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Tonga: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Tonga

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with Tonga, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 5, 2002,** with the officials of Tonga on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 10, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 5, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Tonga.

The document listed below will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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TONGA

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with Tonga

Approved by Daniel Citrin and Shigeo Kashiwagi

January 10, 2003

- The 2002 Article IV Consultation discussions were held in Nuku'alofa between October 22 and November 5, 2002. The staff team comprised Martin Cerisola (head), Alberto Jiménez de Lucio (STA), Reza Baqir, and Papa N' Diaye (all APD). Tonga remains on a 12-month consultation cycle.

- The mission met with the Minister of Finance and Governor of the National Reserve Bank of Tonga (NRBT), Sioisua 'Utoikamanu, and with representatives from other government agencies, the private sector, and major donors.

- During the 2001 Article IV consultation, Executive Directors were concerned about the relaxation of macroeconomic policies and stressed the importance of adhering to policies that would help preserve external viability. They urged the authorities to limit the fiscal deficit by reducing current expenditures, especially the public wage bill, and by shifting the burden of taxation away from foreign trade and toward domestic transactions. Directors also recommended a sharp reduction in bank credit expansion. They felt that the conduct of exchange rate policy was appropriate and encouraged the NRBT to continue to adjust the pa'anga as needed to meet foreign reserve targets. Directors emphasized the importance of good governance and transparency for attaining macroeconomic stability and for promoting foreign investment and private sector participation in the economy.

- Tonga accepted the obligations under Article VIII, Section 2, 3, and 4, on March 22, 1991 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

- Data quality, coverage, and timeliness continue to impede economic analysis and effective surveillance of policies in Tonga. Some improvements have been made since the last consultation. Tonga has agreed to participate in the General Data Dissemination System (GDDS).

This report was written by Mr. Cerisola.

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EXECUTIVE SUMMARY

Macroeconomic Setting:

- **Tonga's economic performance has deteriorated markedly in recent years**. Slow progress in dealing with structural weaknesses and increased difficulties in preserving sound fiscal and monetary policies have adversely affected macroeconomic stability and external viability. Economic growth has averaged 1 percent in the past two years, inflation has accelerated to 10 percent, the exchange rate has depreciated markedly, and official reserves have declined to about 1¾ months of imports, leaving Tonga in a vulnerable condition.

- **The near-term economic outlook is highly uncertain**. Downside risks in the world economy could affect exports and inflows from private remittances. Growth and external viability are also vulnerable to changes in oil prices and transportation costs. Were external pressures to materialize, several public and private sector enterprises would suffer, intensifying the pressure on fiscal and monetary policies. Based on current expansionary policies, growth would recover somewhat but inflation would likely accelerate further.

Policy Discussions:

- **The authorities and the staff agreed that urgent and resolute action was needed to restore macroeconomic stability and preserve external viability**. Increased spending and optimistic revenue assumptions could compromise the authorities' budget target. The staff proposed several tax and expenditure measures, consistent with the reforms underway in the areas of tax administration and public service, to ensure that a sound fiscal position was restored. With bank credit envisaged to sustain its strong momentum, discussions focused on options available to tighten liquidity in the near term, including tighter credit ceilings, and the need to reform the framework supporting monetary policy.

- **The staff stressed that, in the absence of corrective measures, gross reserves could fall below one month of imports of goods and services**. Fiscal adjustment, supported by an immediate tightening of monetary policy, could restore reserves to two months of imports and contain inflation and preserve stability in the near-term.

- **Comprehensive reforms in public financial management, revenue administration, public service, and foreign investment should enhance the economy's ability to withstand shocks and lay a solid foundation for better long-term growth prospects**. Success with these reforms would provide the public and private sectors with simpler, more transparent, and predictable frameworks for policy making.

I. INTRODUCTION

1. **The 2002 Article IV consultation discussions took place against the background of growing vulnerabilities**. For many decades, macroeconomic stability and external viability in Tonga were supported by a conservative fiscal policy framework, a well-anchored monetary policy, a comfortable level of official reserves, and a stable exchange rate. However, in more recent years, economic growth has been low, inflation has accelerated markedly, pressure on public finances has intensified, official reserves and the exchange rate have declined sharply, and unemployment—particularly among youth—has become a serious social concern.

2. **Much of this deterioration reflects the inability to arrest long-standing structural weaknesses, increased policy slippages, and a gradual erosion of traditional boundaries between the government, the royal family, and the private sector**. Limited progress has been made in broadening the narrow production and export base, in reducing the dependence on external transfers, and in strengthening a tax system heavily dependent on relatively high tariffs. Expansionary fiscal and monetary policies have fuelled domestic demand and led to increasing imbalances that have threatened macroeconomic stability and external viability. Given the large share of the public sector in the economy, the erosion of boundaries across sectors has weakened budget constraints and further complicated macroeconomic management. The loss of most of the Tonga Trust Fund (TTF) in 2001, which amounted to about US$37 million in 1999/00 and represented about 25 percent of GDP, has exacerbated these problems by further restricting the economy's ability to buffer adverse shocks. With limited policy instruments, the authorities have relied primarily on increased exchange rate flexibility to protect official reserves. More recently, the government has begun to embark on reforms to strengthen public sector governance and promote private sector activity under an Economic and Public Sector Reform Program (EPSRP) supported by the Asian Development Bank (AsDB). With mounting economic difficulties, pressure for political change has grown (Box 1).

II. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

3. **Real GDP growth picked up from about ½ percent in 2000/01 (fiscal year July–June) to 1½ percent in 2001/02, with most sectors of the economy experiencing modest growth**. Conditions in agriculture improved owing to high prices for squash and vanilla and construction rebounded sharply with the assistance provided by the international community to rebuild structures destroyed by Cyclone Waka (Tables 1 and 2, Figure 1, and Box 2). Tourism and services have been weak since late 2000, partly reflecting the unwinding of the impact of millennium celebrations and the impact of September 11 events and the cyclone, but tourist arrivals have been recovering markedly in recent months.

Box 1. Tonga: Political Developments

Tonga's political system is unique in the Pacific region. It is the only constitutional monarchy, currently ruled by King T. Tupou IV, who has been in power since 1965. Under its 1875 Constitution, Tonga's Government is comprised of three main bodies: the Executive, the Legislative Assembly, and the Judiciary. The King, who heads the Privy Council, and the Cabinet, serve as the Executive. The Privy Council (PC) is the highest executive authority and consists of the Cabinet and other members the King may appoint. The Cabinet is comprised of the Prime and Deputy Prime Ministers, eight other ministers, and the governors of the two provinces: Ha'apai and Vava'u. The Legislative Assembly is unicameral and consists of Privy Counsellors and Cabinet ministers, nine elected representatives of the holders of the 33 hereditary noble titles, and nine representatives elected by the people. Elections for both types of representatives are held separately every three years.

Members of the royal family have become increasingly involved in policy-making and the economy in the past few years. Prince 'Ulukalala Lavaka Ata, the King's younger son, has been the Prime Minister since January 2000. The King's older son, Crown Prince Tupoutu'a is a major shareholder in several large private companies in key sectors of the economy, such as power generation and distribution, telecommunications, and banking. The Princess owns the Tongan satellite company and duty-free shops.

The political atmosphere has become more confrontational in recent years. The Human Rights and Democracy Movement (HRDM) is the main political opposition to the hereditary nobles. The HRDM has argued for raising public awareness about the lack of official transparency and accountability, emphasizing the need to improve public governance. This has led to several confrontations with the more conservative sectors of the government. In elections held in March 2002, the HRDM increased its majority from six to seven seats of the peoples' representatives in the Legislative Assembly. The HRDM has proposed the establishment of a "democratic monarchy", which would create a bicameral Parliament with the lower house members elected by the people, and limit the King's power to dissolve it and to veto legislation.

Box 2. Tonga: The Impact of Cyclone Waka

Cyclone Waka (CW) struck the island groups of Vava'u and Niua in late December 2001. CW was the most severe in 40 years and caused substantial damage to relatively weak structures. The housing sector was particularly affected, with about 60 percent of all structures damaged. Much of the damage was to old residential and poorly constructed buildings, the majority of which were uninsured. Many rain water collection systems were also damaged and destroyed, but water tanks were largely unaffected. No major damage was inflicted to transport infrastructure or land. Several crops suffered extensive damage.

Official relief assistance was provided by Australia, Canada, New Zealand, the U.K., and France to deal with housing and school repairs and with relief supplies. In May 2002, the World Bank approved a US$5.85 million Emergency Recovery (IDA) loan to assist in rehabilitating the social infrastructure as well as to strengthen Tonga's emergency and risk management capacity to deal with natural disasters.

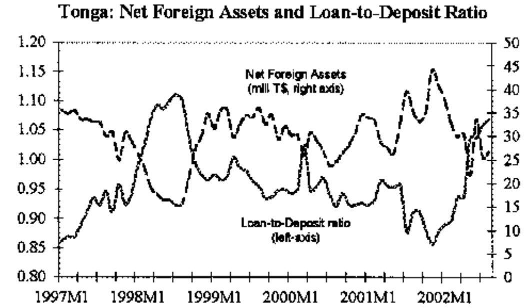
4. **Knock-on effects from external shocks and competing demands on the budget have made it increasingly difficult to preserve the traditionally sound fiscal framework.** The staff estimates annual budget deficits of around 1½ percent of GDP over the past two fiscal years (Table 3).[1] Increased support to public enterprises and rapid growth in current expenditures, partly reflecting the impact of external shocks and the decision to raise public wages by 20 percent for cost of living adjustment in 2000/01, strained the authorities' ability to adhere to their long-standing fiscal rule of matching recurrent expenditures and revenues. Tax revenues increased sharply in 2001/02, partly owing to some administrative improvements, including a recovery of income tax arrears. The deficit was primarily financed through placement of bonds with the banking system and some external financing. Total public debt has risen from about 50 percent of GDP in 1999/00 to 60 percent of GDP in 2001/02, largely owing to the depreciation of the pa'anga. About 80 percent of debt is external on concessional terms (Figure 2).

Tonga: A Comparison of Public Wage Bill, FY2001
(In Percent of GDP)

Tonga	Fiji	Vanuatu	Samoa
14.8	11.5	11.6	8.7

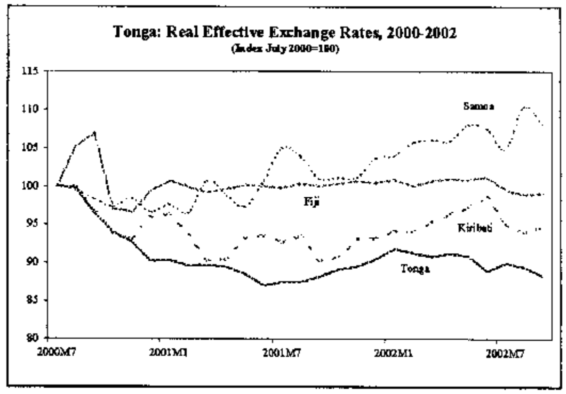
5. **Rapid credit expansion made it increasingly difficult for the NRBT to anchor money growth**. Between June 2000 and September 2002, credit to the private sector expanded by about 40 percent, and brought the ratio of bank loans to deposits close to a five-year high in September 2002. About two-thirds of the increase in credit corresponds to a few companies in key sectors like power, telecom, and retail services, with the remainder for housing and personal consumption. Credit to public sector enterprises also expanded rapidly, but represented only 5 percent of total banking sector credit (roughly 1½ percent of GDP) by September 2002. Interest rates became increasingly stimulatory, with deposit rates negative and lending rates barely positive in real terms. Given its limited capital base and low income from shrinking foreign reserves, the NRBT has not been able to conduct open

Tonga: Net Foreign Assets and Loan-to-Deposit Ratio



[1] These estimates are based on below-the-line financing data. Preliminary official budget outcomes for 2000/01 and 2001/02 have been revised markedly and show a marked improvement in the above-the-line fiscal position. However, these revisions are difficult to reconcile with problems in tax compliance, budget execution and monitoring, and in the accounting system. The staff estimated these balances from "below the line" using financing data sources deemed to be more reliable. Fiscal accounts have not been officially audited since 1998/99, when the new accounting system was introduced, as the system has been deemed unreliable by the Auditor General.

market operations to contain domestic demand.[2] Instead, it introduced formal indicative quarterly ceilings on each bank's credit to the nonfinancial private sector in June 2002. At end-September, three out of four banks breached the ceilings by about 2 percentage points.



