

**LAPSE OF
TIME**

SM/17/340
Supplement 1

December 21, 2017

To: Members of the Executive Board

From: The Secretary

Subject: **Tonga—Staff Report for the 2017 Article IV Consultation—Informational Annex**

Board Action:	Executive Directors' consideration on a lapse of time basis
Publication:	Yes*
Questions:	Ms. Loukoianova, APD (ext. 39694)
Document Transmittal in the Absence of an Objection and in accordance with Board policy:	Friday, December 29, 2017—WTO After Board Consideration—Asian Development Bank

***Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the document will be published.**



TONGA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 19, 2017

Prepared By

The Asian and Pacific Department
(In consultation with other departments)

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FUND RELATIONS¹

Membership Status

Joined September 13, 1985; Article VIII.

General Resources Account

	SDR Million	Percent Quota
Quota	13.80	100.00
Total holdings of currency	10.36	75.10
Reserve position in the Fund	3.44	24.90

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	6.58	100.00
Holdings	5.37	81.64

Outstanding Purchases and Loans

None

Financial Arrangements

None

Projected Obligations to Fund*

(SDR million; based on existing use of resources and presenting holdings of SDRs)

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest	0.00	0.01	0.01	0.01	0.01
Total	0.00	0.01	0.01	0.01	0.01

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

Exchange Arrangement

The exchange rate arrangement is a pegged exchange rate within horizontal bands. Tonga has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 and maintains an exchange control system that is free of restrictions on the making of payments and transfers for current international transactions. 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

¹ As of September 2017.

New Zealand dollars, with the U.S. dollar as the intervention currency. In July 2014, the Fijian dollar was added to the basket replacing the Japanese yen, and, in July 2010, 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.

Last Article IV Consultation

Staff discussions were held during March 2016. On June 13, 2016, the Executive Board of the IMF concluded the 2016 Article IV consultation with Tonga and endorsed the thrust of the staff appraisal (IMF Country Report No. 16/178).

Technical Assistance

The Legal Department (LEG) provided assistance on AML/CFT issues for the Pacific islands countries, including Tonga in 2002–05. LEG also provided assistance on the National Reserve Bank of Tonga Act and Financial Institutions Act in 2013–14. MCM provided TA assistance on enhancing the monetary policy framework and developing securities market and on FX reserve management in 2017. PFTAC has been providing TA on an on-going basis on budgetary management; tax administration; tax audit and risk management; banking legislation and supervision; and balance of payment, national accounts and government finance statistics.

Resident Representative

The Regional Resident Representative Office for Pacific Islands, including Tonga, was opened on September 2010 in Suva, Fiji. Mr. Tubagus Feridhanusetyawan is the resident representative.

PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC) COUNTRY STRATEGY 2016–18¹

Background

Tonga economy continues to grow. Weaker global economic outlook and inward looking policies by development partners may lead to risk associated with future grant financing, private remittances, and revenues from tourism. Non-performing loans in the banking system continue to decrease, while fiscal policy options are tightly constrained by the level of public debt.

Strategy 2017–18

PFTAC's TA strategy is guided by the APD regional strategy and is planned within the results framework for Phase V of the PFTAC funding cycle.

In the public financial management area, the focus is primarily to assist the authorities to implement high priority reforms identified in the PFM Roadmap and in the Joint Policy Reform Matrix between the government and development partners. In the last two years, PFTAC assisted in developing the Roadmap, as well as planning to upgrade the government's FMIS. For FY2017–18, PFTAC TA focused on accounting and reporting improvements that include adoption of international public sector accounting standards-cash basis; and revising the Chart of Accounts to respond to data needs for better budgeting, statistics, and financial reporting. In the medium-term, PFTAC is ready to support other Government's efforts such as to develop an effective medium-term budget framework, and improving PFM legislations.

In the revenue area assistance was provided in: (a) the development of a strategy for strengthening the tax audit function including a review of organizational and staffing arrangements, management practices, planning methods, risk analysis programs, and underlying audit methods and procedures; and (b) reviewing the Consumption Tax Act and Regulations and benchmarking against international best practice to simplify and modernize laws. Tonga was included in the 2017, FAD Review of Tax Reforms in the PFTAC region.

