

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/160

3:00 p.m., November 23, 1987

R. D. Erb, Acting Chairman

Executive Directors

J. E. Ismael

Alternate Executive Directors

S. M. Hassan, Temporary
Yang W., Temporary
E. L. Walker, Temporary
L. Hubloue, Temporary
M. Hepp, Temporary
S. K. Fayyad, Temporary
R. Wenzel, Temporary
J. Reddy
L. M. Piantini, Temporary
R. Comotto, Temporary
C. L. Haynes, Temporary
D. Saha, Temporary
A. R. Al-Abdullatif, Temporary
V. J. Fernández, Temporary
M. A. Kyhlberg, Temporary
V. Rousset, Temporary
G. Schurr, Temporary
I. Sliper, Temporary
S. Rouai, Temporary
V. K. Malhotra, Temporary
T. Morita, Temporary
F. Di Mauro, Temporary

L. Van Houtven, Secretary and Counsellor
J. K. Bungay, Assistant

Also Present

Asian Department: H. Neiss, Deputy Director; C. M. Browne, F. Le Gall.

Exchange and Trade Relations Department: B. C. Stuart. Legal Department:
P. L. Francotte.

1. TONGA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Tonga (SM/87/253, 11/2/87). They also had before them a background paper on recent economic developments in Tonga (SM/87/257, 11/6/87).

Mr. Reddy made the following statement:

The economic performance of Tonga in recent years has been broadly satisfactory. The average annual real rate of GDP growth since 1983 has been maintained at over 3 percent. The inflation rate has fluctuated rather erratically from year to year. Because of the heavy dependence on New Zealand as the single most important supplier of imported goods, prices in Tonga have depended heavily on the inflation rate in New Zealand and the exchange rate of the pa'anga vis-à-vis the New Zealand dollar. The current account of the balance of payments, as well as the overall balance, consistently produced surpluses between 1983 and 1987. The gross external reserves position, at an equivalent of over five months of imports, remains comfortable. The debt service ratio between 1983 and 1987 has remained low--below 2 percent of current receipts.

Small sea-locked island economies invariably have a weak underlying external payments position. The country's small size itself limits the scope for both import substitution and for diversification of exports, given the limited resources. Similarly, the scope for diversifying the sources of imports is also limited because of geographical isolation, shipping difficulties, and high transportation costs. Nonetheless, within the constraints of limited resources, diversification remains a worthwhile objective, especially because the outlook for traditional exports and for further growth in external aid and private remittances is not bright. Therefore, my authorities agree with the staff that in the longer term, structural changes are required to shift the allocation of resources to the traded goods sector and to increase private savings and investment. Currently, the focus of government policy is on the expansion of the tourist industry and on manufacturing sector development in order to strengthen and diversify sources of foreign exchange earnings.

The staff report identifies actual and potential problems in two areas although the balance of payments has been in surplus in recent years, and there are no major immediate problems facing the country. The two problem areas include the fiscal outcome for 1986/87, and the outlook for 1987/88; and the fragility of the underlying external payments position.

Fiscal management in Tonga was prudent until 1986/87 with the budget in approximate balance. In 1986/87, the budget deficit increased to 4 percent of GDP in spite of good revenue performance. The main reason for the deterioration in the budget was the sharp increase in expenditures. While the details regarding the areas of expenditure overrun are not known, it appears that the major contributory factors were salary increases for the lower grades in the civil service, higher subsidy payments, and sharply higher development expenditures. These developments have been of concern to the authorities; therefore, the budget for 1987/88 provided for an elimination of the overall deficit primarily through the cancellation or phasing out of nonpriority capital projects and through tight control on current real expenditures at the 1986/87 level.

The budget for 1987/88 may have been too ambitious, since some additional current expenditures had to be approved early in the new financial year. The fiscal deficit in 1987/88 is now estimated to remain at about 3 percent of GDP. In view of the surplus liquidity in the system and the comfortable reserves position, the authorities intend to finance the deficit equally from external concessional loans and domestic sources. While a fiscal deficit of 3 percent of GDP may be considered somewhat high, deficits of such magnitudes can become sustainable if domestic resource mobilization is intensified through additional incentives and new instruments for promoting savings. In the meantime, the authorities intend to keep tight control on extra-budgetary expenditures; to this end, they have established a Budget Administration Unit in the Ministry of Finance.

