

Tonga: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion

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 2007 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 20, 2007, with the officials of Tonga on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 25, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A supplement on the joint IMF/World Bank debt sustainability analysis.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 11, 2007 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

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

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TONGA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Tonga

Approved by Steven Dunaway and Anthony Boote

June 25, 2007

Discussions: Nuku'alofa, April 11–20, 2007. The team met with Prime Minister Sevele, Minister of Finance 'Utoikamanu, National Reserve Bank of Tonga Governor Mafi, and other senior government officials.

Team: Messrs. D'Hoore (head), and Meses. Amornvivat and Fujita (all APD). Mr. Gordon (APD) and Ms. Sucharitakul (OED) joined the discussions.

Political and Economic Context: Tonga, a constitutional monarchy with substantial powers assigned to the King and the nobility, is in the midst of a difficult transition. Pro-democracy riots broke out in the capital city in November 2006, resulting in extensive damage and disruptions to economic activity. On the policy front, a 70 percent wage award to civil servants in 2005, and a large redundancy program in 2006, have put strains on the budget.

Exchange Rate: Tonga's currency, the pa'anga, is pegged to a basket of currencies (comprising the US, Australian, and New Zealand dollars, and the yen), with the arrangement allowing monthly deviations of up to 5 percent from the peg. Tonga has accepted the obligations of Article VIII, Sections 2, 3, and 4. Tonga presently imposes an exchange restriction subject to approval under Article VIII, Section 2(a), in the form of tax certification requirement imposed on certain current international transactions.

Outreach: Staff met with business leaders, donors, and representatives of the diplomatic corps.

Statistical Issues: Tonga's data quality remains hampered by deficiencies that complicate surveillance of policies.

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EXECUTIVE SUMMARY

Background

- **The economy has experienced large shocks.** Following the 70 percent civil service wage award in late 2005, almost 20 percent of civil servants took voluntary redundancy in mid-2006, at large cost to the budget. Riots in November 2006 caused serious damage to the capital city's business district, and disrupted economic activity. Real GDP is projected to fall by 3½ percent in the fiscal year ending in June 2007. Yet the economy appears to be recovering; and inflation has continued to decline, owing largely to a tight credit policy and the maintenance of a basket peg.
- **Cautious conduct of fiscal and monetary policy has helped to contain the negative impact of the wage settlement.** The strains on the fiscal position due to the wage settlement and redundancy payments were partly contained through expenditure restraint and large revenue gains. Despite revenue losses in the wake of riots, the authorities have maintained their deficit target for the year. Monetary policy succeeded in reining in high private credit growth in 2006, and has since been eased.
- **Significant threats to debt sustainability have emerged.** The authorities are seeking a possible \$50 million (20 percent of GDP) loan to finance reconstruction projects. This and other loans' debt service requirements would place serious strain on the medium-term fiscal and external positions.

Key Policy Issues

Against this background, the staff recommended that the authorities:

- **Capitalize on recent gains to place fiscal policy on a sustainable track,** by sustaining revenue gains, resisting pressures on the wage bill, and ensuring that non-wage spending is prioritized. The authorities should consider scaling back external borrowing plans that would heighten medium-term risks of debt distress.
- **Closely monitor credit developments.** While the recent easing of policy to accommodate reconstruction-related credit is understandable, the external position remains fragile. Monetary tightening may become necessary, particularly if new fiscal pressures emerge, and the authorities should make greater use of the flexibility in the foreign exchange regime to counter real exchange rate appreciation.
- **Accelerate the pace of implementation of structural reforms** to improve the business environment for the private sector and make the economy more dynamic.

I. THE COUNTRY CONTEXT

1. **Since mid-2005, the economy has come under repeated stress.** Following a 6-week strike in July-August 2005, the government agreed to a settlement with the unions calling for civil service wages to be raised by 70 percent over two years, at a full annual cost of about 7 percent of GDP. To contain the medium-term fiscal impact of the settlement, the government launched a voluntary redundancy program in the last weeks of the fiscal year ending in June 2006, which resulted in an 18 percent reduction in civil service staffing—about 3 percent of Tonga’s total labor force, at a substantial cost to the budget (Box 1).

2. **More recently, Tonga’s political transition was marred by an unexpected bout of violence.** A democratic movement has

gained strength in recent years, demanding a reduction in the substantial powers that remain assigned to the King and the nobility. While the transition had been peaceful until then, the government’s rejection, in November 2006, of a proposal by a national commission to increase popular representation in parliament sparked riots in the capital city, Nuku’alofa. Eight people lost their lives, while the city’s business district was ransacked—estimates of total losses in structures and inventories range from 10 to 25 percent of GDP. Tensions have subsided since then, but they could flare again as the trials of looters get underway, and as the political debate intensifies in the run-up to the parliamentary elections in March 2008.

Tonga: Chronology of Recent Developments

- 2005 March—Elected MPs enter the cabinet for the first time. Cabinet members had previously been picked by the King.
- 2005 July-September—Prolonged strike by public sector workers, with violence in the capital. Agreement with unions on a 70 percent civil service wage increase.
- 2005 December—World Trade Organization (WTO) agrees to admit Tonga as its 150th member. Negotiations had been ongoing for a decade. Next step: ratification.
- 2006 March—Fred Sevele becomes PM, the first elected commoner to do so.
- 2006 June-July—Government’s retrenchment program is implemented—about 20 percent of civil servants take a voluntary severance package.
- 2006 September—King Tupou IV dies, and is succeeded by the Crown Prince.
- 2006 November—Rioting erupts in the capital Nuku'alofa, in protest at the slow speed of democratic reforms.

3. **These developments came against a background of longstanding economic challenges.** Tonga is an island economy with a small population (about 100,000), and a high exposure to shocks. Economic growth has been muted for much of the past 15 years—real per capita GDP growth averaged about 1½ percent per year. Emigration has been substantial: an estimated 100,000 Tongans live abroad, mainly in New Zealand, the United States, and Australia. As a result, remittances have grown to the equivalent of almost half of GDP.

II. ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Developments

4. **Economic activity was disrupted, albeit briefly, by the November unrest.** Output growth, having slowed in FY05/06, is now projected to turn negative in FY06/07, with real GDP declining by 3½ percent, owing mainly to the direct and indirect impacts of the November unrest, with a sharp drop in commerce and tourism services. However, the disruption to activity was temporary, as several businesses quickly relocated their operations elsewhere. Meanwhile, consumer price inflation slowed to about 5 percent by early 2007, from about 10 percent in FY04/05, owing to a deceleration in fuel and food prices, a broadly stable nominal exchange rate, and a firm monetary policy. Contrary to earlier concerns, the wage settlement does not appear to have put upward pressure on private sector wages so far.¹

5. **The conduct of fiscal policy after the settlement contributed to mitigate its negative impact.**² In FY05/06, the fiscal balance swung into a deficit of 3⅓ percent of GDP from a 2½ percent surplus the year before. The wage bill rose to 20 percent of GDP from 12 percent of GDP in FY04/05, reflecting payment of the first installment of the wage settlement and the voluntary redundancy program which was implemented at a cost of about 7½ percent of GDP to the budget³, financed by a drawdown of government deposits in banks. Nonetheless, non-wage spending was kept under tight control, and revenues increased sharply, much of the gains reflecting an improvement in collection efficiency brought about by the consumption tax introduced in April 2005 and higher customs revenues. Against this background, the FY06/07 budget targeted a modest narrowing of the deficit to 2⅓ percent of GDP, with revenues expected to remain buoyant, a decline in the wage bill ratio to GDP, and a substantial increase in non-wage spending projected to be funded by donor grants and loans. With the November unrest, fiscal plans came under strain. However, despite revenue losses, the authorities have decided to maintain their overall deficit target, which would require trimming non-wage spending.

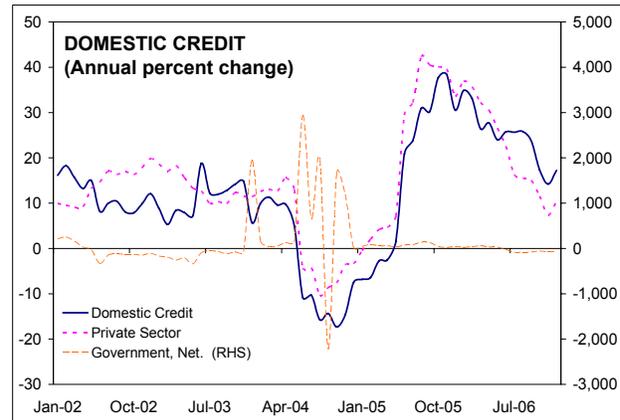
6. **The National Reserve Bank of Tonga (NRBT) took steps during 2006 to limit private credit growth and cope with the liquidity implications of the large severance payments.** Credit ceilings had been introduced in January 2006 to counter rapid credit

¹ The private sector, which is made up mainly of small businesses, is not heavily unionized. Anecdotal evidence suggested that public sector wages had lagged private sector wages before the wage settlement.

² Chapter 1 of the accompanying Selected Issues papers contains a detailed description of fiscal developments in FY05/06 and FY06/07.

³ In addition to the severance packages, the redundancies required transfers to the retirement fund of 2 percent of GDP to cover the full funding of redundant workers' public pensions, as required under pension law.

growth reflecting strong demand for housing loans and ample bank liquidity.⁴ With private credit growth still running high at about 22½ percent (y-o-y) by the end of FY05/06, bank-by-bank ceilings were reset for the 6-month period to December. In addition, to contain the expected liquidity effects of the government redundancy payments, the NRBT also stepped up its issuance of central bank notes.⁵ In the event, growth in private sector credit decelerated sharply to an annual rate of 10½ percent by end-December 2006. In early 2007, however, the NRBT eased liquidity in response to the riots, lowering reserve requirements and reducing the outstanding stock of notes, to support private credit for reconstruction and business restocking. Nonetheless, the public sector is also expected to play a large role in reconstruction and the authorities are attempting to secure a financing package from the People's Republic of China (PRC) of up to US\$50 million (20 percent of GDP).



7. **External developments remained mixed.** The external current account deficit is projected to widen to 10½ percent of GDP in FY06/07 from 8¼ percent of GDP in FY05/06, as imports remain steady despite the drop in output, and transfers reportedly declined, despite higher donor grants.⁶ Donor loans, mainly from the Asian Development Bank, and recorded private inflows should remain broadly at their FY05/06 level. While the NRBT remained concerned about pressures on official reserves, they remained broadly stable from mid-2005 to early 2007, despite the riots.

B. Medium-Term Outlook and Risks

8. **Economic growth should return to positive, albeit low, levels in the medium term.** Real GDP growth is projected at 1 percent in FY07/08, held back by low business and consumer confidence, despite the temporary boost provided by reconstruction activity. For the medium term, real GDP should remain on a low trend rate of about 1 percent a year, as the economy remains beset by numerous physical or structural impediments, including its

⁴ Chapter 2 of the accompanying Selected Issues papers describes recent developments in household credit.

⁵ NRBT notes of 28 days or shorter maturity were issued at rates around 4-5 percent. Notes issues had been discontinued in early 2001, because of their negative impact on the NRBT's financial position.

⁶ Private remittances data show a decline of about 10 percent cumulatively over FY05/06-FY06/07 (Box 2). The data remains plagued with serious weaknesses, however. The authorities, as well as bankers and other business people met by the staff, do not believe that remittances dropped sharply. Moreover, no plausible explanation for a large change in the behavior of remitters could be advanced.

small size and remoteness, and the legacy of high government involvement in productive activities. Moreover, there remain low expectations for the strong push on structural reform that would be needed to achieve faster growth.

9. **The external situation is likely to remain fragile and vulnerable to any loosening of macroeconomic policies.** Excluding the impact of external borrowing plans currently being considered, the medium-term fiscal deficit would remain in the 1-1½ percent range, at a level broadly consistent with the authorities' de facto policy of eschewing recourse to domestic bank financing. As a result, the external current account would improve marginally over the medium term, and official reserves would stabilize at 2¼ months of imports of goods and services by 2010—just under 3 months of imports of goods, the authorities' own benchmark—, a small buffer for a country subject to frequent shocks (Table 5).

10. **Even this relatively unfavorable scenario is subject to significant risks.** The economy will continue to be subject to uncertainty and shocks, foremost in the context of Tonga's difficult political transition. There are lingering risks on the policy front that could derail efforts to restore stability, in particular those that might arise from pressures to increase public sector hiring in the face of slow private employment growth. Moreover, a further drop in remittances and terms of trade shocks could present significant challenges, especially as reserves would remain at a low level.

11. **Against this backdrop, the borrowing plans currently being considered raise serious concerns for debt sustainability.** At close to 37 percent of GDP, public external debt is high, and stress tests suggest that fiscal and external sustainability remain susceptible to domestic and external shocks, placing Tonga at a high risk of debt distress. Given these risks, the authorities' recent efforts to secure a large loan from the PRC to pay for reconstruction would make it difficult for Tonga to maintain a sustainable debt profile in the medium term.⁷ The loan would mainly support reconstruction and urban infrastructure development, yielding at best a limited increase in medium-term productive capacity and without any immediate generation of exports. Even under the terms sought by the Tongan authorities, the permanent increase in the external debt service profile—about 2 percent of GDP per year for 20 years starting in 2013—would heighten pressures on the budget and on the balance of payments, and a sharp increase in risks of debt distress.

⁷ The short-term effect on debt ratios would be large, as GDP would not change and the likely grant element would be low. With most labor and material inputs expected to be procured externally, there would be little impact on growth and inflation during the construction phase. Loan terms sought by the Tongan authorities would entail a relatively low grant element of about 30 percent, reflecting an interest rate of 2 percent, a 5-year grace period, and a 25-year maturity.

III. POLICY DISCUSSIONS

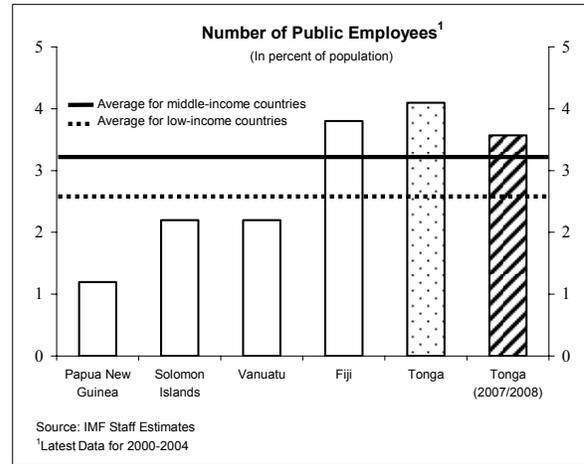
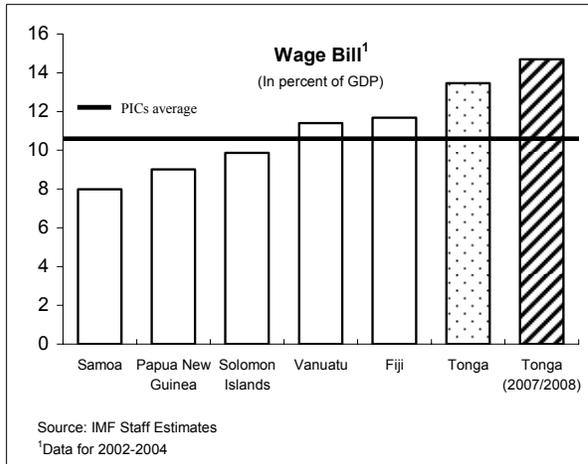
The discussions covered short- and medium-term economic prospects and policies. The authorities underscored their intention to exercise caution in policy making, noting that current challenges were more difficult than in previous years. The staff welcomed this emphasis and highlighted the need to restore significant buffers to deal with future shocks and ensure fiscal and external sustainability.