In statistics, Tonga is relatively well advanced against the overall results framework; based on PFTAC advice, it produces National Accounts on two independent measures with production of a range of income indicators. Balance of payments statistics are now being developed according to BPM6 standards. However, sources, quality, and timeliness need to be strengthened. Engagement with the Tonga Department of Statistics (TDS) has strengthened since 2014, when PFTAC took over the provision of national accounts TA, formerly provided by an Australian-funded resident advisor. Recent work has focused on the much greater use of tax returns to estimate GDP by production, though a secure data flow from the tax office is yet to be established.

¹ As of October 2017.

ESS and GFS support were provided by IMF HQ until 2015; GFS TA is now being provided through a PFTAC resident advisor, while ESS TA is now funded through TAOLAM. A GFS TA mission to Tonga in June 2017 continued to delineate the public sector and reviewed and refined the mapping of the national chart of accounts bridge table for GFS compilation purposes. A four-year time series (FY2013-16) of GFS data for the budgetary central government is now available. The PFTAC PFM advisors and the GFS advisor will work with the authorities to improve the classification, accuracy, timeliness and completeness of data for financial and economic reporting. An ESS mission covering BOP and the IIP is scheduled for November 2017.

In financial sector supervision, since 2013, PFTAC has assisted the NRBT with the deployment of standard prudential returns and with establishing enhanced off-site analysis; and the development of the NRBT's on-site supervision framework and prudential standards. The most recent work was assisting the NRBT with performing on-site examinations of a number of commercial banks, which includes examination preparedness, scoping, planning, execution, and report writing. PFTAC reviewed the NRBT's complete set of Prudential Statements and drafted additional guidelines to ensure compatibility with the amendments made to the Financial Institution Act. In March 2016, the IMF Legal Department completed a desk review of the Financial Institutions Act, and currently been asked to review the latest amendments to the Banking Act (former Financial Institutions Act). Technical assistance in FY2019 will focus on the non-bank sector.

In the macroeconomic area, TA in 2015 was provided jointly by PFTAC and a secondee from the Reserve Bank of New Zealand, who was recruited by PFTAC and funded by the ADB, to build capacity for macroeconomic forecasting and analysis and link this analysis into budget processes. The TA focused on developing GDP forecasting and a macroeconomic programming framework. In October 2015, staff from the Ministry of Finance and National Planning (MFNP), the Tonga Department of Statistics (TDS), and the Ministry of Revenue and Customs (MORC) participated in a five-day workshop on practical applications of the macroeconomic programming framework. During 2015–17 staff also participated in high level dialogues and workshops on enhancing resilience to natural disasters, strengthening fiscal frameworks, medium-term expenditure planning for national sustainable development, forecasting tax revenues, and compiling and forecasting GDP.

WORLD BANK-IMF COLLABORATION¹

The IMF team led by Ms. Elena Loukoianova (mission chief to Tonga) has a close working relationship with the Bank team led by Mr. Kim Alan Edwards (Country Economist). The teams have an ongoing dialog on a range of macroeconomic and structural issues. The level of cooperation and coordination is good and includes the following:

- 2017 Article IV Consultation Discussions. The World Bank provided support and analytical inputs to the Article IV mission, as in the previous missions. In addition, Bank and Fund staffs prepared jointly the Debt Sustainability Analysis (DSA) appendix to the staff report.
- Economic Updates. IMF analysis continues to be a vital input to the ongoing budget support program, with IMF assessments used as the basis for decisions regarding the appropriateness of the overall macroeconomic policy framework.
- Structural Fiscal Reforms. Bank and Fund staffs continue to collaborate on ongoing analytical work on public expenditure (including public service remuneration), the medium-term macro-framework, and general structural issues. A joint work on the structural reforms and investment priorities is included as an appendix in the 2017 Article IV staff report.

