

**FOR
AGENDA**

SM/08/174

June 18, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Tonga—Staff Report for the 2008 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2008 Article IV consultation with Tonga, which is tentatively scheduled for discussion on **Wednesday, July 2, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Tonga indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Ms. Liu (ext. 36134) and Ms. Fujita (ext. 37368) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, June 26, 2008; and to the Asian Development Bank and the European Commission, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

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TONGA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Article IV Consultation with Tonga

Approved by Jeremy V. Carter and Anthony Boote

June 17, 2008

- **Discussions:** Nuku'alofa, April 9–18, 2008. The team met with Prime Minister Sevele, Minister of Finance Matoto, National Reserve Bank of Tonga Governor Mafi, and other senior government officials, as well as private sector representatives.
- **Team:** Ms. Liu (Head), Fujita, and Mr. Vitek (all APD). Ms. Cocker (OED) joined the discussions.
- **Past surveillance:** The 2007 Article IV Consultation was completed on July 11, 2007. Executive Directors' views and comments can be found at <http://www.imf.org/external/country/TON/index.htm>.
- **Focus of discussions:** Near-term macroeconomic policies should be geared toward reviving growth while containing inflation and vulnerability. Over the medium term, policies will need to aim at putting the budget on a sound footing, improving debt dynamics, and promoting investment and structural reform to boost private sector-driven growth.
- **Outreach:** The mission held a press conference on April 18, and also met with business, donor, and diplomatic representatives.
- **Exchange rate:** Basket peg with monthly adjustment band of ± 5 percent. The weights for the currencies in the basket are U.S. dollar, 52 percent; New Zealand dollar, 23 percent; Australian dollar, 19 percent; and Japanese yen, 6 percent.
- **Exchange system:** Accepted the obligations of Article VIII, Sections 2, 3, and 4. The authorities plan to retain the exchange restriction in the form of a tax certification requirement applied to various current international transactions, and agreed to review this requirement in the context of the 2009 Article IV consultation discussions. The Board approved this restriction until July 9, 2008 or the 2008 Article IV consultation, whichever is earlier. At this point, staff does not propose an approval of this restriction.
- **Statistics:** Data quality, coverage, and timeliness have been hampered by several deficiencies, including capacity constraints, which have complicated effective surveillance.

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EXECUTIVE SUMMARY

Background: Tonga's economy has shown resilience in the aftermath of the November 2006 riots, with policies and strong remittances underpinning the recent recovery. Government reconstruction loans and the King's coronation in August 2008 may provide additional growth stimulus. However, the global upswings in fuel and food prices have intensified pressures on inflation and external reserves. Outward migration has been substantial, and strong remittances have become the key mitigating factor to external shocks. Near-term growth prospects are favorable, but risks remain, particularly from further hikes in world food and fuel prices.

Main Issues: Adverse terms-of-trade shocks have complicated economic management in delivering low inflation and stable growth, while safeguarding external stability. As recognized by the authorities, it is important to improve Tonga's resilience to external shocks through rebalancing the policy mix toward a tighter monetary stance, supported by fiscal prudence and increased exchange rate flexibility.

Staff's Views: Rebalancing the policy mix would improve the macroeconomic framework to address concerns of rising inflation and external vulnerability.

- On the fiscal front, a balanced budget in FY07/08 is likely to be achieved, and maintaining this stance in FY08/09 is crucial to sharing the burden of macroeconomic management while generating fiscal savings to buffer increases in debt service over the medium term. Achieving this objective will require sustainable fiscal measures to further improve tax administration and rationalize capital spending in line with donor financing and Tonga's implementation capacity. Moving toward a more orderly public wage policy is also critical to reduce fiscal vulnerability arising from ad hoc and large wage adjustments experienced in the past.
- The joint WB/IMF Debt Sustainability Analysis suggests that with the proposed reconstruction loan, Tonga remains at a high risk of debt distress, mitigated by large remittance inflows. Debt sustainability hinges on a phased utilization of the loan in line with the medium-term fiscal framework to support capital projects that will generate growth and employment opportunities. Tonga should rely as much as possible on donor grants to finance future development.
- Early actions to tighten monetary policy are warranted to anchor inflation expectations in advance of the finalization of the FY08/09 budget. Monetary tightening should be achieved through the use of effective, market-based instruments, including the issuance of central bank notes.
- Rebalancing the policy mix would support increased exchange rate flexibility to safeguard reserves while keeping inflation under control, as well as help correct a likely modest overvaluation of the pa'anga to ensure external stability over the medium term.

Authorities' Views: There was broad agreement on issues and policy requirements. The authorities are aiming at a balanced budget and will take additional measures if needed to ensure the target is met. On the monetary front, the authorities acknowledged that inflation has already exceeded their comfort zone of single digit levels. They are committed to tightening monetary policy, if necessary, to safeguard reserves and contain inflation. They noted that the magnitude of exchange rate depreciation will be carefully considered given its inflationary impact.

I. INTRODUCTION

1. **Tonga's economy has shown resilience in the aftermath of the November 2006 riots and is now on a path to recovery.**¹ The key factor underpinning resilience has been private investment. Donor supported government reconstruction loans are expected to add further momentum to the recovery. The King's coronation in August 2008 may also provide additional growth stimulus. Political stability seems to have been restored, and the parliamentary election in late April 2008 did not generate any marked discontent.

2. **The global upswings in fuel and food prices, however, have intensified pressures on inflation and external reserves, the latter mitigated to a large extent by strong inflows of remittances.** Tonga continues to rely heavily on imports, mostly of food and fuel, while its export base remains narrow, making the trade balance highly vulnerable to major external price shocks. With limited employment opportunities, outward migration has been substantial, and remittances from abroad have risen steadily. Remittances are now the key mitigating factor to external shocks.

3. **The economy continues to face structural and policy impediments that undermine growth.** Over the past decade, real GDP growth averaged 1.9 percent, underperforming most other Pacific Island countries (PICs). High costs of labor and energy, limited export diversification, and the lack of long-term investment to improve productivity and efficiency are among the main factors that continue to impede high sustainable growth.

4. **Against this background, discussions centered on the appropriate policy mix to improve the economy's resilience to external shocks, supported by medium-term structural reforms to improve growth potential.** Staff recommendations would facilitate progress toward achieving the authorities' objectives of lowering inflation and maintaining external stability, while supporting economic recovery under a less favorable global environment.

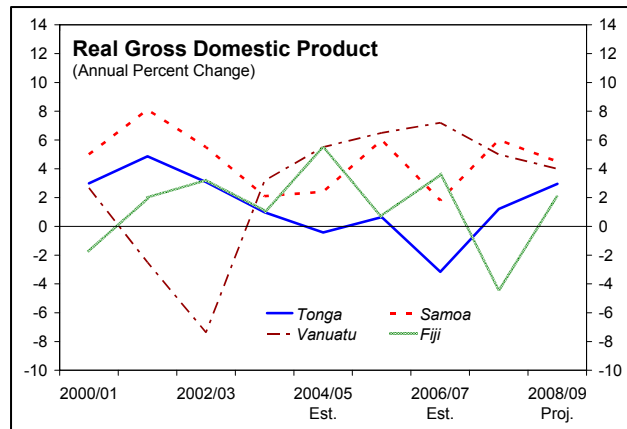
II. ECONOMIC AND POLICY DEVELOPMENTS

Background

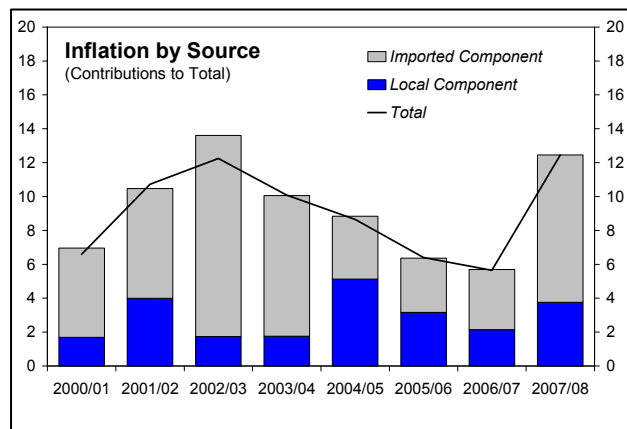
5. **Tonga's output growth was severely disrupted in FY06/07 (ending June), following the November 2006 riots.** Policies and strong remittances have underpinned the recent recovery (Table 1).

¹ Tonga's constitutional monarchy was challenged by a vocal force calling for a move toward more democracy following the death of the previous King Topou IV in September 2006. In November 2006, the government's rejection of a proposal to increase popular representation in parliament sparked riots in the capital city, Nuku'alofa, with estimates of losses in infrastructure and inventories exceeding 10 percent of GDP.