A. Fiscal and Debt Policy

12. **The authorities' fiscal policy objective for the remainder of FY06/07 is to offset the impact of the November events on the budget deficit.** Recognizing that fiscal room remains critically limited, the authorities have maintained their overall deficit target for FY06/07 at the level of the original budget target (about 2 $\frac{1}{3}$ percent of GDP). They were confident that, with a vigorous collection effort in the second half of the year, the revenue losses from the riots could be limited to less than 2 $\frac{2}{3}$ percent of GDP. There was scope for expenditure savings of the same magnitude, given that emergency spending had been contained within the budget's general contingency allowance, and that non-wage current and capital spending were running well below budget by the end of the third quarter. The staff supported the overall approach, underscoring the need for tight control on spending to ensure that savings were realized.

13. **For the FY07/08 budget, the team encouraged the authorities to capitalize on recent achievements to place fiscal policy on a sustainable track.** Continued efforts in improving revenue administration and compliance would be necessary to sustain the recent gains in collection efficiency. The wage bill is projected to decline to about 15 percent of GDP—a saving of 3 percent of GDP—, provided hiring pressures are resisted. The team understood the need for a measured increase in non-wage current and capital spending, after several years of compression, but it argued for a careful prioritization of the budget in these areas. In all, assuming donor financing in line with recent averages (about 1 percent of GDP), a reduction in the overall deficit to about 1 percent of GDP for FY07/08 appeared achievable.

14. **While the authorities intend to submit a draft budget to Parliament broadly in line with the staff's views, they confirmed that they would continue to seek a large loan from the People's Republic of China.** The authorities indicated that while they would target a small budget deficit in FY07/08 of about 1 percent of GDP, they were in discussion with the Chinese authorities on a large loan to finance mainly reconstruction projects. While acknowledging the political momentum behind these efforts, they considered that implementing these projects was not inconsistent with their short-term macroeconomic objectives given that, with most labor and material inputs procured externally, little pressure would be placed on domestic demand and inflation; nor with their long-term goals, as they were confident that debt service obligations could be met by savings in future budgets. However, they recognized the currency risk attached to the loans.



15. **The staff expressed serious concerns about the risks that such large borrowing would impose on fiscal and external debt sustainability.** The staff shared the results of its preliminary debt sustainability analysis, pointing to heightened risks of medium-term debt distress, and urged the authorities to consider scaling back their borrowing plans and ensure that all risks were carefully accounted for in their analysis of debt sustainability, including the risks related to changes in currency valuation. The staff also argued that, given that the size of the planned projects was considerable, maximizing the role of the private sector in reconstruction efforts would help reduce the need for public financing.

16. **As regards revenue policy, the authorities intend to complete the comprehensive reform envisaged under WTO accession in FY07/08 (Box 3).** The remaining tax bills are planned to be tabled at the 2007 session of Parliament, starting in June. The bills include a reduction in tariffs compensated by increases in non-discriminatory excises as well as income tax reform. The authorities were confident that the revenue impact of these tax changes would be neutral, as it was designed to be. The staff welcomed these plans, and encouraged the authorities to stand ready to take corrective revenue measures if the need arose, noting that recent progress in improving tax administration would need to be sustained. The authorities agreed on the need to pursue recent initiatives in this area, with donor and PFTAC support.

17. **For the medium term, the authorities and the staff agreed that continued efforts to reduce the wage bill would be crucial to ensure that fiscal consolidation is sustained.** Despite the retrenchment, the wage bill remained large by international or regional standards, reflecting high unit wages relative to per capita income, or a high level of civil service employment. A lower wage bill would allow more flexibility in allocating public resources toward development priorities. The authorities intend to pursue their public sector reform program, which focused on improving professionalism, efficiency, and accountability, and they expect that attrition would allow a reduction in staffing numbers. They also favored adopting a more orderly mechanism to adjust public wages to avoid the disruption associated with large one-off settlements. In this regard, developing a medium-term fiscal framework,

with support from the AsDB, would also be beneficial in strengthening public financial management.

18. **The staff argued that a government purchase of the power company would constitute another source of fiscal and debt risk for Tonga.** In 2005, the authorities had come under political pressure to re-acquire the power assets of a private telecom and power company.⁸ As recent negotiations with a potential private investor broke off following the riots, the authorities are reconsidering taking temporary ownership of the assets, at an upfront cost that could exceed 4 percent of GDP. The staff stressed the risks to public finances associated with the transaction. In the staff's views, the authorities could best facilitate the process by ensuring that the policy environment for the power sector, including price regulation, was conducive to private sector participation.

B. Monetary, Financial and Exchange Rate Policies

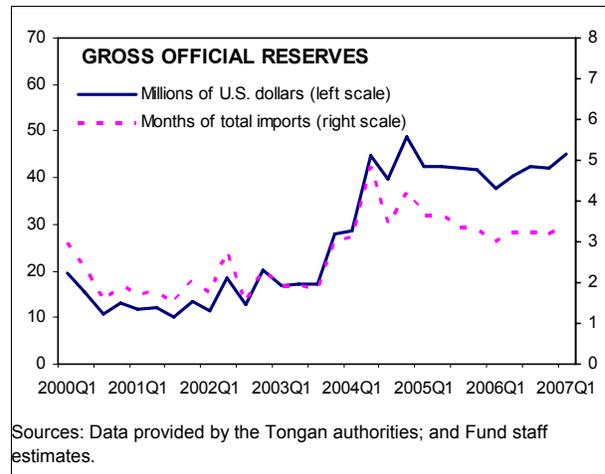
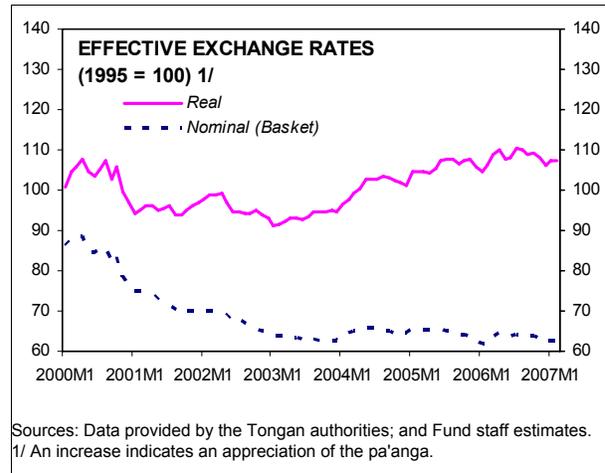
19. **The team took the view that the recent easing of the monetary stance was understandable, given the disruptions caused by the November events.** The NRBT's prudent conduct of monetary policy had been instrumental in reducing inflation and limiting pressures on foreign reserves in the wake of the wage settlement. This said, a concern of the staff remained that, with the lifting of credit ceilings and sharp increases in liquidity, private credit could expand rapidly and prove difficult to control. The NRBT stressed, however, that it monitored monetary developments closely, and would take prompt action if needed.

20. **The greater use of indirect monetary policy instruments has strengthened the NRBT's monetary policy capabilities.** The issuance of NRBT notes in mid-2006, for the first time in several years, had opened the way to a more flexible conduct of monetary policy. While the NRBT might still have to rely on distortionary credit ceilings, the staff encouraged the bank to push forward with the strengthening of the legal framework underlying the use of indirect instruments, including planned amendments to the NRBT Act that provide for a doubling of the central bank's capital and a clarification of profit transfer rules. The authorities confirmed their plans to table these amendments at the 2007 parliamentary session. The staff also called for introducing statutory limits on central bank credit to the government, giving a legal basis to the authorities' de facto policy, as a way to solidify progress toward monetary policy independence.

⁸ Private owners of this company include the new King, who, upon acceding to the throne, indicated his desire to divest from the power company.

21. **The NRBT's pegging of the pa'anga to its reference basket has brought both benefits and risks.** The staff agreed that the anchoring role of the exchange regime had been useful in reducing inflation in recent years.

However, by pegging the pa'anga narrowly to the NRBT's currency basket, and with inflation in Tonga remaining well above that of trading partner countries, the currency had appreciated in real effective terms over the period 2003-06, albeit to a level that does not clearly suggest overvaluation. Tonga's fiscal situation, its weak export performance, and the difficulties in achieving rapid progress on the structural reforms raised concerns about external competitiveness, which warranted the use of the flexibility provided by the current exchange rate arrangement to allow the pa'anga to depreciate relative to the currency basket.⁹ The authorities acknowledged the risks that a sustained appreciation of the real exchange rate posed for external competitiveness, but they considered that a broadly stable nominal exchange rate had been crucial to ensuring a decline of inflation and the maintenance of financial stability, despite repeated shocks. They pointed out that foreign reserves had held steady thus far, and underscored their readiness to tighten monetary policy if significant pressures emerged.



22. **The authorities tightened foreign exchange regulations in 2006.** Reflecting in part its concerns about incipient pressures on reserves in FY05/06, the NRBT issued four exchange control directives aimed at tightening documentary requirements for applications to authorized dealers. The NRBT indicated that the new exchange control directives were intended to improve the efficiency of existing regulation, while yielding a reduction in the scope for avoidance of capital account restrictions. In reviewing Tonga's exchange system in connection with the issuance of the NRBT exchange control directives, the staff has determined that the tax clearance certification requirement imposed by the authorities on the making of payments and transfers for certain current international transactions constitutes an exchange restriction under Article VIII, Section 2(a). It constitutes an exchange restriction since its scope is not limited to the payments of outstanding taxes related to the relevant payments or transfers but extends to the payments of all other taxes due by the applicant for foreign exchange.

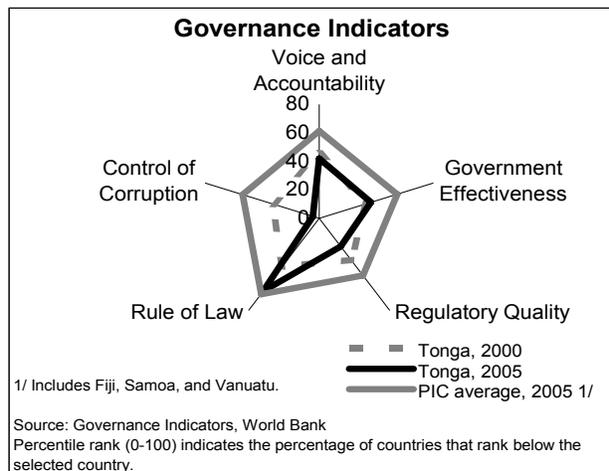
⁹ Moreover, the staff noted that, in the event of a permanent decline in remittances (not fully offset by a concurrent decline in imports), a fall of the real exchange rate would be needed to restore external balance. As noted above, however, the authorities were not convinced that remittances had sharply declined.

23. **Banking soundness indicators suggest that banks' balance sheets and incomes remain solid.** Financial stability was preserved in the wake of the November events, despite the liquidity position of some banks coming under stress. While there was a small increase in the share of impaired assets in total loans in the year to December 2006, bank profitability remained healthy, and provisioning levels were adequate. While the NRBT did not see a systemic risk, it agreed that bank supervision should remain vigilant, as the debt servicing capacity of some borrowers had clearly deteriorated. The NRBT also noted that the prudential framework had improved with the adoption of additional supervision guidelines in 2006 after the Financial Institutions Act of 2004 became effective in October 2005.

C. Structural Reforms and Other Issues

24. **The accession to the WTO is an important achievement on the structural policy front, but, as recognized by the authorities, further reforms are needed to improve the business environment and the performance of public enterprises.**

Private sector activity continues to be constrained by critical impediments such as restrictions on business licensing and visas, and red tape. Moreover, Tonga's performance on the World Bank's governance indicators has deteriorated in recent years, and remains well below the levels of regional comparators. A strong effort to create a more favorable investment climate would help boost investment, particularly in Tonga's promising sectors of tourism and marine resources. The authorities concurred with this assessment, which formed the basis of the work of a public-private task force set up in early 2006, and indicated that they would revive efforts to implement the task force's recommendations.



25. **The staff encouraged the authorities to step up the pace of implementation of their reform program for public enterprises.** A comprehensive agenda had been developed in recent years, with the enactment of a Public Enterprise Reform Act, but implementation has been hampered by capacity constraints and political sensitivity. The staff supported the authorities' focus on improving enterprise management and accountability, which would help reduce the fiscal risks associated with poor performance.

26. **The staff pressed for additional efforts to improve statistical capacity.** Key weaknesses in the national, external and public accounts hamper effective surveillance. The authorities were aware of these shortcomings, and will continue to seek technical assistance to improve the reliability, coverage, and timeliness of statistics.

IV. STAFF APPRAISAL

27. **The economy has shown resilience in the face of large shocks.** Following the 70 percent wage award to civil servants in 2005, almost 20 percent of staff took voluntary redundancy in mid-2006 at a large cost to the budget. Tonga's first violent bout of civil unrest, in November 2006, led to serious damage to the capital city's central business district, and a blow to business and consumer confidence, and as a result, real GDP is projected to decline by 3½ percent in FY06/07. Yet the effects on activity appear to have been limited; inflation had stabilized in the mid-single digits; financial stability had been maintained, and exchange reserves losses had been contained. This said, medium-term growth prospects are expected to remain muted, and the economy remains vulnerable to shocks.

28. **Cautious conduct of fiscal policy remains crucial to ensure stability.** The persistent strains on the fiscal position arising from the wage settlement were partly contained through expenditure restraint and revenue gains. Despite the riots, the fiscal position is expected to improve this year. Going forward, putting fiscal policy on an appropriate track, while allowing moderate growth in non-wage spending after several years of compression, will require consolidating revenue gains, and resisting wage and hiring pressures. Reducing the wage bill remains the linchpin of medium-term fiscal consolidation efforts.

29. **The authorities should consider scaling back their external borrowing plans.** Their current plans to borrow externally for reconstruction projects up to US\$50 million (20 percent of GDP) entail considerable risks for external debt sustainability in the medium term. The loan's debt service requirements would place severe pressure on the fiscal and external position, heightening risks of debt distress. For the same reason, the staff advises the authorities against a possible state acquisition of the power company.

30. **The NRBT should continue to monitor closely monetary and credit developments following its recent easing of policy.** The authorities successfully reined in private credit growth in 2006, and took forceful action to absorb the large amount of liquidity arising from the redundancy payments. The recent easing of monetary policy to provide liquidity in the aftermath of the riots seems justified in the short term. In the period ahead, the desirability of sustaining the current stance will hinge, inter alia, on the direction of fiscal policy, with a possible need to tighten credit policy should fiscal pressures re-emerge. Furthermore, while the current level of the exchange rate does not clearly suggest overvaluation, the recent trend is a cause of concern, and the authorities should also make greater use of the flexibility in their foreign exchange regime to counter real exchange rate appreciation. Moreover, as explained in paragraph 22, the tax certification requirement imposed on certain current international transactions gives rise to an exchange restriction subject to Fund approval. As the restriction has been imposed for balance of payments reasons, it applies to all relevant applications for foreign exchange on a non-discriminatory basis, and the authorities intend that the problem of tax arrears giving rise to this requirement

will be resolved within 12 months, staff recommend the approval of the retention of the exchange restriction through July 9, 2008 or the conclusion of the next Article IV consultation with Tonga, whichever is earlier.

31. **WTO accession will be a significant step whose impact could be much leveraged by stepping up other reforms.** The staff welcomes the authorities' intention to seek parliamentary ratification of WTO accession, which will help integrate Tonga in the world economy. Other reforms remain imperative, however, to achieve faster growth and encourage private foreign investment. The focus of policymakers efforts should turn to implementing existing well-developed plans.

32. **The staff encourages the authorities to pursue efforts to improve statistical capacity.** The Fund will continue to assist the authorities with technical assistance in various areas where there remains a need to improve the reliability, coverage, and timeliness of statistics.

It is proposed that the next Article IV consultation with Tonga takes place on a 12-month cycle.

