

**IMMEDIATE
ATTENTION**

SM/10/96
Supplement 1

April 22, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Tonga—Staff Report for the 2010 Article IV Consultation—Informational Annex**

The attached informational annex is being issued as a supplement to the staff report for the 2010 Article IV consultation with Tonga (SM/10/96, 4/22/10), which is being considered on a lapse of time basis. Unless an objection from the authorities of Tonga is received prior to the conclusion of the Board's consideration, the document will be published. Any requests for modifications for publication must be received two days before the Board concludes its consideration.

Questions may be referred to Mr. N'Diaye (ext. 39751) and Mr. Porter (ext. 37316) 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 Friday, April 30, 2010; 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)

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INTERNATIONAL MONETARY FUND

TONGA

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2010 Consultation with Tonga

(In consultation with other departments)

April 21, 2010

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ANNEX I. TONGA: FUND RELATIONS
(As of March 31, 2010)

I. **Membership Status:** Joined September 13, 1985; 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
Net cumulative allocation	6.58	100
Holdings	7.07	107.48

IV. **Outstanding Purchases and Loans:** None.

V. **Financial Arrangements:** None.

VI. **Projected Obligations to Fund:**^{1/}

(SDR Million; based on existing use of resources and present holdings of SDRs):

	<u>2010</u>	<u>2011</u>	<u>Forthcoming</u> <u>2012</u>	<u>2013</u>	<u>2014</u>
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

^{1/} When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

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 United States, 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.

The authorities have removed in April 2010 the exchange restriction in the form of a tax certification requirement applied to various current international transactions. The exchange restriction subject to approval under Article VIII, Section 2 (a) consisted of a 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 May, 2009 and the Executive Board discussed the staff report (IMF Country Report No. 09/292) on September 4, 2009.

IX. Technical Assistance:

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

Pacific Financial Technical Assistance Centre (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 CENTRE (PFTAC)¹ (As of March 2010)

Assistance to Tonga since 2006 included 27 advisory missions across all technical assistance (TA) sectors. During 2006–March 2010, Tonga has sent 63 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 GFSM 2001 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 visited Tonga in mid-March 2008 to further assist in these areas. A PFTAC mission on decentralization also visited Tonga in May 2008 and made several recommendations in this area. A scoping mission on Medium Term Budgeting in Tonga will take place in late March 2010.

Tax Administration and Policy

Tonga has improved revenue policy and administration over the last three years. Key outcomes are: the passing of new Income tax and Customs Acts, both self assessed; a post implementation review of the value-added tax (VAT) and substantial change to the tax administration principally with the introduction of self assessment. This progress has complemented the introduction of the consumption tax in 2005 and has seen tax revenues increase steadily to GDP in recent years.

An IMF/PFTAC Tax Policy and Administration mission in March 2008 had the objective of reviewing tax policy issues in small Pacific island countries and in particular to consider the

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.

fiscal challenges posed by prospective trade liberalization and assess the experience with the VAT. The mission visited Fiji, Kiribati, Samoa, Solomon Islands, and Tonga. In Tonga, the mission found that the consumption tax was catalytic to the improvement of revenues collected in an environment of the political will to reform of the public sector and also dissatisfaction with the performance of some existing taxes.

Revenue losses arising from trade liberalization through the Pacific Island Countries Trade Agreement (PICTA) and Pacific Agreement for Closer Economic Relations (PACER) have been estimated as high as 27 percent of total revenue by external research.² This presents an issue for Tonga to deal with in the immediate future to replace those lost revenues.

Informal discussions between PFTAC and Tongan revenue officials regarding the modernizing of stamp duties also Customs administration and processes where improvements to trade revenues can be made.

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 conducting on-site examinations of banks was provided in late 2005 and again in February 2006. 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. Peripatetic advisors to provide assistance and training in the conduct of on-site bank examinations are being provided by Monetary and Capital Markets Department (MCM). The PFTAC Advisor visited the NRBT in January 2010 to review, among other things, the adequacy of prudential reporting requirements for banks. Based on that visit, additional visits by the Advisor are planned for later in 2010 to strengthen prudential bank reporting requirements and assist the authorities in revising/updating bank regulations.

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.

² Soni, Harris and Zinner-Toa: *Responding to the Revenue Consequences of Trade Reforms in the Forum island Countries*: September 2007: Report commissioned by the Pacific Island Forum Secretariat.