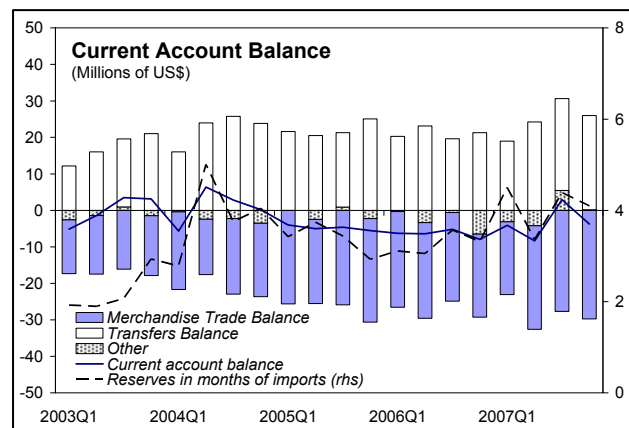
- *Real GDP contracted by about 3¼ percent in FY06/07 (following ¾ percent growth a year earlier), but the private sector quickly relocated their businesses and replenished their lost inventories. Preliminary indicators for the first half of FY07/08 suggest that the economy is on a path to recovery led by the services sector. Nevertheless, the agricultural sector continues to contract, with its dominant export crop, squash, continuing to suffer from sub-optimal quarantine standards, financing difficulties, and sluggish demand in the niche market overseas.*



- *Adverse terms-of-trade shocks contributed to inflation pressures. Major increases in external food and fuel prices, combined with a nominal depreciation of the pa'anga against the currencies of major trading partners, have led to a marked increase in CPI inflation, which reached 12½ percent at end-March 2008 (from 6¾ percent at end-December 2007). Domestic CPI inflation appears to be on a rising trend as well, albeit modest, suggesting a recovery in domestic demand, while monetary easing in early 2007 may have also played a role. The impact of the public wage settlement on inflation was somewhat offset by retrenchment of about 20 percent of total civil service workers (Tables 2 and 3).*



- *Tonga's external position weakened in the last few years, reflecting mainly the impact of rising fuel prices (Table 4). The current account deficit in FY07/08 is projected to remain at about 10 percent of GDP, as further increases in food and fuel prices are expected to be largely offset by increases in remittances. External reserves have declined somewhat since last June to around 3-month of imports, and are*



likely to continue this downward trend towards end-FY07/08 reflecting the recent fuel price hikes.

Outlook and Risks

6. **Prospects for economic recovery are favorable, but with downside risks, particularly from further hikes in world fuel and food prices in the near term** (Table 5).

- *Near term:* Real GDP is projected to expand by 1¼ percent in FY07/08, underpinned by a recovery in private domestic demand, while the contribution of external demand to growth remains negative. Inflation is expected to remain high at above 10 percent over the next few months, reflecting the combined effect of the pass-through of higher fuel and food prices and a further modest depreciation of the pa'anga against the currencies of Tonga's major trading partners.
- *Medium term:* Real GDP growth is expected to reach 2¾ percent in FY08/09 as reconstruction activity gains momentum, and to return to its long-run average of 1¾ percent over the medium term. Inflation is expected to trend downward as world prices of fuel and food are projected to stabilize over the medium term (based on the WEO assumptions).
- *Near-term risks:* On the upside, the King's coronation in August 2008 is likely to stimulate growth through rising remittances, hotel occupancy, and consumption spending in the run-up to the event. On the downside, high fuel and food prices could entrench high inflation and intensify external vulnerability, weakening domestic confidence and real economic activity. The King's coronation could also possibly lead to spending overrun in the budget.
- *Medium-term risks:* Tonga has untapped growth potential, especially in tourism, and a strong base to support remittances, which could be channeled to productive investment, including for export diversification. However, competition in tourism could be stiff, especially from Fiji where tourism infrastructure and services are significantly more developed. Continued adverse terms-of-trade shocks and the reemergence of wage pressures are major risks to fiscal and external sustainability. Tonga's constitutional reform toward a democratic system could also potentially spark tensions when the process begins in 2010.

The Authorities' Views

7. **The authorities broadly concurred with these assessments.** However, they expect food inflation in Tonga to be somewhat contained as Tonga remains largely a subsistence-supported economy, and if price differentials become significant, Tongans are highly likely to replace the imported food with locally produced root crops. The rising world fuel prices, however, could have a significant impact on inflation as electricity generation in Tonga is entirely fuel based. Moreover, at an average of about two cars per family, higher oil prices

could force substitution away from imported food in order to maintain levels of petrol consumption.

III. POLICIES TO IMPROVE RESILIENCE AND SUSTAIN RECOVERY

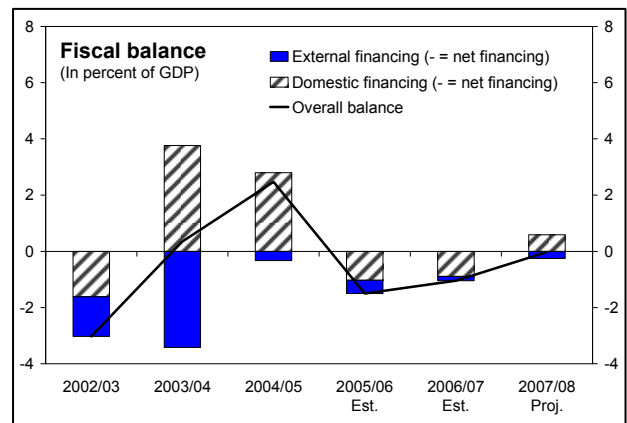
In response to significant adverse terms-of-trade shocks, rebalancing the policy mix toward a tighter monetary stance, supported by fiscal prudence and increased exchange rate flexibility, would address concerns of rising inflation while safeguarding external stability.

A. Ensuring Fiscal Prudence

Background

8. **A balanced budget in FY07/08 is likely to be achieved, but maintaining this stance in FY08/09 will be challenging in the absence of new measures.**

- *Significant efforts have been made to achieve a balanced budget in FY07/08. During the first nine months of FY07/08, revenue performance remained buoyant, boosted by a recovery of arrears and a containment of the public wage bill and nonwage spending.*



- *The authorities have proposed a balanced budget in FY08/09 to limit domestic and nonconcessional external borrowing, but there are downside revenue risks. The budget proposes over 20 percent growth in tax revenue to support higher maintenance and capital spending. At the same time, the budget also focuses on improving business competitiveness through a reduction in the maximum tariff rate to 20 percent (from 45 percent). In addition, it aimed at supporting household disposable income by lifting the individual income tax exemption threshold to TOP7,400 (from TOP2,500), together with a reduction in the corporate tax rate for large taxpayers.*

Policy Issues and Staff Views

9. **Continued fiscal prudence is warranted to share the burden of macroeconomic management to ensure domestic and external stability in the near term, while generating fiscal savings to buffer increases in debt service over the medium term.**

- *Achieving a balanced budget in FY08/09 will require sustainable fiscal measures, particularly by further improving tax administration and rationalizing capital spending. It is important to maintain the momentum of tax revenue collection achieved so far, while*

containing allocations of contingency funds and rationalizing capital spending priorities to a level that is in line with Tonga's implementation capacity and the availability of nondebt generating financing.

- *A more orderly public wage adjustment process is also important to reduce fiscal vulnerability.* The wage bill remains large by regional standards. A sustainable wage structure could include annual wage adjustment broadly in line with inflation, supported by limited public hiring and a gradual decompression of the public wage structure to retain high-skilled workers. Moreover, public wage adjustment will need to be formulated within a medium-term fiscal framework to ensure fiscal sustainability (Box 1).

The Authorities' Views

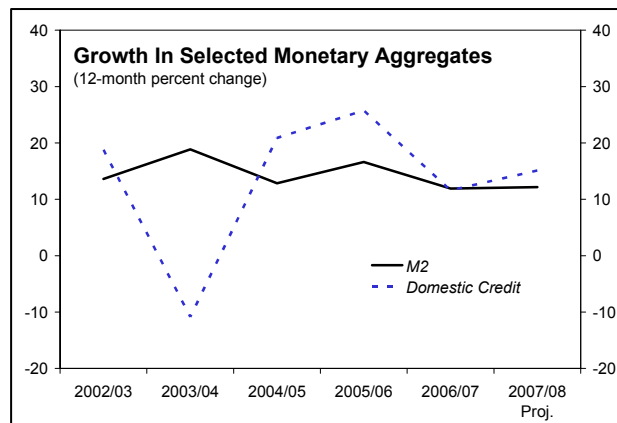
10. **The authorities are committed to a balanced budget, and there are contingency funds to buffer potential shortfalls in tax revenue.** They noted that, if necessary, additional expenditure measures will be taken, mostly through prioritization of capital spending, to ensure limited recourse to domestic financing. They have already revived a high level Expenditure Review Committee to conduct quarterly budget reviews with the aim to minimize possible fiscal slippages.

B. Moving Toward Monetary Tightening and Improved Exchange Rate Flexibility

Background

11. **Monetary policy was eased in several steps in early 2007 to support economic recovery.** At the time, inflation was less of a concern. The impact of monetary easing has only started to materialize recently.

