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Statement by the Hon. **SIOSIUA T.T. 'UTOIKAMANU**,
Governor of the Bank for **TONGA**,
at the Joint Annual Discussion

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It is an honor for me to address the Board of Governors of the International Monetary Fund and the World Bank Group on behalf of the Government of the Kingdom of Tonga at the 2007 Annual meetings.

I would like to congratulate and welcome Mr. Robert B. Zoellick on his appointment as President of the World Bank Group. I also take this opportunity to thank his predecessor Mr Paul Wolfowitz for guiding the World Bank Group during his tenure in office.

Since the Singapore Annual Meetings, the global economy continues to show strong growth, projected at 5.2 percent in 2007 and 4.8 percent in 2008. Despite this, the recent financial market turbulence has heightened global uncertainty about future economic outlook. The role of the Fund in safeguarding global stability and growth is even more critical.

Amidst an uncertain global economy, rapid globalization has heightened economic interdependence. This has subsequently escalated the level of concern over a list of global challenges, which can no longer be treated separately from national development efforts. Amongst the most pronounced concern is climate change.

There is overwhelming evidence of the speed of climate change, the source of the problem and its consequences for developing countries and in particular Small Island Developing States (SIDS). Tonga joins other members in echoing its concern over the impact of climate change and calls for more committed and concerted effort to establish collective actions to combat the impact of climate change.

Tonga's national sustainable development strategies aligns with the Bank's work in global public goods, and in particular the five priorities which the Bank will continue to maintain, with climate change as the biggest challenge. Recognizing this, Tonga has made progress in translating its commitment to addressing the impact of climate change, by enhance its policy focus on energy efficiency, as it remains the most effect way to reduce green house gas emissions.

Aid effectiveness

Against a backdrop of increasingly complex aid architecture which has manifested in a multitude of aid channels, fragmentation of aid flows, and aid earmarking, it is undeniably clear that if aid is to be effective and has impact, it can no longer be business as usual when it comes to aid management. Tonga is pleased to see that the Bank has renewed its commitment to country-based development model, which focuses on country led development strategies. This approach is critical in any international effort to align multiple sources of financing with national priorities and systems.

The recent ratification of the Paris Declaration on Aid Effectiveness by Tonga, followed by the signing of the Joint Declaration on Aid Effectiveness between Tonga and its development partners is a milestone in the country's effort to ensure that aid coherence is aligned to development results. Notwithstanding this optimism, how effectively aid is aligned and integrated within Tonga's country programme will require further consultation and engagement at the local level. Furthermore, Tonga urges the international community to accord more attention to transparency in aid allocation, and clearer and simpler rules for disbursements linked to performance.

Domestic Economic Developments

Turning to the domestic front, at the last Annual Meetings, an assessment of the economic condition and the economic challenges Tonga faced at the time suggested increasing economic stability. Since then, Tonga has experienced severe shocks caused by civil unrest in November 2006, resulted in the destruction of 80 percent of the central business district of the capital, Nuku'alofa, or the equivalent of 20% of GDP, which has once again put severe pressure on government's fiscal situation.

However, Tonga's economy has demonstrated considerable resilience in the face of severe shocks. The government's recovery and reconstruction initiatives in late 2006 and early 2007 have helped to offset some of the damage caused by the social unrest. Macroeconomic stability remains the cornerstone of government's economic and fiscal policies, together with restoring social stability.

By far the biggest challenge for Tonga is to unite in building a more dynamic domestic economy led by an internationally competitive private sector offering employment opportunities. After bouncing back from earlier fiscal crises, oil shocks, cyclones and so forth, the Tongan economy has recently had to recover

from two domestic shocks comprising a large public sector pay settlement and the civil disorder.

Once again, the economy's foundations of macroeconomic stability and local and international confidence are being restored, but the far bigger challenge is ahead of us: to unite in building a more dynamic domestic economy led by an internationally competitive private sector offering growing employment and incomes.

Tonga's domestic economy has achieved only moderate growth in production as measured by real GDP growth. However, Tonga has enjoyed increasing real domestic living standards largely due to a combination of:

- high levels of formal qualifications within a system of universal education;
- high migration of skilled workers to higher-income countries; and
- high remittances from those skilled workers back to Tonga;

Tourism is one of the few sectors that offer a realistic prospect of sustainable growth in incomes and employment, especially for younger people.