In the absence of a central banking institution, it was convenient for the authorities to peg the exchange rate of the pa'anga to the Australian dollar, since Australia has historically been an important trading partner and a valuable source for foreign aid for Tonga. The authorities appreciate the need to review the existing exchange arrangement in view of the growing importance of trade with other countries in the region. A new exchange rate mechanism, which would take into account trade and services flows, is under consideration, although no operational decisions are likely until after the establishment of a central bank.

As with the exchange rate policy, the conduct of monetary policy has also been constrained by the absence of a central bank. The rate of domestic credit creation declined in 1986/87. The liquidity growth remained large--34 percent--because of the external surplus. The liquidity growth in 1987/88 is likely to be somewhat less, owing to a lower-than-expected surplus in the balance of payments. The authorities share the staff viewpoint that higher interest rates on deposits, together with a contributory pensions scheme, could play a significant role in raising

financial savings in the economy. As explained in the staff report, Tonga is in the process of establishing a central bank. Its establishment will allow for new instruments to be developed for liquidity management and for resource mobilization. The establishment of a central bank would also open the way for interest rates to play a more active role in monetary policy. The authorities are currently reviewing interest rates, and they intend to introduce legislation in 1988 to make interest rates more flexible.

The small size of Tonga, the limited natural and human resources, the geographical isolation, and the underdeveloped infrastructure will continue to pose major problems for future economic development. To some extent, Tonga's future development will depend on the speed with which the authorities tackle some of the structural problems. However, the future prospects for the economy will depend crucially on the easy access of Tongan exports to the Australian and New Zealand markets, on the continued flow of remittances from Tongans living abroad, and on the continued flow of foreign assistance on concessional terms.

Mr. Sliper made the following statement:

I agree basically with the conclusions in the staff report, and I would like to add my support for some of the economic strategies that have been identified by the staff and Mr. Reddy. On the overall mix of policies, it seems that the authorities have followed a prudent course. For the most part, fiscal and monetary policies have been satisfactory. Public enterprises have been run along commercial lines and the basic public sector has concentrated on providing economic infrastructure. The Government is to be congratulated for ensuring that only a limited volume of public debt has been contracted, with the consequence that the debt service ratio remains at the very manageable level of 2 percent of export earnings. The average annual growth rate this decade of about 3 percent attests to the generally appropriate mix of policies being followed by the authorities.

I agree with the emphasis in the staff report on the problem represented by the fiscal deficit, both for last year and the coming year. What is perhaps of as much concern as the magnitude of the deficit itself, about 3 percent of GDP, is the procedural weakness that has been brought to light--the ease with which additional or supplementary expenditures can be approved. Some procedural modifications have been introduced, including the setting up of a new Budget Administration Unit. I would be grateful for any comments on the likely success of these changes, and more generally, on the degree of political resolve that exists to bring the fiscal situation into balance. Behind that question lies a real concern about the deficit and its potential

to become a very serious imbalance. We have all seen and experienced many cases of little deficits growing into big deficits. Similarly, we all know that it is much easier to act now rather than later.

On the strategy of export diversification, I very much agree with the thoughts outlined by Mr. Reddy. In brief, diversification must be pursued even if the prospects appear limited and the constraints large. In the end, much more will depend on getting the economic framework right rather than on efforts to direct investment from the center to particular areas or sectors.

In this regard, I welcome the intention expressed by Mr. Reddy as to the authorities' willingness to look at the exchange rate system. While there may have been good historical reasons for pegging the pa'anga to the Australian dollar, the changing pattern of both exports and imports, as outlined in Table 20 of SM/87/257, suggests that a more flexible system might be more appropriate. I would hope that next year, when the proposed central bank has been established, the authorities will engage in a serious study of different exchange rate management systems.

In conclusion, I agree that, given the size of Tonga and the satisfactory economic position, a 24-month consultation cycle is appropriate.

