FOR AGENDA

SM/08/174
Correction 1

July 1, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached correction to SM/08/174 (6/18/08) has been provided by the staff.

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 9, line 5: for "labor unions" read "the Public Service Association"

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

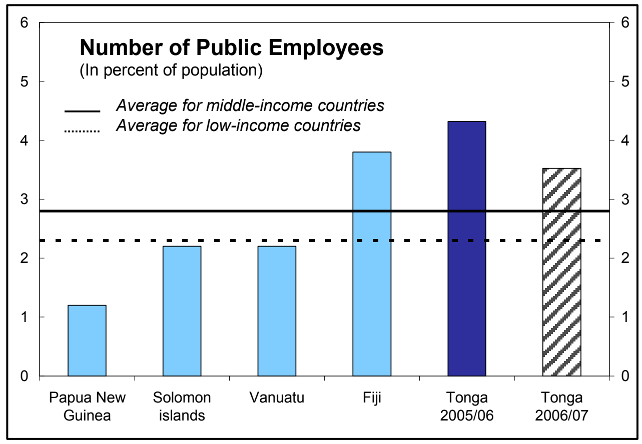
This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

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 the Public Service Association 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.



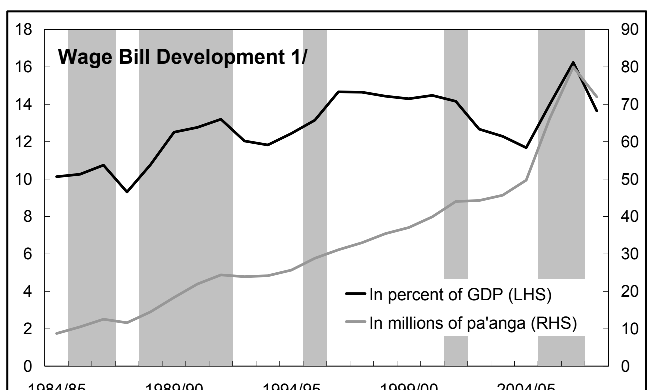
These developments had significant fiscal implications. The total cost of the wage settlement, including one-off payments such as severance package, accounts for about 9 percent of GDP in FY05/06, and 3¾ percent in FY06/07. Despite the substantial civil service retrenchment in end-FY05/06, the wage bill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

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.

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.



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.