- *Private sector credit growth picked up gradually.* It reached 16½ percent (y/y) at end-February 2008, from 6½ percent at end-March 2007. Banks' business loans, however, grew at a faster pace (to almost 30 percent by end-December 2007), while growth in housing loans has been relatively slow.
- *Excess liquidity climbed up to over 30 percent of reserve money in early 2008, but it has declined to around 10 percent in recent months.* This draw down was largely used to finance oil imports, with a corresponding decline in NFA of the NRBT.



Box 1. The Civil Service Wage Settlement

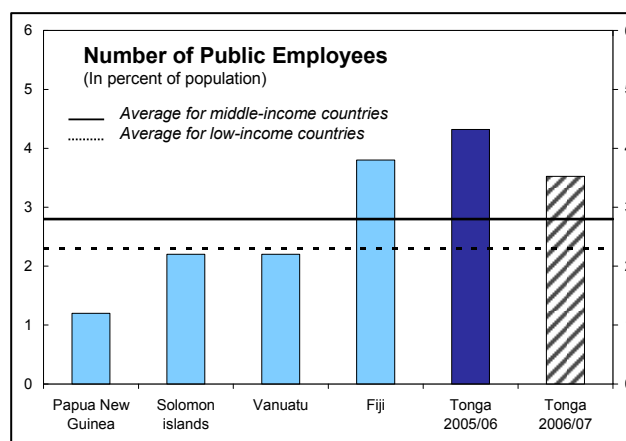
Substantial wage settlements over the past few years have imposed significant challenges to fiscal management.

Following a civil service strike that lasted six weeks, the government and labor unions agreed in September 2005 on a large civil service wage increase of 60–80 percent, with the wage increase for FY05/06 to be paid in two phases during FY05/06 and FY06/07. To partly offset these large wage increases, the government carried out a major voluntary redundancy program in April–June 2006, reducing personnel by 18 percent.

These developments had significant fiscal implications. The total cost of the wage settlement, including one-off payments such as severance package, accounts for about 9 percent of GDP in FY05/06, and 3¾ percent in FY06/07. Despite the substantial civil service retrenchment in end-FY05/06, the wage bill is still projected to increase to 13¾ percent of GDP in FY07/08 from its pre-settlement level of 11¾ percent in FY04/05.

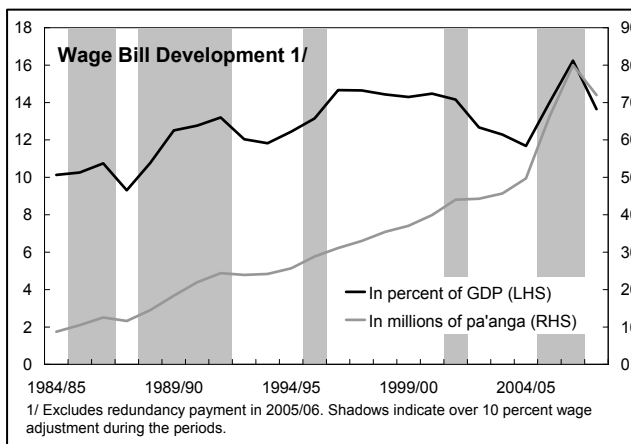
An orderly wage-setting mechanism is needed to enhance fiscal management.

Periodic and sizable nominal wage increases were often the result of years of real wage compression which left public wages substantially below levels in the private sector. With assistance from the Asian Development Bank, the government introduced performance-based contracts for public workers in 2003, granting high salary increases to senior workers to help recruit and retain qualified staff. However, increased salary disparities caused widespread dissatisfaction among civil servants at lower grades, which triggered the civil service strike in 2005. Introducing a sound public wage policy may require the support of labor unions, as well as the acceptance of the civil servants to the needed reform.



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	90.5	80.0	76.7
Of which: 60 % increase	...	19.0	...	...
40 % carryover	...	...	9.6	...
Additional 40 % increase	...	...	9.6	...
Severance package 1/	...	24.3	...	...
Wage bill excluding one-off payments	49.7	66.2	70.4	76.7
(In percent of GDP)				
Wage and salaries expenditure	11.7	19.1	16.2	13.8
Of which: 60 % increase	...	4.0	...	...
40 % carryover	...	...	1.9	...
Additional 40 % increase	...	...	1.9	...
Severance package 1/	...	5.1	...	...
Wage bill excluding one-off payments	11.7	13.9	14.3	13.8
Memorandum item:				
Number of civil servants (person)	4,563	4,422	3,615	...

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



1/ Excludes redundancy payment in 2005/06. Shadows indicate over 10 percent wage adjustment during the periods.

Policy Issues and Staff Views

12. Monetary easing in early 2007 was appropriate to revive the economy at a time of low inflation, but a shift towards monetary tightening is warranted now with the economy recovering and inflation rising.

- *Early monetary actions are needed to anchor inflationary expectations in advance of the finalization of the FY08/09 budget.* This is crucial to minimize wage pressures and to prevent high inflation from becoming entrenched, as well as to help contain liquidity pressure on the balance of payments.
- *Monetary tightening should be achieved through the use of effective, market-based instruments, including the issuance of NRBT notes and increases in reserve requirements.* The reliance on administrative controls, such as credit ceilings, should be limited.
- *The NRBT could also step up prudential measures to help monitor the fast growth in business loans.* A continuation of this trend could pose risks to financial stability going forward, especially in an environment of low growth that could undermine business and households' debt servicing capacity. The enactment of amendments to the NRBT Act, approved by parliament in August 2007, will help further enhance the NRBT's capital base, strengthen its accountability in bank operations, and clarify its profit transfer rules.

The Authorities' Views

13. The authorities are committed to tighten monetary policy if necessary in order to safeguard reserves and contain inflation, supported by a balanced budget.

- *Monetary actions are guided by two key considerations: maintaining reserves at a minimum of three months of imports and keeping inflation under control.* The authorities acknowledged that inflation is already running at above their comfort zone of single digit levels, and they are closely monitoring external developments, particularly oil payments and remittances, as both items have significant but offsetting implications for reserves.
- *The NRBT concurred that relying on market-based instruments is desirable.* They noted, however, that the issuance of NRBT notes will only be efficient if there is excess liquidity in the system. Achieving monetary tightening beyond that stage may require the use of other instruments, including statutory reserve requirements and credit ceilings, to contain credit growth. A continued reliance on NRBT notes at that stage may result in increased costs for the NRBT, undermining its own financial soundness.

C. Improving External Viability

Background

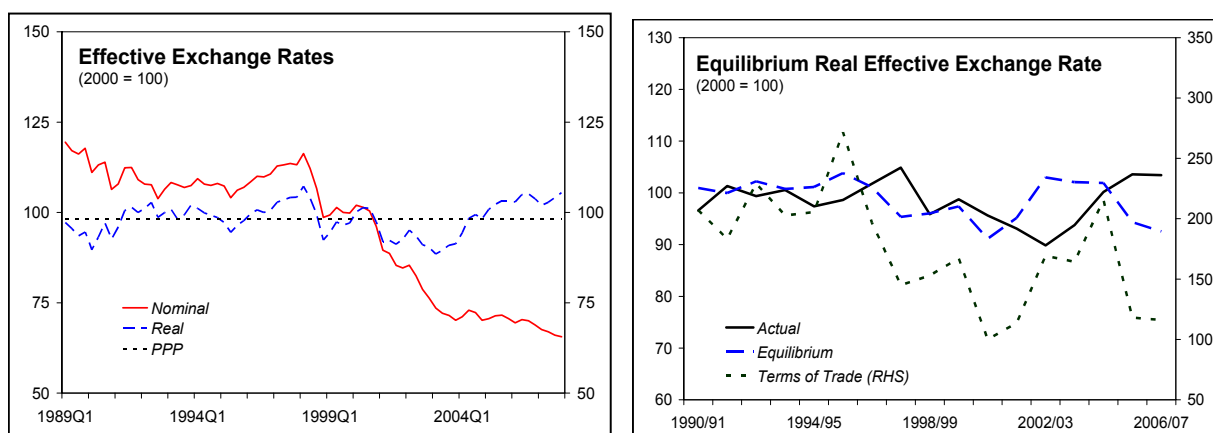
14. **Staff analysis suggests that Tonga's REER appears to be broadly in line with economic fundamentals, although quantitative estimates point toward a likely overvaluation that could be corrected within the adjustment band under the current exchange rate regime.** The results are subject to considerable uncertainty due to significant data deficiencies.