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. Follow-up missions on BOP statistics were undertaken in April 2008 and March 2009, resulting in revised BOP estimates based on the *Balance of Payments Manual, 5th edition* (BPM5) standards being compiled. A further advisory mission on BOP was undertaken in March 2010 to assist in improving the use of source data and the methodology, as well as mapping the estimates to the BPM6 classification. In addition to the an advisory mission on revenue estimation and review of National Accounts Statistics (NAS) in mid-March 2008, a further TA advisory mission in March 2009 and a short-term expert mission in February 2010 implemented significant improvements in NAS methodology and use of source data, resulting in substantial improvements in the estimates and dissemination of an expanded range of NAS estimates. TA expert missions to develop producer price indexes were also undertaken in July 2008 and March 2009.

ANNEX III. TONGA: RELATIONS WITH THE WORLD BANK GROUP (As of March 30, 2010)

Tonga became a member of the World Bank Group in 1985. Since that time, the World Bank has approved six IDA credits and grants worth a total of SDR 18.6 million (equivalent to approximately USD 28 million based on exchange rates at the time of each loan approval).

There is scope for the Bank to potentially commit as much as USD 30 million in new IDA and trust fund assistance to Tonga during the IDA-15 period (FY09–FY11). Tonga's indicative IDA-15 envelope of approximately USD 7.5 million has been increased to USD 11.5 million to allow for additional reconstruction efforts following the impact of the tsunami in September 2009 on the outlying Niua islands. The Bank also has potential scope to provide further additional funds for Tonga on top of its IDA allocation, to respond to the impacts of the global slowdown and to assist Tonga participate in regional arrangements to improve broadband connectivity. In addition, the Bank in FY10 has mobilized an additional AUD 10.3 million from the Australian Government through the Pacific Regional Infrastructure Facility (PRIF) to support transport sector investments, particularly road maintenance.

Given Tonga's debt position, all new IDA support for Tonga is provided on grant terms.

Key components of the World Bank's current engagement include:

- **Health:** The Tonga Health Sector Support Project (an IDA credit of USD 10.9 million equivalent approved in 2003) has successfully supported Tongan Government efforts to improve the performance of the health sector, particularly Vaiola hospital, and make further progress toward the MDGs. The project closed in early FY10.
- **Education:** The Tonga Education Support Project (an IDA credit of USD 1 million approved in 2005 in conjunction with a New Zealand grant of USD 4.1m) introduced a successful schools grants program. School grants, allocated on a capitation formula, have ensured funding has been allocated equitably and able to be used flexibly by schools for maintenance and educational materials. This program has supported Tonga's own progress toward universal primary education, where the country remains broadly on track.
- **Transport:** The Tonga Transport Sector Consolidation Project (an IDA grant of USD 5.4 million equivalent approved in July 2008) aims to assist the Government to unify transport sector-policy, planning and regulation in the newly established Ministry of Transport. This is intended to improve civil aviation and maritime safety and security. With anticipated grant support through PRIF, the TSCP will also assist the government to directly contract local firms to undertake urgent and necessary road maintenance in a manner which ensures local participation and strengthening of the local industry as well as support maritime and air transport investments. The Australian Government has committed to provide an additional AUD 8.3 million through TSCP over the next 3 years.

- **Post-tsunami reconstruction:** The bank is finalizing a \$5 million investment to support reconstruction in the outlying Niua islands affected by the tsunami. It is anticipated that this will be presented to the Board in May 2010.
- **Energy:** The Bank is currently working with the Tongan Government and other development partners to develop a Tonga Energy Roadmap, as a series of integrated investments and reforms required to improve access and reduce the cost of electricity supply in Tonga, and minimize Tonga's vulnerability to oil price shocks, including by making greater use of renewable sources of energy. Leadership by the Tonga Government has ensured that this process has been a strong example of development coordination in the Pacific region. It is anticipated that the Bank will be able to support the final roadmap – with other development partners and potentially private sector investors – with current unallocated IDA resources, as well as with support through PRIF.
- **Development policy support:** The Bank is discussing options with the Tongan Government to potentially provide finance to assist Tonga respond to the global slowdown. Additional funds could possibly be found on top of Tonga's current IDA allocation from the Bank's pilot crisis response window. Policy actions could focus on implementation of the energy sector road map and improvements in the business environment. Critically, however, moving ahead with this operation will require the Tonga authorities to provide a coherent policy response to the actions that Tonga itself is taking to address fiscal imbalances.
- **Broadband connectivity:** The Bank Group is working with the Tongan authorities and other development partners, particularly the Asian Development Bank, to explore options for landing a broadband cable in Tonga to improve connectivity. Given the regional dimensions of connectivity arrangements, there is potential scope for this to be financed in addition to Tonga's regular IDA allocation.

