

**FOR
AGENDA**

SM/08/174
Supplement 2

June 18, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached informational annex is being issued as a supplement to the staff report for the 2008 Article IV consultation with Tonga (SM/08/174, 6/18/08), 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 will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. This supplement is not being distributed in hard copy. It can be accessed in the Institutional Repository. A link to this document can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

TONGA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2008 Consultation with Tonga

(In Consultation with Other Departments)

June 17, 2008

	Contents	Page
I.	Fund Relations	2
II.	Relations with the Pacific Financial Technical Assistance Centre	3
III.	Relations with the World Bank Group.....	5
IV.	Relations with the Asian Development Bank	7
V.	Statistical Issues	8

ANNEX I. TONGA FUND RELATIONS
(As of April 30, 2008)

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	0.44	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 April 11–20, 2007 and the Executive Board discussed the staff report (IMF Country Report No. 07/297) on July 11, 2007.

IX. **Technical Assistance:**

LEG has provided assistance on AML/CFT issues for the Pacific islands countries, including Tonga, with an emphasis on risk management.

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 February 2008)**

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 delivered lectures on PFM to all CEOs, in late April 2007. A joint PFTAC mission on revenue estimation and Statistics is to visit Tonga in mid-March 2008 to further assist in these areas.

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.

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.

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 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.

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. In addition to the joint PFTAC mission on revenue estimation and statistics in mid-March 2008, a further TA mission is planned for early June 2008 to assist the Statistics Division with GDP and BOP estimates.

ANNEX III. TONGA: RELATIONS WITH THE WORLD BANK GROUP²

(As of May 2008)

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 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. Construction of the hospital, which is the major component of the project, has been satisfactorily completed. Health financing policy has been developed and mechanisms of implementation are being finalized.
- **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. The project’s school grants fund (1) has been successfully implemented in its first phase with nearly all schools having received grants on a capitation basis and spent over 80% of the funds on educational materials and maintenance, and (2) has been successfully evaluated, and lessons learned will be addressed in the second phase. At the request of the Government of Tonga, the IDA Credit Agreement was amended in January 2008 to allocate IDA funding to the third phase of the school grants program in 2009.
- **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. It is being revised by the Ministry of Finance (MoF) and Crown Law. Implementation for activities 2 and 3 (manual, standard bidding documents and training) is under way as MOF has just appointed an individual consultant to provide assistance in the area.

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. 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 project is scheduled to go to the board on June 26, 2008). There is a tentative follow up Tonga Transport project for FY11 which will draw upon the findings of a planned study on infrastructure needs (supported by the new Pacific Regional Infrastructure Facility).
- **Private Sector Development:** The World Bank Group has an active BEE program through the trilaterally funded (IFC, FIAS, World Bank) Tonga Implementation of Regulatory Reform Program (US\$700,000 over two years). A draft MoU for a new BEE project is currently with the Ministry of Finance for review. This project will build upon work carried out under the previous Tonga Regulatory Reform Phase II. Under that project a Taskforce for the Implementation of Regulatory Reform was established in January 2006, overseeing four public-private Working Groups: Starting a Business; Licenses and Permits; Fishing (tax focus); and Immigration. The membership of the Taskforce comprises four Ministers and four senior private sector representatives, and its mandate is to identify and remove regulatory impediments to private sector growth.

Recent Reports/Policy Notes:

- East Asia and Pacific Update: Testing Times Ahead, April 2008
- 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 Credits (in millions of U.S. dollar equivalent, as of May 16, 2008)

Total disbursed	22.1
Undisbursed	5.84

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK³
(As of February 2008)

The Asian Development Bank (AsDB) strategy for Tonga supports the Government's Strategic Development Plan Eight 2006/07–2008/09 (SDP-8) development goals aimed at creating a society in which all Tongans enjoy higher living standards and a better quality of life. The government's strategic objectives emphasize the need to have an average budget deficit less than 2 percent of GDP, inflation below 7 percent, GDP growth in the 3–4 percent range and a reduction in the poverty headcount index below 23 percent, through a dynamic and highly competitive economy driven mainly by the private sector and an efficient public sector.