- *Recent balance of payments dynamics appear sustainable, although trade performance warrants close monitoring in light of a sustained rise in international fuel and food prices.* In the absence of further major external shocks, the current account deficit as a share of GDP is expected to narrow significantly over the medium term as fuel and food prices stabilize. Under this scenario, reserves should remain at around three months of imports. The recent progress with banks to reduce the transaction costs for remittances should support continued strong inflows, which will in turn help reduce external vulnerability. However, the external vulnerability could be aggravated by further increases in food and fuel prices.
- *Quantitative assessments of Tonga's REER indicate a likely overvaluation of 5–10 percent, which could be corrected within the monthly adjustment band under the current exchange rate regime.*²
- *The NRBT seems to have made little use of exchange rate flexibility since 2003, reflecting concerns about the inflationary impact of further currency depreciation.* The pa'anga depreciated by 2¼ percent in nominal effective terms in 2007 against a weighted basket of major currencies, while it appreciated by 5 percent *vis-à-vis* the U.S. dollar. In real effective terms, the pa'anga appreciated by 1¾ percent, reflecting mainly inflation rate differentials with Tonga's trading partners.

Policy Issues and Staff Views

15. **Following a depreciation of about 9 percent during 1997–2003, the REER appreciated by 13 percent over 2003–07, reflecting mainly externally driven higher inflation in Tonga relative to its trading partners.**

² Under a modified version of the Macroeconomic Balance (MB) approach, the REER overvaluation is estimated at 3½ percent in 2006/07, whereas the equilibrium real exchange rate (ERER) approach suggests an overvaluation of about 10 percent. The external sustainability (ES) approach suggests that the REER would need to depreciate by 8½ percent to stabilize the NFA of the banking system at its end-2006/07 level (17 percent of GDP); economy-wide international investment position data are not available.



16. External price competitiveness does not seem to be an immediate concern.

Tonga's exports remain small (less than one-tenth of imports), and its major export product, squash, is limited to a niche market in Japan where competitiveness is dominated by factors such as local production patterns, quarantine standards, and other factors such as bilateral preferential tariff treatment. Staff's preliminary assessment indicates that the current weights in the currency basket remain broadly in line with Tonga's currency composition of trade, provided that export revenues are augmented with remittance receipts, which may be viewed as derived from service exports of human capital.

17. Rebalancing the policy mix would support increased exchange rate flexibility to safeguard reserves while keeping inflation expectations under control. This flexibility in the near term would imply the need for a modest depreciation of the pa'anga in view of the current level of reserves and strong import demand. This should help speed up balance of payments adjustment and a reduction of pressures on reserves by lowering imports, which would help create a virtuous cycle of policies that will reinforce each other to achieve the authorities' policy objectives. Increased exchange rate flexibility within the monthly adjustment band would help correct a likely modest overvaluation of the pa'anga and ensure external stability.

The Authorities' Views

18. The authorities agreed that recent balance of payments dynamics do not indicate large exchange rate misalignment. While the current account deficit widened during the last few years, this was mainly driven by negative terms-of-trade shocks, and remittance inflows have continued to play a stabilizing role by supporting nearly 80 percent of imports. The authorities expected that, in the event of a slowdown in remittances, imports would decline accordingly. The authorities also emphasized that the current exchange rate regime could provide sufficient flexibility to adjust a possible overvaluation, if needed.

19. External price competitiveness was not a concern of major exporters. Despite the fact that exports of squash have weakened in recent years, exchange rate competitiveness has

not been seen as a primary contributing factor, in part because squash production relies highly on imported inputs, including fertilizer, while demanding quarantine standards, financing difficulties, and supply side volatility overseas are more of a concern.

20. **The authorities noted that the magnitude of exchange rate depreciation will be carefully considered given its inflationary impact.** They nevertheless agreed that a prudent fiscal stance and further monetary tightening should allow the NRBT to exercise increased exchange rate flexibility to strengthen the policy framework under less favorable global conditions.

D. Ensuring Debt Sustainability

Background

21. **The last Article IV consultation raised concerns about debt sustainability, particularly relating to the size and timing of the China reconstruction loan.** Agreement with China's EXIM Bank was signed in November 2007 for a RMB 440 million reconstruction loan, currently valued at about US\$63 million (23 percent of GDP), at 2 percent and 20-year maturity, with a grace period of five years. The initial plan was to disburse the overall amount over a two-year period during 2008/09–2009/10 for the reconstruction of Nuku'alofa. The actual disbursements, however, have been postponed as the private sector has taken a significant lead in the reconstruction efforts. The government is currently reassessing the funding requirement for future reconstruction, and is working on a better-defined framework for the use of this loan.

Policy Issues and Staff Views

22. **Reconstruction will need to be implemented in line with the medium-term fiscal framework to ensure debt sustainability.** The Low Income Country Debt Sustainability Assessment (LIC DSA, accompanying document) suggests that Tonga's public and publicly guaranteed external (PPG) debt is manageable in view of the positive debt dynamics over the projection period. For illustrative purposes, the DSA assumes a utilization of US\$10 million of the reconstruction loan per year over FY08/09–FY12/13, with GDP growth rate at historical average and fiscal consolidation. Reflecting Tonga's low exports, however, NPV of external debt and debt service-to-exports ratios are projected to exceed or be close to their respective indicative thresholds of 100 percent and 15 percent, indicating a high risk of debt distress. This risk is significantly mitigated by large remittance inflows. Indeed, remittances have grown over time to reach seven times the value of exports in 2007, are the main sources of foreign exchange earnings, and contribute significantly to revenue and national income.

23. **Limiting the use of nonconcessional financing to support future development program is crucial.** As the DSA illustrative scenario indicates that, if the reconstruction loan mentioned above is disbursed in large sums over the next two years as initially planned, debt service could jump to over 1 percent of GDP and 3 percent of projected reserves starting in FY13/14 (after a five-year grace period), intensifying risks of external debt distress.

24. **A sound public debt management policy is needed to guide Tonga's future development financing and ensure debt sustainability over the medium term.** Given the current public debt dynamics, it is desirable for Tonga to rely as much as possible on donors' grants to finance future development, supplemented by some use of long-term concessional financing. Reliance on nonconcessional external borrowing is highly discouraged. Development projects will need to be prioritized to be in line with the availability of donor grants and concessional resources, as well as the country's implementation capacity. The private sector should be given a broader role in project implementation to improve efficiency. Fiscal prudence, export diversification, and improved tourism, as well as policies to enhance growth prospects are also critical underpinnings to debt sustainability over the medium term.

The Authorities' Views

25. **The authorities broadly agreed with the general assessment of the DSA, indicating that the overall size and business needs of the reconstruction loan are currently being reviewed.** This may lead to a significantly smaller disbursement over a longer horizon than initially planned, along with a well-defined reconstruction program to be financed by such credit. They also noted that donors are planning to step up grant financing for Tonga over the next 2–3 years, but the capacity to fully utilize donor grants will need to be significantly improved. Moreover, a strengthened policy framework and strong remittances should help improve Tonga's capacity in servicing its debt.

E. Structural Reform and Capacity Building

Background

26. **Corporatization and privatization of public enterprises has advanced, but pressure on the government to take over a private power company, Shoreline, currently owned by the King, has increased.**³ The value of Shoreline was estimated by Deloitte and Touche, an international accounting firm, at US\$21 million in March 2007. Combined with an additional US\$5 million administrative fee, the total value of this transaction could cost the government nearly 10 percent of GDP or 59 percent of reserves. The government is considering using the foreign exchange proceeds from the sale of Westpac Bank of Tonga to help finance this transaction, which could take place in the second half of FY07/08.

27. **Tonga's governance indicators (World Bank, 2006) are perceived as weaker than those of its regional peers.** In particular, administrative impediments to business, including restrictions on business licensing, land issues, and immigration visas, continue to deter investors. However, these indicators may be outdated in view of recent developments in this area. In particular, the Cabinet passed the Procurement Bill in late 2006, and final

³ There is a strong call from general public for the King to divest all his holdings in private companies prior to his coronation in August 2008 to minimize the risk of conflict of interest.

preparations are underway to outsource certain government operations starting in FY08/09. In addition, training courses have been provided on corporate governance and compliance, and task forces have been created to review land, immigration visa, and business licensing issues. The Independent Anti-Corruption Commission has also been granted legal enforcement power to help enforce public governance.

Policy Issues and Staff Views

28. **Structural reform in Tonga should aim at raising efficiency, reducing quasi-fiscal risks, and improving governance.** In this context, the proposal by the government to retake the Shoreline is of concern, including to the donor community.

- *In particular, the estimated value of the company seems too large to be absorbed by the fiscal accounts.* The use of the foreign exchange proceeds from the sale of Westpac Bank of Tonga for this transaction would undermine the objective of the NRBT to support reserves under increased external pressure.
- *The government should make every effort to seek potential investors who may be interested in acquiring Shoreline in the near future.* Options to delay payments associated with the underlying financial transaction until Shoreline is sold to private investors should be considered as the best approach.

29. **Sound measures to address administrative impediments to investment and increased transparency are two key pillars to improve public governance in Tonga.** In this context, implementation of the new Procurement Bill is a step in the right direction. Outcomes of the task forces on governance should also be transformed to concrete, monitorable measures. Moreover, improved public discussion of policies and timely dissemination of information could help correct perceptions.

The Authorities' Views

30. **Efforts will be made to ensure that the repurchase of Shoreline by the government will be transparent, while options are being considered to minimize the fiscal burden of this transaction.** While noting the political sensitivity of this issue, the authorities agreed that the search for potential investors should be given priority.