6. **Expansionary macroeconomic policies led to a marked decline in net foreign assets, a weaker exchange rate, and higher inflation**. Net foreign assets of the banking system declined from about US$20 million in November 2001 to US$12 million (Tables 4 and 5) in September 2002. The pa'anga depreciated sharply against a basket of currencies between July 2000 and November 2001, but since then, it has been more stable against the basket, as the authorities sought to keep the pa'anga broadly unchanged against the U.S. dollar.[3] Between November 2001 and September 2002, the pa'anga depreciated by about 6 percent in nominal effective terms and by around 1½ percent in real effective terms against the basket (as foreign inflation has been close to 2½ percent), primarily reflecting the weakening of the U.S. dollar vis-à-vis the New Zealand and Australian dollars. Rapid credit expansion, higher public wages and oil prices, and the pass-through from the exchange rate depreciation, has accelerated inflation close to 10 percent (year-on-year) since late 2001.

7. **Depleted reserves and the loss of most of the TTF have left Tonga vulnerable**. Gross official reserves, which used to hover around US$30 million (equivalent to 5–6 months of total imports) in the first half of the 1990s, have more than halved in recent years. Reserves were momentarily boosted to US$18 million (about 2½ months of total imports) at end-2001/02, following the disbursement of the first tranche of the US$10 million EPSRP and

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[2] The NRBT's low capital base and income have been caused by several factors, including: (i) the government's decision not to transfer the domestic currency counterpart to the currency in circulation at the time of the NRBT's establishment in 1989; (ii) a very small paid-up capital (about T$1 million); and (iii) the NRBT's decision to invest a substantial amount of foreign exchange reserves in a new office building, which was completed in 1993/94.

[3] The value of the pa'anga is determined on the basis of a weighted basket of currencies which comprise the U.S. dollar (52 percent), the New Zealand dollar (23 percent), the Australian dollar (19 percent), and the Japanese yen (6 percent). The exchange rate of the pa'anga against the U.S. dollar, which is the intervention currency, is determined daily by the NRBT. Rates for the other currencies are determined based on the cross rates provided by the Bank of England. The NRBT is allowed to vary the value of the pa'anga relative to the basket, at its own discretion, by 5 percent per month.

higher private transfers (Table 6 and Figure 3).[4] However, sustained demand pressures brought reserves back to US$13 million (equivalent to 1¾ months of imports) by end-September 2002. In addition, a loss of about US$34 million in mid-2001 brought the value of the assets in the TTF to about US$3 million in 2001/02 and has left the economy with no significant cushion to buffer adverse shocks and more dependent on transfers, particularly from Tongans living abroad, which accounted for about 60 percent of total imports in 2001/02 (Table 7).[5]

8. **Looking forward, the near-term economic outlook is highly uncertain**. A slowdown in the world economy could affect foreign exchange inflows from Tongans living abroad, particularly from those in the United States, as well as exports, like squash, fish, and tourism, which account for about 60 percent of total exports. However, this may be partly tempered by a continued tourism reflow from competing regional locations. Growth and external viability would also depend on how oil prices and transportation costs evolve in the period ahead. Were external pressure to intensify, several public and private sector enterprises with foreign exchange liabilities would suffer, increasing demands on the budget, credit, and reserves. Based on current expansionary policies, growth could pick up somewhat but inflation would likely accelerate further.

9. **Medium-term prospects depend on Tonga's ability to restore macroeconomic stability and pursue structural reforms**. Fiscal consolidation and private sector development, complemented by structural reforms and external assistance, would help establish the conditions for sustainable growth and to stabilize public debt. Under an illustrative medium-term scenario, growth could increase gradually to about 3 percent, roughly the average growth rate during the 1980s, supported by increased capital accumulation and productivity. The external current account deficit could decline to more sustainable levels and be largely financed by further official assistance and private flows. Higher gross reserves would help reduce Tonga's vulnerability to shocks. Without major

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[4] The balance of payments (BOP) is compiled by the NRBT based on information from the banking system on foreign exchange transactions. There are large measurement and classification problems, mainly regarding private remittances, imports of goods and services, and capital flows. The official BOP is compiled by the Statistics Department with a lag of about two years and the figures differ markedly from those compiled by the NRBT.

[5] The assets in the TTF were held offshore and managed by a former U.S. bank employee who was appointed by the King as a financial advisor. The Government has filed suit in U.S. courts alleging fraudulent management, but the authorities are skeptical about the chances of recovering a significant part of the TTF. The reasons for the loss of most of the TTF are not completely clear to the staff, particularly whether it may have been the result of domestic governance problems. However, its loss does reflect an operational framework with weak public accountability and lack of transparency. The forthcoming selected issues paper will discuss the international experience with asset management and the lessons for Tonga.

reforms, persistently large budget deficits and a loss of external financing would require the authorities to restrict credit to the private sector and depreciate the pa'anga in order to restrain imports. As a result, the economy would remain stagnant and inflation accelerate, while reserves would remain at low levels. Public indebtedness would rise markedly, even though the debt service ratio should remain low given the large share of concessional debt and insignificant access to capital markets. All in all, these trends would leave Tonga highly vulnerable to adverse shocks (Annex I).

III. Policy Discussions

10. **For many past decades, modest but positive economic growth, prudent fiscal policy, adequate official reserves, relatively stable social conditions, and the possibility of relying on the TTF may have provided Tonga with some sense of security and blurred the perception that comprehensive structural reforms were needed (Box 3).** Given the marked deterioration in economic conditions in recent years, the government seems increasingly aware that swift and decisive action is needed to restore a favorable performance over the medium term. With macroeconomic conditions envisaged to further deteriorate in the absence of corrective actions, the discussions centered on the following issues:

- ***the need to restore a sound fiscal position and strengthen the monetary policy framework to arrest rapid domestic demand growth so as to contain inflation and preserve official reserves.***
- ***maintaining exchange rate flexibility under the basket peg to support macroeconomic adjustment, competitiveness, and official reserves.***
- ***the role of reforms in enhancing growth prospects and governance, by providing a simpler, more transparent, and predictable framework for public and private sectors.***

A. Fiscal Policy

11. **The staff stressed that the fiscal stance in 2002/03 was not expected to improve as needed.** The authorities explained that the 2002/03 budget aimed for a marked improvement in the fiscal stance by targeting an underlying surplus of about ½ percent of GDP when adjusting for the expenditure associated with the World Bank loan for the reconstruction costs of Cyclone Waka. While endorsing this objective, the staff expressed serious concern that relatively optimistic revenue assumptions, together with decisions made subsequent to the budget's approval to support the resumption of Royal Tongan Airlines' (RTA) international operations and to assist other public enterprises, could bring the underlying deficit to 2¼ percent of GDP (the unadjusted deficit would be 5 percent of GDP). While such a deficit would be largely financed externally, it would not assist monetary policy in reversing the sustained decline in the level of reserves and in improving macroeconomic stability and external viability.

Box 3. Tonga: Fund Policy Recommendations and Implementation

Over several past consultations, Fund policy advice has consistently stressed the need for restoring sound macroeconomic policies and for addressing long-standing structural weaknesses to arrest increased macroeconomic instability, ensure external viability, and enhance long-term growth prospects. Major recommendations included: (i) restoring a sound budget position by scaling back the public sector wage bill and broadening the tax base; (ii) enhancing the effectiveness of monetary policy by recapitalizing the NRBT to restore its ability to conduct open market operations and anchor money; (iii) encouraging private sector development mainly through foreign direct investment, an improved regulatory environment, and land reform. In addition, the staff also recommended establishing clear rules and guidelines for investing those assets in the TTF, consolidating it with the budget, and publicizing its financial statements in a timely manner.

While the Ministry of Finance and the NRBT have agreed with most of these policy recommendations, the authorities' record of implementation has been poor, owing to difficulties in building up political consensus and to capacity constraints. The authorities emphasized that with the loss of the TTF, a political consensus has emerged to go ahead with major reforms. They have enacted new legislation to strengthen public finance management and revenue administration, scale back public service, enhance governance in public sector enterprises, simplify business licensing, and promote foreign investment.

12. **The staff proposed tax and expenditure measures to ensure the achievement of the budget deficit target and recommended that measures be implemented prior to or in conjunction with the additional expenditure initiatives**. Measures in the areas of tax administration and public service would also help to bolster the credibility of the authorities' commitment to pursue reforms. Thus, the staff proposed several options: (i) eliminating exemptions on import duties for personal and household goods and for unleaded gasoline (about ½ percent of GDP); (ii) monitoring closely exemptions for imports of aid-funded projects and government imports (about ¼ percent of GDP); (iii) broadening the sales tax to all imported goods and increasing its rate from 5 percent to 7½ percent (about ¾ percent of GDP); (iv) raising certain user charges and license fees, which have declined markedly in real terms (about ½ percent of GDP). On the expenditure side, the wage bill and other current expenditures were also projected to grow markedly, and savings of at least 1 percent of GDP could be obtained. The authorities broadly agreed with these recommendations and noted that some combination of increased taxes and lower spending would help achieve the targeted underlying surplus.

13. **Maintaining a sound medium-term budget position would require major improvements in tax and expenditure administration, budget execution and control, as well as a major reform of the tax regime**. The authorities explained that the reforms under the Public Finance Management Act (PFMA) and the Revenue Service Administration Act would restore the effectiveness of traditional budgetary functions (Box 4). These reforms would improve tax compliance—especially for income taxes and customs duties—by establishing a system to better identify taxpayers and monitor their liabilities, particularly of large businesses, and by increasing automation and reducing discretion at customs. The authorities and the staff also agreed that these reforms would help strengthen the monitoring

Box 4. Tonga: Fiscal Transparency and Tax Administration

The Current Situation

The Pacific Financial Technical Assistance Center (PFTAC) has recently conducted assessments of fiscal transparency and tax administration issues in Tonga. A fiscal transparency assessment was conducted in September 2001 using the questionnaire on the *IMF's Code of Good Practices on Fiscal Transparency*. Some of the most important shortcomings are:

- Expenditure decisions can be made outside the budgetary appropriation mechanism by the Royal Family and the Privy Council, which can be authorized by a special warrant signed by the Prime Minister. There is no explicit legal independence of the tax administration from political influence.

- The coordination and management of budgetary and extra-budgetary activities needs to be strengthened. The accounting system does not provide an adequate means for monitoring budget execution and cash management. Automation of records and information on tax arrears is limited.

- Budgetary concessions to businesses under the Industrial Development Incentives Act (IDI) have not been monitored. Tax compliance remains weak, particularly for income taxes and customs duties. There are governance problems at the Customs Service. There is weak control over quasi-fiscal activities conducted in the public sector, particularly for public sector enterprises. There are limited internal audit functions with other government agencies. The Auditor General (AG) is not legally independent and reports directly to the Prime Minister rather than the Parliament.

- There are no public releases of monthly or quarterly reports on budget execution. There is no legal requirement to submit mid-year budget reviews to Parliament.

A "Modernization Plan for the Revenue Service Department" was prepared in June 2002 and concluded that tax administration is weak and operating below required standards. Main problems identified were:

- The lack of a system to identify taxpayers and monitor their tax liabilities.
- Limited coordination between tax and customs administration to detect evasion.
- No auditing of companies' books.

The New Legislation

The authorities have recently enacted the Public Finance Management Act (PFMA) and the Revenue Service Administration Act (RSAA), which are expected to significantly improve their ability to execute and monitor budgetary management and enhance tax administration and compliance. Major changes are:

- Minister of Finance (MOF)'s ability to effectively control cash flows in government agencies and other ministries is significantly strengthened, as expenditure decisions would only be possible if authorized by an appropriation. Clear penalties have been defined for unauthorized spending.
- The MOF will present quarterly summaries on budget execution and monthly reporting. The MOF will have four months from the end of the fiscal year to present a final budget outcome to Parliament. The AG will have to present a written assessment to the MOF and Parliament.
- A Taxpayer Identification Number will be established to better identify and check tax liabilities.
- Legal constraints to audit tax payers are eliminated.

of exemptions—especially those issued under the Industrial Development Incentives (IDI) Act and for petroleum products—as well as ensure that expenditure decisions are made within the budgetary appropriation mechanisms. Reducing the large public wage bill and limiting assistance to public enterprises would also be assisted by reforms under the Public Service Reform Act and Public Enterprise Act. The authorities and the staff agreed that tax administration efforts should be "revenue enhancing" in the transition to a major "revenue neutral" reform of the tax regime in 2004/05, which should broaden the tax base, simplify its structure, reduce exemptions, and minimize loopholes.