As agreed with the government, the new Country Partnership Strategy (CPS) 2007–2012 for Tonga will support the SDP-8 implementation in alignment with the objectives of the 2005 Paris Declaration on Aid Effectiveness. The CPS will focus on poverty reduction by means of three intervention pillars—pro-poor, environmentally sustainable integrated urban infrastructure development; financing of pro-poor policies through effective, prudent macroeconomic and fiscal management; and private sector development—that address binding constraints on growth. Capacity strengthening and institution building will be among the key outcomes of the results-based CPS. The CPS outcomes expected are (i) improved fiscal governance, (ii) improved social services delivery in urban areas, and (iii) an improved private sector-enabling environment.

AsDB has approved 15 loans totaling \$57.8 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Fifty-four technical assistance projects with a value of \$15.3 million were also provided to improve capacity and strengthen institutional development in various sectors. Past AsDB 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 SDP-8, 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.

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. The country has been participating in the GDDS since May 30, 2006. The metadata are posted on the Fund's Dissemination Standards Bulletin Board (<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. However, the response rates are very poor and there are major delays in data processing due to staff capacity and shortages. In August 2004, a PFTAC mission proposed improvements to source data and methodologies and suggested revisions of recent GDP estimates. A follow up mission took place in March 2008 with a focus on balance of payments and national accounts estimates and building linkages between government finance and national accounts statistics. The mission found only a few of the GDP components were compiled to a reasonable standard and were based on actual data (e.g. electricity and water supply). The mission raised concerns about the widespread use in compilation of out-of-date fixed ratios, extrapolations not founded on good data, and inappropriate price deflators.

The Consumer Price Index is based on a basket of goods and services from the 2000/01 Household Income and Expenditure Survey. Technical assistance is being provided in 2008 on the development of an import price index.

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. 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. No data are reported for publication in the *IFS* or *GFS Yearbook*.

External Sector Statistics

Official BOP statistics 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

Until recently, the reporting of monetary and financial statistics (MFS) to the Fund for publication in *International Financial Statistics* (IFS) was irregular. This was particularly worrisome since these data are shared with APD through an integrated monetary database. This situation has improved, as the NRBT now reports data for the central bank, other depository corporations, and monetary aggregates using the standardized report forms (SRFs). These data were published for the first time in the March 2008 issue of *IFS* and *IFS Supplement on Monetary and Financial Statistics*. The NRBT will have to allocate resources to improve the quality of MFS by obtaining source data suitable for compilation of the SRFs in line with the recommendations of the *Monetary and Financial Statistics Manual*.

Tonga: Table of Common Indicators Required for Surveillance
(As of May 18, 2008)

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶
Exchange Rates	3/2008	5/2008	M	M	<i>M</i>
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	1/2008	2/2008	M	M	<i>M</i>
Reserve/Base Money	3/2008	5/2008	M	M	<i>M</i>
Broad Money	3/2008	5/2008	M	M	<i>M</i>
Central Bank Balance Sheet	3/2008	5/2008	M	M	<i>M</i>
Consolidated Balance Sheet of the Banking System	3/2008	5/2008	M	M	<i>M</i>
Interest Rates ²	3/2008	5/2008	M	M	<i>M</i>
Consumer Price Index	11/2007	2/2008	M	M	<i>M</i>
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	NA	NA	NA	NA	<i>NA</i>
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	12/2007	1/2008	M	Q	<i>Q</i>
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	6/2007	1/2008	A	A	<i>A</i>
External Current Account Balance	Q3/2007	1/2008	Q	Q	<i>Q</i>
Exports and Imports of Goods and Services	Q3/2007	1/2008	Q	Q	<i>Q</i>
GDP/GNP	2007	1/2008	A	A	<i>A</i>
<i>Gross External Debt</i>	<i>6/2007</i>	<i>1/2008</i>	<i>A</i>	<i>A</i>	<i>A</i>

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).