31. **There is a need to update the Governance Indicators for Tonga in view of the latest developments.** The government is ready to work closely with the donor community to monitor the implementation of the Procurement Bill and further improve transparency.

IV. STAFF APPRAISAL

32. **Tonga's economy is recovering from the aftermath of the November 2006 riots.** However, adverse terms-of-trade shocks have contributed to inflation and balance of

payments pressures, and complicated economic management aiming at delivering low inflation and stable growth while safeguarding external stability.

33. **As recognized by the authorities, it would be desirable to improve the economy's resilience to external shocks through rebalancing the policy mix.** This would require a policy shift toward a tighter monetary stance and a sound fiscal framework to contain inflation, while facilitating greater exchange rate flexibility at a time of significant external pressure.

34. **The authorities' commitment to a tighter monetary policy stance is welcome, but early actions are warranted to anchor inflationary expectations, particularly in advance of the finalization of the FY08/09 budget.** Monetary tightening should be conducted through the use of effective, market-based instruments, and reliance on credit ceilings should be limited. High credit growth to the business sector may also need to be closely monitored to ensure financial stability. The extent of monetary tightening may need to be reviewed on a timely basis to avoid inflation becoming entrenched.

35. **A balanced budget for FY08/09 is appropriate to share the burden of macroeconomic management.** Meeting this target requires sustained efforts to limit new public hiring, contain nonwage spending, and improve tax administration. This is crucial to address downside risks arising from new tax measures introduced in the past two years. Further improvement in expenditure management is also essential, including a prioritization of capital projects in line with the availability of donor grants and nonconcessional financing, and Tonga's implementation capacity. The authorities' decision to utilize the Expenditure Review Committee to conduct quarterly budget reviews is timely to help minimize risks of fiscal slippage. Over the medium term, the fiscal framework should aim at small budget surpluses to buffer future increases in debt service payments, underpinned by tax administration reform and a more orderly public wage policy.

36. **The exchange rate appears to be broadly in line with economic fundamentals, although quantitative estimates point toward a likely modest overvaluation which could be corrected under the current exchange rate regime.** Given the current level of reserves and rising import demand, a modest depreciation of the pa'anga may be required in the near term to speed up a real adjustment in the balance of payments, thereby containing pressures on reserves. An improved policy mix would provide scope for a modest depreciation while keeping inflation expectations under control.

37. **The authorities plan to retain the exchange restriction in the form of a tax certification requirement applied to various current international transactions.** The Board approved this restriction until July 9, 2008 or the 2008 Article IV consultation, whichever is earlier. In the absence of the firm timetable for the removal of this restriction, staff does not propose further approval of this restriction.

38. **Tonga's medium-term debt sustainability hinges on the strength of fiscal consolidation and prospects for securing nondebt-creating flows.** Tonga's public debt dynamics reveal that donor grants and long-term concessional loans are the preferred form of financing. Recourse to nonconcessional borrowing should be avoided. The reconstruction

loan of US\$63 million puts Tonga over the external debt distress thresholds over the medium term, suggesting a high risk of distress. In this context, the authorities' decision to review the size of this loan is timely, and the amount of annual disbursement should be kept to levels consistent with Tonga's medium-term fiscal framework and implementation capacity. Remittances play an important role in significantly mitigating external debt and debt service risks. Nevertheless, a sound public debt management policy, together with export diversification and increased tourism, will further enhance Tonga's debt sustainability.

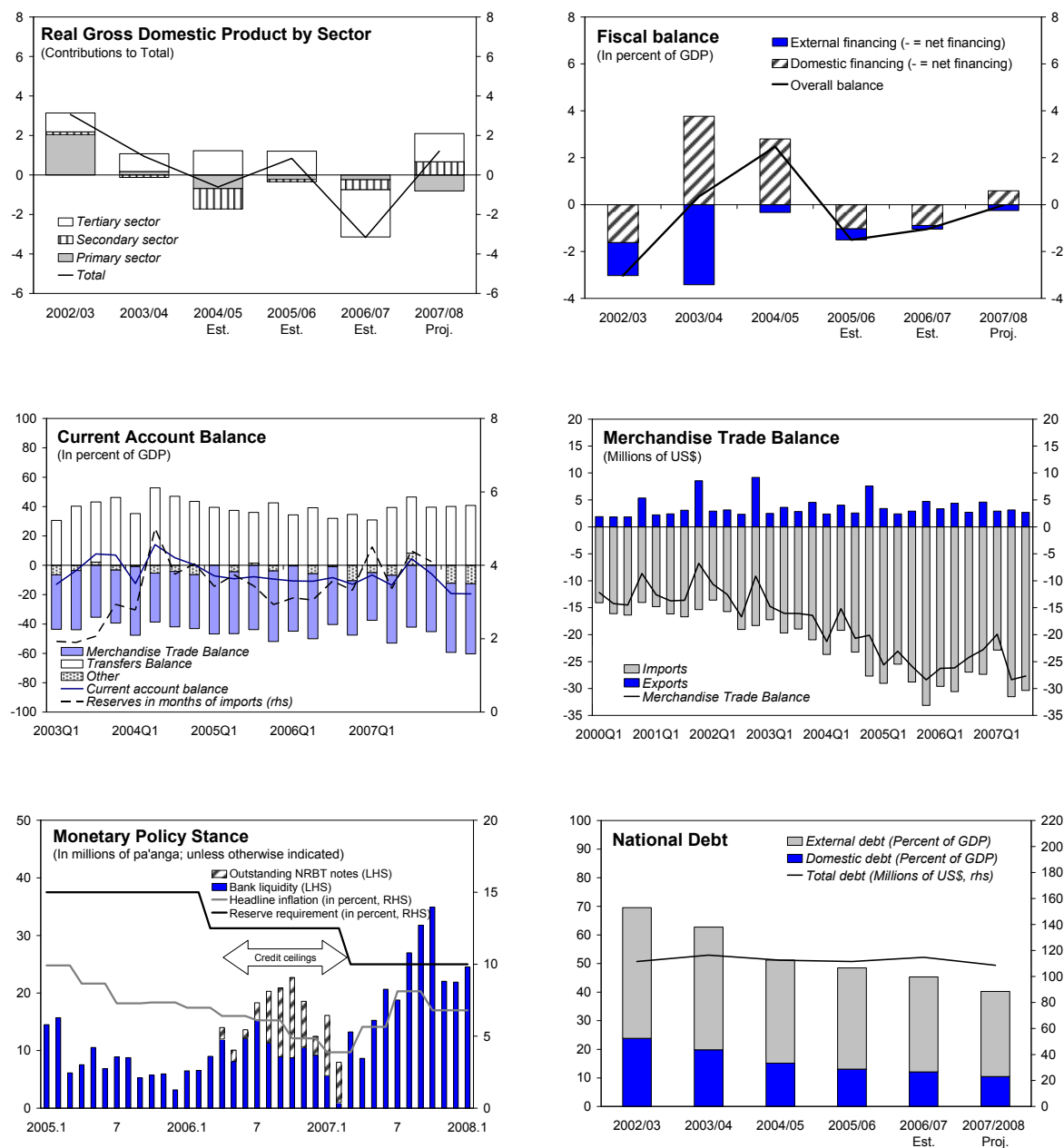
39. **The government's plan to temporarily renationalize Shoreline should be carefully reviewed and articulated to the public.** Every effort should be made to seek potential investors who may be interested in acquiring the company in the near future. In the meantime, options to delay payments associated with the underlying financial transaction by the government until Shoreline is sold to private investors should be considered.

40. **The authorities have made progress in the area of governance, including through the approval by the Cabinet of a Procurement Bill to be implemented in FY08/09.** Further efforts are needed to address land, immigration visa, and business licensing issues, which have deterred investment and given rise to public perceptions of weak governance. Moreover, public discussion of policies and timely dissemination of information could help improve transparency and help communicate the authorities' policy intentions.

41. **Improving statistical capacity remains a priority, and further technical assistance in this area is needed.** The authorities have identified the national accounts and price statistics as priorities in need of technical assistance, and they are encouraged to work closely with PFTAC and AsDB to review the existing TA programs to help address these issues.