B. Monetary and Exchange Rate Policy

14. **The staff stressed that containing inflation and protecting official reserves will require a new framework for monetary policy centered on the active use of open market operations (OMOs)**. Rapid credit growth has brought to the fore the limited effectiveness of direct instruments for monetary control and the need to restore the conditions for using indirect instruments.[6] The staff noted that low government bond yields (relative to inflation), a limited capital base, and low income from declining foreign reserves have been the main factors restraining the NRBT's ability to conduct OMOs as well as the development of a secondary market for public debt. Until the NRBT is recapitalized, the staff proposed that the government issue bonds with positive yields in real terms for the NRBT to use, on behalf of the government, for the sole purpose of conducting OMOs. This would allow the NRBT to conduct OMOs and make the government absorb directly the costs of these operations, while helping to restore market interest rates to positive levels in real terms. The new framework should also be supported by strict limits on government borrowing from the NRBT. The authorities confirmed that, under the new PFMA, the government would be allowed to issue bills for this purpose and impose modest costs to the budget.

15. **In the transition to this new framework, credit ceilings need to be enforced or replaced with other instruments**. The authorities intended to enforce penalties on those banks that breach the ceilings by shifting government deposits in these banks to the NRBT. However, with liquidity having tightened and becoming more evenly distributed across banks, they did not rule out resorting to higher reserve requirements (Box 5).[7] These changes in the monetary policy framework, together with fiscal adjustment, would help contain growth in net domestic assets by restricting credit to the private sector and by limiting the government's recourse to bank financing. These policies would help attain a gross reserves target of two months of total imports and preserve macroeconomic stability (Table 8).

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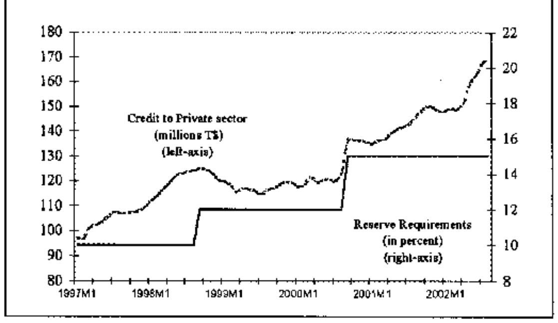
[6] The forthcoming selected issues paper will discuss options for monetary control.

[7] Under the current legislation, minimum reserve requirements can be raised up to 25 percent.

Box 5. Tonga: The Effectiveness of Reserve Requirements for Monetary Control

For many years, the NRBT has relied on several direct and indirect instruments of monetary control. One instrument that has been used in the past is the minimum reserve requirements (MRR). As seen in the figure, the NRBT increased the MRR from about 10 percent of total liabilities in 1997 to 12 percent in the third quarter of 1998, and to 15 percent in the third quarter of 2000. Raising the MRR has generally resulted in a significant reduction in the stock of credit to the private sector. This has been the case despite the uneven distribution of liquidity in the banking system and the weak financial condition of two other domestic banks. However, the figure suggests that the more recent MRR increase resulted in a less significant and less persistent decline in credit than in previous episodes.

Tonga: Reserve Requirements and Private Sector Credit



In assessing the potential impact of future MRR increases on credit, the following factors are likely to be critical:

First, there was substantial excess liquidity in previous years, but competition among major banks to preserve market share has intensified in recent years and contributed to the sharp rise in the loan-to-deposit ratio. Liquidity has now tightened considerably and become more evenly distributed across banks. This should enhance the effectiveness of raising MRR to tighten monetary policy.

Second, the rapid expansion of loans since September 2000 has been largely concentrated on a few specific corporate projects in key sectors (about two-thirds of the increase), as well as on housing and personal consumption (about one-third). Given this concentration and the sectoral composition (telecom, power), the demand for credit may be quite inelastic to higher interest rates or to credit ceilings. Raising MRR could have a large asymmetrical impact on credit availability across different borrowers.

Third, one of the major banks, which experienced financial difficulties in the past, has undergone a significant restructuring of its assets and has markedly improved its profitability, asset quality, and capitalization levels. This should enhance the effectiveness of raising MRR.

16. **The authorities recognized that maintaining exchange rate flexibility to preserve competitiveness and to protect reserves has been increasingly difficult**. The staff commended the authorities for increasing the flexibility of the pa'anga in recent years in response to the shocks faced by the economy, but warned that the exchange rate policy had become more erratic recently and pressure to fix the value of the pa'anga relative to the U.S. dollar needed to be resisted.[8] The authorities emphasized that the pressure has been difficult to resist in light of the increased foreign exchange losses faced by several large

[8] The forthcoming selected issues paper will present an analysis of the exchange rate regime and policy in Tonga.

companies in key sectors of the economy. In reviewing the exchange rate system, discussions with the authorities and the private sector confirmed that approvals for current international transactions were granted bona fide.[9]

C. Financial Sector Issues

17. **Tonga's banking system has strengthened significantly over recent years, but some risks remain that need to be closely monitored.**[10] Profitability and the ratio of nonperforming loans to capital have strengthened, mainly reflecting the restructuring of and improved management in the development bank and capital contributions from foreign shareholders to one major bank. The authorities and the staff agreed on the need to monitor the risks associated with the rapid expansion of loans and their higher concentration at some individual banks to specific sectors (power and telecom), that are highly vulnerable to oil prices and exchange rate risk.

Tonga: Selected Financial Sector Indicators

(In percent, unless otherwise indicated)

	End-December					
	1997	1998	1999	2000	2001	2002 1/
Capital Adequacy						
Risk-weighted capital ratio	...	...	22.5	18.2	24.6	24.3
Total capital to total assets	23.7	19.4	15.7	13.7	18.1	20.9
Asset Quality						
Non-performing to total loans	7.3	18.0	15.2	9.3	6.3	5.7
Non-performing loans to capital	19.6	61.1	64.1	42.5	22.9	19.9
Non-performing loans net of provisions to total capital	1.8	7.8	9.6	3.3	0.1	-0.1
Profitability						
Return on assets	1.5	0.0	3.1	4.7	6.2	3.2
Return on equity	4.7	0.6	7.4	19.1	26.4	12.2
Net interest margin	5.4	5.4	6.0	6.0	7.3	4.4
Net interest income to gross income	53.4	52.7	52.4	48.2	51.8	63.1
Other						
Risk concentration ratio 2/	29.3	28.2	29.5	37.3	37.1	36.9
Share of loans to non-fcial corporations	32.9	38.2	45.0	52.3	52.6	52.6

Source: National Reserve Bank of Tonga.

1/ Figures as of end-June.
2/ For commercial banks, defined as the share of the largest 10 loans in total loans.

18. **A prompt amendment of the Financial Institutions Act (FIA) should assist the authorities in monitoring risks and in strengthening prudential supervision.** The staff stressed the need for the prompt enactment of the proposed amendments, particularly those related to expanding the NRBT's supervision to other financial institutions and to lower single borrower limits. The authorities explained that the NRBT was limited in enforcing compliance with its regulatory and prudential framework on some nonbank institutions that conducted financial activities. In this regard, they emphasized the critical need to recruit qualified staff to expand off- and on-site supervision. The staff

[9] The NRBT approves current payments exceeding US$50,000 and has delegated to authorized dealers approval authority for payments not exceeding such amount. Capital transactions are also subject to approval by the NRBT.

[10] The banking system is comprised of the NRBT, which supervises all licensed financial institutions, three commercial banks (the Bank of Tonga, ANZ, and MBf Bank) and one development bank (the Tonga Development Bank, (TDB)). Westpac Australia owns 60 percent of Bank of Tonga. Other financial institutions, such as insurance companies and superannuation funds, are not subject to prudential supervision. Capital requirements of 15 percent for commercial banks and 18 percent for TDB are above international standards.

recommended that license fees on financial institutions be raised significantly and shared with the NRBT to cover some of the additional costs of supervision. Given the rapid growth and increased concentration of loans, prudential supervision needed to be supported by more frequent meetings with domestic institutions and home country supervisory authorities, as well as by tightening single borrower limits and by introducing an aggregate limit on loans to connected parties.

D. Other Issues

19. **Initial steps have been taken to promote private sector development and to enhance long-term economic prospects by enacting new legislation under the EPSRP.** The authorities recognized that ensuring the effective implementation of the new legislation was a major challenge ahead. In particular:

- The **Public Service Act** would scale back wage costs and strengthen performance-based incentives, particularly those of managers. The authority to hire and dismiss employees would be delegated to an independent commission reporting to the Prime Minister.

- The **Public Enterprise Act (PEA)** would strengthen governance and tighten budget constraints through better accountability of managers and by establishing clear requirements of information reporting, regular financial statements, and business plans. The staff noted that, in the transition to the full implementation of the PEA, efforts were needed to improve the monitoring of public enterprises, particularly on their borrowings, as well as by forcing them to provide the Government Investment Unit with the necessary information.

- The new **Foreign Investment Act** has simplified the conditions for foreign private sector participation. Requiring foreign investors to form a joint venture with a Tongan resident would assist in developing entrepreneurial skills and human capital in Tonga. The staff stressed that it would be important that this requirement be applied transparently and be supported by removing restrictions to immigration and visa permits for foreign investors.

- The new **Business Licenses Act** has streamlined registration procedures markedly. The authorities explained that future efforts will be focused on repealing the IDI Act, which they expected to do in conjunction with a major tax reform. They recognized that the current restrictions on the duration of leases and revisions to rents also remained an important impediment to private sector development.

- The staff noted that **privatization efforts** should be supported by a transparent framework aimed at diversifying the production as well as the ownership structure of the economy. Bringing new investors into Tonga would also help strengthen the economy's resilience to adverse shocks. The staff argued that the process of finding a strategic partner for Royal Tongan Airlines, as outlined in the 2002/03 Budget, would provide a good opportunity in this regard.

20. **The authorities have made significant progress in dealing with anti-money laundering and other related initiatives.** Tonga is not on the list of noncooperative countries or those with serious systematic problems. A Money Laundering and Proceeds Crime Act was enacted in 2001, establishing a framework consistent with the 40 recommendations of the Financial Action Task Force. As the Transactions Reporting Authority, the NRBT is finalizing a mandatory system for reporting suspicious transactions by financial institutions, but an amendment to the FIA is needed to grant the NRBT authority to request such information. The authorities also noted that commercial banks have anti-money laundering policies in place and report to the NRBT on an informal basis.

21. **Progress with trade liberalization has been slow.** Tonga has ratified the Pacific Island Countries Trade Agreement but prospects for trade liberalization hinge on a major tax reform, which is planned for 2004/05.[11] As for the current status of accession to the WTO, some bilateral meetings were held and discussions with the WTO would be resumed over the next year. Several reforms in the trade regime would be needed to conform with WTO rules. Price controls on basic goods and other commodities would have to be lifted, incentives under the IDI Act removed, and import licensing requirements for safety reasons on motor vehicles, pharmaceuticals, and chemicals eliminated.[12]

22. **More efforts are needed to strengthen the reliability of statistics.** Coordination and reconciliation among entities that generate data remains weak and regular provision of key data to the Fund is limited. The staff welcomed the presentation of the 2002/03 Budget in a GFS format, but noted that the accuracy and reliability of fiscal data needed improvement. In particular, transactions need to be classified properly, entered in the accounting system with shorter lags, and reconciled with other sources (especially on domestic and external debt). In addition, budget outcomes "above the line" need to be reconciled more frequently with estimates from "below-the-line", which also need to be reconciled with monetary survey data. There are also considerable limitations in national accounts and balance of payments statistics (Annex V).

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[11] Most tariff rates range between 0 and 45 percent, with those for food and manufacturing goods falling between rates of 15 and 20 percent. Other imports, such as vehicles and alcohol and cigarettes, are subject to rates of 45 percent and 525 percent, respectively. In addition, a 20 percent port and services tax is also levied on all imports. The average effective tariff rate was around 17 percent in 2001/02.

[12] Most price controls are effected as mark-ups over imported goods. The only price control in effect is on bread. Agricultural and fish products produced locally are not subject to controls. All price controls are reviewed and adjusted, if needed, every two months.