Mr. Comotto said that the staff report clearly highlighted the major policy problems confronting Tonga: most immediately, the need to restore fiscal discipline; and in the longer term, enhancement of domestic resource mobilization and the improvement of resource allocation. There was also the continuing need to strengthen the statistical base. The most worrying aspect of Tonga's recent overspending was that no one seemed sure of exactly what the money had been spent on. It was not easy to judge from the staff report whether that problem was being addressed with sufficient urgency. Of more fundamental concern was the question as to why Tonga had suddenly relaxed control, after having maintained an admirable degree of fiscal balance during some of the most turbulent years of the past decade.

Another area needing some consideration was the appropriate framework for the exchange rate, Mr. Comotto considered. Now that both the Australian and New Zealand dollars were floating freely, the traditional fixed link of the pa'anga to the Australian dollar was too rigid, and somewhat misdirected. However, it was not easy to envisage a superior alternative, and the question was one that went beyond the case of Tonga. Notwithstanding that problem, a more active interest rate policy was likely to have an important role to play, and the establishment of a central bank could provide a useful institutional foundation.

He urged the authorities to take the initiative in accepting the obligations of Article VIII, Mr. Comotto concluded. The authorities had established a commendable record of cooperation with the Fund in the short period that Tonga had been a member, and such a step would be a welcome development. More generally, the acceptance of Article VIII obligations was something to which not enough attention was always paid, and he therefore welcomed the staff's recommendation in that respect for Tonga. Finally, he could support the proposal that Tonga move to a bicyclic consultation procedure in view of the country's past prudent policies.

Mr. Haynes made the following statement:

The economic performance of Tonga in the current volatile international environment is commendable. A growth rate above 3 percent has been sustained since 1983, without putting pressure on the financial system or the balance of payments; at the same time, the debt service ratio has remained below 2 percent of external earnings. The part played by external assistance in the form of grants and concessional loans has been decisive, but the flow of remittance income from emigrants to residents has also been important in supporting the balance of payments. We should not underestimate, however, the authorities' own efforts in the past to keep fiscal deficits down, even though per capita income is low, employment opportunities are limited, and the economic infrastructure needs further improvement.

The staff appraisal points to a number of disturbing signs. The outlook for exports is not very strong, and receipts from remittances and grants are likely to decrease. Spending, both private and public, will have to be restrained to avoid creating balance of payments problems. In addition, although the debt service ratio is very low, the authorities should continue to minimize their use of external commercial borrowing.

I would like to make one point on the proposed establishment of a central bank: I hope that the existence of this new institution will not cause the authorities to deviate from sound fiscal practices, but rather, that it will be designed in such a way as to reinforce the need for prudent fiscal policies.

I also note that the authorities are considering a reform of the interest rate structure, to mobilize greater financial savings and to encourage the commercial banks to seek out more lending opportunities. This objective is desirable but the authorities will need to monitor closely the interest rate spread, given the presence of a single commercial bank.

As far as the exchange rate is concerned, the volatility associated with pegging to a single currency might suggest pegging to a small basket of currencies. This would tend to minimize price fluctuations. In setting the new rate, one would

have to address considerations of competitiveness. However, sight should not be lost, in designing exchange rate policy, of the importance of exchange rate stability for very small open economies, such as many of those represented by this chair.

Mrs. Walker made the following statement:

While recognizing the constraints Tonga faces because of its size and location, I believe that progress can be made to bring about further economic development. Slippages occurred last year, most notably in the fiscal sector, but according to Mr. Reddy, the authorities are open to constructive policy changes in several important areas, and we urge them to follow through with these plans.

Central to the development effort will be tighter control of the fiscal position, which unfortunately has deteriorated significantly in the past year and is projected to remain weak next year. Therefore, additional measures to bring about an improvement in the fiscal position will be necessary, and I urge the authorities to take immediate steps to achieve a reduction in the fiscal deficit. In this regard, I wonder whether there is scope for reduction in subsidies to the Commodities Board and the airlines, and I would appreciate staff comment on this point. In addition, consideration should be given to broadening the revenue base and stimulating private saving through the implementation of a civil service pension scheme. A more flexible interest rate policy could also contribute to increased savings where socially feasible. The Budget Administration Unit to be created should be able to assist in tighter control over expenditure, which is particularly needed after the budget is formulated. Finally, we would caution the authorities against contracting expensive commercial debt in financing their fiscal deficit.