Box 1. The Civil Service Wage Settlement

Tonga has experienced substantial increase in wage and salaries expenditures over the last years. Following a civil service strike that lasted six weeks over July-August 2005, the government and unions agreed on a settlement under which salaries of civil servants would increase by 60–80 percent, effective from July 2005, with the salary increase for the first year paid in two phases, in FY05/06 and FY06/07.¹

These developments have had significant fiscal implications. The total cost of the wage increase was about 4¼ percent of GDP for FY05/06, reflecting the first phase of the wage increase, a partial adjustment of paychecks. In FY06/07, the additional cost of the settlement is estimated at about 4¼ percent of GDP, reflecting not only the full wage adjustment but also the complement of the first year’s partial adjustment of the pay raise, 40 percent of total wage increases (the “carry-over” in the table). On account of these two developments, average wages increased by about 92 percent in FY06/07 from their base level in FY04/05, albeit only temporarily, returning in FY07/08 to a level 70 percent above this base.

Wage and Salaries Expenditure				
	2004/05	2005/06	2006/07	2007/08
	Prel.		Proj.	
	(In millions of pa'anga)			
Wage and salaries expenditure	49.7	90.8	83.7	75.3
<i>Of which:</i> 60 % increase	...	19.0	...	...
40 % carryover	...	...	9.6	...
Additional 40 % increase	...	...	9.6	...
Severance package 1/	...	24.5	...	...
	(In percent of GDP)			
Wage and salaries expenditure	11.9	20.1	18.1	15.2
<i>Of which:</i> 60 % increase	...	4.2	...	...
40 % carryover	...	...	2.1	...
Additional 40 % increase	...	...	2.1	...
Severance package 1/	...	5.4	...	...
<i>Memorandum item:</i>				
Wage bill excluding one-off payments (in percent of GDP)	11.9	14.7	16.0	15.2

1/ Includes additional wage increase of 40 % for leaving staff.

Partly offsetting these large wage increases, staffing cuts have reduced personnel by a significant 18 percent, albeit adding the short-term costs of severance packages. Staff cuts were achieved in a short round of voluntary redundancies implemented in the last weeks of June 2006. The severance packages for the voluntary redundancies imposed an additional cost on the budget, estimated at 5½ percent of GDP, while under pension law, the government was required to fund pension liabilities of departing civil servants, at a cost of 2 percent of GDP. To finance the cash cost of the redundancy program, the government had considered an asset sale to a foreign investor, but discussions did not conclude by the end of June. As a result, the program was financed by the government withdrawing its domestic bank deposits, which depleted the fiscal cushions accumulated during previous years.

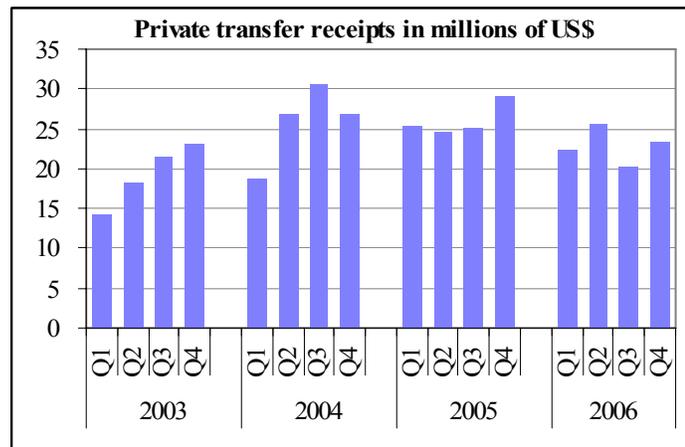
¹ As part of the public sector reform program, the government introduced performance-based contracts for public workers in 2004. Disparities in salaries among civil servants became large, as senior workers obtained high salary increases, causing widespread dissatisfaction among civil servants at lower grades.

Box 2. Remittances in Tonga

Remittances grew at a rapid pace in the first half of the decade. Tonga's private transfer receipts grew by close to 15 percent a year (in pa'anga) over 2000-05. As a result, aggregate remittance flows reached 45 percent of GDP in 2005, placing Tonga among the world's largest remittance recipients in relation to GDP. The bulk is remitted from Tongan migrants in Australia, New Zealand, and the U.S. towards the household sector.¹ While remittance growth was supported by sustained income growth in the host economies—and valuation effects played a limited role over the reference period—, growth in private transfer receipts in Tonga consistently outpaced income growth in the main host countries over the past decade, faster even than the continued increase in the number of migrants might imply.

Lately, however, there appears to have been a break in this trend. Based on overseas exchange transaction (OET) data, private transfer receipts in U.S. dollar terms peaked in the third quarter of 2004 and have since declined. Total gross receipts in 2006, in U.S. dollar terms, were 12 percent below the level in 2005.

However, the data is notoriously difficult to obtain, especially as remittances come in through different channels. For example, a 1994 survey of Tongans living in Sydney showed that remittances were sent evenly through bank transfers, hand-carried cash, and in-kind deliveries. Both market participants and authorities are unconvinced that remittances have declined sharply, with the apparent drop possibly related to the



fact that in-kind remittances, which are not tracked in OET data, have become more common.

Moreover, some positive response of remittances to the recent unrest are expected in the short term. Apart from household income support, remittances have long served as a shock absorber in Tonga: filling in the financial gap needed for reconstruction of damaged assets; and smoothing consumption for those affected. The latest data showed a pick-up of remittances in the months of January and February, albeit still at levels below than those of the same period in the previous year.

¹ A recent survey prepared for G-20 workshop estimated that close to 90 percent of total remittances went to households

Box 3. Tonga: Comprehensive Tax Reform

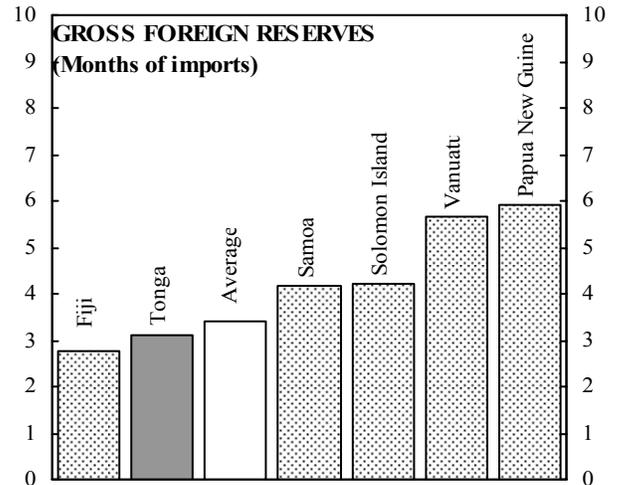
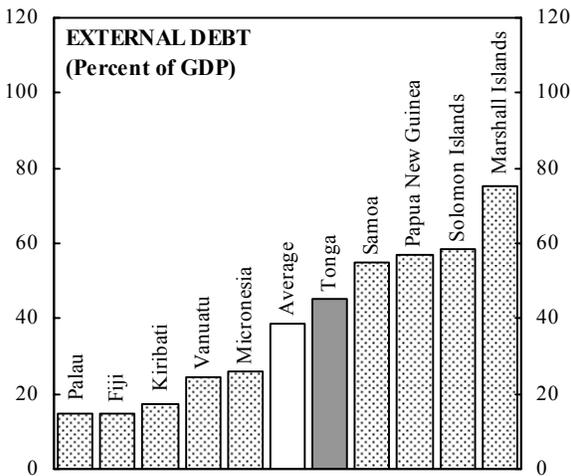
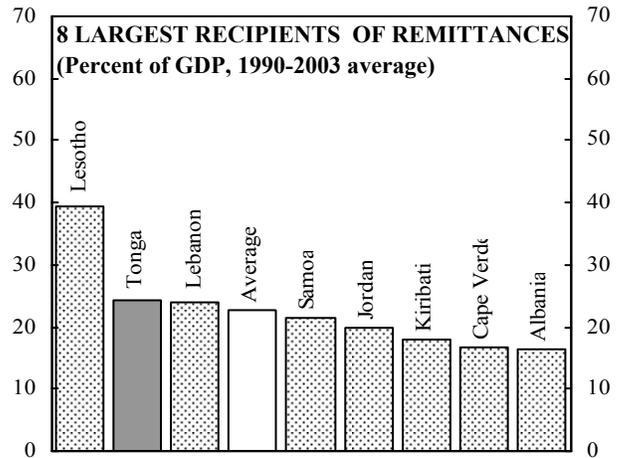
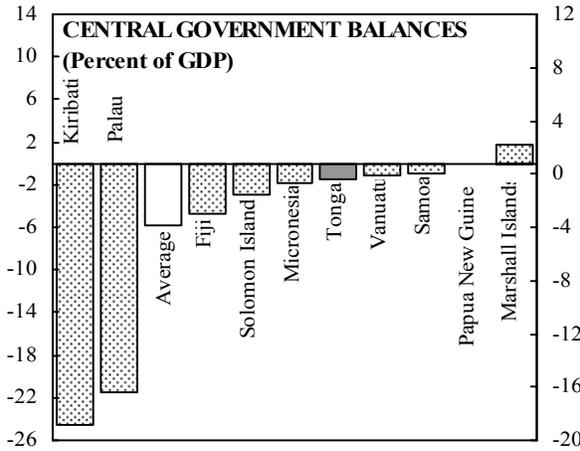
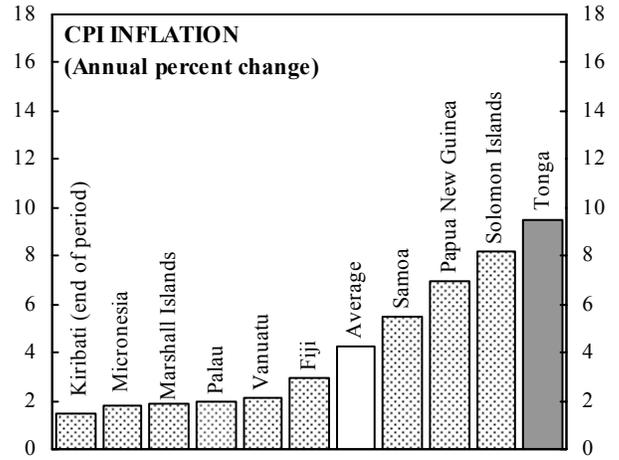
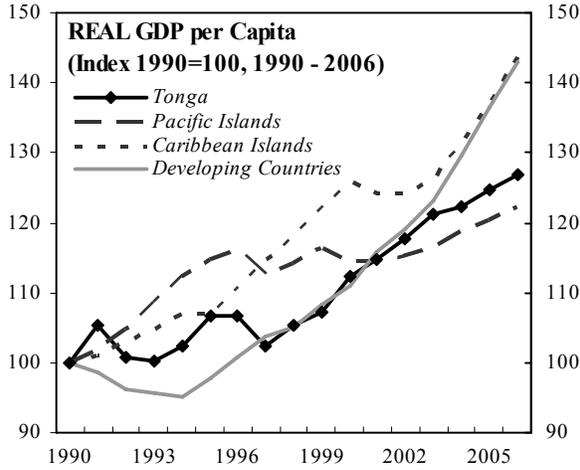
Tonga is in the process of a comprehensive tax reform. As a part of trade liberalization process, a comprehensive tax reform package was approved in 2002, shifting revenue sources away from trade taxes to greater reliance on domestic taxation. For the first phase of the reform, a broad-based consumption tax was introduced in April 2005. Administrative efforts have also been made to strengthen tax compliance and enforcement, including registration of large businesses, introduction of a new computer system, and reorganization of one-stop shop for customs tariff payments.

The remaining parts of the tax reform are scheduled to be implemented in FY07/08. With planned accession of the WTO and associated reduction in tariffs, the authorities plan to submit the final set of domestic tax bills to the Parliament in June 2007. The key features of the reform include:

- **Corporate income tax** rate of 25 percent will be introduced for both domestic and foreign companies, replacing the current differential rates for foreign companies of 37-40 percent and domestic companies of 15–30 percent;
- the **individual income tax** threshold will be raised;
- **excise tax** coverage will be extended from domestically manufactured goods to both domestic and imported excisable goods, such as beer, cigarettes, motor vehicles, and liquor; and,
- **customs tariff** duty rates will be reduced to a maximum of 15–20 percent.

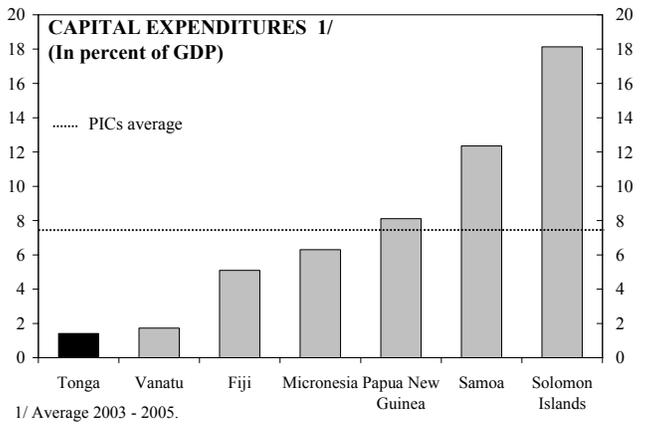
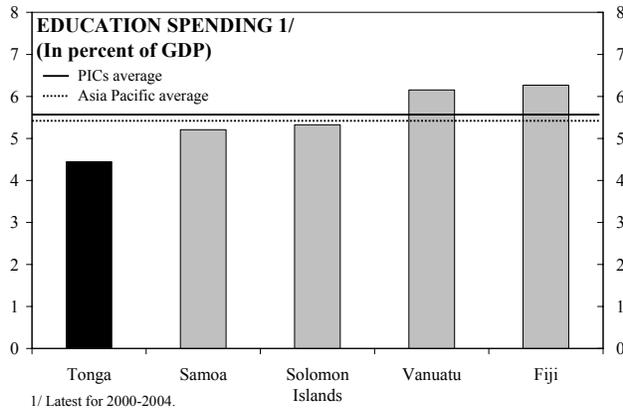
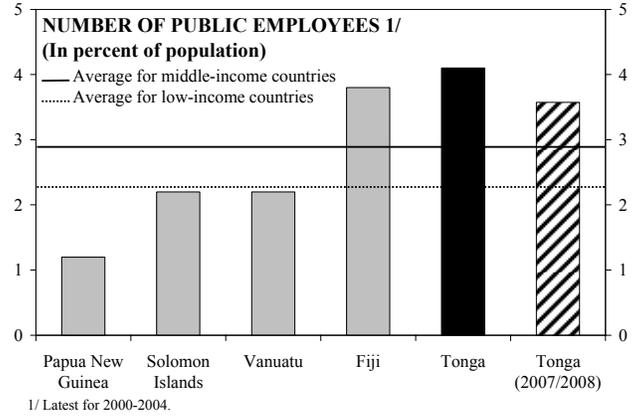
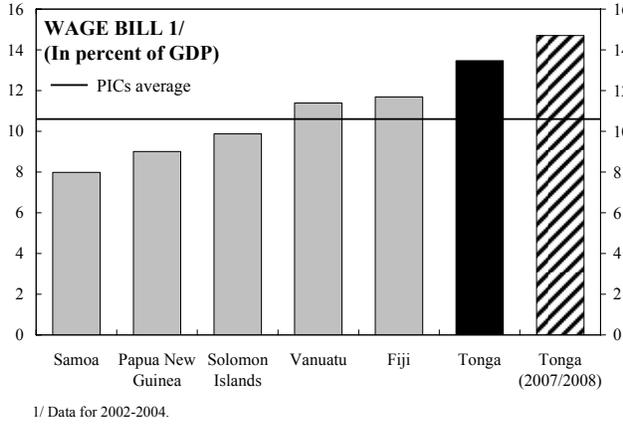
This set of tax reform is planned to be revenue neutral. Care has been taken to set tax rates to prevent a potential revenue shortfall. The authorities plan to offset the revenue foregone resulting from tariff reduction mainly through excise tax collection.

