank member in 2009.

PFTAC TA has been moderate and concentrated in the revenue and statistics sectors. Recent PFTAC TA has been focused on assisting the authorities achieve the gains planned from revenue reforms through on-the-job assistance in revenue administration following the completion of an ADB project that supported the PFTAC-designed reforms. There has also been significant assistance in developing national accounts and balance of payments statistics, in part to allow Tuvalu to meet the requirements of IMF membership. PFTAC provided TA in 2012 to develop a PFM Reform Roadmap.

Strategy 2012–2014

PFTAC's TA strategy is guided by the APD regional strategy note and is planned within the results framework for the current PFTAC funding cycle.1

PFTAC TA aims to support the authorities sustain progress on improving fiscal sustainability. PFTAC will continue to work closely with the broader development partner group to ensure coherence and will aim to support implementation of actions in the authorities' shared policy matrix. Development of a PFM Roadmap and enhancement of national accounts statistics are expected to be the main focus.

In the **Public Financial Management** area, PFTAC provided support in 2012 to develop a PFM roadmap to prioritize the strengthening of PFM weaknesses identified in the 2011 PEFA (*1.2*). Support to implementation of specific elements will also be available, in coordination with other development partners and in particular the AusAID-supported budget and treasury advisors. Officials from Tuvalu have regularly attended PFTAC's PFM workshops, including the annual 2 week Strategic Development Workshop jointly sponsored by PFTAC and the Australian Department of Finance at ANU in Canberra. PFTAC would look to assist the authorities implement a follow-up PEFA assessment, probably in 2015 (*1.1*).

In the **revenue** area, the main focus will be continuing support in the enforcement of SOE tax obligations through an enhanced compliance improvement program. It is anticipated that this program will roll out to include large corporate and individual business enterprises during 2014/15. The IT operating system was re-established in 2013/14 after data base issues were resolved and maintenance and effective use of the system will be an important tool in improving compliance. PFTAC plans a support Mission in May 2014 with a follow up support mission in early 2015.

In **statistics**, PFTAC will resume providing regular assistance on national accounts compilation (*4.1*), taking over from SPC which has been doing this since 2010. Training will also be provided to increase capacity in the statistics office so that ultimately broader measures of national income and saving (*4.3*) can be regularly produced. PFTAC has been providing support on balance of payments compilation (*4.6, 4.9*) but this has been taken over by the JSA Project on the Improvement of External Sector Statistics in the Asia and Pacific Region.

In **financial sector supervision**, PFTAC will be available to provide strategic support should the authorities begin implementing the financial institutions act passed in 2010. Given the lack of in country capacity, establishing a basic on and off site supervision program (*3.1 and 3.4*) will require TA resources well in excess of PFTAC's availability. As in other sectors though, PFTAC would be able to provide strategic oversight to the process if other partners were able to provide resources for on the job support.

No direct **macroeconomic** support is currently envisaged, with the TTFAC and ADB's PEM TA currently taking the lead in these areas.

STATISTICAL ISSUES

(As of July 1, 2014)

I. Assessment of Data Adequacy for Surveillance
General: Data have shortcomings that hamper surveillance. Shortcomings are most serious in the national accounts and monetary statistics. The Pacific Financial Technical Assistance Centre (PFTAC) and the Statistics Department (STA) have provided technical assistance (TA) to the Central Statistics Division (CSD) of the Ministry of Finance to help compiling statistics for surveillance and the authorities' own policy analysis and formulation. The CSD will need to train additional staff to improve data provisioning.
National accounts: With PFTAC assistance, the compilation methodology for the national accounts is gradually improving. Attention needs to be paid to improving source data for national accounts.
Price statistics: The consumer price index (CPI) is the only price index compiled in Tuvalu. The CSD produces a quarterly CPI, which is timely and of reasonable quality. The CPI weights were revised in 2011, based on the 2010 Household Income and Expenditure Survey.
Government finance statistics (GFS): The MOF compiles the central government data for budget analysis and control. However, the classifications of some accounts, particularly on capital spending, need to be improved to be in line with international standards. GFS data are not reported to STA. The authorities are participating in the Japan Administered Account for Selected IMF Activities (JSA)-funded three-year regional GFS capacity building project. It is anticipated that a total of three missions to Tuvalu will be conducted under this project, the first two of which occurred in April 2012 and April 2013. Staff resource levels continue to be an impediment to an efficient and effective GFS data compilation.
Monetary and financial statistics: Tuvalu uses the Australian dollar as its legal tender and does not have a central bank. Monetary and financial statistics are currently not produced in Tuvalu. The National Bank of Tuvalu and the Development Bank of Tuvalu provided the Article IV mission with their balance sheets, which were used to produce the monetary data on the two banks.
Balance of payments and International Investment Position (IIP): The IMF has been providing TA to Tuvalu under the JSA Project on the Improvement of External Sector Statistics (ESS) in the Asia and Pacific Region. Three TA missions have been conducted since April 2013. Important progress has been made in improving coverage and classification of the ESS. Moreover, capacity has been developed and the CSD compiler has taken ownership of most of the compilation process. However, shortcomings remain in the coverage of FDI, exports, and debt-related transactions and positions. There is also a high risk of sudden disruption of the compilation process and deterioration of data quality as the CSD has only one ESS compiler, who also compiles other macroeconomic statistics.

II. Data Standards and Quality	
Tuvalu began participating in the General Data Dissemination System in 2013.	No data ROSC are available.

III. Reporting to STA
Annual balance of payments and IIP statements, both in BPM6 format, were submitted to STA in May 2014 for the first time (data are currently under review). Other statistics are currently not being reported to STA.

Tuvalu: Table of Common Indicators Required for Surveillance
(As of July 1, 2014)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange rates[1]	7/1/14	7/1/14	D	NA	NA
International reserve assets and reserve liabilities of the monetary authorities[2]	04/2014	05/2014	M	I	NA
Reserve/base money	NA	NA	NA	NA	NA
Broad money	NA	NA	NA	NA	NA
Central bank balance sheet	NA	NA	NA	NA	NA
Consolidated balance sheet of the banking system	04/2014	05/2014	M	I	NA
Interest rates	04/2014	05/2014	M	I	NA
Consumer price index	03/2014	05/2014	Q	Q	NA
Revenue, expenditure, balance and composition of financing[3]—general government[4]	NA	NA	NA	NA	NA
Revenue, expenditure, balance and composition of financing[3]—central government	04/2014	05/2014	M	M	M
Stocks of central government and central government-guaranteed debt[5]	04/2014	05/2014	A	A	NA
External current account balance	12/2012	05/2014	A	A	A
Exports and imports of goods and services	12/2012	05/2014	A	A	A
GDP/GNP	12/2012	05/2014	A	A	NA
Gross external debt	12/2013	05/2014	A	A	NA
International investment position[6]	12/2012	05/2014	A	A	A

[1] Tuvalu uses the Australian dollar as its legal tender.

[2] 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. Tuvalu does not have a monetary authority. Foreign assets of National Bank of Tuvalu and the Consolidated Investment Fund constitute the official reserves of Tuvalu.

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

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

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

TUVALU

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

August 5, 2014

Approved By
Brian Aitken and Vikram Haksar (IMF), and Satu Kahkonen (IDA)

Prepared jointly by the staffs of the International Monetary Fund and the International Development Association

This year's Debt Sustainability Analysis (DSA) concludes that Tuvalu is at a high risk of debt distress, the same risk rating assigned in the previous DSA conducted in 2012. While a large fiscal surplus was recorded over the last two years, allowing the country to build up needed fiscal buffers, the increase in expenditures envisaged in the 2014 budget—financed by a temporary but large increase in foreign grants— implies a significant increase in the risk to fiscal sustainability. Under the baseline scenario, where the increase in the spending envelope is not scaled back in line with the unwinding of foreign grants in a timely manner, the budget would slip into a deficit from 2015 onwards. Although the PV of debt to GDP ratio would initially fall below the indicative policy threshold as fiscal buffers are depleted, over the medium term debt would build up again as fiscal buffers are exhausted, and reach above the indicative threshold in outer years of the projection. This trajectory underscores why a modest fiscal surplus is needed to lower the risk of debt distress to moderate levels. Also, placing growth on a higher trajectory by addressing structural weaknesses should strengthen the country's ability to service debt.