IV. Staff Appraisal

23. **Tonga's macroeconomic performance has deteriorated in recent years**. Limited progress in dealing with long-standing structural weaknesses and increased difficulties in preserving sound fiscal and monetary policies have adversely affected macroeconomic stability and external viability. As a result, economic growth has been weak, official reserves have been depleted, the pa'anga has depreciated markedly, public indebtedness and inflation have risen rapidly, and unemployment has become a serious social concern. Tonga's ability to buffer adverse shocks has been significantly hampered by the loss of the Tonga Trust Fund.

24. **Some initial good steps have been taken to enhance long-term economic prospects**. Legislation on public financial management, public service and public sector enterprises, business licensing, and foreign investment has been enacted that would provide a sound basis for comprehensive reforms. However, critical to the success of these reforms is that their implementation enhance the institutional framework and governance in Tonga by effectively providing a simpler, more transparent, and predictable framework for public and private sectors.

25. **Macroeconomic conditions will deteriorate sharply unless rapid and decisive actions are taken**. With the economy in a vulnerable condition, the continued large demands on the budget and the banking system from different sectors would further complicate macroeconomic stability and external viability. This deterioration will be difficult to arrest given the limited instruments the authorities can rely on.

26. **Pressures on the budget are poised to seriously undermine a much needed improvement in the budget balance for 2002/03**. Continued support to ailing public sector enterprises and relatively optimistic assumptions on revenues would result in a significantly higher deficit than envisaged in the 2002/03 Budget. The staff strongly recommends that tax and expenditure measures be implemented prior to or in conjunction with those expenditures that were not budgeted so as to prevent the authorities from resorting to domestic financing. It would also be important that the fiscal measures are consistent with the reforms underway, particularly in the areas of tax administration and public service reforms. This strategy would bolster the credibility of the authorities' commitment to the reforms.

27. **Efforts to improve tax administration, budget execution and control, and to reduce the public wage bill and the support to public enterprises should strengthen the fiscal position in preparation for a major reform of the tax regime**. The reforms under the Public Financial Management Act and the Revenue Service Administration Act should restore the effectiveness of traditional budgetary functions and improve tax compliance. These reforms would also improve the monitoring of exemptions—especially those issued under the IDI Act and for petroleum products, as well as ensure that expenditure decisions are made within the budgetary appropriation mechanisms. Public service and enterprise reform should

also assist in containing expenditure and help to ensure that a reform of the tax regime does not deteriorate the fiscal position. The staff endorses the proposed reform of the tax regime, which should broaden its base, simplify its structure, reduce exemptions, and minimize loopholes.

28. **Preserving official reserves and containing inflation requires a new framework for monetary policy**. There is a need to recapitalize the NRBT soon to restore its ability to effectively anchor money through open market operations, make it independent from budgetary needs, and allow yields for government securities to reflect inflation trends. Strict limits on government borrowing from the NRBT also need to be established and any financing to the government should be done at interest rates consistent with inflation. Until a new framework is established, credit ceilings need to be enforced or replaced with other instruments. Penalties on those banks that breach the ceilings need to be established and enforced. Alternatively, higher reserve requirements should be imposed to quickly stem the rapid growth in credit, build foreign reserves, and contain inflation.

29. **Exchange rate policy should preserve competitiveness and ensure external viability**. Recent attempts to peg the pa'anga against the U.S. dollar need to be resisted in light of the low reserves and weak macroeconomic fundamentals.

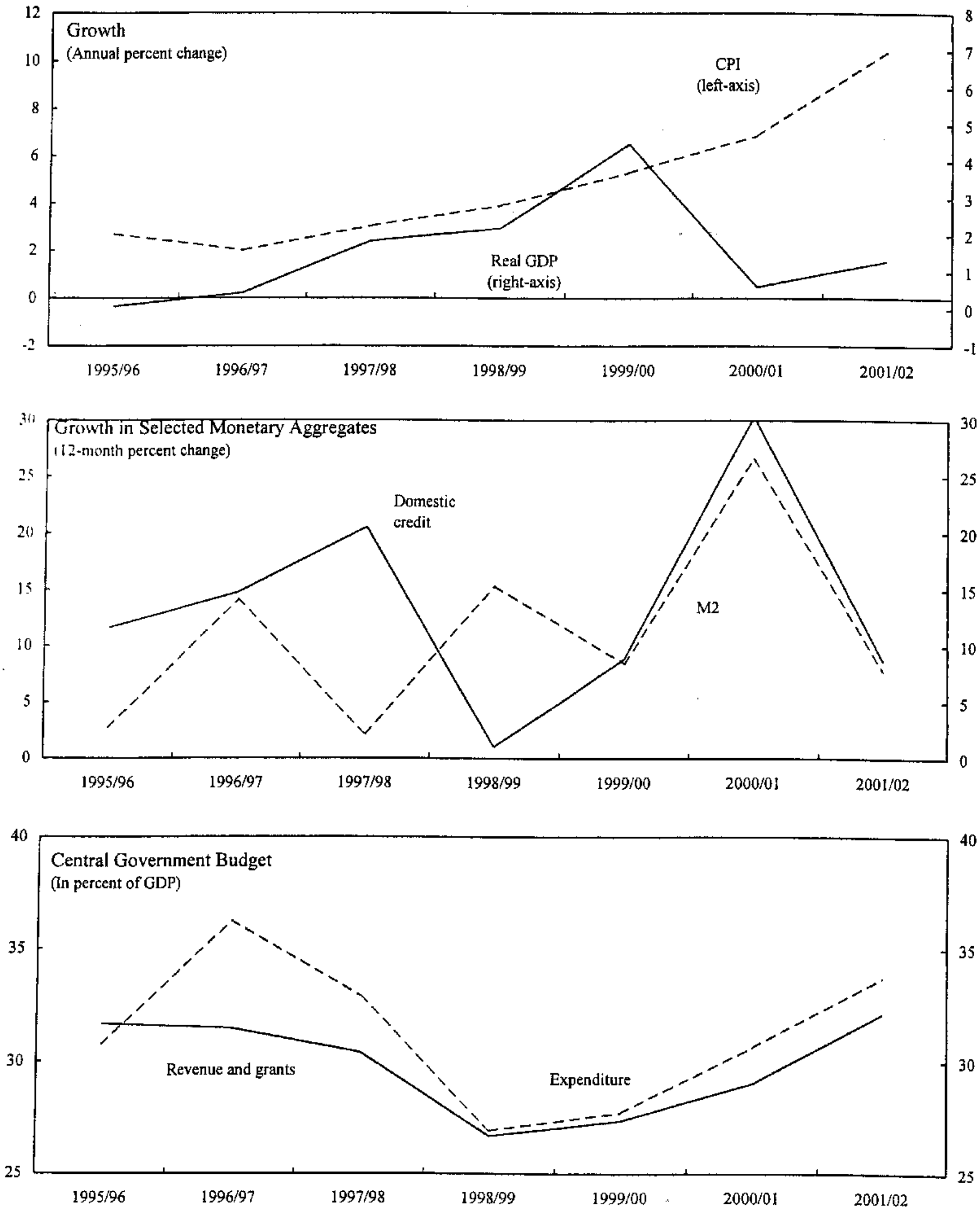
30. **Some risks in the banking system need to be closely monitored**. The loan concentration ratio at commercial banks has risen markedly, particularly to sectors highly vulnerable to external shocks and to a real depreciation of the exchange rate. This is particularly important given the relatively high single borrower limits and the lack of aggregate limits on lending to connected parties. A prompt amendment of the Financial Institutions Act should strengthen prudential supervision and the monitoring of risks in the financial system, as well as establish a mandatory reporting by commercial banks of suspicious transactions in the financial system.

31. **Improving the reliability of statistics is critical for conducting policies and for an effective surveillance**. The coordination and reconciliation of data among agencies should be more systematic and greater efforts should be made to provide key data to the Fund on a regular basis.

32. It is proposed that the next Article IV consultation with Tonga take place on the standard 12-month cycle.

FIGURE 1

Tonga: Real, Fiscal, and Monetary Sector Developments, 1995/96-2001/02 1/

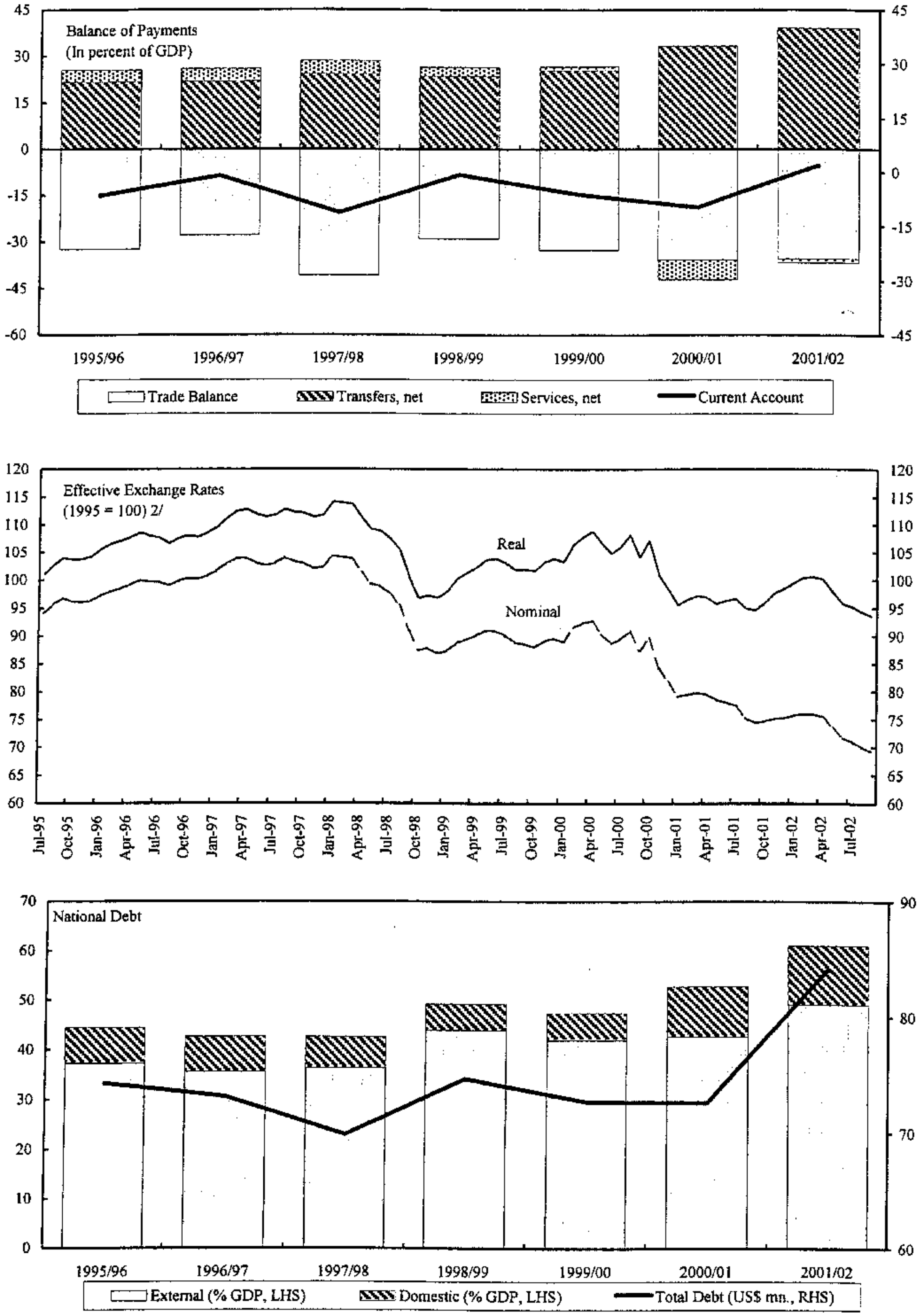


Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Fiscal year ending June.