Figure 1: Tonga: Regional Comparators, (Averages, 2001–06)



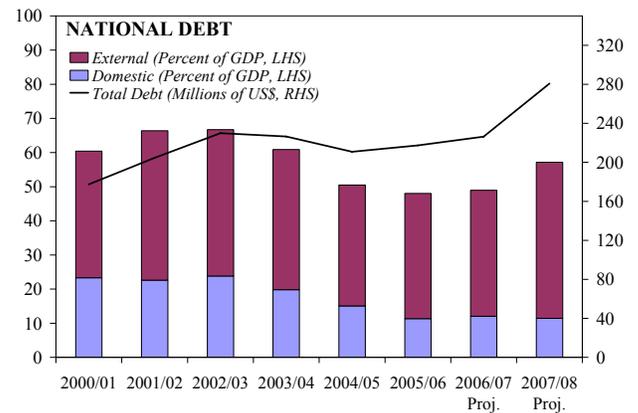
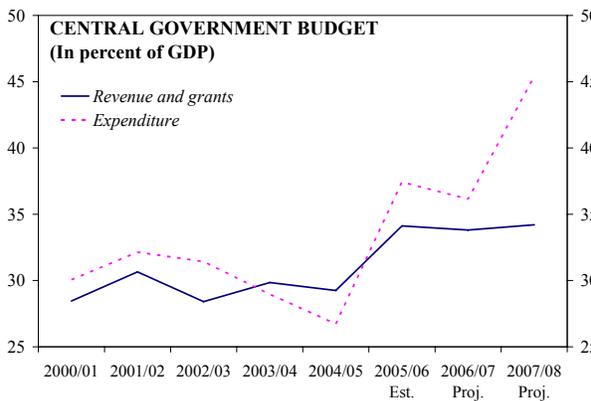
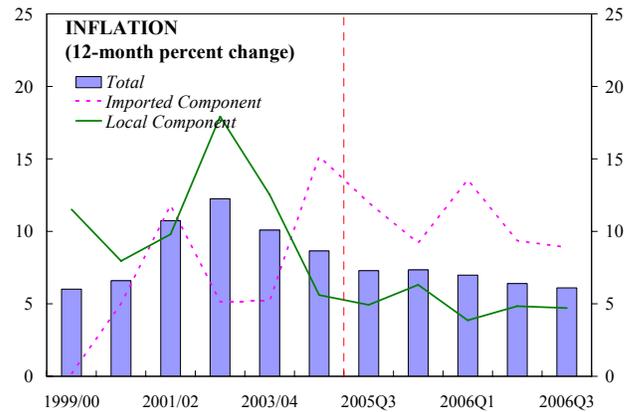
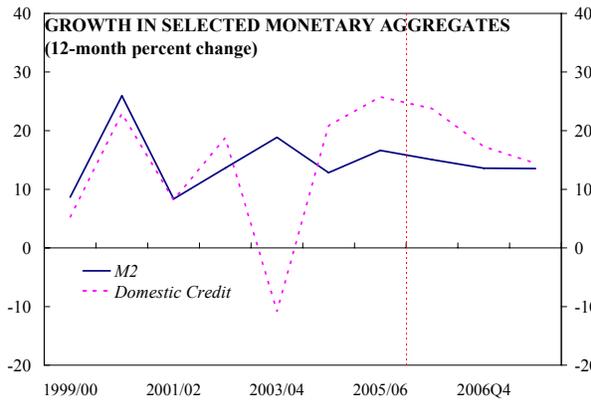
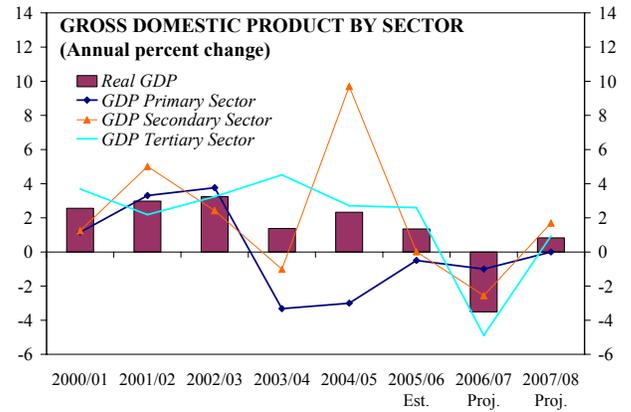
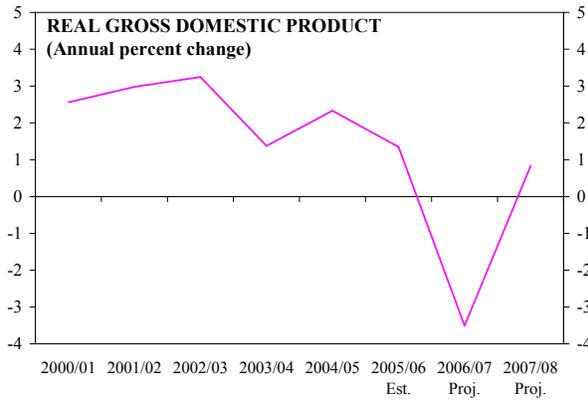
Sources: Data provided by the Tongan authorities; and Fund staff estimates.

Figure 2. Tonga: Regional Fiscal Comparisons



Sources: Fund staff estimates.

Figure 3. Tonga: Real, Fiscal, and Monetary Sector Developments, 1999/2000–2006/07^{1/}



Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Fiscal year ending June.

Table 1. Tonga: Selected Economic Indicators, 2002/03–2007/08 ^{1/}

Nominal GDP (2005/2006): US\$ 225.3 million
 Population (2006): 101,134
 GDP per capita (2005/06): US\$2,201
 Quota: SDR 6.9 million

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
			Prel.		Proj.	
(Percent change)						
Output and prices						
Real GDP	3.2	1.4	2.3	1.3	-3.5	0.8
Consumer prices (period average)	11.1	11.7	9.7	7.0	5.9	5.3
(In percent of GDP)						
Central government finance						
Total revenue and grants	28.4	29.9	29.3	34.1	33.8	34.2
Total revenue	27.6	28.5	27.9	31.9	30.9	31.3
Grants	0.8	1.4	1.3	2.2	3.0	3.0
Total expenditure and net lending	31.4	29.0	26.7	37.4	36.1	45.4
Of which: Current expenditure	26.1	27.3	25.8	36.9	34.8	38.4
Capital expenditure	2.5	1.0	1.0	1.0	1.4	7.1
Overall balance (incl. reconstruction loan)	-3.0	0.9	2.5	-3.3	-2.3	-11.2
Overall balance (excl. reconstruction loan)	-3.0	0.9	2.5	-3.3	-2.3	-1.0
External financing (net)	1.4	2.9	0.3	0.2	1.4	11.1
Domestic financing (net)	1.6	-3.8	-2.8	3.1	0.9	0.1
(Annual percentage change)						
Money and credit						
Total liquidity ^{2/}	18.2	16.7	13.3	13.3	6.8	...
Of which: Broad money (M2)	13.6	18.9	12.8	16.6	7.3	...
Domestic credit	18.8	-10.9	20.9	25.8	11.9	...
Of which: Private sector credit	12.7	-4.3	29.4	22.6	11.9	...
Interest rates (end of period)						
Average deposit rate ^{3/}	4.6	5.1	5.2	5.6	5.7	...
Base lending rate ^{3/}	9.0	9.5	9.0	9.4	9.4	...
(In millions of U.S. dollars)						
Balance of payments						
Exports, f.o.b.	17.6	13.8	16.0	15.1	15.6	15.9
Imports, f.o.b.	-74.2	-82.6	-105.4	-117.7	-118.9	-132.5
Services (net)	-5.4	-2.9	-9.9	-7.8	-10.1	-22.9
Income (net)	-1.5	-0.3	1.6	2.8	2.1	2.3
Services and income (net)	-6.9	-3.2	-8.3	-4.9	-8.0	-20.6
Transfers (net)	58.7	79.7	91.9	89.0	87.6	91.4
Of which: Private transfer receipts	68.1	90.1	107.4	102.2	91.0	97.3
Current account balance (incl. reconstruction loan)	-4.9	7.7	-5.7	-18.5	-23.7	-45.8
Current account balance (excl. reconstruction loan)	-4.9	7.7	-5.7	-18.5	-23.7	-20.8
(In percent of GDP)	-3.1	4.2	-2.6	-8.2	-10.5	-19.0
Overall balance	-1.2	27.3	-3.6	-3.9	-3.3	-3.7
Terms of trade (percent change)	71.2	-16.3	-12.9	16.3	...	...
Gross international reserves (end of period)						
In millions of U.S. dollars	17.2	44.8	42.5	40.4	37.1	33.5
In months of goods and services imports	2.0	4.8	3.7	3.2	2.9	2.2
External debt						
External debt (in percent of GDP)	42.9	41.1	35.4	36.7	36.9	45.7
Debt service ratio ^{4/}	6.3	8.7	8.3	9.3	10.5	9.8
Exchange rates						
Pa'anga per U.S. dollar (end of period) ^{5/}	2.0	4.8	3.7	3.2	2.0	...
Pa'anga per U.S. dollar (period average) ^{5/}	1.9	3.9	1.7	1.4	2.0	...
Real effective exchange rate (1990=100) ^{5/}	89.9	93.7	100.2	103.5	105.0	...
Nominal effective exchange rate (1990=100) ^{5/}	75.2	71.4	71.1	70.5	69.5	...

Sources: Data provided by the Tongan authorities; and Fund staff estimates and projections.

^{1/} Fiscal year beginning July.

^{2/} From the *Banking Survey*, which includes the Tonga Development Bank.

^{3/} Through 3Q 2006.

^{4/} In percent of exports of goods and services.

^{5/} Through December 2006.

Table 2. Tonga: Summary of Government Operations, 2002/03-2007/08

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	
				Prel.	Budget 1/ Proj.	Proj.	
(In millions of pa'anga)							
Total revenue and grants	99.3	111.0	122.1	154.5	184.5	156.3	168.0
Total revenue	96.4	105.9	116.6	144.6	155.1	142.7	153.5
Current revenue	96.4	105.9	116.6	144.6	155.1	142.6	153.5
Tax revenue	80.7	86.1	98.4	122.2	137.1	121.4	132.0
Nontax revenue 2/	15.7	19.7	18.2	22.4	18.0	21.2	21.5
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants (in cash)	2.9	5.2	5.5	9.9	29.4	13.7	14.5
Total expenditure and net lending	109.8	107.7	111.6	169.4	194.6	167.2	223.0
Total expenditure	100.3	108.7	112.6	170.6	195.0	167.5	223.8
Current expenditure	91.3	101.7	107.9	167.0	170.3	160.9	188.8
Wages and salaries 3/	44.3	45.7	49.7	90.8	85.4	83.7	75.3
<i>Of which: Redundancy Package</i>	0.0	0.0	0.0	24.5	0.0	0.0	0.0
Retirement funds employer contribution	1.5	1.5	2.6	3.8	4.6	4.5	4.1
Interest expense	2.3	3.2	3.8	3.3	3.4	3.4	3.1
Other current expenditures	43.2	51.3	51.8	69.1	76.9	69.3	106.3
Purchases of goods and services	32.1	36.7	40.2	47.6	56.7	48.7	87.1
Subsidies and other transfers	8.9	10.4	9.4	10.7	18.5	18.4	17.5
Transfer to retirement funds 4/	2.2	4.1	2.1	10.7	1.7	2.2	1.7
Capital expenditure	8.6	3.9	4.3	4.6	24.6	6.6	35.0
Expenditure discrepancy	0.4	3.1	0.5	-1.0	0.0	0.0	0.0
Total lending minus repayments	9.5	-0.9	-1.1	-1.2	-0.3	-0.3	-0.8
Current balance	5.1	4.2	8.7	-22.5	-15.2	-18.2	-35.3
Overall balance (incl. reconstruction loan)	-10.5	3.3	10.5	-14.9	-10.1	-10.8	-55.0
Overall balance (excl. reconstruction loan)	-10.5	3.3	10.5	-14.9	-10.1	-10.8	-5.0
Total financing	10.5	-3.3	-10.5	14.9	10.1	10.8	55.0
External financing	4.9	10.7	1.4	1.0	8.5	6.5	54.4
<i>Of which: reconstruction loan 5/</i>	...	...	...	...	...	...	50.0
Domestic financing 6/	5.7	-14.0	-11.9	14.0	1.6	4.4	0.6
<i>Of which: Processing delay</i>	0.0	0.0	0.0	9.1	0.0	-9.1	0.0
(In percent of GDP)							
Total revenue and grants	28.4	29.9	29.3	34.1	36.6	33.8	34.2
Total revenue	27.6	28.5	27.9	31.9	30.7	30.9	31.3
Current revenue	27.6	28.5	27.9	31.9	30.7	30.8	31.2
Tax revenue	23.1	23.2	23.6	27.0	27.2	26.3	26.9
Nontax revenue 2/	4.5	5.3	4.4	4.9	3.6	4.6	4.4
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants (in cash)	0.8	1.4	1.3	2.2	5.8	3.0	3.0
Total expenditure and net lending	31.4	29.0	26.7	37.4	38.6	36.1	45.4
Total expenditure	28.7	29.2	27.0	37.7	38.6	36.2	45.6
Current expenditure	26.1	27.3	25.8	36.9	33.7	34.8	38.4
Wages and salaries 3/	12.7	12.3	11.9	20.1	16.9	18.1	15.3
<i>Of which: Redundancy Package</i>	0.0	0.0	0.0	5.4	0.0	0.0	0.0
Capital expenditure	2.5	1.0	1.0	1.0	4.9	1.4	7.1
Expenditure discrepancy	0.1	0.8	0.1	-0.2	0.0	0.0	0.0
Total lending minus repayments	2.7	-0.3	-0.3	-0.3	-0.1	-0.1	-0.2
Current balance	1.5	1.1	2.1	-5.0	-3.0	-3.9	-7.2
Overall balance (incl. reconstruction loan)	-3.0	0.9	2.5	-3.3	-2.0	-2.3	-11.2
Overall balance (excl. reconstruction loan)	-3.0	0.9	2.5	-3.3	-2.0	-2.3	-1.0
Total financing	3.0	-0.9	-2.5	3.3	2.0	2.3	11.2
External financing	1.4	2.9	0.3	0.2	1.7	1.4	11.1
<i>Of which: reconstruction loan 5/</i>	...	...	...	...	...	...	10.2
Domestic financing 6/	1.6	-3.8	-2.8	3.1	0.3	0.9	0.1
<i>Of which: Processing delay</i>	0.0	0.0	0.0	2.0	0.0	-2.0	0.0
<i>Memorandum item:</i>							
Nominal GDP (in millions of pa'anga)	349.4	371.9	417.3	452.6	504.7	462.4	491.2

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Nominal GDP used is the one projected in the 2006 Article IV consultation.

2/ Nontax revenue for 2005/06 includes unclassified revenue of TOP3.4 million.

3/ Wage bill for 2006/07 includes TOP 9.6 million of carryover payments from 2005/06.

4/ Includes an additional transfer of TOP 8.6 million associated to the redundancy program in 2005/06.

5/ Assumes half of total amount is spent for capital expenditure, while the rest is for current spending.

6/ Includes domestic net bond financing and net changes in government cash balance and investment.