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK³ (As of March 2010)

The Asian Development Bank (AsDB) strategy for Tonga supported the Government's Strategic Development Plan Eight 2006/07–2008/09 (SDP-8) in alignment with the objectives of the 2005 Paris Declaration on Aid Effectiveness. The Country Partnership Strategy 2007–2012 (CPS) focuses 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.

The SDP8 ended in June 2009 and a new National Strategic Planning Framework (NSPF) is now in place. The NSPF takes a longer term strategic approach and focuses on a limited number of uniquely national or whole of government priorities – with the implementation details to be contained in the corporate plans of ministries and departments. The NSPF identified seven outcomes fundamental to producing sustained and more equitable economic growth – (i) community development, (ii) private sector growth, (iii) constitutional reform, (iv) improved provision and maintenance of infrastructure, (v) increased performance of technical and vocational training, (vi) improved health, and (vii) environmental sustainability and climate change. The three pillars of the AsDB's strategy for Tonga remain valid in light of the outcome objectives highlighted under NSPF.

AsDB has approved 15 loans and two grants totaling \$79.1 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Fifty-eight technical assistance (TA) projects with a value of \$17.5 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 two grant-financed projects and three TA projects in the country portfolio. The grant-financed program approved in 2009 will help Tonga mitigate the impact of the global economic crisis, while establishing the basis for higher, more equitable and sustainable growth in the medium term and creating an economy more resilient to future shocks. Another grant-financed project supports enhancing living standards by improving urban infrastructure. The three ongoing TA projects focus on public enterprise reforms, urban planning and management system and economic and strategic management. Tonga also benefits from a number of regional technical assistance projects in private sector

³ Prepared by Asian Development Bank staff.

development, economic management, infrastructure-related activities, public financial management, statistics and HIV/Aids prevention and capacity development.

Tonga: Loan, Grant and Technical Assistance Approvals, 2005–09

	2005	2006	2007	2008	2009
Loan approvals					
Number	0	0	0	0	0
Amount (in millions of U.S. dollars)	0	0	0	0	0
Grant approvals					
Number	0	0	0	1	1
Amount (in millions of U.S. dollars)	0	0	0	11.3	10.0
Technical assistance approvals					
Number	1	2	1	1	2
Amount (in millions of U.S. dollars)	0.7	0.9	0.5	0.7	1.0

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

Following PFTAC assistance in 2008 and 2009 a new series of national accounts was released in June 2009. The new series retains a 2000/01 base year but has been revised to improve coverage and estimation techniques. However, source data remains weak and needs to be improved to allow a long overdue rebase of the national accounts.

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

With PFTAC assistance in March 2009 the Statistics Department developed revised draft BoP statistics and methodology and made recommendations for further improvements in compilation techniques and source data. A follow-up mission took place in March 2010. The MOF has put in place a system that provides detailed information on official sector external disbursements and debt service.

Monetary and Financial Statistics

NRBT 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 April 7, 2010)

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶
Exchange Rates	2/2010	March/2010	M	M	<i>M</i>
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	1/2010	March/2010	M	M	<i>M</i>
Reserve/Base Money	1/2010	March/2010	M	M	<i>M</i>
Broad Money	1/2010	March/2010	M	M	<i>M</i>
Central Bank Balance Sheet	1/2010	March/2010	M	M	<i>M</i>
Consolidated Balance Sheet of the Banking System	1/2010	March/2010	M	M	<i>M</i>
Interest Rates ²	1/2010	March/2010	M	M	<i>M</i>
Consumer Price Index	1/2010	March/2010	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	02/2010	March/2010	M	Q	<i>Q</i>
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	02/2010	March/2010	A	A	<i>A</i>
External Current Account Balance	Q4/2009	March/2010	Q	Q	<i>Q</i>
Exports and Imports of Goods and Services	Q4/2009	March/2010	Q	Q	<i>Q</i>
GDP/GNP	2008/09	March/2010	A	A	<i>A</i>
Gross External Debt	6/2009	March/2010	A	A	<i>A</i>
<i>International Investment Position</i>	<i>NA</i>	<i>NA</i>	<i>NA</i>	<i>NA</i>	<i>NA</i>

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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).