FIGURE 2

Tonga: External and Debt Indicators, 1995/96-2001/02 1/

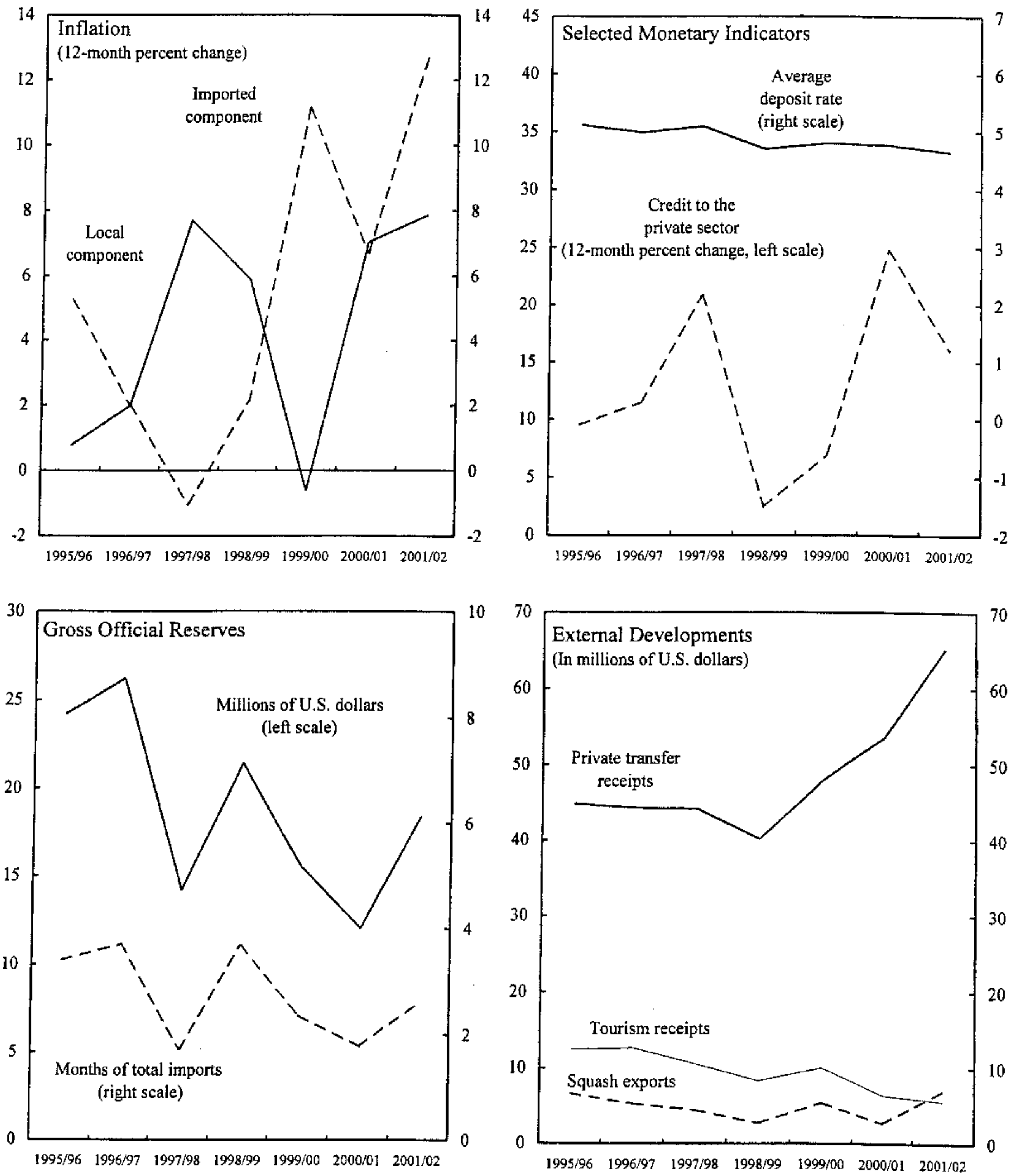


Sources: Data provided by the Tongan authorities; IMF, Information Notice System; and Fund staff estimates.

1/ Fiscal year ending June.

2/ An increase indicates an appreciation of the pa'anga.

FIGURE 3
Tonga: Inflation, Credit, and Official Reserves, 1995/96-2001/02



Sources: Data provided by the Tongan authorities; and Fund staff estimates.

Table 1. Tonga: Selected Economic Indicators, 1998/99-2002/03 1/

Nominal GDP (2001/2002): US$ 136.1 million
Population (2001): 100,673
GDP per capita (2001/02): US$1,352
Quota : SDR 6.9 million

	1998/99	1999/00	2000/01	Est. 2001/02	Proj. 2002/03 Status Quo	Proj. 2002/03 Measures
		(Percent change)				
Output and prices						
Real GDP	2.9	6.5	0.5	1.6	2.5	1.0
Consumer prices (period average)	3.9	5.3	6.9	10.4	15.0	10.5
		(In percent of GDP)				
Central government finance 2/						
Revenue	26.1	27.0	28.2	31.4	26.2	29.4
Grants	0.5	0.4	0.9	0.7	1.0	1.1
Total expenditure and net lending	26.9	27.7	30.6	33.7	32.2	32.7
Current expenditure	26.7	27.1	26.2	27.2	27.1	27.5
Capital expenditure	1.3	1.3	1.1	3.4	3.0	3.0
Overall balance	-0.2	-0.4	-1.6	-1.6	-5.0	-2.2
External financing (net)	1.4	-0.6	-0.2	4.4	5.2	5.3
Domestic financing (net)	-0.1	0.7	1.8	-2.8	-0.3	-3.2
Other	0.0	0.0	0.0	0.0	0.1	0.1
Discrepancy	-1.1	0.3	0.0	0.0	0.0	0.0
		(Percent change)				
Total liquidity 3/	10.9	14.1	27.5	9.3	11.7	3.7
Of which: Broad money (M2)	15.3	8.4	26.5	7.8	11.3	2.9
Domestic credit	-6.1	5.3	23.0	8.2	22.3	4.7
Private sector credit	-5.6	4.1	17.4	14.6	20.0	8.0
Interest rates						
Avg. deposit interest rate (end-period)	4.7	4.8	4.8	4.6	...	...
Base lending rate (end-period)	9.0	9.0	9.0	9.0	...	...
		(In millions of U.S. dollars)				
Balance of payments						
Exports, f.o.b.	12.1	10.9	11.8	17.8	14.0	14.5
Of which: Squash	2.7	5.5	2.7	7.1	...	...
Imports, f.o.b.	-55.5	-62.6	-60.8	-65.9	-72.0	-69.9
Services (net)	4.3	1.9	-8.7	-1.9	-4.2	-1.1
Income (net)	2.9	-0.5	-1.1	-0.6	-2.0	0.0
Services and Income (net)	7.2	1.5	-9.8	-2.4	-6.2	-1.2
Transfers (net)	35.3	40.5	45.6	53.2	49.4	49.4
Of which: Private transfer receipts	40.2	48.0	53.6	65.2	62.1	62.1
Current account balance	-1.0	-9.7	-13.3	2.7	-14.9	-7.2
(In percent of GDP)	-0.6	-6.1	-9.7	2.0	-10.8	-5.3
Overall balance	7.2	-5.9	-3.5	6.5	-12.2	-4.7
Terms of trade (percent change)	16.1	11.6	-1.7	...	...	...
Gross international reserves (end-period)						
In millions of US dollars	21.4	15.6	12.0	18.4	6.2	13.7
In months of total imports 4/	3.7	2.4	1.8	2.6	0.8	1.9
		(In percent)				
External debt						
External debt/GDP	42.0	42.0	42.7	49.1	53.5	54.6
Debt service ratio 5/	10.6	9.7	17.2	6.0	9.3	8.8
Exchange rate (period average)						
T$ per US$ (end-period)	1.59	1.69	2.15	2.15	...	...
T$ per US$	1.58	1.64	1.97	2.18	...	...
Real effective exchange rate (1990=100)	101.1	104.5	100.2	97.7	...	...
Nominal effective exchange rate (1990=100)	90.3	89.9	83.1	75.1	...	...

Sources: Data provided by the Tongan authorities; and Fund staff estimates and projections.

1/ Fiscal year beginning July.
2/ Government finance data for 2002/03 are staff estimates reflecting the staff's policy recommendations.
3/ From the Banking Survey, which includes the Tonga Development Bank.
4/ For 2002/03, it excludes imports financed with World Bank loan.
5/ In percent of exports of goods and services.

Table 2. Tonga: Real Sector Developments, 1997/98-2001/02

(Percentage changes, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01	Est. 2001/02
GDP (1995/96 prices)	2.4	2.9	6.5	0.5	1.6
Of which:					
Agriculture, forestry, and fisheries	-0.1	-3.2	10.6	-6.3	1.0
Manufacturing	11.4	16.4	0.7	2.0	3.0
Construction	5.6	10.4	-0.2	1.8	9.0
Commerce, restaurants, and hotels	2.3	-6.0	17.9	0.5	-2.0
Transportation and communications	3.0	10.4	4.6	1.1	2.0
Finance and real estate	14.0	7.5	6.2	0.4	2.0
Government services	0.3	8.9	-2.9	10.0	1.5
GDP (by sector; constant prices)					
Of which:					
Agriculture, forestry, and fisheries	25.4	23.9	24.8	23.2	23.1
Manufacturing	4.1	4.6	4.4	4.4	4.5
Construction	5.3	5.7	5.3	5.4	5.8
Commerce, restaurants, and hotels	11.6	10.6	11.8	11.8	11.4
Transportation and communications	7.3	7.8	7.7	7.7	7.8
Finance and real estate	8.2	8.6	8.5	8.5	8.6
Government services	14.5	15.3	14.0	15.3	15.3
Consumer prices (period average)					
All items	3.0	3.9	5.3	6.9	10.4
Domestic component	7.7	5.9	-0.6	7.0	7.9
Imported component 1/	-1.0	2.1	11.1	6.7	12.7
Memorandum item:					
Nominal GDP (in millions of pa'anga)	218.9	237.3	260.6	270.3	296.5

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ The increase in 1999/00 reflects a 20 percent upward adjustment of tobacco prices.