Table 3. Tonga: Banking Survey, 2002/03-2006/07 1/

	2002/03	2003/04	2004/05	2005/06	2006/07			
					Sep.	Dec	Mar	Jun. Proj.
(In millions of pa'anga; end of period)								
Net foreign assets	29.5	83.7	76.3	71.9	76.8	75.6	76.4	61.7
Foreign assets	49.2	109.3	91.8	95.0	96.9	95.9	99.7	85.0
NRBT	36.9	89.7	82.1	83.2	85.3	84.2	90.4	75.7
DMBs	12.2	19.6	9.7	11.8	11.7	11.8	9.3	9.3
Foreign liabilities	-19.7	-25.6	-15.5	-23.1	-20.2	-20.3	-23.3	-23.3
NRBT	-0.2	-0.8	-3.2	-7.1	-4.7	-4.3	-4.2	-4.2
DMBs	-17.6	-23.0	-11.4	-15.3	-14.9	-15.4	-18.7	-18.7
TDB	-1.8	-1.8	-0.9	-0.6	-0.6	-0.6	-0.4	-0.4
Net domestic assets	149.1	121.3	154.2	186.1	188.2	198.8	196.2	215.2
Net domestic credit	195.2	174.0	210.3	264.5	279.8	278.1	277.0	296.1
Government (net)	-0.5	-14.5	-25.2	-18.9	-6.0	-9.0	-18.8	-18.9
Non-financial public enterprises	12.5	13.2	8.6	5.4	4.9	4.4	4.0	4.0
Private sector	183.2	175.3	226.8	278.0	280.9	282.7	291.8	311.0
Other items, net	-46.1	-52.7	-56.1	-78.4	-91.6	-79.3	-80.9	-80.9
Total liquidity	169.2	197.4	223.7	253.4	270.9	271.6	266.3	270.7
Broad money (M2)	151.9	180.5	203.7	237.5	254.1	255.3	249.8	254.8
Narrow money	51.6	65.8	68.7	55.7	64.6	70.1	68.7	58.1
Quasi money	100.2	114.7	134.9	181.8	189.5	185.2	181.1	196.8
Notes and bills 2/	17.3	16.9	20.1	15.9	16.8	16.3	16.4	15.9
Government lending funds 3/	9.4	7.6	6.8	6.1	6.0	5.8	6.4	6.1
(Annual percentage change)								
Net foreign assets	-4.2	184.0	-8.9	-5.8	-5.6	-0.3	12.3	-14.2
Net domestic assets	21.4	-18.6	27.2	20.7	13.7	15.9	12.0	15.6
Net domestic credit	18.8	-10.9	20.9	25.8	23.8	17.3	14.4	11.9
Private sector	12.7	-4.3	29.4	22.6	15.0	10.4	6.6	11.9
Total liquidity	18.2	16.7	13.3	13.3	12.8	12.8	12.3	6.8
Broad money (M2)	13.6	18.9	12.8	16.6	15.1	13.6	13.6	7.3
(In millions of U.S. dollars)								
Net foreign assets	13.7	41.8	39.5	34.9	38.1	37.8	38.5	30.3
Foreign assets	22.9	54.6	47.5	46.1	48.1	48.0	50.2	41.7
NRBT	17.2	44.8	42.5	40.4	42.3	42.1	45.5	37.1
DMBs	5.7	9.8	5.0	5.7	5.8	5.9	4.7	4.6
Foreign liabilities	-9.2	-12.8	-8.0	-11.2	-10.0	-10.2	-11.7	-11.4
<i>Memorandum items:</i>								
Velocity (GDP/average M2)	2.5	2.2	2.2	2.0	...	...	...	1.8
Pa'anga per U.S. dollar (end of period)	2.15	2.00	1.93	2.06	2.01	2.00	1.99	...
Average M2 (pa'anga millions)	142.2	166.0	192.7	224.0	233.4	240.2	245.8	252.8
NRBT notes (pa'anga millions)	0.0	0.0	0.0	1.5	12.0	3.3	0.0	...
Nominal GDP (pa'anga millions)	349.4	371.9	417.3	452.6	...	...	...	462.4

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Comprises the National Reserve Bank of Tonga (NRBT), the deposit money banks, and the Tonga Development Bank (TDB).

2/ Comprises bills and promissory notes issued by financial sector and held outside the sector.

3/ Represents borrowing by the Government from foreign sources for onlending to the TDB.

Table 4: Tonga: Balance of Payments Summary, 2002/03-2007/08

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

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
					Proj.	
Trade balance	-56.7	-68.8	-89.3	-102.5	-103.2	-116.6
Exports, f.o.b.	17.6	13.8	16.0	15.1	15.6	15.9
Imports, f.o.b.	-74.2	-82.6	-105.4	-117.7	-118.9	-132.5
<i>Of which: reconstruction loan</i>	...	...	...	...	...	-12.5
Services (net)	-5.4	-2.9	-9.9	-7.8	-10.1	-22.9
Receipts	25.0	25.7	23.7	25.4	24.4	25.1
Payments	-30.4	-28.6	-33.6	-33.2	-34.5	-48.0
<i>Of which: reconstruction loan</i>					0.0	-12.5
Income (net)	-1.5	-0.3	1.6	2.8	2.1	2.3
Receipts	2.2	2.8	3.4	4.9	4.0	4.5
Payments	-3.7	-3.1	-1.8	-2.1	-1.9	-2.2
Current transfers (net)	58.7	79.7	91.9	89.0	87.6	91.4
Official transfers (net)	0.0	0.2	0.0	0.0	5.8	5.1
Private transfers (net)	58.7	79.4	91.9	89.0	81.7	86.3
Current account balance	-4.9	7.7	-5.7	-18.5	-23.7	-45.8
(In percent of GDP)	-3.1	4.2	-2.6	-8.2	-10.5	-19.0
Capital and financial account balance	7.9	36.9	12.5	21.7	20.5	42.1
Official capital flows (net)	7.7	13.7	4.7	8.4	9.5	30.3
<i>Of which: reconstruction loan</i>	...	...	...	...	...	25.0
Private capital flows (net)	0.2	23.2	7.7	13.3	11.0	11.8
Errors and omissions	-4.2	-17.2	-10.4	-7.1	0.0	0.0
Overall balance 1/	-1.2	27.3	-3.6	-3.9	-3.3	-3.7
Memorandum items:						
Gross official foreign reserves	17.2	44.8	42.5	40.4	37.1	33.5
In months of imports (goods and services) 2/	2.0	4.8	3.7	3.2	2.9	2.2
Exchange rate						
Pa'anga per U.S. dollar (period average)	2.20	2.05	1.94	2.01	...	...
Pa'anga per U.S. dollar (end of period)	2.15	2.00	1.93	2.06	...	...

Source: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Changes in the net official foreign reserves.

2/ The current year's imports.

Table 5. Tonga: Medium-Term Scenario, 2004/05–2011/12 1/

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
	Prel.		Projections					
	(Percent change)							
Output and prices								
Real GDP	2.3	1.3	-3.5	0.8	1.3	1.3	1.2	1.2
Consumer prices (period average)	9.7	7.0	5.9	5.3	5.6	5.7	5.8	6.0
	(In percent of GDP)							
Central government finance								
Total revenue and grants	29.3	34.1	33.8	34.2	34.3	34.3	34.4	34.4
Total revenue	27.9	31.9	30.9	31.3	31.3	31.3	31.3	31.3
Grants	1.3	2.2	3.0	3.0	3.0	3.1	3.1	3.2
Total expenditure and net lending	26.7	37.4	36.1	45.4	44.9	35.7	35.5	35.8
Current expenditure	25.8	36.9	34.8	38.4	38.0	33.1	32.9	32.9
Capital expenditure	1.0	1.0	1.4	7.1	7.1	2.8	2.8	3.1
Expenditure discrepancy	0.1	-0.2	...	...	...	...	...	...
Net lending	-0.3	-0.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Overall balance (incl. reconstruction loan)	2.5	-3.3	-2.3	-11.2	-10.6	-1.4	-1.1	-1.3
Overall balance (excl. reconstruction loan)	2.5	-3.3	-2.3	-1.0	-1.1	-1.4	-1.1	-1.3
External financing (net)	0.3	0.2	1.4	11.1	10.6	1.3	1.1	1.3
Of which: reconstruction loan	0.0	0.0	0.0	10.2	9.5	0.0	0.0	0.0
Domestic financing (net)	-2.8	3.1	0.9	0.1	0.1	0.1	0.0	0.0
	(In millions of U.S. dollars)							
Balance of payments								
Exports, f.o.b.	16.0	15.1	15.6	15.9	16.2	16.4	16.7	17.0
Imports, f.o.b.	-105.4	-117.7	-118.9	-132.5	-136.1	-129.8	-135.0	-140.4
Services and income (net)	-8.3	-4.9	-8.0	-20.6	-19.2	-5.6	-4.6	-3.7
Current account balance (incl. reconstruction loan)	-5.7	-18.5	-23.7	-45.8	-44.3	-20.5	-19.7	-19.9
Current account balance (excl. reconstruction loan)	-5.7	-18.5	-23.7	-20.8	-19.3	-20.5	-19.7	-19.9
(In percent of GDP)	-2.6	-8.2	-10.5	-19.0	-17.2	-7.5	-6.8	-6.5
Capital account balance (incl. reconstruction loan)	12.5	21.7	20.5	42.1	43.0	19.8	20.0	21.3
Capital account balance (excl. reconstruction loan)	12.5	21.7	20.5	17.1	18.0	19.8	20.0	21.3
Official capital flows (net)	4.7	8.4	9.5	30.3	31.1	7.8	7.8	8.9
Private capital flows (net)	7.7	13.3	11.0	11.8	11.9	12.0	12.2	12.4
Overall balance	-3.6	-3.9	-3.3	-3.7	-1.3	-0.7	0.3	1.5
Gross international reserves (end of period)								
In millions of U.S. dollars	42.5	40.4	37.1	33.5	32.2	31.5	31.8	33.3
In months of imports (goods and services)	3.7	3.2	2.9	2.2	2.1	2.3	2.2	2.2
External debt								
External debt (in percent of GDP) 2/	35.4	36.7	36.9	45.7	53.5	51.8	50.0	48.8
Debt service ratio 3/	8.3	9.3	10.5	9.8	9.3	7.8	9.4	8.6
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	91.9	89.0	81.7	86.3	90.7	95.3	100.1	104.5
(In percent of imports, goods and services)	66.1	59.0	53.3	47.8	49.0	57.0	57.8	58.2

Sources: Data provided by the Tongan authorities; and Fund staff estimates and projections.

1/ Fiscal year beginning July.

2/ Public sector external debt.

3/ In percent of exports of goods and services.

Table 6. Tonga: Banking Sector Indicators, 2001–06 1/

(In percent; end of period)

	2001	2002	2003	2004	2005	2006
Capital Adequacy						
Risk-weighted capital ratio	24.7	21.9	21.9	23.9	19.6	20.3
Total capital to total assets	18.2	17.8	18.5	16.3	16.3	17.4
Asset Quality						
Non-performing loan to total loans	6.3	7.7	9.6	5.9	4.2	4.7
Non-performing loans to capital	22.9	30.5	39.1	24.3	20.2	20.3
Non-performing loans net of provisions to total capital	1.2	6.4	14.2	0.1	3.0	6.2
Profitability						
Return on assets	6.4	5.6	5.8	6.0	6.6	5.5
Return on equity	27.3	21.4	23.0	22.1	24.9	21.9
Net interest margin	7.1	8.8	8.7	10.0	8.6	8.0
Net interest income to gross income	49.3	64.5	61.2	61.1	60.5	60.0
Other						
Risk concentration ratio 2/	37.3	41.9	35.9	17.7	11.5	17.1
Share of loans to non-financial corporations 3/	52.6	55.1	49.7	36.3	35.0	42.3

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Include the Tonga Development Bank.

2/ For commercial banks, the data are defined as the share of the largest 10 loans in total loans.

3/ Includes commercial banks.

Table 7. Tonga: Progress on Millennium Development Goals

	1990	1995	Latest Data 2001-05	Target 2015
Goal 1: Eradicate Extreme Poverty and Hunger				
Prevalence of child malnutrition (percent of children under 5)	...	...	...	...
Goal 2: Achieve Universal Primary Education				
Net primary enrollment ratio (percent of relevant age group)	...	...	95	100
Goal 3: Promote Gender Equality				
Ratio of girls to boys in primary and secondary education (percent)	...	...	103	100
Proportion of seats held by women in national parliament (percent)	0	0	3	...
Goal 4: Reduce Child Mortality				
Under 5 mortality rate (per 1,000)	32	29	24	2/
Infant mortality rate (per 1,000 live births)	26	24	20	...
Goal 5: Improve Maternal Health				
Births attended by skilled health staff (percent of life births)	92	...	95	3/
Goal 6: Combat HIV/AIDs, Malaria, and Other Diseases				
Contraceptive prevalence (percent of woman ages 15-49)	...	41	33	4/
Incidence of tuberculosis (per 100,000 people)	34	31	25	4/
Goal 7: Ensure Environmental Sustainability				
Forest area (percent of total land area)	6	...	6	5/
Nationally protected areas (percent of total land area)	...	...	8.6	5/
CO2 emissions (metric tons per capita)	0.8	1.1	1.1	5/
Access to an improved water source (percent of population)	100	...	100	5/
Access to improved sanitation (percent of population)	96	...	96	5/
Goal 8: Develop a Global Partnership for Development				
Fixed line and mobile telephones (per 1,000 people)	46	71	99	...
Personal computers (per 1,000 people)	...	6	49	...

Source: World Bank; World Development Indicators Database, April 2007.

1/ Goal is to have 1990 rate.

2/ Goal is to reduce 1990 under 5 mortality by two-thirds.

3/ Goal is to reduce 1990 ratio by three-quarters.

4/ Goal is to have it halted by 2015 and begun to reverse.

5/ Goal is to reverse the loss of environmental resources.

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

TONGA

Joint IMF/World Bank Debt Sustainability Analysis 2007¹

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

Approved by Anthony Boote and Steven Dunaway (IMF)
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JUNE 22, 2007

The updated debt indicators suggest that Tonga's risk of debt distress has increased. With the anticipated increase in the external debt burden, the baseline scenario indicates a substantial breach of the threshold for NPV of debt-to-exports over the projection period. Alternative scenarios and stress tests demonstrate vulnerability of the debt profile to adverse shocks and highlight the importance of prudent fiscal policy management.

A. Background

Tonga's total external debt as a percentage of GDP has declined over the past few years. External public debt fell from 42 percent of GDP in 2003/04 to 35½ percent of GDP in 2004/05 and remained broadly stable in 2005/06, in line with the decline in loan disbursements following the completion of large projects financed by the ADB. Fiscal surpluses in 2003/04 and 2004/05 have also helped to reduce public debt, bringing it down to below 50 percent of GDP in 2005/06 from over 60 percent of GDP in 2003/04.² With the government's efforts to limit domestic financing, meantime, domestic public debt has declined substantially to 11¼ percent of GDP in 2005/06 from 19¾ percent in 2003/04.

¹ This supplement provides an updated debt sustainability analysis (DSA) for Tonga. The DSA was prepared jointly with the World Bank in accordance with the Debt Sustainability Framework for low-income countries approved by the Executive Boards of the IMF and IDA. The debt data underlying this exercise were provided by the Tongan authorities.

² Tonga was not included in the list of countries potentially eligible for debt relief under the HIPC initiative (See the joint Fund/Bank board paper "Review of Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries" March 2006, page 7).

Debt burden indicators have remained below indicative policy-based thresholds, with the exception of the NPV of debt-to-exports ratio.³ At end-2005/06, the stock of external public debt amounted to \$80.7 million, with a net present value of 20¾ percent of GDP. Most of the relevant indicators including the NPV of debt-to-GDP remained below the thresholds. However, the NPV of debt-to-exports ratio is estimated at 115 percent in 2005/06, higher than its threshold of 100 percent.

More recently, the civil unrest in November 2006 has increased risks of debt distress.

Economic activity was briefly disrupted: output growth, having slowed in 2005/06, is now projected to turn negative in 2006/07, with real GDP declining by 3½ percent, owing mainly to the direct and indirect impacts of the unrest. The public sector is also expected to play a large role in reconstruction and is attempting to secure a financing package from a donor of up to \$50.0 million (20 percent of GDP).

The medium-term framework assumes a fiscal adjustment to take place, with large loan disbursements in coming years posing an additional debt burden. A fully-tied project loan of \$50.0 million, mainly for reconstruction of the central business district, is expected to be disbursed in 2007/08 and 2008/09. A fiscal deficit of between 1 and 1½ percent is projected thereafter, with continued improvement in revenue administration and expenditure restraint. As external assistance is expected to gradually increase, the government will be able to allocate its resource to capital expenditure while successfully avoiding domestic financing, keeping inflation at about 6 percent. In this environment, GDP growth will remain at about 1¼ percent over the projection period.

