FOR INFORMATION

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To: Members of the Executive Board

From: The Secretary

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Questions:	Ms. Jurzyk, APD (ext. 34223)

***If the authorities consent to the publication of this assessment, it may be published by the AsDB.**

Tuvalu—Assessment Letter for the Asian Development Bank

September 17, 2020

This letter provides IMF staff's current assessment of macroeconomic conditions, prospects, and policies of Tuvalu. It has been requested by the Asian Development Bank in relation to the Proposed Pacific Disaster Resilience Program (Phase 3). The program is targeted to be approved in December 2020.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

1. **To prevent the emergence of COVID-19 in Tuvalu, in March 2020 the authorities implemented strict containment measures**. After the World Health Organization declared COVID-19 a global pandemic, the Tuvaluan authorities pre-emptively announced a State of Public Health Emergency in March, subsequently banning all international flights, imposing restrictions on all vessels and planes coming into the country, and introducing quarantine protocols on all repatriated citizens. To alleviate the potential strain on government services in the capital, the authorities facilitated migration of citizens to their home islands whenever feasible. As a result, Tuvalu remained COVID-free as of August 31, 2020.

2. **While the economy performed well in 2019, the COVID-19 pandemic has significantly lowered the near-term growth prospects.** In 2019, the economy grew at 6 percent (estimated), mostly owing to the construction projects undertaken in preparation for the Pacific Island Forum. However, in 2020, travel restrictions, combined with the need to re-prioritize public spending towards COVID-19 measures, have necessitated putting the planned construction projects on hold. Travel restrictions have also adversely affected the ability of Tuvaluans to works as seafarers, thus lowering the amount of remittances sent to the island, while supply chain distortions impacted trade and business services. As a result, the economy is expected to contract by -0.5 percent in 2020. Growth is expected to gradually recover to 3 percent in 2021 provided that the pandemic subsides, travel and other restrictions are lifted domestically and abroad, and economic activity normalizes. Buoyant fishing revenues, grants from developments partners, and lower imports of construction materials are expected to increase the 2020 current account surplus to 17 percent of GDP. Reserves are expected to remain adequate, at 16 months of imports.

3. **The balance of risks is tilted to the downside both in the short and the longer term.** The uncertainty surrounding the forecast is amplified by existing data gaps, the extent of the exposure of the small economy to volatile fishing revenues and grants, and a very uncertain path of the global COVID-19 pandemic. In the near term, longer-than-expected travel restrictions could further delay planned infrastructure projects. They could also prevent seafarers and other seasonal workers from getting jobs abroad, negatively impacting remittances. Renewed outbreaks in countries that process fish caught in Tuvalu's waters could impact operations of canneries, thus lowering fishing revenues. Financial market volatility could lower the value of assets in the Tuvalu Trust Fund, which would limit distributions to the Consolidated Investment Fund, and, in turn, funds available to the government. In the longer term, Tuvalu remains vulnerable to the impact of climate change and natural disasters, and to a change in favorable weather patterns that lie behind its strong fishing revenues, with implications for the fiscal revenues and the current account.

POLICY RESPONSE AND SETTINGS

4. **The authorities reacted strongly to mitigate the effects of the COVID-19 pandemic on the economy.** In March, the government passed a 2020 Supplementary Budget of AUD18.9 million (28 percent of 2019 GDP, or around 20 percent of estimated 2019 total expenditures). It included the

additional spending for the purchase of medical equipment for COVID-19 response, relocation of citizens to outer islands and repatriation of Tuvaluans from abroad, preparation and maintenance of quarantine centers, salaries of doctors, improvement in broadband connectivity, and a working capital facility for the private sector. To support the population, the authorities have instituted temporary universal cash payments to all citizens living in Tuvalu. Government has also reprioritized the existing spending to increase assistance to outer islands.

5. **The pandemic response is expected to weaken Tuvalu's near-term fiscal stance despite buoyant fishing revenues and higher than projected donor support that will partially offset higher spending**. The 2020 fiscal deficit (including grants) is expected to widen to 12 percent of GDP as a result of one-off health and other stimulus spending. The deficit is expected to be financed by disbursements from the Consolidated Investment Fund, without incurring additional public debt. Higher concessional financing from development partners would help preserve the value of the CIF.