The external sectors' performance is summed up in structure of the balance of payments, which clearly shows Tonga's trade imbalance and the importance of private transfers in funding this appetite for imports. This structure also underscores that despite the serious implications of the standard benchmark estimates of debt sustainability, there needs to be more work on the long term implications of the importance of remittances and its impact on policy prescriptions.

Remittances

Remittances are the main source of maintaining the standard of living as they constitute an important source of income for the household. The World Bank Study on labour mobility in the Pacific in 2006 concluded recipient household migration and remittances have positive impact on poverty alleviation; induces higher savings and stimulates business activities and results also in larger investments in education. Strong and stable remittance growth has strengthened liquidity with the level of gross official external reserves exceeding 5 months of import cover.

In terms of inflation, the annual inflation rate has been falling since December 2005 and dropped to 3.9 % at the end of March 2007. This decrease in the rate of inflation has largely been due to falling domestic prices. In the year to March 2007, the domestic rate of inflation was close to the rate of inflation for imported goods, whereas previously domestic inflation had been higher than imported inflation. Monetary policy plus reduced reliance on taxes on imports have both helped in restraining domestic inflation. This has contributed to higher real living standards.

The emphasis on macroeconomic stability has been maintained as the driver for prudent monetary and fiscal policies.

The Government has managed to ensure that there is sufficient credit to enable the private sector to borrow and expand without threat to the economy from the private sector having to compete against government domestic borrowing. Legislation has been passed this year to strengthen the inflation-fighting capability and focus of the central bank.

Fiscal controls have protected core services for the public, and a successful programme of revenue reforms is now nearing completion. An excessive reliance on taxes on imports is being overcome.

While in 2003/04 taxes on international trade provided 53 percent of government revenue leaving only 47 percent to be raised from domestic sources, the government's revenue reform effort aims to move away from trade taxes to domestic taxes on incomes, general goods and services (consumption tax), and excise goods (alcohol and tobacco). By 2006/07, with the passage of revenue related legislation, it is expected that domestic taxes will account for almost 90 percent of government revenues, with only around 10 percent being raised from border taxes.

This modernising of the tax system prepares the way for domestic-based businesses to compete on an equal footing with foreign-based businesses without the artificial disincentives and commercial distortions arising from over-reliance on trade taxes. These microeconomic impacts are being supplemented by reducing regulatory costs and barriers to the private sector.

The new tax system is compatible with the Kingdom's international obligations to members of the global trading community on a multilateral and bilateral basis. This represents progress towards preparing the Kingdom's economy for trade liberalization, especially as we have become the most recent member of the WTO.

Conclusion

In summary, the development challenges for Tonga and other small island states are numerous and varied.

Tonga's domestic economy is expected to return to a positive growth in 2007/08 following a softening of economic activities in 2006/07 as a result of the wage settlement and the social disorder in November 2006.

The recovery after the shock of 16 November 2006 testifies to the buoyancy of government's fiscal management situation. With prudent fiscal management policies in place, Tonga has managed to maintain economic stability.

The experience of Tonga demonstrates the important nexus between international migration and development. The established relationship between migration and its contribution to poverty alleviation and economic development, and the significant contribution of remittances to development is clear. As the World Bank Study illustrated, labour mobility is a potential vehicle for achieving our commitments to pro-poor strategies such as the MDG and other global commitments to achieving national sustainable development strategies.

The development constraints faced by the Pacific Small Island States, such as Tonga, can be significant, and are exacerbated by the region's fragility and high vulnerability to natural disasters and external shocks. Apart from challenges relating to macroeconomic management, social development concerns and pressures for political reform, there are also the pronounced threats relating to energy security and climate change. Recognising these global concerns, Tonga has made positive steps to integrate these issues into a pragmatic country led programme.

The strategic directions of the Fund and the Bank can make a difference to Tonga and other small island countries. To promote an outward looking economy, we must collectively adopt a shared vision for regional integration and cooperation. Our efforts to expand outwards can be more effectively and successfully accomplished through regional integration and cooperation.

Finally, we would like to acknowledge with appreciation the technical and financial assistance that both institutions have provided to the government and people of Tonga. The assistance contributes to improving the standard of living of the Tongan people and we look forward to a continued close working relationship with the Fund and the Bank in the future.

May I conclude by wishing the Bank and the Fund continued success in resolving the difficult challenges that lie ahead.

Thank you.