Key Macroeconomic Assumptions
(In percent; unless otherwise indicated)

Period average	2001/02-05/06	2006/07-11/12	2012/13-26/27
Real GDP growth	2.3	0.4	1.2
Growth of exports of goods and services (U.S. dollar terms)	12.8	3.7	5.4
Current account (in percent of GDP)	-0.9	-11.2	-6.2
Inflation	10.0	5.7	6.0
Overall fiscal balance (in percent of GDP)	-0.9	-4.7	-1.6

B. External Debt Sustainability Analysis

In the baseline scenario, the NPV of debt-to-exports breaches its indicative policy-based threshold by a large margin and increases substantially over the medium term (Table I.1).

The net present value of external public debt to exports is expected to rise steeply to above 245 percent in 2008/09, reflecting the planned large loan disbursement. While the indicator is projected to decline in subsequent years as the high level of remittances continue to have a countervailing effect, however, it remains above its indicative threshold of 100 percent. The

³ The debt thresholds for Tonga based on the World Bank's Country Policy and Institutional Assessment in 2005 are: NPV of debt-to-exports (100 percent), GDP (30 percent) and revenues (200 percent); and debt service in percent of exports (15 percent) and revenues (25 percent).

NPV of public external debt as a percent of GDP is projected to increase significantly over the next few years to 41⅓ percent in 2008/09, declining gradually but remaining above the policy-dependent threshold of 30 percent through 2023/24.

Stress tests underscore that Tonga's debt profile is vulnerable to adverse shocks. (Table I.2, Figure I.1). One of the main risks identified in the set of stress tests is new public sector borrowings on less favorable terms. If this were to occur, the debt stock indicators would rise well above their threshold levels, although the debt service ratio would remain under its threshold. In contrast, a return of key variables including GDP and export growth to historical averages would imply an improvement in all ratios.

C. Public Debt Sustainability Analysis

The planned loan disbursements in 2007/08 and 2008/09 pose a significant risk to public debt sustainability (Table I.3). Total public debt is projected to increase over the next two years, reaching a high of 64⅓ percent in 2008/09 in nominal terms (52 percent in NPV terms). While total public debt is projected to gradually decline in subsequent years, mainly attributed to favorable fiscal management, it is expected to remain above 50 percent of GDP over the projection period. Domestic public debt is also projected to narrow gradually, in line with the recent policy commitments, to below 10 percent of GDP in 2011/12 and thereafter.

Alternative scenarios and stress tests highlight the vulnerability of the total public debt position (Table I.4, Figure I.2). The public debt trajectory is most sensitive to growth shocks, which would cause quite a sharp increase in the debt stock and debt service indicators. Furthermore, if other debt-creating flows increase or the exchange rate is depreciated in 2007/08, the public debt dynamics would look less favorable. On the other hand, a return of real GDP growth and primary fiscal balance to historical averages would see a marked improvement in all ratios.

D. Staff Assessment

Based on the LIC-DSA, staffs conclude that Tonga's debt dynamics are subject to a high risk of debt distress. The NPV of debt-to-exports remains above the threshold by a large margin over the projection period, and the threshold for the NPV of debt-to-GDP is also breached with the anticipated loan disbursement starting in 2007/08. Stress tests highlight vulnerabilities to debt sustainability, including the risks around lower growth and a sharp fall in the value of the currency, while the alternative scenario shows that a return of real GDP growth and primary fiscal balance to historical averages would strongly enhance debt sustainability. This emphasizes the critical importance of fiscal discipline and prudent debt management, and progress on key areas of the reform agenda to ensure economic recovery.

Table I.1. Tonga: External Debt Sustainability Framework, Baseline Scenario, 2003/04-2026/27 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/ Standard Deviation 6/	Projections							
	2003/04	2004/05	2005/06		2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2006/07-11/12 Average	2016/17
External debt (nominal) 1/	55.7	45.8	44.2		44.0	50.7	56.6	53.1	49.8	48.4		45.9
o/w public and publicly guaranteed (PPG)	42.0	35.5	35.8		37.1	45.8	53.4	51.5	49.8	48.4		45.9
Change in external debt	12.8	-9.9	-1.6		-0.2	6.7	5.8	-3.5	-3.3	-1.4		-0.2
Identified net debt-creating flows	-22.3	-9.6	0.3		7.2	13.7	11.9	2.4	2.0	1.9		1.9
Non-interest current account deficit	-4.7	1.6	7.3	5.7	9.7	18.3	16.6	7.1	6.5	6.2	10.7	5.6
Deficit in balance of goods and services	39.4	46.1	49.0		50.2	57.8	55.0	44.4	43.2	42.2		40.5
Exports	21.8	18.4	18.0		17.7	17.0	16.7	16.6	16.5	16.4		17.3
Imports	61.2	64.5	67.0		68.0	74.8	71.7	61.0	59.7	58.5		57.8
Net current transfers (negative = inflow)	-43.9	-42.7	-39.5	8.6	-38.8	-37.9	-36.8	-35.9	-35.6	-34.9		-33.9
Other current account flows (negative = net inflow)	-0.3	-1.9	-2.1		-1.8	-1.7	-1.6	-1.4	-1.2	-1.0		-1.0
Net FDI (negative = inflow)	-12.7	-3.6	-5.9	4.0	-4.9	-4.9	-4.6	-4.4	-4.2	-4.0		-3.8
Endogenous debt dynamics 2/	-4.8	-7.6	-1.1		2.4	0.4	0.0	-0.3	-0.3	-0.3	0.3	0.1
Contribution from nominal interest rate	0.5	1.1	0.9		0.8	0.7	0.6	0.4	0.3	0.3		0.6
Contribution from real GDP growth	-0.5	-1.1	-0.6		1.5	-0.3	-0.6	-0.7	-0.6	-0.6		-0.5
Contribution from price and exchange rate changes	-4.8	-7.6	-1.4		...	...	...	...	...	...		...
Residual (3-4) 3/	35.1	-0.3	-1.9		-7.3	-7.0	-6.1	-5.9	-5.3	-3.2		-2.1
o/w exceptional financing	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0		0.0
NPV of external debt 4/	...	...	29.1		28.0	36.6	44.4	41.4	38.4	37.3		33.8
In percent of exports	...	...	161.6		157.8	215.4	265.0	249.2	233.3	228.2		196.0
NPV of PPG external debt	...	...	20.7		21.1	31.7	41.2	39.8	38.4	37.3		33.8
In percent of exports	...	...	115.0		118.9	186.1	245.9	239.9	233.3	228.2		196.0
Debt service-to-exports ratio (in percent)	8.7	19.4	20.1		21.4	20.5	19.5	17.5	18.5	8.6		13.7
PPG debt service-to-exports ratio (in percent)	8.7	8.3	9.3		10.5	9.8	9.3	7.8	9.4	8.6		13.7
Total gross financing need (billions of U.S. dollars)	-28.3	3.3	11.3		19.4	40.6	39.3	15.3	15.4	10.9		15.9
Non-interest current account deficit that stabilizes debt ratio	-17.6	11.5	8.9		9.8	11.5	10.8	10.6	9.8	7.6		5.8
Key macroeconomic assumptions												
Real GDP growth (in percent)	1.4	2.3	1.3	2.2	-3.5	0.8	1.3	1.3	1.2	1.2	0.4	1.2
GDP deflator in US dollar terms (change in percent)	12.7	15.7	3.2	0.8	3.8	6.1	5.5	4.9	4.7	4.4	4.9	2.5
Effective interest rate (percent) 5/	1.3	2.3	2.0	1.4	0.5	1.9	1.7	1.2	0.8	0.6	0.6	1.1
Growth of exports of G&S (US dollar terms, in percent)	-6.9	0.3	2.1	2.5	-1.3	2.6	5.2	5.4	5.1	4.9	3.7	5.4
Growth of imports of G&S (US dollar terms, in percent)	6.3	24.9	8.6	7.2	16.7	17.8	2.5	-9.7	3.7	3.7	3.3	4.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	56.9	44.3	44.4	56.9	56.9	56.9	52.7	56.9
<i>Memorandum item:</i>												
Nominal GDP (millions of US dollars)	181.8	215.3	225.3		225.6	241.3	257.9	274.2	290.4	306.8		376.9
Source: Staff simulations.												

1/ Includes both public and private sector external debt.

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

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

4/ Assumes that NPV 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.

Table I.2. Tonga: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006/07-2026/27
(In percent)

	Projections							
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2016/17	2026/27
NPV of debt-to-GDP ratio								
Baseline	21	32	41	40	38	37	34	29
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007/08-26/27 1/	21	27	32	31	29	28	20	12
A2. New public sector loans on less favorable terms in 2007/08-26/27 2/	21	37	52	51	50	49	49	51
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007/08-08/09	21	32	42	41	39	38	35	30
B2. Export value growth at historical average minus one standard deviation in 2007/08-08/09 3/	21	33	46	44	43	41	38	31
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007/08-08/09	21	37	55	53	51	50	45	39
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007/08-08/09 4/	21	41	58	57	55	54	50	38
B5. Combination of B1-B4 using one-half standard deviation shocks	21	42	67	65	63	61	56	44
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007/08 5/	21	44	57	56	54	52	47	40
NPV of debt-to-exports ratio								
Baseline	119	186	246	240	233	228	196	143
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007/08-26/27 1/	119	157	193	186	179	171	117	58
A2. New public sector loans on less favorable terms in 2007/08-26/27 2/	119	219	310	306	302	299	281	251
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007/08-08/09	119	186	246	240	233	228	196	143
B2. Export value growth at historical average minus one standard deviation in 2007/08-08/09 3/	119	245	440	430	419	410	355	250
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007/08-08/09	119	186	246	240	233	228	196	143
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007/08-08/09 4/	119	239	349	342	334	328	288	189
B5. Combination of B1-B4 using one-half standard deviation shocks	119	249	418	409	399	392	343	229
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007/08 5/	119	186	246	240	233	228	196	143
Debt service ratio								
Baseline	10	10	9	8	9	9	14	12
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007/08-26/27 1/	11	10	11	11	13	12	12	7
A2. New public sector loans on less favorable terms in 2007/08-26/27 2/	11	10	14	16	18	17	21	17
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007/08-08/09	11	10	11	11	13	12	13	10
B2. Export value growth at historical average minus one standard deviation in 2007/08-08/09 3/	11	12	18	19	21	20	21	18
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007/08-08/09	11	10	11	11	13	12	13	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007/08-08/09 4/	11	10	12	13	14	13	16	14
B5. Combination of B1-B4 using one-half standard deviation shocks	11	11	15	16	18	17	19	17
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007/08 5/	11	10	11	11	13	12	13	10
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	55	55	55	55	55	55	55	55

Source: Staff projections and simulations.

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

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

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

4/ Includes official and private transfers and FDI.

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

Table I.4.Tonga: Sensitivity Analysis for Key Indicators of Public Debt 2006/07-2026/27

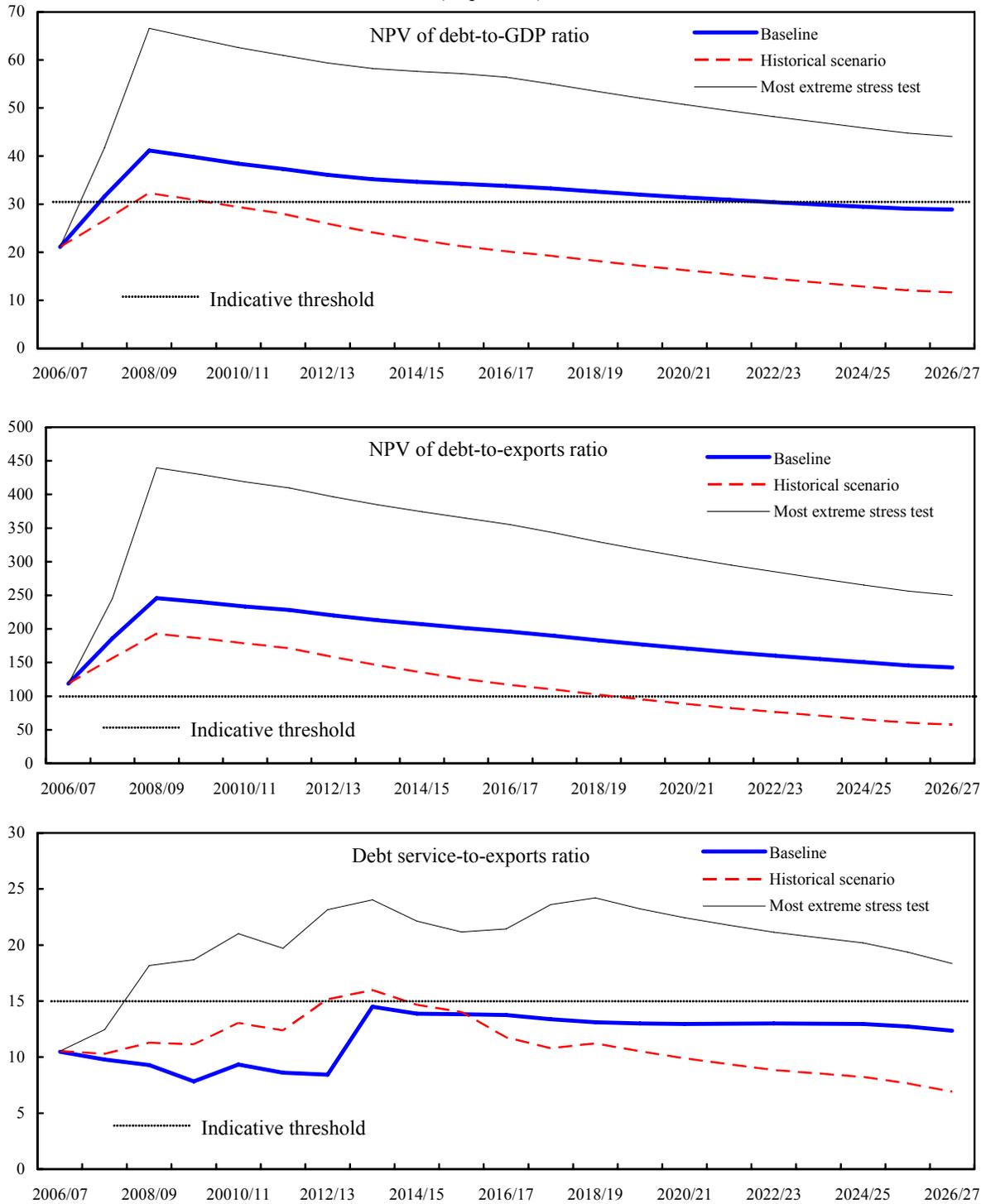
	Projections							
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2016/17	2026/27
NPV of Debt-to-GDP Ratio								
Baseline	33	43	52	50	48	47	42	35
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	33	34	34	32	30	28	22	12
A2. Primary balance is unchanged from 2006/07	33	35	36	36	35	34	32	33
A3. Permanently lower GDP growth 1/	33	43	53	52	51	50	52	71
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007/08-2008/09	33	44	55	54	52	51	51	52
B2. Primary balance is at historical average minus one standard deviations in 2007/08-2008/09	33	36	39	37	35	34	28	21
B3. Combination of B1-B2 using one half standard deviation shocks	33	35	37	35	33	32	26	19
B4. One-time 30 percent real depreciation in 2007/08	33	52	61	59	56	55	50	43
B5. 10 percent of GDP increase in other debt-creating flows in 2007/08	33	52	61	59	57	55	51	44
NPV of Debt-to-Revenue Ratio 2/								
Baseline	98	126	152	146	140	135	121	101
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	98	98	100	94	88	83	63	36
A2. Primary balance is unchanged from 2006/07	98	102	106	104	101	98	94	95
A3. Permanently lower GDP growth 1/	98	127	154	151	147	144	150	203
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007/08-2008/09	98	128	159	156	151	149	146	151
B2. Primary balance is at historical average minus one standard deviations in 2007/08-2008/09	98	105	113	108	102	97	83	62
B3. Combination of B1-B2 using one half standard deviation shocks	98	102	107	102	97	92	77	55
B4. One-time 30 percent real depreciation in 2007/08	98	152	178	172	164	158	144	125
B5. 10 percent of GDP increase in other debt-creating flows in 2007/08	98	152	178	172	165	160	147	127
Debt Service-to-Revenue Ratio 2/								
Baseline	7	6	5	5	5	5	8	8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	7	6	2	0	3	3	5	1
A2. Primary balance is unchanged from 2006/07	7	6	2	1	3	3	6	5
A3. Permanently lower GDP growth 1/	7	6	5	5	6	5	9	15
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007/08-2008/09	7	6	6	5	6	6	9	12
B2. Primary balance is at historical average minus one standard deviations in 2007/08-2008/09	7	6	3	1	3	3	6	3
B3. Combination of B1-B2 using one half standard deviation shocks	7	6	2	1	3	3	6	2
B4. One-time 30 percent real depreciation in 2007/08	7	6	6	5	6	5	9	9
B5. 10 percent of GDP increase in other debt-creating flows in 2007/08	7	6	9	6	6	6	9	11