BACKGROUND

1. **Being one of the smallest and most isolated countries in the world, Tuvalu faces tremendous challenges**. With a population of some 11,000 people living on 26 square kilometers, Tuvalu is more than 3,000 kilometers away from its nearest major external market. Despite substantial, albeit volatile, foreign aid and a boom in the fisheries sector, growth prospects are hampered by weak competitiveness and capacity, with remoteness causing high transportation cost and isolation, and the lack of scale increasing transaction cost.

2. **The authorities are cognizant of the challenges and have developed a broad reform agenda**. A development strategy and reform package, which were formulated in consultation with development partners, have been fleshed out in an effort to enhance governance and social development, facilitate private sector growth, and safeguard macroeconomic stability.

3. **The budget achieved a substantial surplus for the second consecutive year in 2013, but a dramatic increase of budget spending in 2014 has called into question its fiscal sustainability.** The fiscal surplus reached 26.3 percent of GDP, reflecting record high fishing license fees and higher than expected tax revenue and foreign aid. Nevertheless, the 2014 budget targets a more than 20 percent expansion of spending, which would be financed by a large temporary increase of foreign grants and transfers. The substantial fiscal expansion would result eventually in a depletion of fiscal buffers and accumulation of foreign debt.

4. **Meanwhile, the government's external assets have risen markedly.** The Consolidated Investment Fund (CIF), which serves as a fiscal buffer and is fully controlled by the government of Tuvalu, has been built up to more than $A 15 million (38 percent of GDP). The Tuvalu Trust Fund (TTF), which was capitalized by development partners in 1987, has grown from $A130 million in 2012 to more than $A 140 million in 2013 (356 percent of GDP). The TTF is not fully sovereign and is owned instead by Tuvalu, Australia, and New Zealand, amongst others countries. It cannot be drawn down freely: when its market value exceeds a "maintained value" indexed to Australian CPI, the TTF Board—representing both development partners and Tuvalu government—can decide to transfer the funds in excess of the target income to the CIF. This DSA analyzes gross public debt because of the limited conditional access to the TTF.

5. **Since the previous DSA conducted in 2012, public and publicly guaranteed (PPG) debt has continued to decline, but is expected to rise as a result of public enterprise borrowing in the near term.** As of end-2013, total PPG debt stood at US$ 14.6 million, equivalent to 41 percent of GDP. External debt was US$ 12.5 million (35 percent of GDP), and domestic debt—owed to domestic banks—stood at US$ 2.1 million (6 percent of GDP). Bilateral development partners provide only grant assistance, while multilateral institutions, most notably the Asian Development Bank, provided concessional loans to the government. Meanwhile, loans contracted at nonconcessional terms by two fishing joint ventures established by the National Fishing Corporation

of Tuvalu (NAFICOT) and Asian companies account for a significant share of public debt. These loans are largely guaranteed by the government, and constitute contingent government liabilities. [1] Recently, one joint venture has been working on a new loan agreement to finance the expansion of its fishing capacity, which implies a large addition of public debt in the near term—most likely in 2014 or 2015.

Tuvalu: Public Debt, End-2013

	Creditor	Outstanding amount (US$ million)	Outstanding amount (Percent of GDP)	Concessional
External Debt		**12.5**	**35.3**	
Central Government Debt	ADB	6.2	17.4	Yes
Development Bank Debt	EIB	1.4	3.8	No
Fishing Joint Venture Debt	Commercial bank	5.0	14.1	No
Domestic debt		**2.1**	**5.8**	No

6. **This DSA is built on a baseline macroeconomic framework that assumes an accommodative and procyclical fiscal policy.** Without a timely action to cut back the spending envelope from the 2014 budget level, the fiscal balance would shift into a deficit from 2015 onwards, which would be financed initially by drawing down the CIF, and later, when the CIF is fully depleted in 2021, by concessional borrowing. This would cause debt-to-GDP ratio to decline over the medium term as the current debt is amortized, and build up again as new borrowing occurs. Although weaknesses in the banks and public enterprises could pose large liabilities to the government, these costs are not assumed in the baseline because of the lack of reliable data—the cost of addressing banking fragilities needs to be assessed on the basis of a prudent regulation and resolution framework, while the fiscal cost associated with public enterprise weaknesses should be estimated in the context of a comprehensive public enterprise reform package.

7. **Compared to the previous DSA, the main features of the current macroeconomic framework can be summarized as follows:**

- **Growth**. Real GDP is projected to grow by an average of 2.2 percent per annum over the medium term and 2 percent over the long run, compared to a constant of 1.2 percent in the previous DSA.

- **Inflation**. Inflation is projected to reach about 3 percent in the near term and gradually moderate to below 2 percent in the long run, which is similar to the previous DSA.

[1] An effectively defunct and wholly government-owned public enterprise called the National Fishing Corporation of Tuvalu (NAFICOT) is party to the two fishing joint ventures (JV). NAFICOT owns 50 percent of the JV that was established together with a company of the Taiwan Province of China, and 40 percent of the Korean one.

- **Balance of payments.** Exports of goods and services are projected to remain stable at 60 percent of GDP over the medium and long run compared to just above 10 percent in the previous DSA, with the difference reflecting revision to the data to account for large exports by fishing joint ventures following a recent technical assistance on external account statistics. Imports of goods and services would peak at 168 percent of GDP in the medium term and moderate to 115 percent of GDP over the long run; in the previous DSA, imports would peak at 151 percent of GDP over the medium term, and moderate to 112 percent of GDP over the long run. The current account deficit would widen to 37 percent of GDP over the medium term, and then narrow to 4.4 percent of GDP by the end of the projection period, a level close to the last DSA.

- **Fiscal.** Revenue is slightly higher than in the last DSA over the medium term, reflecting buoyant fishing license fees. However, it is expected to fall to 45 percent of GDP towards the end of the projection period, compared to 56 percent in the last DSA. Grants as a share of GDP will also fall over time, reaching 13 percent of GDP by 2034 compared to 17 percent of GDP in the previous DSA. Expenditures are projected to decline from 100 percent of GDP in 2014 to 62 percent in 2034, while the last DSA projected expenditure to be broadly stable at above 80 percent of GDP.

- **Discount rate.** The discount rate has been increased from 3 percent in the last DSA to 5 percent, reflecting the most recent DSA guidelines.

Tuvalu: Key Macroeconomic Assumptions
(In percent)

	2012 DSA	2014 DSA
	2012-2017 AVG	2014-2019 AVG
Real GDP growth	1.2	2.2
Inflation (GDP deflator)	1.9	2.1
Current account balance/ GDP	0.5	-11.9
Revenue excluding grants/ GDP	58.5	60.0
Grants/GDP	13.7	24.4
Expenditure/GDP	81.0	87.0
Fiscal Balance/GDP	-8.8	-2.2

8. **Risks to the baseline scenario are on the downside.** Vulnerabilities in state-owned banks and public enterprises imply large government liabilities. Uncertainties within the fisheries sector could pose additional risks to revenue and fiscal soundness. Moreover, a slowdown in advanced and emerging economies, including China, could undermine activity and reduce job opportunities in the Pacific region, which would weaken the demand for Tuvaluan seafarers and seasonal workers, adversely affecting Tuvalu's growth prospects.