The medium-term balance of payments scenario underscores the need for this tighter fiscal control as well as the avoidance of excessive monetary expansion. The creation of a central bank is a welcome development. Further development of the export sector will be important to achieve a sustainable balance of payments in the medium term. I welcome the measures the authorities have taken to develop the industrial and tourism sectors, while I note the limited potential for further export growth in these areas. Furthermore, a more flexible exchange rate policy, which according to Mr. Reddy the authorities are considering, could help provide more appropriate incentives for the traded goods sector, including tourism. Therefore, we welcome the authorities' openness on this matter.

We would support the notion that a more complete data base would assist in economic policy formulation in Tonga.

Finally, I welcome the fact that the authorities have benefited from the Article IV consultation, and either have taken or are considering a number of steps the Fund staff has recommended. It is in these small countries perhaps that the Fund's advice is most useful.

The staff representative from the Asian Department said that Tonga's expenditure control had weakened to a surprising extent over the past 18 months since the previous Article IV consultation. One important factor had been the pressure on the Government to increase its expenditure before the general election held at the beginning of 1987; given the presence of a stronger opposition after the election, the additional pressures for increased expenditure could not be resisted fully by the authorities. Moreover, the administrative control procedures in the Ministry of Finance, which had not been updated for several years, had proven to be rather poor. In addition, a "demonstration effect" had played a role: Ministers in the departments saw that it was quite easy to obtain approval for additional proposals, and further pressure for increased expenditure had occurred.

A number of measures had been taken in recent months to tighten up the procedures, as was evident, including an increased dialogue between the Ministry of Finance and other departments, the staff representative continued. The new Budget Administration Unit, as mentioned by Mr. Reddy, was a welcome attempt to control supplementary expenditures, which were indeed the main source of the problem. It was felt that if procedures could be improved and the accounts could be brought up to date, then more detailed information would be available to the Cabinet when requests were made for supplementary expenditure. The Cabinet would pay more attention to total available resources and to whether the requested expenditure was consistent with longer-term development objectives, and would thus adopt a more restrictive approach to spending. It was clear that the authorities were committed to re-establish control over expenditure.

With regard to the establishment of the central bank, it was expected that legislation would be put before Parliament in the middle of 1988, and that the bank would become operational late in 1988, the staff representative commented. While the role of monetary policy would remain somewhat limited in a country such as Tonga, the authorities did feel that the banking system could play a larger role in the development of the private sector. In that regard, a change was expected in interest rate policy, to help promote both private savings and investment. The authorities believed that higher deposit rates would stimulate domestic savings, as a part of the process by which interest rate spreads were reduced. There was currently a very large spread between the amounts that the commercial bank earned on foreign exchange invested in Australia and the relatively low rates paid to most depositors.

The mission had discussed with the authorities a number of possible exchange rate arrangements that could replace the present system of pegging to the Australian dollar, the staff representative recalled. One possibility was a basket of the Australian and New Zealand dollars, reflecting their importance in trade, as well as the U.S. dollar, reflecting the importance of remittances from the United States. The authorities were interested in changing the exchange rate arrangements because they felt that the wide price fluctuations that they had suffered in recent years as a result of the current arrangements had been detrimental. They were also interested in the possible use of a more active exchange rate policy for purposes of export diversification and import substitution, although the possibilities for expanding the traded goods sector were limited. In that regard, it had been noted during the mission discussions that the exchange rate policies followed by other Pacific island countries in the past few years had often included basket arrangements and more active exchange rate policies than in the 1960s and 1970s. The mission had not made any firm recommendations, but the authorities had indicated their willingness to review in detail possible exchange rate policy options, probably after the establishment of the central bank.

The statistical base in Tonga was weaker than those of most other Pacific island countries, the staff representative considered. Some progress had been made during the past year: there had been two missions from the Bureau of Statistics, one on balance of payments statistics and one on money and banking statistics. The authorities were considering the wide range of recommendations that had been made by those missions, and it was expected that the recommendations would be implemented in the future. The World Bank had provided useful assistance in the preparation of national accounts. As part of the tightening of the budget control procedures, a number of experts were working in the Ministry of Finance on budget accounts, including some computerization projects. The authorities had probably received as much technical assistance as could be absorbed at present, but it was clear that the statistical base would remain an important focus for future technical assistance.