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

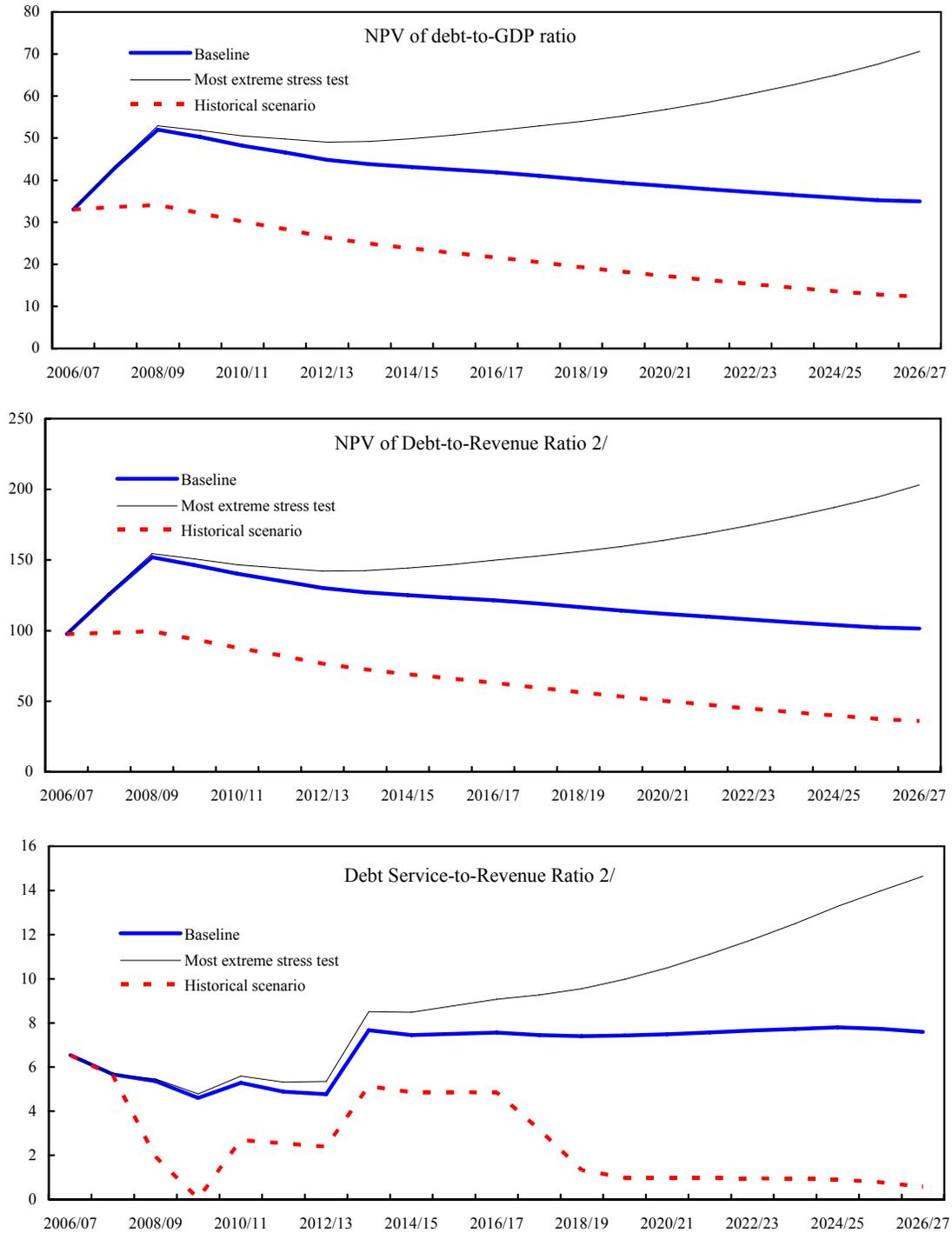
2/ Revenues are defined inclusive of grants.

Figure I.1. Tonga: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006/07-2026/27 (In percent)



Source: Staff projections and simulations.

Figure I.2.Tonga: Indicators of Public Debt
Under Alternative Scenarios, 2006/07-2026-27
(In percent)



Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2016/17.

2/ Revenue including grants.

INTERNATIONAL MONETARY FUND

TONGA

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2007 Consultation with Tonga

(In Consultation with Other Departments)

June 15, 2007

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II.	Relations with the Pacific Financial Technical Assistance Centre	3
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V.	Statistical Issues	8

ANNEX I. TONGA FUND RELATIONS
(As of March 31, 2006)

- I. **Membership Status:** Joined 9/13/85; Article VIII
- II. **General Resources Account:**
- | | SDR Million | % Quota |
|----------------------------|-------------|---------|
| Quota | 6.90 | 100.00 |
| Total holdings of currency | 5.19 | 75.20 |
| Reserve position in Fund | 1.71 | 24.81 |
- III. **SDR Department:**
- | | SDR Million | % Allocation |
|----------|-------------|--------------|
| Holdings | 0.36 | n.a. |
- IV. **Outstanding Purchases and Loans:** None.
- V. **Financial Arrangements:** None.
- VI. **Projected Obligations to Fund:** None.
- VII. **Exchange Rate Arrangement:**
- Since February 11, 1991, the value of the pa'anga is determined based on a weighted basket of currencies comprising the U.S., Australian, and New Zealand dollars, with the U.S. dollar as the intervention currency. In July 2000, the Japanese yen was added to the basket, and the monthly maximum adjustment limit was raised to 5 percent from 2 percent that had prevailed since March 1998, when the allowance for adjustment was introduced. Tonga has accepted the obligations of Article VIII, Sections 2, 3 and 4. Tonga presently imposes an exchange restriction subject to approval under Article VIII, Section 2(a). This restriction consists of the tax certification requirement imposed by the authorities on the making of payments and transfers for certain current international transactions: (i) payments for oil imports; (ii) airline ticket sales; (iii) payments for specified charges/fees/services; (iv) insurance payments; (v) lease payments; (vi) payments for medical expenses incurred by residents; (vii) transfers by nonresidents of profits and dividends abroad; (viii) external loan payments; and (xi) maintenance payments including remittances for family living expenses.
- VIII. **Last Article IV Consultation:**
- Staff discussions were held during March 15–28, 2006 and the Executive Board discussed the staff report (IMF Country Report No. 06/241) on June 2, 2006.
- IX. **Technical Assistance:**
- PFTAC has provided assistance on budgetary management; tax administration; banking legislation and supervision; and balance of payments and national accounts statistics.
- X. **Resident Representative:** None.

**ANNEX II. TONGA: RELATIONS WITH THE
PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE¹
(As of April 2007)**

Assistance to Tonga since 2002 included 31 advisory missions, mostly on tax and customs administration and banking. During 2000–06, Tonga has sent 54 officials to the Centre's regional seminars, workshops and training courses, and six attachments were organized.

Public Financial Management

Since 2003, PFTAC's missions have focused on complementing the considerable assistance provided by other TA agencies, including through the introduction of a midyear economic review and fiscal update, reconciliation of monetary and fiscal data, and changes in budget documentation. For the 2003/04 and 2004/05 budgets, assistance was provided in presenting the final aggregate budget figures on a GFSM2001 basis. In 2004, PFTAC arranged for a Tongan official to participate on a delegation of Pacific Island officials to the Australian Commonwealth Ministry of Finance. During 2005, the PFTAC PFM Advisor participated in a joint donor/government Feasibility Study related to a proposed long-term Financial and Economic Management Program (FEMP), as well as worked with the Ministry of Finance on assessing the financial implications of the proposed civil service wage increase. Since then assistance in the form of a peripatetic advisor has been provided in 2006, and again in 2007, to assist in revenue estimation work. The PFM Advisor has also been requested by the government to deliver lectures on PFM to all CEOs, in late April, 2007.

Tax Administration and Policy

A tax reform package, including a new consumption tax, was designed by PFTAC in 2002. Follow-up missions in 2003 and 2004 were designed to assist preparations for the implementation of that package. At the end of January 2005, the Minister of Finance announced a substantially altered plan to implement a consumption tax and some other changes on April 1, 2005. PFTAC was not requested to assist in its implementation. The Centre will, however, provide assistance in the redrafting of the Customs legislation. In late 2005, NZAID offered additional assistance to PFTAC to fund three short expert visits to Nuku'alofa to assist with revenue forecasting; the first of these missions took place in February 2006.

Following the restructuring of the Public Service, PFTAC carried out a mission in September 2006. The mission also coincided with the public consultation of a new income tax and Customs bills, both based on self-assessment principles. The mission's primary recommendations related to the compliance management of large taxpayers, a post

¹ The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan, Korea and New Zealand. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

implementation review of the Consumption tax, workforce management—including change management and the managing of risk in the Customs. The mission identified a number of areas where PFTAC could be of further assistance. No formal response has been received to date which PFTAC recently followed up on. In that context, account does need to be taken of the disruption in Nuku’alofa of the recent civil riots and the resulting change to the governments priorities that would have created.

Banking Sector Regulation and Supervision

An assessment to determine compliance with the Basel Core Principles for Effective Banking Supervision (BCP) was conducted in 2002. It identified some shortcomings in Tonga’s legal framework and resulted in a review of the Financial Institutions Act (FIA). The enhanced FIA was enacted in late 2004. A TA mission provided assistance with drafting regulations and guidelines, and establishing procedures for their implementation in April 2005. Further assistance in supervision was provided in late 2005 and again in February 2006, as the on-site examination process has been regularized with PFTAC assistance. Amendments to the NRBT Act, which will strengthen the central bank’s enforcement capacity, are still awaiting Parliament’s enactment. PFTAC also arranged, through funding provided in late 2005 by NZAID, for the renewal of the secondment of a central banking manager from the Reserve Bank of Fiji to serve as the Deputy Governor of the National Reserve Bank of Tonga.

Economic and Financial Statistics

In 2002, two reviews were undertaken in accordance with the GDDS and the *Data Quality Assessment Framework*; one on BOP statistics and the other on the wider statistical system. Subsequent missions in 2004 finalized GDDS metadata, provided training in BOP concepts and practices, developed a new BOP business survey, and reviewed national accounts data. In September 2005 a partial update of the 2002 statistical system review was done, focused on outputs of the Statistics Division of the Ministry of Finance. Further assistance was provided to peer review GDP and BOP estimates prior to publication. GDDS metadata was approved and published in 2006 on the Data Dissemination Bulletin Board. A TA mission in April 2007 provided further assistance with reviewing BOP statistics.

ANNEX III. TONGA: RELATIONS WITH THE WORLD BANK GROUP²
(As of April 2007)

Since becoming a World Bank Group member in 1985, Tonga has received a total of five IDA credits totaling SDR 15.2million (original amount USD equivalent of 22.8 million). Tonga is eligible for an IDA 14 allocation of SDR 4.2 million (indicative only) over FY2006–08. The IDA allocation for FY07 is SDR 2.9 million (includes front-loading from FY06) and this is on a grant-financed basis. The key components of the Bank’s current program in Tonga are:

- **Health:** The Tonga Health Sector Support Project (USD10.9 million credit approved in mid-2003) aims to support the Government in improving the performance of its health sector through appropriate health financing policy, revised health information systems, and improved management and infrastructure of the country's main hospital. With project support, the Ministry of Health has prepared two National Health Accounts; reviewed the allocation of government resources between public health, primary care, and hospital services; and developed draft policies on introducing limited user fees whilst addressing equity issues in the sector. The project has also supported revisions of health information systems and will soon finance a hospital information system for better sector management and monitoring of results. In collaboration with the Government of Japan, the project has financed the refurbishment of Tonga's principal hospital to adapt the hospital's design to the demands of non-communicable diseases, which are now the health priority in Tonga.
- **Natural Hazard Management:** The Cyclone Emergency Recovery and Management Project, with an IDA credit of US\$5.9 million approved in 2002, is assisting Tonga in replacing and strengthening the resilience of social infrastructure and helping upgrade Tonga’s emergency and risk management capacity to ensure it can cope better with future disasters and the risk posed by climate change.
- **Education System:** The Tongan Education Support Project with an IDA credit of US\$1.0 million and an NZAID trust fund of US\$4.1 million (managed by the Bank) was approved in June 2005. Together with NZAID, the Bank is helping to structure a sector-wide approach that pools donor and Government funding to comprehensively target education priorities, particularly: school curriculum development and associated learning materials development, non-salary resource allocations through school grants, student assessment, and the supply and quality of teachers.
- **Financial Management and Procurement:** An IDF grant of US\$200,000 was approved in December 2003 to support public procurement reforms and procurement capacity building through the provision of technical assistance. The draft Procurement Law, prepared by the government-appointed consultant and based on the UNCITRAL Model Law, has been reviewed by the Bank and comments were provided to the Government. The Government’s Crown Law has drafted the Public Procurement Act 2007, which is expected to be enacted by the Legislative Assembly of Tonga in FY2007. The draft Procurement Act, which has been shared with the Bank, deviates from the draft Procurement Law on which the Bank provided comments as it only provides for the creation of a Government Tenders Board, specifying membership, powers and functions.

² Prepared by World Bank staff.

- **Transport Sector Reform:** The Bank has completed a Transport Sector Review Study that provides analytical assistance to support the Government's commitment to improve the structure and efficiency of the sector, including assessing options for sustainable financing. A study of opportunities for public-private partnership in the airport sector was completed in April 2006, leading to the corporatization of the airport on a business basis (ongoing). The Bank is preparing a lending program to help the Ministry of Transport to consolidate its recent laws and realign its functions, as well as to improve inter-island ferry services. The Bank prepared the Pacific Infrastructure Report (PIR), which among other things, reviews and compares access to infrastructure services among the Pacific Island countries and other small island states. There is a follow up ADB RETA study with a steering committee from ADB, AusAid, and NZAid to build upon PIR findings and preparation of individual country investment programs.
- **Private Sector Development/Business Recovery:** The Bank is providing analytical and technical assistance in cooperation with FIAS and PEP Pacific to support the Government's initiative to create a joint public-private task force as an effort to tackle regulatory impediments to private sector development. In collaboration with the Pacific Enterprise Development Facility (PEDF), the IFC has supported 18 projects in Tonga, 13 of them raising finance locally to start or expand local businesses in fisheries, agriculture, insurance, professional services, laboratory, manufacturing and port services. In 2004, IFC completed a piece of advisory work for the Government on Royal Tongan Airlines.

In December 2006, IFC led a multi-agency mission to Tonga which aimed to analyze and report on the overall impacts of the recent civil unrest on Tongan business, and recommend options to the Government and its donor partners on how to address constraints upon private sector recovery. With some caveats, the Government accepted the overwhelming majority of the mission's recommendations. Discussions are continuing between the IFC, the Government of Tonga, and various private sector organizations with regard to addressing liquidity constraints in the banking sector, providing support for a revitalized program of asset sales and privatization. An extraordinary meeting of the World Bank Group supported regulatory reform taskforce in January 2007 has approved an accelerated program of regulatory reform with the aim of both reducing the immediate burden upon business, and to begin clawing back business confidence.