DEBT SUSTAINABILITY

A. External Debt

9. **Under the baseline scenario, external debt breaches the indicative threshold of debt-to-GDP ratio for prolonged periods.** The threshold for PV of Debt to GDP is determined by the CPIA index, a measure of the country's institutional capacity. While the trajectory shows a decline in debt levels from 52 percent of GDP to just above 20 percent over the medium term, reflecting amortization of existing loans and no new borrowing in the medium term, increased borrowing only

in the outer years, leading to the full depletion of CIF buffers by 2021. This implies that the debt trajectory begins to rise again and breaches the threshold by 2029. (Figure 1) The PV of debt-to-GDP ratio starts at a much higher level than the last DSA, but converges to the level as the last DSA toward the end of the projection period. The negative contribution of residuals (table 1 and 2) to the debt trajectory throughout the medium-term horizon is largely driven by withdrawing from external assets under the CIF.

10. Stress tests show the debt ratios are highly sensitive to exports and exchange rate shocks. A one-time 30 percent nominal depreciation in 2015 would cause the debt-to-GDP ratio to stay above the indicative threshold for most of the projection period. A standard shock to exports also results in a breach of the debt-to-export threshold over the next few years. Also, the threshold for the debt service-to-exports would be breached for four years over the medium term.

B. Public Debt

11. The PV of public debt to GDP stays above the benchmark over the medium term. The PV of debt to GDP stands at 58 percent of GDP in 2014, and while declining gradually below the benchmark of 38 percent over the medium term, would rise again in outer years as new borrowing occurs after the CIF is depleted, reaching 40 percent of GDP by 2034.[2] (Figure 2). Although the breaching of the benchmark is small, it needs to be interpreted with caution. Since domestic banks are struggling with large amounts of nonperforming loans and can hardly extend additional financing on a sustained basis, external borrowing will constitute the main source of public financing, and debt sustainability analysis based on external debt ratios appears more informative at this stage. The PV of debt-to-revenue ratio would rise from 50 percent in 2014 to 69 percent in 2034, while the PV of debt service-to-revenue ratio will fall from 8 percent to 3 percent.

12. Paths of debt indicators are sensitive to alternative assumptions and bound tests. A one-time 30 percent depreciation would push the PV of debt-to-GDP ratio to peak at 73 percent in 2015. A standard shock to growth would cause the PV of debt-to-revenue ratio to rise from 50 percent in 2014 to 194 percent in 2034.

C. External and Public DSA under Alternative Scenario

13. Under an alternative scenario where fiscal policy is anchored by an appropriate fiscal balance target, the risk of debt distress is reduced considerably. Given the volatility of fishing license fees, targeting a structural balance would help reduce procyclicality—the structural balance is estimated on the basis of a moving average of fishing license fees over a period of seven years; fishing license fees in excess of the structural level, i.e. their moving average, would be saved in the CIF, while it can be drawn down in case fishing license fees fall short of the structural level. In the case of Tuvalu, targeting a moderate structural surplus implies saving fishing revenues in the current period given the dramatic increase in fishing license fees in the past few years. Under the alternative scenario, the fiscal policy targets a structural surplus of 0.5-1 percent of GDP over the medium to

[2] The public debt benchmark is derived on empirical basis, and varies among countries with their respective CPIA score.

long run. As a consequence, CIF buffers would be maintained at a comfortable level, and debt indicators will improve significantly—the PV of external debt-to-GDP would fall from 53 percent in 2014 to around 10 percent by 2034.

D. Authorities' View

14. The authorities broadly concurred with the overall assessment of the Debt-Sustainability Analysis, but made a couple of observations. First, the authorities, while recognizing the volatility of fishing revenues, are more optimistic about the near-term outcome, and expect revenues to be higher than staff projection in the next few years. Second, they indicated that the fishing joint venture has a favorable outlook, and the probability for the government to assume the company's debt obligation is small.

E. Conclusions

15. The results of Tuvalu's DSA point to a high risk of debt distress, which is the same conclusion that was drawn in the 2012 DSA. The PV of debt-to-GDP ratio is above the indicative threshold over the long run. Furthermore, a significant portion of public debt was contracted on nonconcessional terms, placing further strains on the country's weak debt servicing capacity.

16. Stress tests show that Tuvalu's debt dynamics are susceptible to shocks. Standard shocks in the DSA, particularly the one-time 30 percent nominal depreciation, as well as slower real GDP growth rates and lower export growth, would cause external debt indicators to breach their respective thresholds over the long run. Public debt indicators also worsen dramatically under bound tests.

17. The risk of debt distress is reduced to a moderate level under the alternative scenario where a modest fiscal structural surplus is implemented. Assuming that the government maintains a structural surplus of 0.5-1 percent of GDP over the medium and long term, all external debt indicators would decline below their indicative thresholds.

Box 1. Macroeconomic Assumptions Under Baseline Scenario

Growth and Inflation

- Growth is expected to be boosted to about 2.5 percent in the next few years thanks to the implementation of a few large infrastructure projects financed by grants from development partners.[1/] Over the long term, the growth will moderate to about 2 percent as these projects are completed. Meanwhile, the share of the public sector in the economy would gradually decline, while the private sector would play a more important role over time on the back of great potential in the fisheries sector, which is consistent with the Te Kakeega II development strategy.
- Inflation is projected to rise to about 3 percent in 2014 as a result of increased government spending and civil servant wages as well as a weakening Australian dollar. Inflation would moderate gradually to just below 2 percent in the outer years.

Balance of Payments

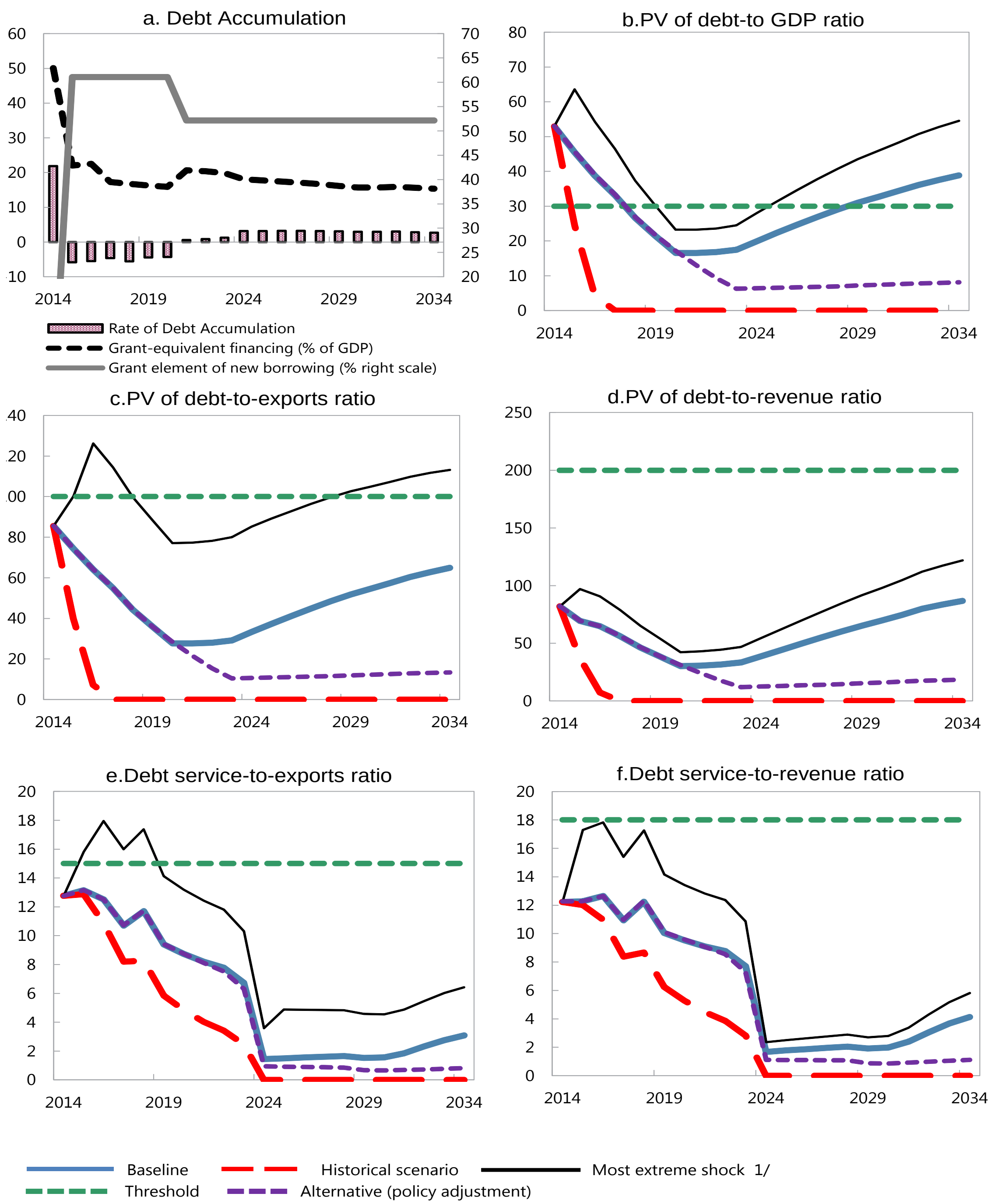
- Current account deficit will peak over the medium term at 37 percent of GDP mainly because of a spike in imports, and gradually narrow to about 4 percent of GDP over the long run. Reflecting improved capacity to tap into the marine resources by both public and private enterprises, fishing exports are expected to double in value over the next 20 years. Driven by large infrastructure projects and the purchase of fishing ships, imports would rise substantially in the next few years, and grow moderately thereafter. The trade balance will move into a deficit over the medium term, and return to a moderate surplus in 2018 and onwards.
- FDI inflows would be minimal and mostly include reinvestment of fishing joint venture earnings. Despite efforts of the authorities to privatize certain public enterprises, there has been little success in attracting foreign investors, and therefore no significant FDI inflows associated with privatization are assumed.