Table 3. Tonga: Summary Table of Government Operations, 1998/99-2002/03

Years ending June 30	1998/99	1999/00	2000/01	2000/01	2001/02	2001/02	2002/03		
		Prel.	Official	Staff Est.	Official	Staff Est.	Projection		
							Budget	Staff Est. 1/	Staff Est. 2/
	(In millions of pa'anga)								
Total revenue and grants	63.3	71.3	78.5	78.5	95.2	95.2	103.8	94.3	100.8
Total revenue	62.1	70.2	76.1	76.1	93.2	93.2	96.4	90.8	97.3
Current revenue	62.1	70.2	76.1	76.1	93.2	93.2	96.0	90.4	96.9
Tax revenue	47.1	52.6	54.6	54.6	74.5	74.5	72.6	70.2	76.2
Trade taxes	29.7	34.2	35.8	35.8	48.5	48.5	50.4	47.1	49.6
Other taxes	17.4	18.4	18.8	18.8	26.1	26.1	22.2	23.1	26.6
Nontax revenue	14.9	17.6	21.5	21.5	18.7	18.7	23.3	20.2	20.7
of which: revolving funds	1.9	3.7	3.0	3.0	4.3	4.3	5.4	5.0	5.3
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.4	0.4
Grants (in cash)	1.3	1.1	2.4	2.4	2.0	2.0	7.5	3.5	3.5
Total expenditure and net lending	63.9	72.2	79.1	82.8	92.4	100.0	112.5	111.5	108.1
Total expenditure	66.6	73.9	73.7	77.4	91.8	99.4	113.2	112.1	108.7
Current expenditure	63.4	70.6	70.8	70.8	80.6	80.6	100.3	94.0	91.0
Wages and salaries	35.4	37.0	39.9	39.9	44.0	44.0	50.6	48.6	46.6
Other current expenditures	28.0	33.5	30.8	30.8	36.6	36.6	49.7	45.4	44.4
Additional expenditures	0.0	0.0	0.0	3.7	1.0	8.6	1.6	7.6	7.6
Capital expenditure	3.2	3.3	2.9	2.9	10.2	10.2	11.2	10.5	10.1
Total lending minus repayments	-2.7	-1.7	5.4	5.4	0.6	0.6	-0.6	-0.6	-0.6
Overall deficit/surplus	-0.6	-0.9	-0.6	-4.3	2.9	-4.7	-8.7	-17.2	-7.3
Total financing	0.6	0.9	0.6	4.3	-2.9	4.7	8.7	17.2	7.3
External financing	3.4	-1.6	-6.2	-0.5	7.3	13.0	6.3	18.0	17.6
Disbursements	4.9	3.0	0.0	6.9	10.9	16.4	10.8	22.0	21.6
Repayments	1.5	4.7	6.2	7.4	3.6	3.4	4.5	4.0	4.0
Domestic financing	-0.3	1.8	6.8	4.8	-6.8	-8.3	2.5	-1.2	-10.7
Bonds issued	0.0	0.0	9.5	9.5	4.0	4.0	4.0	4.0	4.0
Bonds matured	0.0	0.0	1.8	1.7	1.1	1.0	4.0	4.0	4.0
Loan disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loan repayments	0.0	0.0	0.0	0.2	0.0	0.1	0.0	0.0	0.0
Tonga Trust Fund	0.3	1.0	0.1	0.1	0.4	0.4	0.0	0.0	0.0
Net changes in cash balances									
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.4
Discrepancy	-2.5	0.8	0.0	0.0	-3.3	0.1	0.0	0.0	0.0
	(In percent of GDP)								
Total revenue and grants	26.7	27.4	29.0	29.0	32.1	32.1	31.4	27.2	30.5
Total revenue	26.1	27.0	28.2	28.2	31.4	31.4	29.1	26.2	29.4
Current revenue	26.1	26.9	28.2	28.2	31.4	31.4	29.0	26.1	29.3
Tax revenue	19.9	20.2	20.2	20.2	25.1	25.1	21.9	20.3	23.0
Trade taxes	12.5	13.1	13.3	13.3	16.3	16.3	15.2	13.6	15.0
Other taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2
Nontax revenue	6.3	6.8	8.0	8.0	6.3	6.3	7.1	5.8	6.3
of which: revolving funds	0.8	1.4	1.1	1.1	1.4	1.4	1.6	1.4	1.6
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Grants	0.5	0.4	0.9	0.9	0.7	0.7	2.3	1.0	1.1
Total expenditure and net lending	26.9	27.7	29.3	30.6	31.2	33.7	34.0	32.2	32.7
Total expenditure	28.1	28.4	27.3	28.6	31.0	33.5	34.2	32.4	32.8
Current expenditure	26.7	27.1	26.2	26.2	27.2	27.2	30.3	27.1	27.5
Wages and salaries	14.9	14.2	14.8	14.8	14.8	14.8	15.3	14.0	14.1
Other expenditures	11.8	12.9	11.4	11.4	12.4	12.4	15.0	13.1	13.4
Additional expenditures	0.0	0.0	0.0	1.4	0.3	2.9	0.5	2.2	2.3
Capital expenditure	1.3	1.3	1.1	1.1	3.4	3.4	3.4	3.0	3.0
Total lending minus repayments	-1.1	-0.6	2.0	2.0	0.2	0.2	-0.2	-0.2	-0.2
Overall deficit/surplus	-0.2	-0.4	-0.2	-1.6	1.0	-1.6	-2.6	-5.0	-2.2
Total financing	0.2	0.4	0.2	1.6	-1.0	1.6	2.6	5.0	2.2
External financing	1.4	-0.6	-2.3	-0.2	2.5	4.4	1.9	5.2	5.3
Disbursements	2.0	1.2	0.0	2.6	3.7	5.5	3.3	6.4	6.5
Repayments	0.6	1.8	2.3	2.7	1.2	1.1	1.4	1.2	1.2
Domestic financing	-0.1	0.7	2.5	1.8	-2.3	-2.8	0.7	-0.3	-3.2
Bonds issued	0.0	0.0	3.5	3.5	1.3	1.3	1.2	1.2	1.2
Bonds matured	0.0	0.0	0.7	0.6	0.4	0.3	1.2	1.2	1.2
Loan disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loan repayments	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Tonga Trust Fund	0.1	0.4	0.0	0.0	0.1	0.1	0.0	0.0	0.0
Net changes in cash balances	-0.3	0.3	-0.3	-1.1	-3.4	-3.9	0.7	-0.3	-3.2
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Discrepancy	-1.1	0.3	0.0	0.0	-1.1	0.0	0.0	0.0	0.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Staff estimate without measures.
2/ Staff estimate with measures.

Table 4. Tonga: NRBT Balance Sheet, 1997/98-2002/03

(In millions of pa'anga; end-period)

	1997/98	1998/99	1999/00	2000/01	Est. 2001/02	Proj. 2002/03 Status Quo	Proj. 2002/03 Adjustment
Net foreign assets	20.9	33.7	25.8	25.4	39.3	15.2	33.0
Foreign assets	21.3	34.1	26.2	25.8	39.6	15.2	33.1
Foreign liabilities	-0.4	-0.5	-0.5	-0.4	-0.2	-0.1	-0.1
Net domestic assets	-1.0	-11.8	-0.1	7.0	1.3	23.8	3.0
Claims on central government, net	2.7	-0.1	0.2	1.4	-3.5	9.9	-6.9
Claims on financial institutions	0.0	0.0	0.0	8.8	3.6	0.0	0.0
Other items, net	-3.7	-11.7	-0.3	-3.2	1.2	14.0	9.9
Reserve money	19.9	21.9	25.7	32.4	40.6	39.0	36.0
Currency issued	8.2	9.3	10.2	13.1	15.2	13.8	12.6
Banks' deposits at NRBT	11.6	12.6	15.4	19.3	25.5	25.2	23.4
Of which: Required reserve	9.1	11.6	12.5	18.3	20.5	21.5	20.0
Domestic banks demand deposits	2.5	1.0	2.9	1.0	5.0	3.6	3.4
Memorandum items:							
Net foreign assets (in U.S. dollars)	13.9	21.1	15.3	11.8	18.3	6.2	13.7
Money multipliers 1/							
Narrow money	1.1	1.1	1.1	1.0	1.0	1.1	1.1
Broad money	3.9	4.1	3.8	3.8	3.3	3.7	3.7

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Excludes the counterpart of a telecommunication loan of T$10 million in 2000/01.

Table 5. Tonga: Monetary Survey, 1997/98-2002/03 1/

	1997/98	1998/99	1999/00	2000/01	Est. 2001/02	Proj. 2002/03 Status Quo	Proj. 2002/03 Adjustment
	(In millions of pa'anga; end-period)						
Net foreign assets	16.4	34.4	26.9	32.8	33.5	15.2	33.0
Gross international reserves	26.1	39.7	32.0	46.5	44.6	20.2	38.1
Foreign liabilities	-9.7	-5.3	-5.1	-13.8	-11.1	-5.1	-5.1
Net domestic assets	61.4	55.3	70.4	90.3	99.1	132.5	103.4
Domestic credit	84.2	85.0	92.5	120.6	131.0	167.1	138.1
Central government (net)	2.0	0.7	0.8	4.3	-5.6	-6.4	-15.9
Public enterprises	0.6	1.5	2.3	5.4	9.5	14.5	14.5
Private sector	78.9	80.8	86.5	107.9	125.2	159.1	139.6
Other financial institutions	2.7	2.0	3.0	3.0	2.0	2.0	2.0
Other items (net)	-22.8	-29.7	-22.1	-30.3	-31.9	-34.7	-34.7
	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Broad money (M2)	77.8	89.7	97.3	123.0	132.7	147.6	136.5
Narrow money	21.3	24.7	27.9	33.0	42.4	48.6	44.1
Quasi-money	56.5	65.0	69.4	90.0	90.3	99.0	92.4
	(12 month percent change)						
Net foreign assets	-50.2	109.6	-22.0	22.0	2.3	-54.8	-1.5
Net domestic assets	42.1	-9.9	27.4	28.2	9.8	33.6	4.3
Domestic credit	20.5	1.0	8.8	30.3	8.7	27.6	5.4
Central government (net)	-16.8	-64.6	11.8	444.8	-232.2	14.2	182.7
Private sector	20.8	2.4	7.0	24.8	16.0	27.1	11.5
Broad money	2.1	15.3	8.4	26.5	7.8	11.3	2.9
Narrow money	1.8	16.0	13.1	18.3	28.4	14.7	4.1
Quasi-money	2.3	15.0	6.7	29.8	0.3	9.7	2.3
	(Contribution to 12 month percent change in M2; in percent)						
Net foreign assets	-21.7	23.1	-8.4	6.1	0.6	-13.8	-0.4
Net domestic assets	23.9	-7.8	16.9	20.4	7.2	25.1	3.2
Domestic credit	18.8	1.1	8.4	28.8	8.5	27.2	5.4
Central government (net)	-0.5	-1.6	0.1	3.6	-8.0	-0.6	-7.8
Private sector	17.8	2.5	6.3	22.0	14.1	25.6	10.9
Other items (net)	5.1	-8.9	8.5	-8.4	-1.3	-2.1	-2.1
Memorandum items:							
Velocity (GDP/average stock of M2) 2/	2.8	2.8	2.8	2.5	2.3	2.5	2.5
Velocity (GDP/average stock of M1)	10.4	10.3	9.9	8.9	7.9	7.6	7.7
Nominal GDP (pa'anga mn.)	218.9	237.3	260.6	270.3	296.5	346.4	330.9
Average stock of M2 (pa'anga mn.) 2/	77.0	83.8	93.5	110.2	127.9	140.1	134.6
Average stock of M1 (pa'anga mn.)	21.1	23.0	26.3	30.4	37.7	45.5	43.2
Credit to central government (net) with TDB	-19.0	-16.8	-17.5	-12.6	...	0.0	0.0

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Excludes the Tonga Development Bank.
2/ Excludes a telecomunication loan of T$10 million in 2000/01.

Table 6. Tonga: Balance of Payments Summary, 1997/98-2002/03

(In millions of U.S. dollars, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01	Staff est. 2001/02
Trade balance	-66.2	-43.5	-51.7	-49.0	-48.1
Exports, f.o.b.	11.9	12.1	10.9	11.8	17.8
Imports, f.o.b.	-78.1	-55.5	-62.6	-60.8	-65.9
Services (net)	6.9	4.3	1.9	-8.7	-1.9
Receipts	27.8	18.7	18.3	11.6	16.6
Payments	-21.0	-14.4	-16.4	-20.4	-18.5
Income (net)	1.7	2.9	-0.5	-1.1	-0.6
Receipts	4.8	4.0	2.2	1.6	2.3
Payments	-3.0	-1.1	-2.6	-2.7	-2.8
Current transfers (net)	39.4	35.3	40.5	45.6	53.2
Official transfers (net)	0.6	1.4	0.1	0.3	0.4
Private transfers (net) 1/	38.8	33.9	40.4	45.3	52.9
Current account balance	-18.2	-1.0	-9.7	-13.3	2.7
(Percent of GDP)	-11.2	-0.6	-6.1	-9.7	2.0
Capital account balance	7.1	9.0	2.6	0.3	8.0
Official capital flows (net)	6.7	4.2	3.1	-0.3	6.0
Private capital flows (net)	0.4	4.8	-0.6	0.5	2.1
Errors and omissions	-1.0	-0.8	1.3	9.6	-4.2
Overall balance 2/	-12.2	7.2	-5.9	-3.5	6.5
Memorandum items:					
Gross official foreign reserves	14.2	21.4	15.6	12.0	18.4
In months of total imports	1.7	3.7	2.4	1.8	2.6
Exchange rate					
pa'anga per US$ (period average)	1.35	1.58	1.64	1.97	2.18
pa'anga per US$ (end-period)	1.50	1.59	1.69	2.15	2.15

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Estimates for 2001/02 assume that 60 percent of the increase in private remittances financed imports of goods and services.
2/ Changes in the net official foreign reserves.