Recent Reports/Policy Notes:

- East Asia and Pacific Update: Managing through a Global Downturn, November 2006
- At Home and Away—Expanding Job Opportunities for Pacific Islanders through Labor Mobility, August 2006
- Opportunities to Improve Social Services: Human Development in the Pacific Islands, 2006
- The Pacific Infrastructure Challenge, 2006
- Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region, 2006
- Pacific Regional Strategy FY2006-2009, May 2005

World Bank Group Credits (in millions of USD equivalent, as of 16 March 2007)

Total disbursed	16.20
Undisbursed	8.05
IFC investments	none

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK³
(As of April 2007)

The Asian Development Bank (ADB) strategy for Tonga supports the Government's development goals aimed at improving the quality and standard of living for all Tongans. The Government's strategic objectives emphasize the need to achieve a steady average GDP growth of around 2.5% in real terms through a dynamic and highly competitive economy driven mainly by the private sector and an efficient public sector. Achieving this target has now become difficult in light of the political situation, particularly the riot that destroyed the business district of Nuku'alofa in November 2006.

A Country Partnership Strategy (CPS) for Tonga is currently under preparation, with its approval tentatively scheduled in July 2007. The strategy of the ADB in Tonga for 2007–2009 is to support the implementation of Strategic Development Plan (SDP)-8, with a particular emphasis on the achievement of three SDP-8 goals. ADB's lending program under the CPS will focus on the delivery of basic social services and urban reconstruction under an Integrated Urban Development Project to be approved in 2007. The recently approved TA 4865-TON is providing support for SDP-8 implementation, including its midterm review, and will be complemented by new technical assistance during the period 2007–2009, addressing: (i) improved fiscal governance, (ii) private sector development, and (iii) further support for the process of rationalization of public enterprises. ADB will also (iv) provide a TA for preparing the Urban Planning and Management System to complement the PPTA currently ongoing.

ADB has approved fifteen loans totaling \$57.8 million from the Asian Development Fund (ADF) to Tonga since it joined ADB in 1972. Fifty-four technical assistance projects with a value of \$20.1 million were also provided to improve capacity and strengthen institutional development in various sectors. Past ADB investments have focused on finance development and infrastructure development in transport, power, agriculture and fisheries.

Active projects include five TAs in the country portfolio. The latest loan on Economic and Public Sector Reform was completed successfully in 2004. The five ongoing TAs focus on public enterprise reforms, youth micro-enterprise development, preparing the integrated urban development projects, support for the implementation of the Strategic Development Plan 2006/2007—2008/2009, and Rationalization of Public Enterprises, Phase III. Another TA on strengthening pro-poor policy in the Pacific for Tonga for \$0.2m has been implemented on a regional basis to support economic sector work and some work is being prepared to complete that work. It is counted as country TA.

I. TONGA: LOAN AND TECHNICAL ASSISTANCE APPROVALS, 2002–06

	2002	2003	2004	2005	2006
Loan approvals					
Number	1	0	0	0	0
Amount (in millions of U.S. dollars)	10	0	0	0	0
Technical assistance approvals					
Number	1	3	3	1	2
Amount (in millions of U.S. dollars)	0.7	0.9	0.7	0.7	0.9

³ Prepared by Asian Development Bank staff.

ANNEX V. TONGA: STATISTICAL ISSUES

While economic statistics are broadly adequate for surveillance, data deficiencies continue to complicate the monitoring of economic conditions and policy formulation. The Statistics Department (SD) and the Ministry of Finance (MOF) have received, on a regular basis, technical assistance in national accounts, government finance, and balance of payments (BOP) statistics from STA as well as the Pacific Financial Technical Assistance Centre (PFTAC); nevertheless, data provision to the Fund continues with long delays.

The two main sources of statistical information are the Quarterly Bulletin of the National Reserve Bank of Tonga (NRBT), and the annual and semi-annual budget reports from the MOF. Since May 30, 2006, Tonga has been participating in the General Data Dissemination System (GDDS). The metadata is posted on the Fund's Dissemination Standards Bulletin Board and was certified in May 2006 (<http://dsbb.imf.org/Applications/web/gdds/gddscountrycategorylist/?strcode=TON>).

Real Sector Statistics

The national account estimates are based primarily on the production approach; only rough estimates of expenditure components are available. The SD has completed the revision of the national accounts (base period 2000/01), based on the results of a new business establishment survey, and with technical assistance from the Secretariat for the Pacific Community. Significant inconsistencies remain in agricultural, fishing and forestry data. There are insufficient source data and indicators to derive value added for commerce, hotel and restaurant sectors. In August 2004, a PFTAC mission proposed improvements to source data and methodologies and suggested revisions of recent year GDP estimates.

The Consumer Price Index is based on a basket of goods and services from the 2000/01 Household Income and Expenditure Survey.

Labor market statistics are weak: employment statistics have not been compiled since 2003; and average earnings statistics are not available.

Government Finance Statistics

The FY 2002/03 Budget Statement introduced a presentation of fiscal data compiled according to the methodology of the 2001 Government Finance Statistics Manual (GFSM 2001). However, improvements are still needed to ensure accurate and reliable fiscal data. Proper classification of transactions is needed to permit reconciliation with monetary financing data. Lags in updating the accounting system should be shortened. Published data are often subject to significant revisions.

External Sector Statistics

Official BOP figures are compiled annually by the SD with long lags. Monthly trade figures, derived from customs data, are available with a three-month lag. Unofficially, the NRBT compiles monthly balance of payments statistics based on the Overseas Exchange Transactions records of the banking system with a six-week lag. There are significant differences between the BOP estimates compiled by the two agencies. Moreover, large errors and omissions point to possible under recording of imports. Work is needed to reconcile the data on stocks of reserve assets that are available from various data sources. The MOF has put in place a system that provides detailed information on official sector external disbursements and debt service.

Monetary and Financial Statistics

The reporting of monetary and financial statistics to the Fund for publication in *International Financial Statistics* has recently become irregular and less timely. This is particularly worrisome since these data are shared with APD through an integrated monetary database. Responding to an STA's request, the authorities have submitted test monetary data using the standardized report forms (SRFs). These data have yet to be published in the *IFS Supplement on Monetary and Financial Statistics* because data for other depository corporations exhibit significant discrepancies and no current data for the reserve bank have been reported beyond August 2006. Due to resource constraints, the NRBT has not been able to devote sufficient resources to finish this project.

Tonga: Table of Common Indicators Required for Surveillance
(As of June 12, 2007)

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶
Exchange Rates	4/2007	6/2007	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	3/2007	5/2007	M	M	M
Reserve/Base Money	3/2007	5/2007	M	M	M
Broad Money	3/2007	5/2007	M	M	M
Central Bank Balance Sheet	3/2007	5/2007	M	M	M
Consolidated Balance Sheet of the Banking System	3/2007	5/2007	M	M	M
Interest Rates ²	12/2006	2/2007	M	M	M
Consumer Price Index	9/2006	11/2006	M	M	M
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	3/2007	4/2007	M	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	6/2006	3/2007	A	A	A
External Current Account Balance	Q3/2006	3/2007	Q	Q	Q
Exports and Imports of Goods and Services	Q3/2006	3/2007	Q	Q	Q
GDP/GNP	2006	4/2007	A	A	A
Gross External Debt	6/2006	3/2007	A	A	A

¹ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

⁶ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/102
FOR IMMEDIATE RELEASE
August 13, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Tonga

On July 11, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.¹

Background

Economic activity was disrupted by the November 2006 unrest, albeit temporally, following the civil service wage settlement and the voluntary redundancy program in FY05/06 (fiscal year July-June). Real GDP growth, having slowed in FY05/06, is now estimated to turn negative in FY06/07, declining by 3½ percent. The external current account deficit is also estimated to widen to 10½ percent of GDP in FY06/07 from 8¼ percent of GDP in FY05/06, as imports remain steady despite the drop in output, and transfers reportedly declined. Meanwhile, consumer price inflation slowed to about 5 percent by early 2007, from about 10 percent in FY04/05, as the public sector wage increase does not appear to have put upward pressure on private sector wages so far.

The conduct of fiscal policy after the wage settlement contributed to mitigate its negative impact. In FY05/06, the fiscal balance swung into a deficit of 3⅓ percent of GDP from a 2½ percent surplus the year before. The wage bill rose to 20 percent of GDP from 12 percent of GDP in FY04/05, reflecting payment of the first installment of the wage settlement and the voluntary redundancy program. Nonetheless, non-wage spending was kept under tight control, and revenues increased sharply, much of the gains reflecting an improvement in collection efficiency brought about by the consumption tax introduced in 2005 and higher customs revenues.

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. 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.

Despite revenue losses stemming from the November unrest, for FY06/07, the government has maintained its deficit target in the Budget of a deficit of 2 $\frac{1}{3}$ percent of GDP, with buoyant revenue collection and a decline in the wage bill ratio to GDP.

The National Reserve Bank of Tonga (NRBT) took steps during 2006 to limit private credit growth and cope with the liquidity implications of the large severance payments. Credit ceilings, introduced in January 2006, were reset in July 2006 for the 6-month period to December to counter rapid credit growth reflecting strong demand for housing loans and ample bank liquidity. In addition, to contain the expected liquidity effects of the government's redundancy payments, the NRBT also stepped up its issuance of central bank notes. In the event, growth in private sector credit decelerated sharply to an annual rate of 10 $\frac{1}{2}$ percent by end-December 2006. In early 2007, however, the NRBT eased liquidity in response to the riots, lowering reserve requirements and reducing the outstanding stock of notes, to support private credit for reconstruction and business restocking. Nonetheless, the public sector is also expected to play a large role in reconstruction, and the government is seeking a possible large external loan to finance those projects.

However, the economy will continue to be subject to uncertainty and shocks. While economic growth should return to positive, albeit low, levels in the medium term, there are lingering risks on the policy front that could derail efforts to restore stability, in particular those that might arise from pressures to increase public sector hiring. The government's borrowing plan currently being considered also raises serious concerns for debt sustainability, as debt service requirements would place serious strain on the medium-term fiscal and external positions, placing Tonga at a high risk of debt distress. Moreover, a further drop in remittances and terms of trade shocks could present significant pressures on official reserves.

Executive Board Assessment

Executive Directors welcomed the resilience of Tonga's economy in the face of recent large shocks, with inflation declining, continued financial stability, and a contained international reserve position. These achievements reflect the authorities' cautious economic policies, including a tight credit policy and the maintenance of a basket exchange rate peg. Looking forward, Directors stressed that impediments to private sector activity will need to be eliminated in order to improve medium-term growth prospects. A constructive political transition will help to limit economic vulnerabilities on both the domestic and external fronts.

Directors commended the authorities for pursuing prudent fiscal policies in a difficult environment, and looked forward to continued efforts to set fiscal policy on a sustainable track. While the persistent fiscal strains arising from the 2005 wage settlement have been partly contained through expenditure restraint and revenue gains, further fiscal consolidation through the prioritization of nonwage spending and the rationalization of public sector wage setting practices will be needed over the medium term. Directors also noted the importance of resisting pressure for new hires in the short term, and stepping up efforts to build public support for a continued reduction in civil service staffing over the medium term. They welcomed recent gains in revenue collection efficiency, and agreed that continued improvements in revenue

administration and compliance will be critical, especially in light of the planned cuts in import duties and income tax reforms.

Directors stressed that a cautious public borrowing policy is essential to ensuring sustainable public and external debt dynamics. Noting the increased risks to external debt sustainability associated with the proposed reconstruction loan, several Directors encouraged the authorities to consider scaling back their borrowing plans or to attempt to improve the concessionality of the loan. Other Directors, however, pointed out the urgent need and positive growth effects of the planned reconstruction projects. Some Directors encouraged the authorities to maximize the role of the private sector in the reconstruction efforts. Directors also noted the financial risks stemming from a possible state acquisition of the power company.

Directors observed that, while monetary easing in the aftermath of civil disturbances had been justifiable in the short term, credit policy may need to be tightened if fiscal pressures re-emerge. In this light, they welcomed the NRBT's commitment to monitor monetary and credit developments closely. Directors looked forward to the reform of the legal framework supporting the use of indirect monetary instruments and enhancing the independence of monetary policy. They supported recent initiatives to improve financial sector supervision, while calling for continued vigilance in the face of rapid growth in credit to the household sector.

Directors agreed that Tonga's basket peg exchange rate regime has provided a credible nominal anchor and contributed to low inflation. They recommended that the authorities make greater use of the flexibility of their exchange rate regime, as needed, to counter real exchange rate appreciation, and welcomed the authorities' assurance that they will monitor developments affecting Tonga's external balance closely. Directors, however, also pointed to the role of structural reforms in preserving external competitiveness.

Directors underscored the importance of sustaining reform momentum in order to achieve faster growth through an enhanced business and investment environment and strengthened public enterprise performance. To this end, they encouraged the authorities to step up the pace of implementation of their public sector reform program and the recommendations of the public-private task force on the business climate. Directors welcomed Tonga's accession to the World Trade Organization.

Directors encouraged the authorities to strengthen statistical capacity further, and supported continued assistance from the Fund to help improve the reliability, coverage, and timeliness of statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Tonga: Selected Economic Indicators, 2002/03–2007/08 ^{1/}

	2002/03	2003/04	Prel. 2004/05	Prel. 2005/06	Proj. 2006/07	Proj. 2007/08
Output and prices (in percent change)						
Real GDP	3.2	1.4	2.3	1.3	-3.5	0.8
Consumer prices (period average)	11.1	11.7	9.7	7.0	5.9	5.3
Central government finance (in percent of GDP)						
Total revenue and grants	28.4	29.9	29.3	34.1	33.8	34.2
Total expenditure and net lending	31.4	29.0	26.7	37.4	36.1	45.4
Overall balance (incl. reconstruction loan)	-3.0	0.9	2.5	-3.3	-2.3	-11.2
Overall balance (excl. reconstruction loan)	-3.0	0.9	2.5	-3.3	-2.3	-1.0
External financing (net)	1.4	2.9	0.3	0.2	1.4	11.1
Domestic financing (net)	1.6	-3.8	-2.8	3.1	0.9	0.1
Money and credit (in percent change)						
Total liquidity ^{2/}	18.2	16.7	13.3	13.3	6.8	...
<i>Of which:</i> Broad money (M2)	13.6	18.9	12.8	16.6	7.3	...
Domestic credit	18.8	-10.9	20.9	25.8	11.9	...
Private sector credit	12.7	-4.3	29.4	22.6	11.9	...
Balance of payments (in millions of U.S. dollars)						
Exports, f.o.b.	17.6	13.8	16.0	15.1	15.6	15.9
Imports, f.o.b.	-74.2	-82.6	-105.4	-117.7	-118.9	-132.5
Services (net)	-5.4	-2.9	-9.9	-7.8	-10.1	-22.9
Income (net)	-1.5	-0.3	1.6	2.8	2.1	2.3
Services and income (net)	-6.9	-3.2	-8.3	-4.9	-8.0	-20.6
Transfers (net)	58.7	79.7	91.9	89.0	87.6	91.4
Current account balance (excl. reconstruction loan)	-4.9	7.7	-5.7	-18.5	-23.7	-45.8
Current account balance (incl. reconstruction loan)	-4.9	7.7	-5.7	-18.5	-23.7	-20.8
(In percent of GDP)	-3.1	4.2	-2.6	-8.2	-10.5	-19.0
Gross international reserves						
In millions of US dollars	17.2	44.8	42.5	40.4	37.1	33.5
In months of total imports	2.0	4.8	3.7	3.2	2.9	2.2
External debt (in percent)						
External debt (in percent of GDP)	42.9	41.1	35.4	36.7	36.9	45.7
Debt service ratio ^{3/}	6.3	8.7	8.3	9.3	10.5	9.8
Exchange rate (period average)						
Pa'anga per U.S. dollar	1.9	3.9	1.7	1.4	2.0	...
Real effective exchange rate (1990=100) ^{4/}	89.9	93.7	100.2	103.5	105.0	...
Nominal effective exchange rate (1990=100) ^{4/}	75.2	71.4	71.1	70.5	69.5	...

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

1/ Fiscal year beginning July.

2/ From the Banking Survey, which includes the Tonga Development Bank.

3/ In percent of exports of goods and services.

4/ Through end-December 2006.