Fiscal Policy and Financing

- Fishing license fees are projected conservatively at around A$14 million in 2014-2019 and to gradually decline to A$11 million over the long run reflecting the adverse impact of overfishing and climate change.
- Foreign grants to the budget are expected to decline gradually from 51 percent of GDP in 2014 to 13 percent of GDP by 2034. It is assumed that the government's implementation of reforms induces continued support from development partners.
- Given the weakening fishing license fees and foreign grants, expenditures would be compressed gradually from nearly 100 percent of GDP in 2014 to 62 percent of GDP by 2034. This decline also reflects a reduced share of the public sector in the economy, which makes space for the private sector to grow.
- The overall fiscal deficit will hover around 5-7 percent of GDP over the medium term, and decline gradually to just above 4 percent of GDP by 2034. The convergence of fiscal deficit toward current account balance also points to the importance of maintaining a sound fiscal policy to safeguard competitiveness and economic stability. Financing of fiscal deficits would be mostly from external borrowing, while domestic banks suffer from severe asset quality problems and are not capable of providing sustainable financing over the long term.

1/ These expenditures would be extrabudgetary.

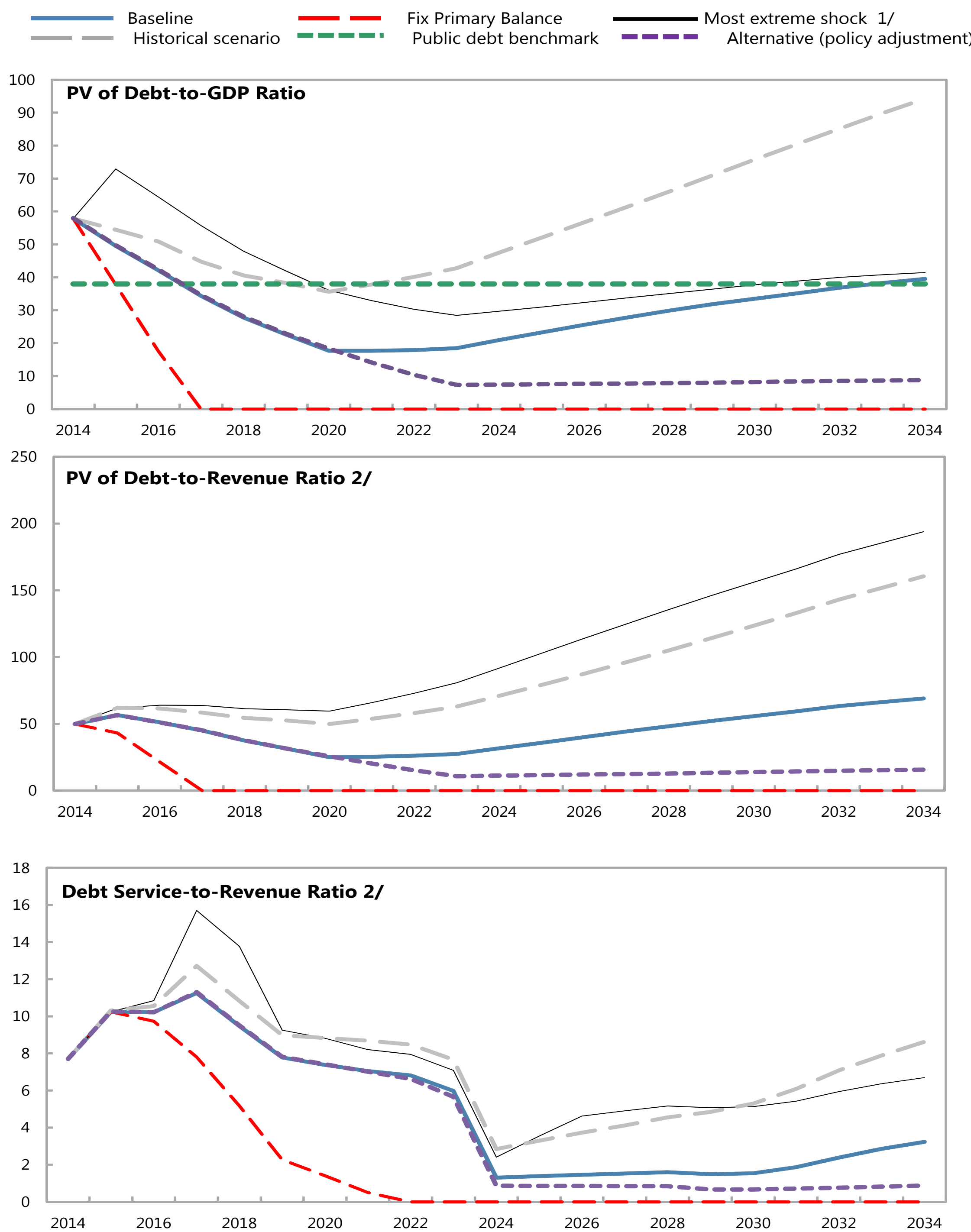
Figure 1. Tuvalu: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2014–2034 1/



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 2024. In figure b. it corresponds to a Alternative (policy adjustment) shock; in c. to a Alternative (policy adjustment) shock; in d. to a Alternative (policy adjustment) shock; in e. to a Alternative (policy adjustment) shock and in figure f. to a Alternative (policy adjustment) shock

Figure 2. Tuvalu: Indicators of Public Debt Under Alternative Scenarios, 2014–2034 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 2024.
2/ Revenues are defined inclusive of grants.