6. **A preliminary analysis suggests that Tuvalu's remains at a high risk of debt distress, in line with the conclusions of the 2018 Debt Sustainability Analysis**. In 2020, the widening fiscal deficit is expected to be financed by non-debt creating flows and the debt-to-GDP ratio is expected to decline to 16 percent of GDP. However, risks to fiscal sustainability in the long run remain high due to elevated current spending, a projected decline in fishing revenues and grants, and the risks of natural disasters. A persistent fiscal deficit is projected to deplete fiscal buffers and cause the present value of debt-to-GDP to breach its benchmark in the long run.

7. **The COVID-19 pandemic has underscored the need to strengthen fiscal frameworks to help maintain fiscal buffers, given the volatility of the fishing revenues and grants**. Focusing on the domestic fiscal balance that excludes the volatile external components like fishing revenues and grants would help. Containing rising current spending (public wages, health, and educational programs) and improving its efficiency, prioritizing capital spending, and mobilizing tax revenue should also be considered.

8. **Efforts to strengthen resilience against the threat of climate change should continue**. Given the high cost of climate mitigation projects (e.g., costal protection projects are estimated to cost 84 percent of GDP), securing sufficient funding and ensuring that the projects are carried out in a fiscally sustainable manner will be key. Strengthening the Public Financial Management framework would promote more efficient use of funds.

9. **Structural reforms to boost the private sector would help diversify sources of growth and reduce high unemployment**. Reform of public enterprises is needed to ensure their viability, reduce fiscal risks, and improve efficiency. A supervisory framework for banks and the pension fund should be introduced to decrease high levels of NPLs and improve risk management. Developing the untapped tourism sector has the potential of offering employment opportunities for Tuvaluans, though it rests on the authorities' ability to implement complimentary reforms, such as waste and water management and business environment reforms.

IMF RELATIONS

10. **Tuvalu is on a 24-month Article IV consultation cycle and has no outstanding purchases or loans and no financial arrangements with the IMF**. The last Article IV consultation was concluded by the Executive Board on June 22, 2018. The Fund provides technical assistance and training from headquarters and the Pacific Financial Technical Assistance Center (PFTAC).

Table 1. Tuvalu: Selected Economic and Financial Indicators, 2015–2021

	2015 Est.	2016 Act.	2017 Act.	2018 Est.	2019 Est.	2020 Proj.	2021 Proj.
Output							
Real GDP growth (percentage change)	9.2	5.9	4.6	3.7	6.0	-0.5	3.0
Prices							
Consumer price inflation (EoP, percentage change)	4.0	2.6	4.4	2.3	2.2	1.5	2.3
General Government Accounts (in percent of GDP)							
Revenue and grants	138	154	114	155	117	116	101
Total expenditure	123	125	111	123	126	128	111
Overall balance (including grants)	15	28	3	32	-9	-12	-10
of which: Domestic current balance 1/	-47	-47	-44	-53	-57	-60	-12
Gross public debt	58	44	35	25	20	16	8
Balance of payments							
Current account balance	-25	11	13	4	8		11.7
Current account balance (in percent of GDP)	-54	21	24	7	12	17	-11
Gross reserves (In months of imports of goods and services) 2/	9	10	11	10	16	16	15
Memorandum items							
Tuvalu Trust Fund (in percent of GDP)	317	304	308	291	269	…	…
Consolidated Investment Fund (in percent of GDP)	54	51	63	63	53	…	…
Tuvalu Survival Fund (in percent of GDP)	…	9	9	13	16	…	…
Nominal GDP (in millions of USD)	35	40	43	46	47	45	48

Sources: Tuvalu authorities; PFTAC; SPC; ADB; World Bank; 2018 IMF's BOP TA; and IMF staff estimates and projections.

1/ Domestic current balance excludes fishing revenue, grants, and capital expenditure.
2/ The sum of liquid assets of the National Bank of Tuvalu, Consolidated Investment Fund, and SDR holdings.