Based on the above cooperation, the Bank and the Fund staff share a common view about Tonga's macroeconomic and structural reform priorities, which mainly aims at mitigating the risks to Tonga's external and fiscal sustainability and at promoting long-term growth. These include:

- Sustainable fiscal management. Tonga is extremely vulnerable to natural disasters and other external shocks, highlighting the importance of maintaining fiscal buffers. Construction costs for infrastructure development and pressures for further increases in payroll spending pose challenges to fiscal sustainability if not carefully managed. The implementation of recent public sector remuneration reforms should be targeted at containing growth in the overall wage bill. Any new borrowing should support high priority investments, be contracted on concessional terms, and remain within sustainable limits. Fiscal sustainability will also be supported by continued improvements in revenue administration and expenditure control, as well as structural reforms. The government's fiscal efforts will need to be supplemented by ongoing provision of grants from donors.
- Making use of the flexibility afforded by the current exchange rate arrangement. This remains important for safeguarding external stability.
- Promoting private drivers of growth. Given fundamental constraints of smallness and isolation, growth prospects are likely to remain concentrated in areas where premiums can be generated to cover higher costs of production. Tourism-servicing sectors, commercial agriculture, and fisheries hold the greatest potential for private sector development. To facilitate development in these areas there is a need to: (i) improve the efficiency and

¹ As of October 2017.

regulation of sectors such as energy, water, and telecommunications to improve service provision and reduce costs.

Table 1. Tonga: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas (February 2016–January 2018)		
	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • Procurement IT systems TA • Social protection and disaster risk management TA • Second inclusive growth development policy operation • NCD tax-policy assessment • Fiscal anchor TA • Public sector remuneration TA 	<ul style="list-style-type: none"> • FY2017 • FY2018 • FY2017 • FY2018 • FY2017 • FY2017/18
Fund Work Program	<ul style="list-style-type: none"> • 2016 Article IV Policy Note • 2016 Article IV Mission • 2016 Article IV Staff Report/Board Meeting • MCM TA on Enhancing the Monetary Policy Framework and Developing Securities Market • 2017 Staff Visit mission • 2017 Article IV Mission • 2017 Article IV Staff Report/Board Meeting 	<ul style="list-style-type: none"> • February 2016 • March 2016 • June 2016 • January 2017 • March 2017 • September/October 2017 • December 2017

RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

The Pacific Approach, 2016–20 serves as the operational framework of the ADB in the Pacific region and the overall country partnership strategy for its 11 Pacific island smaller member countries including Tonga.

The three-pronged strategy of the ADB Pacific Approach 2016–20 focuses on reducing costs, managing risks, and enabling value creation. ADB's mainstay infrastructure program focuses on transport, information and communication technology, and renewable energy to reduce the costs of connectivity and energy. The program's public sector management operations continue to support country efforts to manage financial and economic risks and set to expand its work in climate change and disaster risk management, mobilize more financing for Tonga, introduce innovative solutions to strengthen disaster preparedness, address vulnerability, and build resilience. ADB is also assisting Tonga to create conditions that enable the private sector to grow, strengthen links with the growing economy, and create value.

The focus of the ADB-Tonga COBP 2018-20 on infrastructure investments with major investments in information and communication technology (ICT), energy, water and urban resilience, and land transport sector is consistent with the ADB's Pacific Approach 2016–20 and aligns well with the vision of the Tonga Strategic Development Framework (TSDF II), 2015–25 to create a more progressive Tonga supporting a higher quality of life for all.

ADB funding to Tonga is now on an Asian Development Fund (ADF) blend country basis, that is, it is receiving 50 percent of its resources as grants.

ADB's significant scaling up of both financial and technical support to Tonga reflects both the country's development needs and policy reform efforts. By the end of 2017, ADB will have approved 18 loans and 17 grants totaling just over US\$129 million from the Asian Development Fund (ADF). This has been increasing rapidly in recent years. Since 2008, ADB has committed about US\$71 million in ADF resources to Tonga, compared to total ADF commitments of US\$58 million made in the 35 years between Tonga joining ADB in 1972 and 2007. In the same period since 2008, ADB has also mobilized about US\$35 million in co-financing and over US\$10 million in technical assistance.