Table 1. Tuvalu: External Debt Sustainability Framework, Baseline Scenario, 2011–2034

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-2019 Average	2024	2034	2020-2034 Average
External debt (nominal) 1/	40.7	36.4	35.3			52.0	44.6	37.9	32.1	25.5	20.3		35.6	68.6	
of which: public and publicly guaranteed (PPG)	40.7	36.4	35.3			52.0	44.6	37.9	32.1	25.5	20.3		35.6	68.6	
Change in external debt	-9.9	-4.3	-1.1			16.7	-7.4	-6.7	-5.8	-6.6	-5.2		5.0	2.3	
Identified net debt-creating flows	27.2	-30.1	-26.9			-30.1	34.2	20.1	16.2	6.8	8.6		3.4	1.3	
Non-interest current account deficit	34.7	-26.9	-27.9	-0.7	23.7	-29.7	34.7	20.8	16.9	7.7	9.6		5.3	3.4	4.7
Deficit in balance of goods and services	98.7	51.7	63.4			73.4	106.7	89.6	78.0	60.8	61.1		56.4	54.6	
Exports	37.8	62.8	62.9			61.9	61.1	60.5	60.2	60.0	59.9		59.9	59.9	
Imports	136.5	114.4	126.3			135.3	167.8	150.1	138.2	120.8	121.0		116.2	114.5	
Net current transfers (negative = inflow)	-37.6	-52.6	-45.4	-45.9	8.4	-55.5	-35.8	-35.3	-29.3	-22.9	-22.6		-22.9	-22.5	-22.8
of which: official	-40.9	-56.1	-48.6			-58.6	-38.9	-38.4	-32.4	-26.0	-25.7		-26.1	-25.6	
Other current account flows (negative = net inflow)	-26.4	-26.0	-45.9			-47.7	-36.2	-33.5	-31.8	-30.2	-28.9		-28.2	-28.6	
Net FDI (negative = inflow)	0.3	-4.2	-1.8	-1.6	2.3	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8		-1.8	-1.8	-1.8
Endogenous debt dynamics 2/	-7.8	1.0	2.9			1.5	1.3	1.1	1.1	0.9	0.8		0.0	-0.3	
Contribution from nominal interest rate	1.7	1.6	1.5			2.3	2.5	2.2	1.8	1.5	1.2		0.5	1.0	
Contribution from real GDP growth	-3.5	-0.1	-0.5			-0.8	-1.2	-1.1	-0.7	-0.6	-0.5		-0.5	-1.3	
Contribution from price and exchange rate changes	-6.1	-0.5	1.9			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	-37.0	25.7	25.8			46.8	-41.6	-26.8	-22.0	-13.4	-13.8		1.6	1.0	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	34.5			52.9	45.5	38.8	33.1	26.6	21.4		19.9	38.9	
In percent of exports	...	...	54.9			85.6	74.4	64.1	55.0	44.3	35.8		33.3	64.9	
PV of PPG external debt	...	...	34.5			52.9	45.5	38.8	33.1	26.6	21.4		19.9	38.9	
In percent of exports	...	...	54.9			85.6	74.4	64.1	55.0	44.3	35.8		33.3	64.9	
In percent of government revenues	...	...	41.6			82.0	69.4	64.8	56.1	46.4	38.3		38.8	86.8	
Debt service-to-exports ratio (in percent)	19.4	11.2	11.6			12.8	13.2	12.5	10.7	11.7	9.4		1.4	3.1	
PPG debt service-to-exports ratio (in percent)	19.4	11.2	11.6			12.8	13.2	12.5	10.7	11.7	9.4		1.4	3.1	
PPG debt service-to-revenue ratio (in percent)	15.4	12.5	8.8			12.2	12.3	12.6	10.9	12.2	10.1		1.7	4.1	
Total gross financing need (Millions of U.S. dollars)	16.6	-9.6	-8.6			-9.1	16.7	11.1	9.3	5.7	6.2		2.3	2.7	
Non-interest current account deficit that stabilizes debt ratio	44.5	-22.6	-26.9			-46.5	42.1	27.4	22.7	14.3	14.8		0.2	1.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	8.5	0.2	1.3	1.4	4.9	2.2	2.5	2.5	1.9	2.0	1.9	2.2	1.8	2.1	1.9
GDP deflator in US dollar terms (change in percent)	13.6	1.3	-4.9	6.6	9.1	-1.9	3.3	0.3	0.6	1.4	1.1	0.8	1.5	1.6	1.6
Effective interest rate (percent) 5/	4.1	4.0	4.0	2.7	1.4	6.4	5.1	5.1	4.8	4.8	4.9	5.2	1.7	1.6	2.1
Growth of exports of G&S (US dollar terms, in percent)	5.4	68.5	-3.5	33.8	46.9	-1.2	4.5	1.7	2.0	3.0	2.8	2.1	3.4	3.6	3.5
Growth of imports of G&S (US dollar terms, in percent)	27.7	-15.0	6.4	10.7	20.3	7.5	31.2	-8.1	-5.6	-9.7	3.2	3.1	2.6	3.6	3.1
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	-5.1	61.1	61.1	61.1	61.1	61.1	50.1	52.2	52.2	52.8
Government revenues (excluding grants, in percent of GDP)	47.8	56.6	82.9			64.6	65.6	59.9	59.0	57.3	56.0		51.4	44.7	49.2
Aid flows (in Millions of US dollars) 7/	8.3	11.1	9.4			19.8	9.0	9.4	7.4	7.5	7.5		11.4	13.9	
of which: Grants	8.3	11.1	9.4			19.8	9.0	9.4	7.4	7.5	7.5		7.9	9.6	
of which: Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		3.4	4.2	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			50.1	22.1	22.5	17.3	16.8	16.3		18.1	15.4	17.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			64.8	100.0	100.0	100.0	100.0	100.0		85.6	85.4	86.1
Memorandum items:															
Nominal GDP (Millions of US dollars)	39.3	39.9	38.4			38.6	40.8	42.0	43.0	44.5	45.8		53.9	76.9	
Nominal dollar GDP growth	23.2	1.5	-3.6			0.3	5.8	2.8	2.5	3.4	3.0	3.0	3.4	3.6	3.5
PV of PPG external debt (in Millions of US dollars)			12.3			20.7	18.4	16.2	14.2	11.8	9.8		10.7	29.8	
(PVt-PVt-1)/GDPt-1 (in percent)						21.8	-5.8	-5.5	-4.7	-5.6	-4.5	-0.7	3.1	2.7	2.1
Gross workers' remittances (Millions of US dollars)	4.6	3.8	3.7			3.7	3.8	3.9	4.0	4.1	4.2		4.9	7.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	31.5			48.4	41.6	35.5	30.3	24.3	19.6		18.3	35.6	
PV of PPG external debt (in percent of exports + remittances)	...	...	47.6			74.2	64.5	55.6	47.7	38.4	31.1		28.9	56.3	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	10.1			11.1	11.4	10.9	9.3	10.2	8.2		1.2	2.7	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 2. Tuvalu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–2034
(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	45.3	43.0	41.1			56.9	48.6	41.2	33.4	26.7	21.5		36.5	69.3	
of which: foreign-currency denominated	40.7	36.4	35.3			52.0	44.6	37.9	32.1	25.5	20.3		35.6	68.6	
Change in public sector debt	-10.3	-2.3	-1.9			15.8	-8.3	-7.4	-7.8	-6.6	-5.2		5.0	2.3	
Identified debt-creating flows	4.0	-10.7	-21.8			-19.2	2.4	4.1	6.5	5.0	4.4		4.9	2.0	
Primary deficit	7.0	-11.2	-28.3	8.9	18.7	-18.3	1.6	3.1	5.8	4.6	3.9	0.1	5.4	3.4	4.5
Revenue and grants	69.0	84.3	107.5			116.0	87.6	82.4	76.3	74.0	72.2		66.1	57.3	
of which: grants	21.2	27.8	24.6			51.4	22.1	22.5	17.3	16.8	16.3		14.7	12.5	
Primary (noninterest) expenditure	76.0	73.1	79.1			97.8	89.2	85.4	82.1	78.7	76.2		71.5	60.6	
Automatic debt dynamics	-3.1	0.5	6.5			-1.0	0.8	1.0	0.8	0.4	0.4		-0.5	-1.4	
Contribution from interest rate/growth differential	-3.4	1.1	0.7			1.0	0.5	0.4	0.4	0.2	0.2		-0.6	-1.6	
of which: contribution from average real interest rate	0.9	1.1	1.2			1.9	1.9	1.6	1.2	0.9	0.7		-0.1	-0.2	
of which: contribution from real GDP growth	-4.3	-0.1	-0.5			-0.9	-1.4	-1.2	-0.8	-0.6	-0.5		-0.6	-1.3	
Contribution from real exchange rate depreciation	0.4	-0.6	5.8			-1.9	0.3	0.7	0.4	0.2	0.2		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	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	-14.3	8.4	19.9			35.0	-10.6	-11.5	-14.4	-11.7	-9.6		0.1	0.3	
Other Sustainability Indicators															
PV of public sector debt	...	...	40.3			57.9	49.6	42.1	34.3	27.8	22.6		20.9	39.6	
of which: foreign-currency denominated	...	...	34.5			52.9	45.5	38.8	33.1	26.6	21.4		19.9	38.9	
of which: external	...	...	34.5			52.9	45.5	38.8	33.1	26.6	21.4		19.9	38.9	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	14.3	-3.6	-19.9			-9.3	10.6	11.5	14.3	11.6	9.6		6.3	5.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	37.5			49.9	56.6	51.1	45.0	37.5	31.3		31.7	69.1	
PV of public sector debt-to-revenue ratio (in percent)	...	...	48.6			89.6	75.6	70.3	58.2	48.5	40.4		40.8	88.4	
of which: external 3/	...	...	41.6			82.0	69.4	64.8	56.1	46.4	38.3		38.8	86.8	
Debt service-to-revenue and grants ratio (in percent) 4/	10.6	9.0	7.8			7.7	10.2	10.2	11.3	9.5	7.8		1.3	3.2	
Debt service-to-revenue ratio (in percent) 4/	15.4	13.5	10.2			13.8	13.7	14.1	14.6	12.2	10.1		1.7	4.1	
Primary deficit that stabilizes the debt-to-GDP ratio	17.3	-8.9	-26.4			-34.1	9.9	10.5	13.6	11.3	9.2		0.4	1.0	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	8.5	0.2	1.3	1.4	4.9	2.2	2.5	2.5	1.9	2.0	1.9	2.2	1.8	2.1	1.9
Average nominal interest rate on forex debt (in percent)	4.1	4.0	4.0	2.7	1.4	6.4	5.1	5.1	4.8	4.8	4.9	5.2	1.7	1.6	2.1
Average real interest rate on domestic debt (in percent)	...	5.0	5.5	5.3	0.3	4.5	4.5	4.6	4.6	...	...	4.5	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation)	0.7	-1.3	15.8	-0.9	14.2	-5.4	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.3	0.9	1.8	2.1	1.8	2.7	2.6	2.3	2.2	2.0	1.8	2.2	1.5	1.6	1.6
Growth of real primary spending (deflated by GDP deflator, in percent)	-11.7	-3.6	9.6	-21.2	65.3	26.3	-6.5	-1.9	-2.1	-2.2	-1.4	2.0	0.0	1.0	0.4
Grant element of new external borrowing (in percent)	...	...	...	...	...	-5.1	61.1	61.1	61.1	61.1	61.1	50.1	52.2	52.2	...