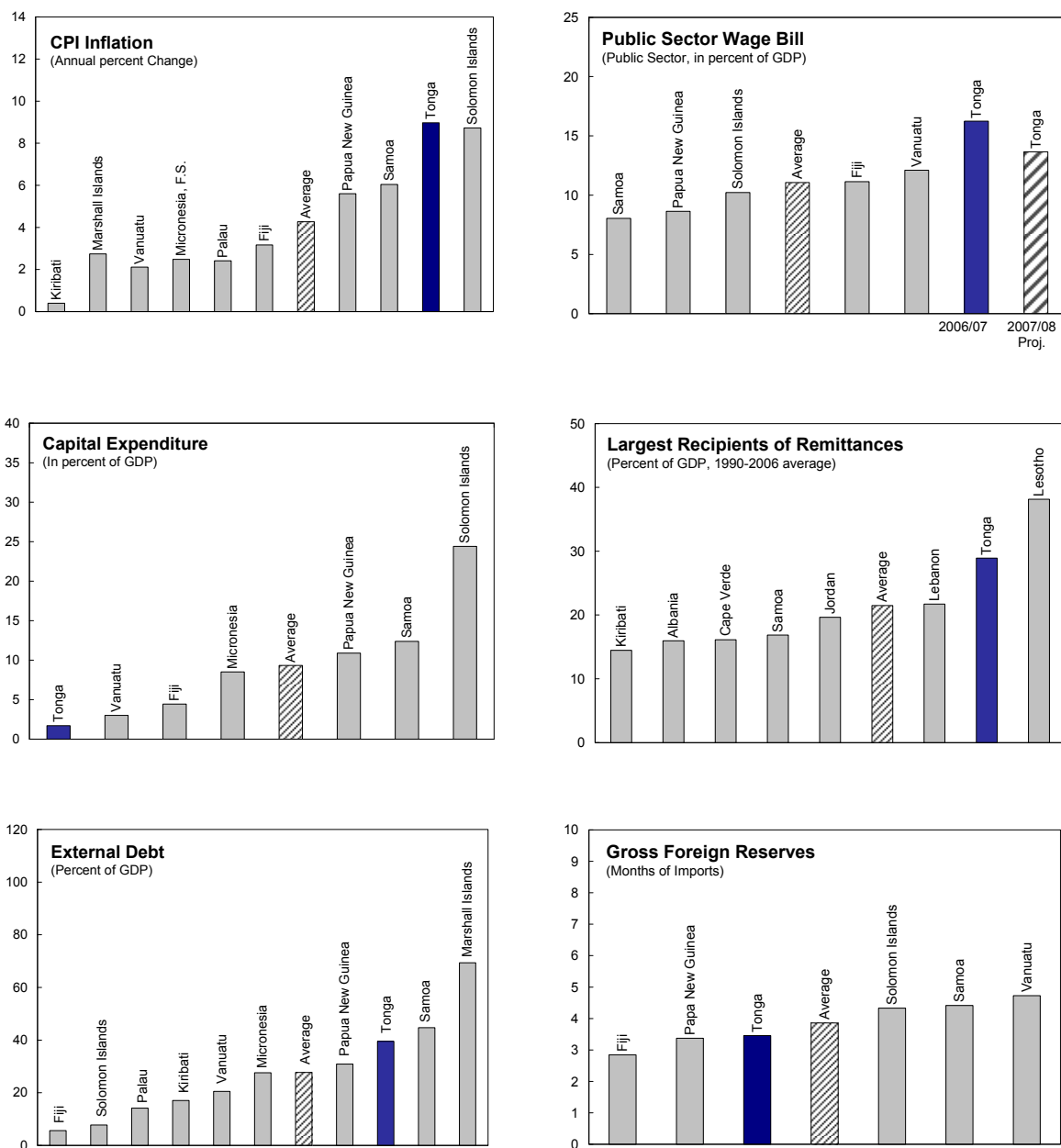
42. It is recommended that the next Article IV consultation with Tonga takes place on a standard 12-month cycle.

Figure 1. Tonga: Economic Developments, 2002/03-2007/08



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

Figure 2. Tonga: Regional Comparators, (Averages, 2002-2008 1/)



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

1/ Projection data for 2008 and estimates for 2007.

Table 1. Tonga: Selected Economic Indicators, 2003/04–2008/09 1/

Nominal GDP (2006/07): US\$ 246.0 million
 Population (2007): 102,360
 GDP per capita (2006/07): US\$ 2,433
 Quota: SDR 6.9 million

	2003/04	2004/05	2005/06	2006/07 Prel.	2007/08 Proj.	2008/09
			(Annual percent change)			
Output and prices						
Real GDP	1.0	-0.4	0.6	-3.2	1.2	2.6
Consumer prices (end of period)	11.7	9.7	7.0	5.1	14.5	12.3
			(In percent of GDP)			
Central government finance						
Total revenue and grants	29.9	28.7	33.4	33.2	31.4	31.8
Total revenue	28.5	27.4	31.3	29.8	29.4	28.6
Grants	1.4	1.3	2.1	3.4	2.0	3.2
Total expenditure and net lending	29.5	26.3	34.9	34.3	31.4	32.1
Of which: Current expenditure	27.3	25.4	35.0	32.5	30.1	30.1
Capital expenditure	1.0	1.0	3.2	1.1	1.3	1.8
Overall balance	0.3	2.5	-1.5	-1.0	0.0	-0.3
External financing (net)	3.4	0.3	0.5	0.2	0.3	-0.2
Domestic financing (net)	-3.8	-2.8	1.0	0.9	-0.6	0.0
Privatization receipts	0.0	0.0	0.0	0.0	0.4	0.5
			(Annual percent change)			
Money and credit						
Total liquidity 2/	16.7	13.3	13.3	13.3	13.7	...
Of which: Broad money (M2)	18.9	12.8	16.6	11.9	14.7	...
Domestic credit	-10.9	20.9	25.8	11.6	15.1	...
Of which: Private sector credit	-4.3	29.4	22.6	9.5	15.5	...
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	9.5	...
			(In millions of U.S. dollars)			
Balance of payments						
Exports, f.o.b.	13.8	16.0	15.4	13.3	14.8	15.5
Imports, f.o.b.	-82.6	-105.4	-122.2	-108.6	-135.0	-154.3
Services (net)	-2.8	-10.0	-7.8	-17.9	-14.4	-13.6
Investment income (net)	-0.4	1.6	2.8	3.5	3.7	3.6
Services and investment income (net)	-3.2	-8.4	-5.0	-14.4	-10.7	-10.0
Current transfers (net)	79.7	91.9	88.9	84.2	104.1	126.0
Of which: Private transfer receipts	90.1	107.4	102.0	93.3	116.5	138.8
Current account balance	7.7	-5.8	-22.8	-25.5	-26.8	-22.8
(In percent of GDP)	4.2	-2.6	-9.7	-10.4	-10.4	-8.8
Overall balance	25.9	-4.0	0.6	4.2	-3.7	2.6
Gross official foreign reserves						
In millions of U.S. dollars	44.8	42.5	40.4	47.1	43.4	46.0
In months of goods and services imports	4.8	3.7	3.1	3.9	3.0	2.8
External debt						
External debt (in percent of GDP)	42.9	36.1	35.4	33.2	29.8	31.4
Debt service ratio 4/	8.2	8.0	7.5	9.8	11.0	10.5
Exchange rates						
Pa'anga per U.S. dollar (period average) 5/	2.05	1.94	2.01	2.00	1.94	...
Pa'anga per U.S. dollar (end of period) 5/	2.00	1.93	2.06	1.95	1.91	...
Nominal effective exchange rate (1990=100) 5/	71.44	71.11	70.50	68.37	65.86	...
Real effective exchange rate (1990=100) 5/	93.76	100.18	103.58	103.43	103.93	...

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 2007.

4/ In percent of exports of goods and services.

5/ Through January 2008.