Table 7. Tonga: Vulnerability Indicators, 1997/98–2002/03

(As percent of GDP, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01	Staff est. 2001/02	Proj. 2002/03 Status Quo	Proj. 2002/03 Adjustment
Financial sector risk indicators							
Public and public guaranteed debt	42.5	50.3	46.7	51.8	61.1	63.7	65.3
Broad money (percent change, 12-month basis)	2.1	15.3	8.4	26.5	7.8	11.3	2.9
Private sector credit (percent change, 12-month basis)	20.8	2.4	7.0	24.8	16.0	27.1	11.5
Share of deposits in broad money (percent)	92.2	91.8	91.7	91.6	91.0	...	...
Share of foreign currency deposits in total deposits (percent)	4.0	4.7	4.1	13.2	5.1	...	...
External indicators							
Exports (percent change, 12-month basis in US$)	-9.8	1.5	-9.5	8.1	50.9	-21.5	-18.7
Imports (percent change, 12-month basis in US$)	29.7	-28.9	12.7	-2.8	8.4	9.2	6.0
Terms of trade (percent change, 12 month basis)	-30.0	17.4	7.0	-37.1	...	...	...
Current account balance	-11.2	-0.6	-6.1	-9.7	2.0	-10.8	-5.3
Capital and financial account balance	4.3	5.9	1.7	0.2	5.9	1.9	1.8
Gross official reserves (in millions of US$)	14.2	21.4	15.6	12.0	18.4	6.2	13.7
Central Bank foreign liabilities (in millions of US$)	0.3	0.3	0.3	0.2	0.1	0.0	0.0
Central Bank foreign currency exposure 1/	1.9	1.3	1.7	1.5	0.5	0.3	0.2
Foreign assets of commercial banks (in millions of US$)	3.2	3.5	3.4	9.6	3.8	...	...
Foreign liabilities of commercial banks (in millions of US$)	6.2	3.0	2.8	6.2	6.5	...	...
Foreign currency exposure of commercial banks 1/	192.8	86.5	81.4	64.6	171.0	...	...
Gross official international reserves (as percent of imports)	16.0	30.8	20.3	16.1	21.5	6.6	15.2
Gross official international reserves (as percent of broad money)	27.4	38.0	27.0	21.0	29.8	10.3	22.4
Short-term debt	0.6	0.7	0.7	0.7	0.7	...	...
Short-term debt to gross official international reserves	7.1	4.7	6.4	11.4	9.1	...	...
Total external debt (percent of GDP)	36.3	42.0	42.0	42.7	49.1	53.5	54.6
Total external debt (as percent of exports of goods and services)	150.1	207.0	219.8	249.3	196.8	248.9	230.5
Debt service ratio (as percent of exports goods and services)	8.2	10.6	9.7	17.2	6.0	8.8	7.4
External interest payments (as percent of exports goods and services)	2.1	2.8	2.7	2.5	2.0	2.3	2.1
External amortization payments (as percent of exports goods and services)	6.1	7.9	7.0	14.7	6.2	6.5	5.3
Exchange rate (pa'anga per US$, end of period)	1.50	1.59	1.69	2.15	2.15	...	...

Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Foreign currency exposure is defined to be foreign liabilities as a percentage of foreign assets.

Table 8. Tonga: Banking Survey, 1997/98-2002/03 1/

(In millions of pa'anga; end-period)

	1997/98	1998/99	1999/00	2000/01	Est. 2001/02	Proj. 2002/03 Status quo	Proj. 2002/03 Adjustment
Net foreign assets	16.4	34.4	26.9	32.8	33.5	15.2	33.0
Net official reserves	20.9	33.7	25.8	25.4	39.3	15.2	33.0
Gross official reserves	21.3	34.1	26.2	25.8	39.6	15.2	33.1
Net foreign assets held by banks	-4.5	0.8	1.1	7.3	-5.8	0.0	0.0
Long-term foreign liabilities 2/	-3.4	-3.5	-3.8	-3.0	-2.7	-2.7	-2.7
Net domestic assets	83.8	71.1	92.4	111.0	119.8	154.0	125.0
Domestic credits	124.8	117.2	123.4	151.9	164.3	201.0	172.0
Central government (net)	0.1	-1.2	-0.7	3.7	-8.5	-9.3	-18.8
Public enterprises	1.8	2.4	3.4	6.4	10.2	15.2	15.2
Private sector	122.9	116.0	120.7	141.8	162.6	195.1	175.6
Other items, net	-41.0	-46.1	-31.0	-40.8	-44.6	-47.0	-47.0
Total liquidity	79.5	88.2	100.6	128.2	140.1	156.5	145.4
Broad Money	75.2	83.5	94.0	121.0	130.6	145.6	134.4
Money	18.7	18.4	24.7	31.0	40.3	46.5	42.0
Quasi money	56.5	65.0	69.4	90.0	90.3	99.0	92.4
Notes and bills 3/	4.3	4.7	6.6	7.2	9.5	10.9	10.9
Government lending funds 4/	17.4	13.9	14.8	12.6	10.4	10.0	10.0

Source: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Consolidated balance sheet of NRBT, commercial banks, and TDB.
2/ Direct external borrowing by TDB.
3/ Comprises bills and promissory notes issued by financial institutions held outside the banking sector.
4/ External borrowing by Government which was onlent to TDB.

TONGA: MEDIUM–TERM SCENARIOS

Reform (Adjustment) Scenario

This illustrative scenario assumes that the adoption of sound macroeconomic policies and the implementation of structural reforms would help to boost two key components of economic growth: capital accumulation and total factor productivity (TFP). Efforts to strengthen tax compliance, public financial management, and to rationalize public employment, would improve the budgetary balance in the transition to a revenue-neutral tax reform in 2004/05 (Table 1). The shift in the structure of taxation and expenditure would allow for a gradual recovery in other current expenditures and public investment, which have been compressed in past years, to complement higher foreign direct investment. Medium-term budget deficits would primarily reflect higher capital expenditure financed externally. Public sector enterprise reform should also assist fiscal policy and help improve TFP growth. Trade liberalization stemming from accession to the WTO would help arrest the small domestic market, and would be assisted by a real effective depreciation of the pa'anga.

As a result, the economy could gradually double its growth rate over the medium-term and inflation could return to low-levels, as the value of the pa'anga becomes more stable, reflecting a robust framework for monetary policy as well as fiscal consolidation. The current account deficit is envisaged to decline gradually to around 3 percent of GDP and should be largely financed by increased private flows and official assistance (Table 2). Official reserves could recover to around 3 months of imports, public debt would stabilize around present levels, and vulnerability would decline markedly.

"Status Quo" (No Measures) Scenario

In this scenario, the inability to restore a sound fiscal framework and to address the structural weaknesses would likely impose severe costs to the economy (Table 3). Capital accumulation and TFP are envisaged to remain stagnant and hurt growth prospects. The lack of private and official financing would force the budget to rely increasingly in domestic sources of financing. This would likely curtail credit to the private sector in order to limit the impact on monetary expansion and inflation. Nonetheless, inflation would continue to accelerate and the pa'anga would depreciate markedly. With limited external financing, the current account would likely shift to balance through a major compression of imports. This would imply a significant contraction in consumption and intensify the constraints on economic growth. The economy would remain in a highly vulnerable condition and would face significant difficulties in arresting major external or domestic shocks owing to the low level of reserves, high indebtedness, and the constraints imposed by the structural weaknesses.

Table 1. Tonga: Medium-Term "Adjustment" Scenario, 1999/00-2006/07

				Projection				
	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Output and prices				(Percent change)				
Real GDP	6.5	0.5	1.6	1.0	1.8	2.0	2.5	3.0
Consumer prices (period average)	5.3	6.9	10.4	10.5	7.5	5.0	3.0	2.5
Saving and investment				(In percent of GDP)				
Consumption	127.5	126.9	126.8	132.3	130.2	127.8	125.2	122.3
Investment	3.8	15.3	9.9	9.4	10.3	11.0	12.5	13.8
Gross domestic saving	-27.5	-26.9	-26.8	-32.3	-30.2	-27.8	-25.2	-22.3
Gross national saving	-2.3	5.6	11.9	4.1	7.1	7.8	9.3	10.7
Central government finance				(In percent of GDP)				
Revenue 1/	27.0	28.2	31.4	29.4	30.7	31.5	32.0	31.9
Grants	0.4	0.9	0.7	1.1	1.1	1.1	1.1	1.1
Total expenditure and net lending	27.7	30.6	33.7	32.7	32.7	33.4	33.9	33.8
Current expenditure	27.1	26.2	27.2	27.5	27.9	28.0	28.2	27.9
Capital expenditure	1.3	1.1	3.4	3.0	4.0	4.5	4.8	5.0
Overall balance (including grants)	-0.4	-1.6	-1.6	-2.2	-0.9	-0.8	-0.8	-0.8
Balance of payments				(In millions of U.S. dollars)				
Exports, f.o.b.	10.9	11.8	17.8	14.5	17.6	19.9	22.2	24.5
Imports, f.o.b.	-62.6	-60.8	-65.9	-69.9	-72.8	-73.9	-76.7	-78.8
Services and Income (net)	1.5	-9.8	-2.4	-1.2	-2.3	-2.4	-2.0	-1.9
Transfers (net)	40.5	45.6	53.2	49.4	53.0	51.9	51.8	51.4
Current account balance	-9.7	-13.3	2.7	-7.2	-4.4	-4.6	-4.7	-4.8
(In percent of GDP)	-6.1	-9.7	2.0	-5.3	-3.1	-3.2	-3.1	-3.1
Net official capital flow	3.1	-0.3	6.0	8.3	0.2	-0.3	-1.1	-1.5
Net private capital flow	-0.6	0.5	2.1	-5.8	3.0	3.8	6.0	8.2
Overall balance	-5.9	-3.5	6.5	-4.7	2.2	2.0	3.2	4.9
Exceptional financing 2/	...	...	0.0	0.0	3.4	3.1	3.0	3.0
Gross international reserves (end-period)								
In millions of US dollars	15.6	12.0	18.4	13.7	15.9	18.0	21.1	26.0
In months of total imports	2.4	1.8	2.6	1.9	2.0	2.2	2.5	3.0
				(In percent)				
Debt Total/GDP	47.5	52.8	61.1	65.3	63.3	62.1	60.9	59.4
External debt/GDP	42.0	42.7	49.1	54.6	53.6	53.0	52.3	51.2
Debt service ratio 3/	9.7	17.2	6.0	8.8	7.4	6.4	6.0	6.0

Source: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Excludes grants.

2/ Exceptional financing would be provided by multilateral and bilateral support.

3/ In percent of exports of goods and services.

Table 2. Tonga: Medium-Term Balance of Payments, "Adjustment" Scenario, 2000/01-2006/07
(In millions of U.S. dollars, unless otherwise indicated)

		Prelim.	Projections				
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Trade balance	-49.0	-48.1	-55.4	-55.1	-54.0	-54.5	-54.3
Exports, f.o.b.	11.8	17.8	14.5	17.6	19.9	22.2	24.5
Imports, f.o.b.	-60.8	-65.9	-69.9	-72.8	-73.9	-76.7	-78.8
Services (net)	-8.7	-1.9	-1.1	-1.8	-1.9	-1.5	-1.4
Receipts	11.6	16.6	18.0	20.6	22.0	23.1	23.9
Payments	-20.4	-18.5	-19.1	-22.4	-24.0	-24.6	-25.3
Income (net)	-1.1	-0.6	0.0	-0.5	-0.5	-0.5	-0.5
Receipts	1.6	2.3	2.0	2.0	2.0	2.0	2.0
Payments	-2.7	-2.8	-2.0	-2.5	-2.5	-2.5	-2.5
Current transfers (net)	45.6	53.2	49.4	53.0	51.9	51.8	51.4
Official transfers (net)	0.3	0.4	0.3	2.2	1.1	1.1	0.6
Official transfer receipts	0.7	0.7	1.4	2.6	1.5	1.5	1.0
Official transfer payments	-0.4	-0.4	-1.1	-0.4	-0.4	-0.4	-0.4
Private transfers (net) 1/	45.3	52.9	49.2	50.9	50.8	50.7	50.8
Private transfer receipts 1/	53.6	65.2	62.1	63.8	63.7	63.6	63.7
Private transfer payments	-8.3	-12.3	-12.9	-12.9	-12.9	-12.9	-12.9
Current account balance	-13.3	2.7	-7.2	-4.4	-4.6	-4.7	-4.8
(Percent of GDP)	-9.7	2.0	-5.3	-3.1	-3.2	-3.1	-3.1
Capital account balance	0.3	8.0	2.4	3.2	3.5	4.9	6.7
Official capital (net)	-0.3	6.0	8.3	0.2	-0.3	-1.1	-1.5
Official capital inflows	4.4	12.4	9.0	2.2	1.6	0.9	0.7
Official capital outflows	-1.8	-7.3	-0.7	-2.0	-1.9	-2.0	-2.2
Private capital (net)	0.5	2.1	-5.8	3.0	3.8	6.0	8.2
Private capital inflows	10.1	6.4	-2.3	3.0	3.8	6.0	8.2
Private capital outflows	-9.6	-4.4	-3.5	0.0	0.0	0.0	0.0
Basic balance	-13.0	10.7	-4.7	-1.2	-1.1	0.2	1.9
Errors and omissions	9.6	-4.2	0.0	0.0	0.0	0.0	0.0
Overall balance 2/	-3.5	6.5	-4.7	2.2	2.0	3.2	4.9
Financing Gap	0.0	0.0	0.0	3.4	3.1	3.0	3.0
Memorandum items:							
Gross official foreign reserves	12.0	18.4	13.7	15.9	18.0	21.1	26.0
In months of total imports	1.8	2.6	1.9	2.0	2.2	2.5	3.0
Nominal GDP (US$ mn.)	137.0	136.1	135.6	140.9	144.4	148.7	153.9

Source: Data provided by the Tongan authorities; and Fund staff estimates.
1/ Estimates for 2001/02 assume that 60 percent of the increase in private remittances financed imports of goods and services.
2/ Changes in net official foreign reserves.