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Revenues excluding grants.

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

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

Table 3. Tuvalu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034

(In percent)

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of debt-to GDP ratio								
Baseline	53	45	39	33	27	21	20	39
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	53	24	4	0	0	0	0	0
A2. New public sector loans on less favorable terms in 2014-2034 2	53	45	39	37	33	31	44	82
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	53	48	43	37	30	24	22	44
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	53	51	54	49	43	38	36	48
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	53	48	42	36	29	23	22	42
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	53	46	39	34	27	22	20	39
B5. Combination of B1-B4 using one-half standard deviation shocks	53	44	31	24	17	12	10	35
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	53	64	54	46	37	30	28	55
PV of debt-to-exports ratio								
Baseline	86	74	64	55	44	36	33	65
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	86	40	7	0	0	0	0	0
A2. New public sector loans on less favorable terms in 2014-2034 2	86	74	65	61	56	52	73	137
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	86	74	64	55	44	36	33	65
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	86	100	126	114	100	88	85	113
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	86	74	64	55	44	36	33	65
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	86	74	65	56	45	37	34	65
B5. Combination of B1-B4 using one-half standard deviation shocks	86	65	41	33	24	16	14	48
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	86	74	64	55	44	36	33	65
PV of debt-to-revenue ratio								
Baseline	82	69	65	56	46	38	39	87
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	82	37	7	0	0	0	0	0
A2. New public sector loans on less favorable terms in 2014-2034 2	82	69	66	63	58	56	85	183
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	82	73	72	63	52	43	44	97
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	82	78	91	83	74	67	71	108
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	82	73	70	61	50	42	42	94
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	82	69	65	57	47	39	40	87
B5. Combination of B1-B4 using one-half standard deviation shocks	82	67	51	42	31	21	20	78
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	82	97	91	79	65	54	55	122

Table 3. Tuvalu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034 (concluded)

(In percent)

Debt service-to-exports ratio								
Baseline	13	13	13	11	12	9	1	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	13	13	11	8	8	6	0	0
A2. New public sector loans on less favorable terms in 2014-2034 2	13	13	10	3	4	2	1	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	13	13	13	11	12	9	1	3
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	13	16	18	16	17	14	4	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	13	13	13	11	12	9	1	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	13	13	13	11	12	9	1	3
B5. Combination of B1-B4 using one-half standard deviation shocks	13	12	11	9	10	8	1	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	13	13	13	11	12	9	1	3
Debt service-to-revenue ratio								
Baseline	12	12	13	11	12	10	2	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	12	12	11	8	9	6	0	0
A2. New public sector loans on less favorable terms in 2014-2034 2	12	12	10	3	4	2	1	6
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	12	13	14	12	14	11	2	5
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	12	12	13	12	13	11	3	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	12	13	14	12	13	11	2	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	12	12	13	11	12	10	2	4
B5. Combination of B1-B4 using one-half standard deviation shocks	12	13	13	11	13	10	1	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	12	17	18	15	17	14	2	6
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	43	43	43	43	43	43	43	43

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 a
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. Tuvalu: Sensitivity Analysis for Key Indicators of Public Debt 2014–2034

		Projections						
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	58	50	42	34	28	23	21	40
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	58	54	51	45	41	38	47	94
A2. Primary balance is unchanged from 2014	58	38	18	0	0	0	0	0
A3. Permanently lower GDP growth 1/	58	50	44	38	33	29	43	118
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	58	55	54	50	47	45	62	114
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	58	65	72	64	57	52	51	65
B3. Combination of B1-B2 using one half standard deviation shocks	58	61	64	58	53	50	59	95
B4. One-time 30 percent real depreciation in 2015	58	73	64	56	48	42	30	41
B5. 10 percent of GDP increase in other debt-creating flows in 2015	58	56	48	40	33	28	27	45
PV of Debt-to-Revenue Ratio 2/								
Baseline	50	57	51	45	38	31	32	69
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	50	62	61	58	54	53	71	161
A2. Primary balance is unchanged from 2014	50	43	21	0	0	0	0	0
A3. Permanently lower GDP growth 1/	50	57	53	49	44	40	63	196
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	50	62	64	64	61	60	92	194
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	50	74	88	84	76	71	77	114
B3. Combination of B1-B2 using one half standard deviation shocks	50	69	77	75	70	68	89	163
B4. One-time 30 percent real depreciation in 2015	50	83	78	73	65	58	45	72
B5. 10 percent of GDP increase in other debt-creating flows in 2015	50	63	58	52	45	39	41	78
Debt Service-to-Revenue Ratio 2/								
Baseline	8	10	10	11	9	8	1	3
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	8	10	11	13	11	9	3	9
A2. Primary balance is unchanged from 2014	8	10	10	8	5	2	0	0
A3. Permanently lower GDP growth 1/	8	10	10	12	10	9	3	10
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	8	11	11	13	12	10	4	11
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	8	10	11	16	14	9	2	7
B3. Combination of B1-B2 using one half standard deviation shocks	8	11	11	15	13	10	3	9
B4. One-time 30 percent real depreciation in 2015	8	12	14	15	14	12	3	6
B5. 10 percent of GDP increase in other debt-creating flows in 2015	8	10	10	13	10	8	2	4

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.