There are 6 projects amounting to US\$72 million (net commitment) active in the portfolio. They include the Tonga-Fiji Submarine Cable project extended to fund domestic marine cable from Tongatapu to Ha'apai and Vava'u; the Nuku'alofa Urban Development Sector project (with co-financing from Australia) and the Outer Island Renewable Energy project (with co-financing from Australia, Denmark, and the European Union); and the Climate Resilience Sector project financed by the Strategic Climate Fund. The Cyclone Ian Recovery project (with co-financing from New Zealand) has climate- and disaster-proofed schools and energy infrastructure on the Ha'apai Island group damaged by cyclone Ian in January 2014. The ADB is active in the joint policy reform dialogue with

¹ As of October 2017.

the government of Tonga including other development partners, which is linked to budget support disbursements through ADB's policy-based lending modality.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2012–17						
	2012	2013	2014	2015	2016	2017
Loan approvals						
Number	0	0	0	0	2	2
Amount (in millions of US\$)	0.0	0.0	0.0	0.0	5.50	5.85
Grant approvals						
Number	0	4	2	3	2	2
Amount (in millions of US\$)	0.0	30.25	8.79	5.76	5.50	5.15
Technical assistance approvals						
Number	3	1	1	1	0	1
Amount (in millions of US\$)	1.38	1.33	0.68	0.30	0.00	0.90

STATISTICAL ISSUES

TONGA—STATISTICAL ISSUES APPENDIX	
As of October 15, 2017	
I. Assessment of Data Adequacy for Surveillance	
<p>General: While economic statistics are broadly adequate for surveillance, the lack of officially reported data continues to complicate the monitoring of economic conditions and policy formulation. The Fund's Statistics Department (STA), in collaboration with the Pacific Financial Technical Assistance Centre (PFTAC), has provided regular technical assistance (TA) to Tonga Statistics Department (TSD) and the Ministry of Finance and National Planning (MOFNP). Recent topics covered by TA included national accounts, government finance, and balance of payments (BOP) statistics.</p>	
<p>National Accounts: GDP compilation capacity is quite limited (only two staff), leading to frequent delays. The coverage of the national accounts data has widened in the past few years because of enhanced TA, but there is still room for improvement. Recent PFTAC TA has worked to use tax data to complement the business survey. A rebase to 2015/16 is planned in 2018/19.</p>	
<p>Price Statistics: The Consumer Price Index (CPI) is based on a basket of goods and services from the 2009–10 HIES. CPI is estimated monthly with lags in dissemination and coverage is limited to the Tongatapu District.</p>	
<p>Government Finance Statistics: GFS compilation has been migrated to GFS2014 with TA provided by PFTAC in June 2017. Timeliness and ease and efficiency in reporting remain an issue. Source data are often available with a significant time lag and in-year sub-annual reporting requires considerable manual intervention. The financial accounting system has not been upgraded and thus is not capable of capturing all transactions with much of the government's financial business processes and data collection completed on a manual basis. For example, the budget is compiled manually; debt management is conducted outside of the financial accounts; aid revenue data is not included in the financial accounts; and payments and receipts are both processed and recorded on a manual basis. Reconciliation with monetary and BOP data requires enhancement and published data are often subject to significant revisions. Consolidated financial statistics for the general government are not published due to lack of source data and capacity and up until now, no data are reported for publication in the GFS Yearbook (GFSY).</p>	
<p>Monetary and Financial Statistics: NRBT reports data for the central bank, other depository corporations, and monetary aggregates using the standardized report forms (SRFs).</p>	
<p>Financial Sector Surveillance: Tonga compiles FSIs for deposit takers and reports them to STA on a regular quarterly basis.</p>	
<p>External Sector Statistics: Source data have shortcomings in accuracy, completeness, timeliness, and classification, reflecting also resource limitations. Large net errors and omissions remain due to under-reporting of components. Data gaps could be addressed by enhancing the IIS response rate and gathering more accurate financial transactions data; obtaining data on compensation of employees, remittances, and acquisition of goods and services by overseas workers; and capturing capital transfers related to donor-funded construction projects. The challenges to improve external sector statistics faced with the TSD and the NRBT are 1) to improve coverage of items in financial account by enhancing IIS response rate and gathering more accurate banks' financial transactions data, 2) to obtain not captured data e.g. compensation of employees, remittances and acquisition of goods and services by overseas workers and incorporate them into BOP statistics, 3) to capture capital transfers accompanied by main construction projects and incorporate them into BOP statistics, and 4) to maintain adequate staff resources for compiling and disseminating balance of payments and IIP in accordance with the international standards.</p>	
II. Data Standards and Quality	
The country has been participating in the GDDS since May 30, 2006.	No data ROSC is available.