With regard to Article VIII status for Tonga, the authorities had indicated their willingness to move to that status, and the move was under active consideration, the staff representative from the Asian Department reported. Tonga was on a bicyclical consultation schedule. It had been tentatively agreed, reflecting the wishes of the authorities, that an interim consultation be held in August 1988, with another full consultation to be scheduled in 24 months.

Mr. Reddy stated that for reasons that were well understood, it was not very easy for Directors to become interested in tiny, faraway countries such as Tonga. He even recalled instances in the past where the Chairman had had to sum up an almost nonexistent discussion. The meeting that day had been a more fortunate one. Two main areas of concern had been expressed, Mr. Reddy noted. The first area concerned public finance, including both the central government deficit and the deficits of the state enterprises. Directors had emphasized the importance of expenditure

control, and the importance of domestic resource mobilization. The need for positive real rates of interest and the compulsory pension scheme for civil servants had also been mentioned. In that context, he drew attention to the establishment of a Budget Administration Unit in the Treasury, which should ease the problem somewhat.

The other area of concern related to the need to address the structural weaknesses in the balance of payments, and in particular to reduce excessive reliance on workers' remittances and foreign aid, Mr. Reddy noted. Directors had alluded to the need to review the exchange rate. The authorities were conducting a review of their exchange rate policy.

Finally, Mr. Reddy observed that Mr. Comotto had urged Tonga to accept the obligations of Article VIII. In practical terms, moving from Article XIV to Article VIII would make no difference, since Tonga already maintained an exchange system free of restrictions. Given the underlying weakness in the balance of payments, his authorities were cautious about accepting Article VIII status immediately; they would like to see a significant strengthening in the underlying balance of payments position before reaching a firm decision on that matter.

The Acting Chairman made the following summing up:

Directors were in agreement with the thrust of the staff appraisal, and considered that Tonga's economic performance in the first half of the 1980s had been satisfactory. Steady, although moderate, real GDP growth had been achieved, combined with a sound external payments position. Appropriate fiscal policy guidelines had been observed, ensuring that the overall budgetary outturn, including external grants, was in approximate balance. Despite low exports, remittances from Tongans living abroad and external aid had led to repeated current account surpluses, and the external debt position had remained quite manageable.

Directors were concerned, however, about recent fiscal trends. Current spending, including subsidies to public enterprises, had increased rapidly, mainly because of weaker expenditure control. Directors believed that the restoration of fiscal discipline was essential to maintain external viability and to support an increase in domestic savings. In those circumstances, the traditional controls on public expenditure should be reimposed quickly and resolutely, and in that context, Directors welcomed the establishment of a Budget Administration Unit. If the rate of growth of current spending was not contained, the balance of payments could soon become unsustainable. Accordingly, Directors concluded that difficult decisions were needed, which would require strong political will on the part of the authorities.

Directors indicated that, while adjustment policy had to focus on reversing recent fiscal trends, interest and exchange rate policies could play a useful supporting role. Market-oriented interest rates would help to promote private savings and encourage greater efficiency in the use of capital. Reviewing the fixed link with the Australian dollar would give scope for greater flexibility in exchange rate policy. While recognizing the difficulties a small open economy faced when establishing an exchange rate policy, Directors believed that greater flexibility in the exchange rate arrangement would facilitate reducing price fluctuations in Tonga and would strengthen competitiveness. In view of the limited debt servicing capacity, external commercial borrowing should be avoided.

Directors welcomed the prospective establishment of a central bank, which should strengthen the conduct of monetary policy. The task of policy formulation would also be facilitated by the availability of a more comprehensive data base.

Directors also noted that Tonga's economy remained vulnerable to exogenous factors and that its poor resource base highlighted the need to strengthen the economic structure, shift the allocation of resources to the traded goods sector, and increase savings and productive investment.

Directors welcomed the authorities' consideration of moving to Article VIII status. It is expected that the next Article IV consultation with Tonga will be held in 24 months, in accordance with the biennial consultation procedure.

APPROVED: July 13, 1988

LEO VAN HOUTVEN
Secretary