Press Release No. 14/398
FOR IMMEDIATE RELEASE
August 28, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation with Tuvalu

On August 25, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tuvalu.

Growth is picking up modestly on a generally stable outlook, and inflation has been moderate. Activity has benefited from increased competition in the retail sector and a recent boom in the fisheries sector as well as development partners' support, while banking weaknesses have constrained financial support for the private sector, and the poorly managed public enterprises have strained government finances and hampered the country's business climate.

The balance of payments has been supported by large fishing-related receipts and official aid. Fishing exports and receipts of fishing license fees have more than doubled in the past few years, and official aid by development partners has also risen sharply. Remittances, however, have shrunk markedly since the global financial crisis largely as a result of limited human capacity and weak competitiveness. Meanwhile, imports have been generally stable on account of restrained budget spending until recently. As a result, foreign exchange reserves have risen to 8 months of imports.

The fiscal policy achieved a substantial surplus in 2013. In addition to record high fishing license fees, tax revenues also outperformed the budget mainly because of improved compliance by public enterprises. The favorable revenue has been reinforced by higher-than-expected foreign grants. As a result, fiscal buffers have been built up to comfortable levels. However, a large budget expansion in 2014 has increased risks to fiscal sustainability. The 2014 budget envisages a more than 20 percent increase in expenditures, mostly current spending, which is financed by a temporary large increase in foreign grants and transfers—once it is unwound, the fiscal balance would likely move into a significant deficit over the medium term.

[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.

Vulnerabilities in banks and public enterprises could compound fiscal risks. The unsupervised state-owned banking system suffers from severe asset quality problems. Non-bank public enterprises continue to make losses as a whole, reflecting weak governance and the cost of assuming social responsibilities. These weaknesses could ultimately result in a large increase in public liabilities.

Executive Board Assessment[2]

Executive Directors welcomed the authorities' significant progress in implementing reforms on a broad front, in particular as regards public financial management. They noted that, while Tuvalu's growth prospects over the medium term are generally positive, debt sustainability remains a key concern, and vulnerabilities in banks and public enterprises pose large fiscal risks. Challenges arising from climate change and Tuvalu's remoteness and small size also need to be addressed.

Directors called for urgent actions to strengthen the fiscal position. While buffers have been built up in the past two years as revenues over-performed, the budget expansion in 2014 could undermine debt sustainability. Accordingly, they encouraged the authorities to unwind this expansion by cutting expenditures, keeping public sector wages aligned with productivity growth, and rationalizing social spending. More broadly, the adoption of a medium-term fiscal framework that targets a structural budget surplus and builds up savings will boost resilience against adverse shocks.

Directors also underscored the importance of further reform of public enterprises that continue to burden the budget. They encouraged the authorities to enhance the transparency and accountability of these entities and better identify their social responsibilities. Stricter control of public guarantees will also be needed, going forward.

Directors expressed concern about unaddressed fragilities in the banking system. They encouraged the authorities to take actions to resolve nonperforming loans and develop contingency plans. More broadly, they recommended the establishment of a sound regulatory framework and a comprehensive review of bank balance sheets. In this context, Directors welcomed the decision to set up a banking commission that will play a key role in ensuring financial stability.

Directors took note of the staff assessment that Tuvalu's real effective exchange rate is broadly in line with fundamentals. Nonetheless, they emphasized that continued reforms are essential to enhance competitiveness. They encouraged the authorities to implement the next phase of the

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

Policy Reform Matrix, and highlighted the importance of strengthening education as well as the institutional capacity of the public sector, including as regards the compilation of economic statistics. Continued engagement with development partners will be key to mitigate the effects of climate change.

Tuvalu: Selected Social and Economic Indicators, 2010–2015 1/

	2010	2011	2012	2013	2014	2015
				Est.	Proj.	
			(Percent change)			
Real sector						
Real GDP growth	-2.7	8.5	0.2	1.3	2.2	2.5
Consumer price inflation (period average)	-1.9	0.5	1.4	2.0	3.3	3.1
			(In percent of GDP)			
Government finance						
Revenue and grants	71.9	69.0	84.3	107.5	116.0	87.6
Revenue	55.5	47.8	56.6	82.9	64.6	65.6
of which: Tax revenue	16.5	16.9	15.0	19.0	15.1	18.0
Fishing license fees	20.6	14.9	21.8	45.4	33.8	32.8
Grants 2/	16.4	21.2	27.8	24.6	51.4	22.1
Total expenditure	95.7	77.9	75.0	81.1	100.2	92.1
Current expenditure	92.5	76.1	75.0	81.0	100.1	91.9
of which: Wages and salaries	33.8	31.3	31.9	32.2	38.0	36.2
Capital expenditure and net lending	3.2	1.8	0.0	0.2	0.2	0.2
Overall balance	-23.8	-8.9	9.3	26.3	15.8	-4.4
Extra budgetary grants 3/	31.8	21.2	29.3	25.2	25.7	31.4
Tuvalu Trust Fund (stock, $A million)	108	119	131	141	146	145
Consolidated Investment Fund (stock, $A million)	7.2	3.2	4.5	14.5	20.6	18.2
			(Percent change, unless otherwise indicated)			
Money and credit						
Deposits	-8.3	8.6	9.7	29.3	9.5	...
Credit	0.9	15.1	-11.4	-7.7	0.8	...
Lending interest rate (in percent) 4/	10.6	10.6	10.6	10.6	10.6	...
			(In millions of Australian dollars, unless otherwise indicated)			
Balance of payments						
Current account balance	-4.1	-13.9	9.8	10.5	11.5	-16.3
(In percent of GDP)	-11.9	-36.5	25.3	26.4	27.7	-37.2
of which:						
Exports of goods	10.9	10.2	19.9	20.5	21.1	21.9
ow/ Fish	10.4	9.4	19.5	20.1	20.7	21.4
Imports of goods	-17.3	-17.6	-16.7	-19.1	-22.3	-35.8
Fishing license fees	7.2	5.7	8.4	18.0	14.1	14.3
Current transfers (net)	15.2	14.3	20.3	18.0	23.1	15.7
ow/Remittances	4.3	4.4	3.7	3.8	4.0	4.1
Capital and financial account balance	10.0	12.3	0.8	1.2	0.5	13.4
of which: .TV domain license fees	2.0	1.9	3.7	4.4	4.1	4.1
Capital transfers (net)	7.5	12.3	4.7	5.1	5.8	9.1
Gross official reserves 5/	26.6	24.1	27.5	36.5	48.5	45.6
(In months of next year's imports)	6.1	6.6	6.6	7.8	7.9	7.9
			(In percent of GDP, unless otherwise indicated)			
Debt indicators						
Gross public debt	55.6	45.3	43.0	41.1	56.9	48.6
External	50.6	40.7	36.4	35.3	52.0	44.6
Domestic	5.1	4.6	6.7	5.8	4.9	4.1
Exchange rates						
Australian dollars per U.S. dollar (period average)	1.1	1.0	1.0	1.0	...	...
Nominal effective exchange rate (2005=100)	111.2	119.1	122.7	123.7	...	...
Real effective exchange rate (2005=100)	108.3	111.0	112.4	110.6	...	...
Nominal GDP (In millions of Australian dollars)	34.7	38.1	38.5	39.7	41.7	43.8

Sources: Tuvalu authorities; PFTAC; SPC; ADB; World Bank; and IMF staff estimates and projections.