Table 2. Tonga: Summary of Government Operations, 2003/04-2008/09

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
				Prel.	Proj.	
(In millions of pa'anga)						
Total revenue and grants	111.0	122.1	158.3	163.6	174.0	191.9
Total revenue	105.9	116.6	148.4	146.7	162.8	172.7
Current revenue	105.9	116.6	148.4	146.7	162.8	172.7
Tax revenue	86.1	98.4	125.9	126.4	144.9	152.2
Nontax revenue 1/	19.7	18.2	22.5	20.3	17.9	20.5
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0
Grants (in cash) 2/	5.2	5.5	9.9	16.9	11.2	19.2
Total expenditure and net lending	109.8	111.6	165.4	168.8	174.2	193.9
Total expenditure	110.7	112.6	166.7	169.4	174.2	192.6
Current expenditure	101.7	107.9	165.9	160.3	166.9	181.8
Wages and salaries 3/	45.7	49.7	90.5	80.0	76.7	81.5
Of which: Redundancy Package	0.0	0.0	24.3	0.0	0.0	0.0
Retirement funds employer contribution	1.5	2.6	3.8	3.8	4.4	4.7
Interest expense	3.2	3.8	3.2	3.2	4.2	4.5
Other current expenditures	51.3	51.8	68.3	73.4	81.7	91.0
Capital expenditure	3.9	4.3	15.3	5.6	7.2	10.9
Expenditure discrepancy	5.1	0.5	-14.6	3.4	0.0	0.0
Total lending minus repayments	-0.9	-1.1	-1.2	-0.6	0.0	1.3
Current balance	4.2	8.7	-17.5	-13.6	-4.1	-9.1
Overall balance (incl. grants)	1.3	10.5	-7.1	-5.1	-0.1	-2.0
Total financing	-1.3	-10.5	7.1	5.1	0.1	2.0
External financing	12.7	1.4	2.3	0.8	1.4	-1.2
Domestic financing 4/	-14.0	-11.9	4.9	4.4	-3.3	0.2
Privatization receipts	0.0	0.0	0.0	0.0	2.0	3.0
(In percent of GDP)						
Total revenue and grants	29.9	28.7	33.4	33.2	31.4	31.8
Total revenue	28.5	27.4	31.3	29.8	29.4	28.6
Current revenue	28.5	27.4	31.3	29.8	29.4	28.6
Tax revenue	23.2	23.2	26.5	25.7	26.1	25.2
Nontax revenue 1/	5.3	4.3	4.7	4.1	3.2	3.4
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0
Grants (in cash) 2/	1.4	1.3	2.1	3.4	2.0	3.2
Total expenditure and net lending	29.5	26.3	34.9	34.3	31.4	32.1
Total expenditure	29.8	26.5	35.1	34.4	31.4	31.9
Current expenditure	27.3	25.4	35.0	32.5	30.1	30.1
Wages and salaries 3/	12.3	11.7	19.1	16.2	13.8	13.5
Of which: Redundancy Package	0.0	0.0	5.1	0.0	0.0	0.0
Capital expenditure	1.0	1.0	3.2	1.1	1.3	1.8
Expenditure discrepancy	1.4	0.1	-3.1	0.7	0.0	0.0
Total lending minus repayments	-0.3	-0.2	-0.3	-0.1	0.0	0.2
Current balance	1.1	2.0	-3.7	-2.8	-0.7	-1.5
Overall balance (incl. grants)	0.3	2.5	-1.5	-1.0	0.0	-0.3
Total financing	-0.3	-2.5	1.5	1.0	0.0	0.3
External financing	3.4	0.3	0.5	0.2	0.3	-0.2
Domestic financing 4/	-3.8	-2.8	1.0	0.9	-0.6	0.0
Privatization receipts	0.0	0.0	0.0	0.0	0.4	0.5
Memorandum item:						
Nominal GDP (in millions of pa'anga)	371.9	424.8	474.4	492.7	554.1	603.6
Total external public debt outstanding (in percent of GDP)	42.9	36.1	35.4	33.2	29.8	31.4
Of which: PRC Reconstruction loan 5/	...	...	...	...	...	4.2

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

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

2/ Grants are mostly spent for other current expenditures.

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

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

5/ The loan is excluded from the government accounts.

Table 3. Tonga: Banking Survey, 2004/05–2007/08 1/

	2004/05	2005/06	2006/07				2007/08			
			Sep	Dec	Mar	Jun	Sep	Nov	Dec	Jan
(In millions of pa'anga; end of period)										
Net foreign assets	76.3	71.9	76.8	75.6	76.4	81.1	92.8	81.4	103.0	102.7
Foreign assets	91.8	95.0	96.9	95.9	99.7	103.6	114.5	103.3	123.1	122.4
NRBT	82.1	83.2	85.3	84.2	90.4	91.6	104.8	94.8	114.6	113.1
DMBs	9.7	11.8	11.7	11.8	9.3	12.0	9.7	8.5	8.5	9.2
Foreign liabilities	-15.5	-23.1	-20.2	-20.3	-23.3	-22.6	-21.7	-22.0	-20.2	-19.7
NRBT	-3.2	-7.1	-4.7	-4.3	-4.2	-4.7	-4.8	-4.4	-4.9	-3.7
DMBs	-11.4	-15.3	-14.9	-15.4	-18.7	-17.2	-16.2	-16.9	-14.7	-15.3
TDB	-0.9	-0.6	-0.6	-0.6	-0.4	-0.6	-0.6	-0.6	-0.6	-0.6
Net domestic assets	154.2	186.1	188.2	198.8	196.2	211.4	210.2	220.1	212.4	211.9
Net domestic credit	210.3	264.5	279.8	278.1	277.0	295.2	307.9	321.8	306.7	306.4
Government (net)	-25.2	-18.9	-6.0	-9.0	-18.8	-12.9	-11.6	-9.6	-25.9	-29.6
Nonfinancial public enterprises	8.6	5.4	4.9	4.4	4.0	3.7	3.5	4.4	4.8	5.0
Private sector	226.8	278.0	280.9	282.7	291.8	304.3	315.9	327.0	327.9	331.0
Other items (net)	-56.1	-78.4	-91.6	-79.3	-80.9	-83.7	-97.6	-101.7	-94.4	-94.5
Total liquidity	223.7	253.4	270.9	271.6	266.3	287.1	297.8	296.3	307.6	302.4
Broad money (M2)	203.7	237.5	254.1	255.3	249.8	265.8	277.5	275.8	287.1	282.0
Narrow money	68.7	55.7	64.6	70.1	68.7	73.8	79.9	77.7	78.8	76.3
Quasi money	134.9	181.8	189.5	185.2	181.1	192.0	197.6	198.1	208.3	205.7
Notes and bills 2/	20.1	15.9	16.8	16.3	16.4	21.4	20.3	20.5	20.5	20.5
Government lending funds 3/	6.8	6.1	6.0	5.8	6.4	5.4	5.3	5.2	5.2	5.2
(Annual percent change)										
Net foreign assets	-8.9	-5.8	-5.6	-0.3	12.3	12.7	20.9	8.3	36.2	34.1
Net domestic assets	27.2	20.7	13.7	15.9	12.0	13.6	11.7	12.9	6.8	13.9
Net domestic credit	20.9	25.8	23.8	17.3	14.4	11.6	10.0	13.9	10.3	11.5
Private sector	29.4	22.6	15.0	10.4	6.6	9.5	12.5	14.9	16.0	16.6
Total liquidity	13.3	13.3	12.8	12.8	12.3	13.3	9.9	8.8	13.3	13.1
Broad money (M2)	12.8	16.6	15.1	13.6	13.6	11.9	9.2	7.8	12.5	12.5
(In millions of U.S. dollars)										
Net foreign assets	39.5	34.9	38.1	37.8	38.5	41.7	47.5	42.5	54.6	55.0
Foreign assets	47.5	46.1	48.1	48.0	50.2	53.3	58.5	53.9	65.3	65.5
NRBT	42.5	40.4	42.3	42.1	45.5	47.1	53.6	49.5	60.7	60.6
DMBs	5.0	5.7	5.8	5.9	4.7	6.2	5.0	4.4	4.5	5.0
Foreign liabilities	-8.0	-11.2	-10.0	-10.2	-11.7	-11.6	-11.1	-11.5	-10.7	-10.5
Memorandum items:										
Velocity (GDP/average M2)	2.2	2.1	...	...	...	1.9	...	...	...	...
Pa'anga per U.S. dollar (end of period)	1.93	2.06	2.01	2.00	1.99	1.95	1.96	1.92	1.89	1.87

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, 2003/04–2008/09 1/

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

	2003/04	2004/05	2005/06	2006/07	2007/08 Proj.	2008/09
Trade balance	-68.8	-89.3	-106.7	-95.3	-120.2	-138.8
Exports, f.o.b.	13.8	16.0	15.4	13.3	14.8	15.5
(Annual percent change)	-21.2	16.0	-3.8	-13.6	11.1	4.9
Imports, f.o.b.	-82.6	-105.4	-122.2	-108.6	-135.0	-154.3
(Annual percent change)	11.3	27.5	15.9	-11.1	24.3	14.3
Services (net)	-2.8	-10.0	-7.8	-17.9	-14.4	-13.6
Receipts	25.8	23.7	25.3	19.4	24.8	29.2
Payments	-28.6	-33.6	-33.2	-37.3	-39.2	-42.8
Investment income (net)	-0.4	1.6	2.8	3.5	3.7	3.6
Receipts	2.7	3.4	4.9	6.4	8.0	8.5
Payments	-3.1	-1.8	-2.1	-2.9	-4.3	-4.8
Current transfers (net)	79.7	91.9	88.9	84.2	104.1	126.0
Official transfers (net)	0.3	0.0	0.0	0.0	0.3	0.5
Private transfers (net)	79.4	91.9	88.9	84.2	103.8	125.5
Current account balance	7.7	-5.8	-22.8	-25.5	-26.8	-22.8
(In percent of GDP)	4.2	-2.6	-9.7	-10.4	-10.4	-8.8
Capital and financial account balance	37.0	12.5	22.5	26.9	27.7	25.3
Official capital flows (net)	13.7	4.8	8.4	9.8	7.3	5.3
Private capital flows (net)	23.2	7.7	14.1	17.1	20.5	20.1
Errors and omissions	-18.8	-10.7	1.0	2.7	-4.7	0.0
Overall balance 2/	25.9	-4.0	0.6	4.2	-3.7	2.6
Memorandum items:						
Gross official foreign reserves	44.8	42.5	40.4	47.1	43.4	46.0
In months of goods and services imports 3/	4.8	3.7	3.1	3.9	3.0	2.8
Exchange rate						
Pa'anga per U.S. dollar (period average)	2.05	1.94	2.01	2.00	2.15	2.29
Pa'anga per U.S. dollar (end of period)	2.00	1.93	2.06	1.95	2.07	2.22
Nominal GDP	181.8	219.1	236.2	246.0	258.3	258.8
Commodity price indexes (2005 = 100)						
Food	94.8	100.5	105.2	118.9	138.9	149.8
Fuel	63.8	86.2	109.6	125.5	163.2	181.7

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

1/ Excludes reconstruction loan.