1/ Tuvalu uses the Australian dollar as its currency. It has no central bank.
2/ Includes transfer from the Tuvalu Trust Fund to the Consolidated Investment Fund.
3/ Estimated by staff based on balance of payments and fiscal data.
4/ Average of personal, business, overdraft, and housing loans.
5/ Defined as the sum of foreign assets of the National Bank of Tuvalu, the Consolidated Investment Fund, and SDR holdings.

Statement by Jong-Won Yoon, Executive Director for Tuvalu and Kyounghwan. Moon, Senior Advisor to Executive Director August 25, 2014

On behalf of the Tuvaluan authorities, we would like to thank staff for their constructive policy discussions and a well-written report. This is the third Article IV consultation between staff and the authorities since Tuvalu joined the Fund in 2010. The authorities are broadly in line with staff assessments, including policy actions for securing fiscal sustainability, financial stability, and structural reforms. We would like to express the authorities' deep appreciation to the Fund and development partners for their assistance. The authorities look forward to continued close engagement with the Fund and development partners.

Tuvalu is the smallest and the least populous member country in the Fund, with the population of slightly above ten thousand and comprised of nine reef atoll islands. Its unique features of smallness and remoteness, like other Pacific island countries, as well as the absence of natural resources apart from tuna in the territorial waters impose severe constraints on Tuvalu's development. As part of the global community, its economy is not immune to global economic shocks such as food and oil prices. Tuvalu is one of the most vulnerable countries due to its lack of economies of scale and limited infrastructure and capabilities. As low-lying islands at no more than 15 feet above sea level, Tuvalu is particularly susceptible to climate change. Despite these challenges, the authorities will continue their efforts to build adequate policy buffers for enhancing economic resilience to achieve sustainable growth, along with continued assistance from the international community.

Economic Outlook

The economic growth of Tuvalu has been showing moderate recovery. In 2013, GDP is estimated to have increased by 1.3 percent, which is slightly higher than the growth in 2012, mainly due to the increases of revenues in the fisheries sector[1] and grants from development partners. GDP is expected to further increase by over 2 percent with the implementation of large infrastructure projects, including upgrading airport runaways, financed by development partners over the medium term.

Inflation has stabilized below 2 percent over the last years benefiting from lower global food and fuel prices but there are signs of slight upward pressures. The 2013 price inflation was 2 percent, but it is expected to pick up with the increase of government expenditures and weakening Australian dollar, which is Tuvalu's legal tender.

[1] In 2013, fishing license fees increased to AUS$ 18 million (45 percent of GDP) from AUS$ 8 million in 2012. The authorities expect this high level of fishing license fees would be maintained over the next 3 or 4 years thanks to El Niño.

Balance of payment has improved but is subject to large uncertainties. In 2013, the current account surplus is estimated to be 25 percent of GDP and gross official reserves are expected to reach around 8 months of imports. However, there remain uncertainties over current account surplus, given Tuvalu's heavy dependence on its uncertain sources of fishing exports, fishing license fees and foreign aid.

Fiscal policy

Tuvalu achieved its second consecutive fiscal surplus of AUS$ 10.5 million, around 26 percent of GDP, in 2013. For the first time since 2002, total domestic revenue excluding grants exceeded total expenditure. This positive fiscal performance has strengthened the government's financial position. The Consolidated Investment Fund (CIF), which serves as a fiscal buffer, increased to AUS$ 19.9 million, around 48 percent of GDP as of March 2014. At this level, the CIF would be able to assist the authorities to finance unexpected budget financing gaps for several years.

The authorities agree that ensuring fiscal sustainability is crucial. While the 2014 total government expenditure has increased about 20 percent from the 2013 level, total revenue is also expected to increase, targeting fiscal surplus in 2014. The authorities are aware of the fiscal risks given the bumpy revenue streams and will continue their effort to rein in expenditure and broaden tax base.

- Wages have increased by 25 percent in 2014, but this is the first increase since 2010 and the increase is about AUS$ 720/year for 900 government employees, who make up about two thirds of employees in the formal labor market. The authorities will make efforts to establish the proper wage-setting mechanism to avoid a sharp increase of wages.
- Under the Tuvalu Scholarship Program, about 30 students receive scholarships each year. Extending their studies has resulted in an increase of its cost, and the authorities will enhance the monitoring of the performance so as to ensure the effectiveness of the program.
- Because of the limited medical facilities in Tuvalu, the authorities have sent patients to Fiji, India, and New Zealand under the Tuvalu Medical Treatment System. The authorities are aware of the risk of its potential overspending and will continue to make efforts to improve its cost effectiveness through establishing a comprehensive database in addition to limiting referrals within available budget funds.
- The Tuvalu Cooperative Society (TCS) is the main wholesaler and retailer in Tuvalu and the authorities are considering the re-starting of assistance to the TCS to provide basic foods to the outer islands. The authorities would carefully seek the most cost effective way to achieve the goal of ensuring food security.
- The authorities have strengthened their audit program for tax collection since the arrival of a tax advisor in 2012. Implementation of audit on public enterprises contributed to the increase of tax compliance in 2013. The authorities plan to start audit on the private sector in 2014 and enhance their enforcement capacity.

The authorities welcome staff's proposal of introducing a medium term fiscal framework targeting a structural fiscal surplus. The main purpose of establishing the Tuvalu Trust Fund (TTF) in 1987 is to have a rainy day fund for Tuvalu. The authorities believe that the current TTF and CIF scheme has served Tuvalu well, but they also consider that combining the operation of the TTF with a medium term fiscal framework could help build fiscal buffers and ensure fiscal sustainability. The authorities would be open to further discussion with staff.

Strengthening public financial management will continue to be one of the main policy priorities in Tuvalu. A Central Procurement Unit has been established to oversee the purchases of goods and services. The new procurement rules would ensure the efficient use of budget and promote transparency of the procurement process.

Banking Sector

The authorities agree with staff that supervisory and regulatory framework in the banking sector needs to be strengthened. The authorities are in the process of setting up the Banking Commission, which will play a role of ensuring financial stability. The authorities will also make efforts to improve the prudence of the banking system. Given the limited infrastructure in the banking sector, financial services are restricted to a small number of people and access of outer islanders is constrained. The authorities are mindful of capacity constraints and would be grateful of technical or financial assistance from the Fund and development partners to strengthen the financial system.

Structural Reforms

The authorities are committed to further strengthening public enterprise reform. All of civil servants have resigned from Board positions in public enterprises (PEs). Recruiting process is under way for staffing the Public Enterprise Reform and Management Unit. The authorities are also working with the Asian Development Bank on public enterprise reform to improve governance, administration and profitability of PEs. Given the lack of economies of scale in Tuvalu, it is to some extent inevitable for PEs to bear a part of burden in providing their services. Moreover, it is hard to distinguish between commercial activities and social responsibilities. The authorities will continue to explore ways to improve efficiency of PEs.

The Tuvaluan authorities will continue their well-known reform efforts. Tuvalu's National Strategy for Sustainable Development for 2005 to 2015, Te Kakeega II, was set focusing on the eight strategic areas including good governance, macroeconomic growth and stability and social development. The second phase of Policy Reform Matrix has been complete and the third phase is scheduled to start in the second half of this year, integrated with the government's 2013 reform roadmap. Tuvalu's development achievement has been acknowledged in the areas of strengthened budgetary management and improved school attendance. The authorities will put renewed focus on increased government investment in primary education and health services in addition to gender equality.