2/ Change in gross official foreign reserves.

3/ The current year's imports.

Table 5. Tonga: Medium-Term Scenario, 2005/06–2012/13 1/

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	Prel.				Proj.			
(Annual percent change)								
Output and prices								
Real GDP	0.6	-3.2	1.2	2.6	1.9	1.8	1.6	1.6
Consumer prices (end of period)	7.0	5.1	14.5	12.3	6.1	5.2	4.8	4.2
(In percent of GDP)								
Central government finance								
Total revenue and grants	33.4	33.2	31.4	31.8	32.0	32.1	32.2	32.3
Total revenue	31.3	29.8	29.4	28.6	28.6	28.6	28.6	28.6
Grants	2.1	3.4	2.0	3.2	3.3	3.4	3.5	3.6
Total expenditure and net lending	34.9	34.3	31.4	32.1	31.9	32.0	32.0	32.1
Current expenditure	35.0	32.5	30.1	30.1	29.8	29.8	29.6	29.6
Capital expenditure	3.2	1.1	1.3	1.8	1.9	2.0	2.2	2.3
Expenditure discrepancy	-3.1	0.7	...	...	...	...	...	...
Net lending	-0.3	-0.1	0.0	0.2	0.2	0.2	0.2	0.2
Overall balance	-1.5	-1.0	0.0	-0.3	0.0	0.0	0.1	0.1
External financing (net)	0.5	0.2	0.3	-0.2	0.0	-0.2	-0.1	0.0
Domestic financing (net)	1.0	0.9	-0.6	0.0	-0.1	0.2	0.0	-0.2
Privatization receipts	0.0	0.0	0.4	0.5	0.0	0.0	0.0	0.0
(In millions of U.S. dollars)								
Balance of payments								
Exports, f.o.b.	15.4	13.3	14.8	15.5	16.7	17.8	18.9	20.0
(Annual percent change)	-3.8	-13.6	11.1	4.9	7.5	6.8	6.2	5.7
Imports, f.o.b.	-122.2	-108.6	-135.0	-154.3	-164.6	-167.6	-177.9	-188.1
(Annual percent change)	15.9	-11.1	24.3	14.3	6.7	1.8	6.2	5.7
Services and investment income (net)	-5.0	-14.4	-10.7	-10.0	-11.1	-9.5	-10.1	-10.7
Transfers (net)	88.9	84.2	104.1	126.0	134.9	136.7	145.2	153.5
Of which: Private transfer receipts	102.0	93.3	116.5	138.8	148.7	151.4	160.7	169.9
(Annual percent change)	-5.0	-8.6	24.9	19.1	7.1	1.8	6.2	5.7
Current account balance	-22.8	-25.5	-26.8	-22.8	-24.0	-22.6	-23.9	-25.3
(In percent of GDP)	-9.7	-10.4	-10.4	-8.8	-8.7	-7.6	-7.6	-7.6
Capital account balance	22.5	26.9	27.7	25.3	26.9	28.6	30.5	32.5
Official capital flows (net)	8.4	9.8	7.3	5.3	5.7	5.9	6.4	7.0
Private capital flows (net)	14.1	17.1	20.5	20.1	21.2	22.6	24.0	25.4
Overall balance	0.6	4.2	-3.7	2.6	2.9	6.0	6.6	7.2
Gross international reserves (end of period)								
In millions of U.S. dollars	40.4	47.1	43.4	46.0	48.8	54.8	61.4	68.6
In months of imports (goods and services)	3.1	3.9	3.0	2.8	2.8	3.1	3.2	3.4
External debt								
Public sector external debt (in percent of GDP)	35.4	33.2	29.8	31.4	35.7	36.8	37.7	38.7
Of which: PRC Reconstruction loan	...	...	0.0	4.2	8.0	11.5	14.6	17.6
Debt service ratio 2/	7.5	9.8	11.0	10.5	9.3	10.7	10.3	9.5
Of which: PRC Reconstruction loan	...	...	0.0	0.2	0.3	0.3	0.3	0.3
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	88.9	84.2	103.8	125.5	134.4	136.1	144.5	152.8
(In percent of imports, goods and services)	57.2	57.7	59.6	63.7	63.8	63.5	63.5	63.5
Commodity price indexes (2005 = 100)								
Food	105.2	118.9	138.9	149.8	147.9	145.2	142.5	139.4
Fuel	109.6	125.5	163.2	181.7	180.3	178.2	177.4	176.9

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

1/ Fiscal year beginning July.

2/ In percent of exports of goods and services.

Table 6. Tonga: Banking Sector Indicators, 2003–07 1/

(In percent; end of period)

	2003	2004	2005	2006	2007
Capital adequacy					
Risk-weighted capital ratio	21.9	23.9	19.7	21.3	22.5
Total capital to total assets	18.5	16.3	16.3	17.3	19.1
Asset quality					
Nonperforming loan to total loans	9.6	5.9	4.2	3.7	5.3
Nonperforming loans to capital	39.1	24.4	20.2	16.1	21.6
Nonperforming loans net of provisions to total capital	14.2	0.1	3.0	0.6	3.8
Profitability					
Return on assets	5.8	6.0	6.6	5.4	4.6
Return on equity	23.0	22.1	24.9	21.5	18.0
Net interest margin	8.7	10.0	8.6	8.1	8.1
Net interest income to gross income	61.2	61.1	60.5	60.3	54.0
Other					
Risk concentration ratio 2/	35.9	17.7	11.5	17.1	16.6
Share of loans to nonfinancial corporations 3/	50.9	39.6	37.3	43.8	48.9

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.



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FOR IMMEDIATE RELEASE
July [], 2008

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Appendix I. IMF Executive Board Concludes Article IV Consultation with Tonga

On [July 2, 2008], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.¹

Background

Tonga's economy has shown resilience in the aftermath of the November 2006 riots and is now on a path to recovery. The key factor underpinning resilience has been private investment. Donor supported government reconstruction loans are expected to add further momentum to the recovery. However, the global upswings in fuel and food prices have intensified pressures on inflation and external reserves, the latter mitigated to a large extent by strong inflows of remittances.

Real GDP contracted by about 3¼ percent in FY06/07 (ending June), following the November 2006 riots, but the private sector quickly relocated their businesses and replenished their lost inventories. Preliminary indicators for the first half of FY07/08 suggest that the economy is on a path to recovery led by the services sector.

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.

Adverse terms of trade shocks contributed to inflation pressures. Major increases in external food and fuel prices, combined with a nominal depreciation of the pa'anga against the currencies of major trading partners, have led to a marked increase in CPI inflation, which reached 12½ percent at end-March 2008 (from 6¾ percent at end- December 2007).

Tonga's external position is expected to weaken, reflecting mainly the impact of rising food and fuel prices. The current account deficit is projected to remain high in FY07/08 at about 10 percent of GDP, as sharp increases in imports, reflecting the economy's heavy reliance on oil imports, are matched by increases in remittances. External reserves have declined somewhat since last June, but are expected to stabilize at around 3-months of imports at end-FY07/08 on account of the projected improvements in official and private capital inflows.

Significant efforts have been made to achieve a balanced budget in FY07/08. During the first nine months of FY07/08, revenue performance remained buoyant, boosted by a recovery of arrears and a containment of the public wage bill and nonwage spending. The authorities have proposed a balanced budget in FY08/09 to limit domestic and nonconcessional external borrowing. The budget proposes over 20 percent growth in tax revenue to support higher maintenance and capital spending. At the same time, the budget also propose a reduction of maximum tariff rates and increase in the individual income tax exemption threshold, together with a reduction in the corporate tax rate for large taxpayers.

Monetary policy was eased in several steps in early 2007 to support economic recovery. At the time, inflation was less of a concern. The impact of monetary easing has only started to materialize recently. Private sector credit growth picked up gradually. It reached 16½ percent (y/y) at end-February 2008, from 6½ percent at end-March 2007. Banks' business loans, however, grew at a faster pace (to almost 30 percent by end-December 2007), while growth in housing loans has been relatively slow.

Tonga's total public debt stock declined to 45¼ percent of GDP in FY06/07 from 48½ percent of GDP in FY05/06. External debt to GDP fell as donor financing declined in real terms, while fiscal consolidation to limit domestic budget financing also contributed to a downward trend in domestic public debt to GDP. Following the civil unrest in November of 2006, the government made a significant effort toward securing financing for the reconstruction of the capital city of Nuku'alofa; the government contracted a long-term soft loan of about US\$63 million (or 23 percent of GDP in FY07/08), but disbursements of this loan have been postponed.

Executive Board Assessment

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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.