Table 3. Tonga: Medium-Term "Status Quo" Scenario, 1999/00-2006/07

				Projection				
	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Output and prices				(Percent change)				
Real GDP	6.5	0.5	1.6	2.5	-0.5	0.5	0.5	0.5
Consumer prices (period average)	5.3	6.9	10.4	15.0	20.0	20.0	20.0	20.0
Saving and investment				(In percent of GDP)				
Consumption	127.5	126.9	126.8	136.0	135.1	135.1	137.3	140.2
Investment	3.8	15.3	9.9	9.0	5.6	5.0	4.0	3.6
Gross domestic saving	-27.5	-26.9	-26.8	-36.0	-35.1	-35.1	-37.3	-40.2
Gross national saving	-2.3	5.6	11.9	-1.7	3.2	4.7	4.1	3.8
Central government finance				(In percent of GDP)				
Revenue 1/	27.0	28.2	31.4	26.2	25.9	25.7	25.5	25.3
Grants	0.4	0.9	0.7	1.0	1.0	1.0	1.0	1.0
Total expenditure and net lending	27.7	30.6	33.7	32.2	29.9	30.2	30.0	30.3
Current expenditure	27.1	26.2	27.2	27.1	27.1	26.9	26.6	26.8
Capital expenditure	1.3	1.1	3.4	3.0	2.0	2.0	1.5	1.5
Overall balance (including grants)	-0.4	-1.6	-1.6	-5.0	-3.0	-3.5	-3.5	-4.0
Balance of payments				(In millions of U.S. dollars)				
Exports, f.o.b.	10.9	11.8	17.8	14.0	16.0	17.9	18.7	19.1
Imports, f.o.b.	-62.6	-60.8	-65.9	-72.0	-65.5	-63.6	-63.2	-63.4
Services and Income (net)	1.5	-9.8	-2.4	-6.2	-5.6	-5.5	-5.3	-5.2
Transfers (net)	40.5	45.6	53.2	49.4	51.9	50.9	49.8	49.7
Current account balance	-9.7	-13.3	2.7	-14.9	-3.2	-0.4	0.1	0.2
(In percent of GDP)	-6.1	-9.7	2.0	-10.8	-2.5	-0.3	0.1	0.2
Net official capital flow	3.1	-0.3	6.0	8.3	0.6	0.3	-0.2	-0.2
Net private capital flow	-0.6	0.5	2.1	-5.7	0.0	0.0	0.0	0.0
Overall balance	-5.9	-3.5	6.5	-12.2	-2.6	-0.1	-0.1	0.0
Exceptional financing 2/	...	...	0.0	0.0	0.0	0.0	0.0	0.0
Gross international reserves (end-period).								
In millions of US dollars	15.6	12.0	18.4	6.2	3.5	3.4	3.3	3.3
In months of total imports	2.4	1.8	2.6	0.8	0.5	0.5	0.5	0.5
				(In percent)				
Debt Total/GDP	47.5	52.8	61.1	63.7	68.3	73.4	78.4	84.1
External debt/GDP	42.0	42.7	49.1	53.5	56.8	60.3	64.1	68.2
Debt service ratio 3/	9.7	17.2	6.0	8.8	9.1	8.5	8.6	9.1

Source: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Excludes grants.

2/ Eceptional financing would be provided by multilateral and bilateral sources.

3/ In percent of exports of goods and services.

Tonga: Fund Relations
(As of November 30, 2002)

I. **Membership Status**: Joined 9/13/85; Article VIII

		SDR Million	% Quota
II.	**General Resources Account**:	SDR Million	% Quota
	Quota	6.90	100.0
	Total holdings of currency	5.20	75.3
	Reserve position in Fund	1.71	24.8
III.	**SDR Department**	SDR Million	% Allocation
	Holdings	0.19	n.a.

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

On February 11, 1991, the pa'anga was pegged to a weighted basket of currencies comprising the U.S., the Australian, and the New Zealand dollar, with the U.S. dollar as the intervention currency. In July 2000, the Japanese yen was added to the basket, and 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.

VIII. **Last Article IV Consultation**:

Staff discussions were held during June 14–25, 2001 and the Executive Board discussed the staff report (SM/01/251, 8/31/2001) on September 4, 2001.

IX. **Technical Assistance**:

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. However, Mr. F. Escobar, a consultant to MAE has been an advisor to the National Reserve Bank of Tonga since March 2002.

Tonga: Relations with the Asian Development Bank[1]

(As of November 2002)

The Asian Development Bank's strategy for Tonga for the period 2003–2005 focuses on improving financial and economic management, public sector reform, and supporting private sector and agriculture sector development.

ADB has approved 14 loans totaling $52.9 million from the ADF to Tonga since it joined ADB in 1972. Of the 14 loans, project completion reports have been prepared for 13 projects, nine of which have been post-evaluated. Currently, there is only one loan in the portfolio. This is the Economic and Public Sector Reform Program loan, which was approved in May 2002. The reform program is proceeding well with support from a number of donors including ADB.

Technical assistance grants totaling $12.1 million have been provided for 45 projects since 1972. Five capacity-building technical assistance projects are associated to three above-mentioned loans. Most of the projects are completed except for two: one is on building a performance-oriented public service (approved in May 2002) and the other is the small scale assistance to the Statistics Department. The performance under most projects is considered satisfactory. Planned technical assistance will assist the government in implementing economic and public sector reforms, including efforts to establish an appropriate policy framework and improve the efficiency of public enterprises and the agriculture sector.

Policy dialogue is focusing on supporting implementation of the Economic and Public Sector Reform Program (EPSRP). The objective of the EPSRP is to enhance private sector-led economic growth by (a) promoting policies (including tax reforms) that create a conducive environment for increased investment and employment by the private sector; and (b) improving the efficiency and effectiveness of service delivery by public sector agencies.

Tonga: Loan and Technical Assistance Approvals, 1998–2002

	1998	1999	2000	2001	2002
Loan approvals					
Number	0	0	0	0	1
Amount (in millions of U.S. dollars)	0	0	0	0	10
Technical assistance approvals					
Number	1	0	2	1	1
Amount (in millions of U.S. dollars)	0.4	0	0.3	0.5	0.7

[1] Prepared by Asian Development Bank staff.

Tonga: Relations with the Pacific Financial Technical Assistance Center[1]
(As of November 2002)

PFTAC's assistance to Tonga, often with other technical assistance providers, has focused on the areas of public financial management, tax administration and policy, banking regulation and supervision, and economic and financial statistics.

Public Financial Management
Recent technical assistance from PFTAC has focused on improving the Budget process and establishing performance indicators for a group of ministries. PFTAC also assisted the authorities in preparing fiscal statistics on a GFS basis from the Sun Accounting System Data. A draft of the Questionnaire on the IMF's *Code of Good Practices on Fiscal Transparency* was completed in September 2001. It established priority areas where fiscal transparency could be enhanced More recent assistance has also concentrated on improving cash flow management and budget execution.

Tax Administration and Policy
Much of the assistance has been on developing alternative options for tax policy, which included an assessment of tax impact studies associated with changes in the Industrial Development Incentives Act and with the introduction of a consumption tax. Assistance was also provided to prepare the legislation that would support a tax reform package. Recent efforts have also concentrated on designing a strategy and action plan to modernize and enhance revenue administration, particularly in the area of tax and customs.

Banking sector Regulation and Supervision
A detailed assessment to determine compliance with the Basel Core Principles for Effective Banking Supervision was conducted and has helped to identify the main shortcomings in the Financial Institutions Act (FIA).

Economic and Financial Statistics
In early 2001, a review of operations was conducted to strengthen statistics as recommended by the *General Data Dissemination Systems* (GDDS), and discussions were held to establishing objectives for a possible future participation in the GDDS. An assessment of statistical needs was also conducted in mid-2001, which involved the use of PFTAC's Questionnaire on Statistical Systems and Practices, to set up a program for capacity building. The main recommendations included the need to strengthen national accounts; the update of key benchmark surveys; improving data collection processes; and upgrading computer facilities and networking.

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[1] The Pacific Financial Technical Assistance Centre (PFTAC) is located in Suva, Fiji, and is a multi-donor technical assistance institution financed by the IMF, the UNDP, the AsDB, AusAID, and NZODA, with the IMF as Executing Agency. The Centre's main objective is to enhance skills and the institutional framework for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federal States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Salomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

Tonga: Statistical Issues

Tonga publishes a range of macroeconomic statistics on a regular basis. The two main sources of statistical information are the Quarterly Bulletin of the National Reserve Bank of Tonga (NRBT), and the annual Ministry of Finance (MOF) budget documents. The authorities report to the Fund, the core indicators associated with national accounts (NA), official balance of payments (BOP), and government finance with long lags. Owing to resource constraints, as well as poor coordination among statistical agencies, data weaknesses remain in many areas. The Statistics Department (SD) and the MOF have received, on a regular basis, technical assistance in national accounts, government finance, and BOP statistics from the Pacific Financial Technical Assistance Centre (PFTAC).

NA data are mainly comprised of gross domestic product (GDP) which is estimated from the production side. A rough estimate is only available on expenditure components of GDP. The SD recently published revised GDP estimates for the fiscal years 1993/94 to 1998/99 and provisional estimates for 1999/00, with a new base period (1995/96), based on the results of a Business Establishment Survey. This was done with the technical support and assistance from the Australian Bureau of Statistics and the Secretariat for the Pacific Community. The current Consumer Price Index is based on an updated basket of goods and services derived from the 1992/93 Household Income and Expenditure Survey (HIES). A labor force survey and the decennial population census were done in 1996. PFTAC have recently completed a review and action plan for the statistical system of Tonga, in order to: a) improve the coverage of GDP estimates by using tax data; b) rebase the national accounts to a new benchmark of 2001, making use of the Agricultural census and the 2001 HIES; and c) rebase the CPI.

The FY 2002/03 Budget Statement introduced for the first time a presentation of fiscal data according to GFS methodology. However, major improvements are needed to ensure that fiscal data are accurate and reliable. A proper classification of transactions is needed which should be reconciled with other available information (in particular on domestic and external debt). Lags in entering information to the accounting system need to be shortened. There are large discrepancies between budgetary figures from above and below the lines and poor cross checking with the monetary survey. Fiscal accounts have not been audited since 1998/99. Published data are available only annually and revisions are usually large.

The official BOP figures are compiled by the SD with long lags and were available only on an annual basis. Quarterly data based on bank transactions reported recently to STA provide a breakdown of current and capital account transactions; however, a breakdown of the financial account into assets and liabilities and by functional category is not available. Monthly trade figures derived from customs documents are available with a three-month lag. The NRBT compiles unofficial monthly BOP statistics based on the foreign exchange records of the banking system with a six-week lag. The figures from both agencies show significant differences. Work is needed to reconcile the data on stocks of reserve assets that are available from various data sources. Furthermore, efforts are being made to improve the coordination between the NRBT and the SD so as to produce more timely and reliable BOP data. Technical assistance is being provided from the PFTAC to encourage improvement in the basic data sources, particularly the Overseas Exchange Transactions Recording System. The MOF has put in place a system which provides detailed information on official sector external debt disbursements and service.

Tonga: Reporting of Core Statistical Indicators
(As of December 19, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Date of Latest Observation	10/2002	9/2002	10/2002	10/2002	10/2002	8/2002	10/2002	1Q/2002 4/	1Q/2002 4/	2001/02 4/ 6/	2000/01 4/	2001/02 4/
Date Received	11/2002	11/2001	12/2002	12/2002	12/2002	12/2002	12/2002	8/2002 4/	8/2002 4/	07/2002 4/	07/2002 4/	07/2002 4/
Frequency of Data	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Annually	Annually	Annually
Frequency of Reporting 1/	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	O	O	O
Source of Update 2/	A	A	A	A	A	A	A	A	N	N	N	N
Mode of Reporting 3/	Cable	Cable	Cable/ Mail	Cable	Cable	Cable	Cable/ Mail	Cable/ Mail	Mail	V/ Mail	V/ Mail	V/ Mail
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of Publication	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Annually	Annually	Annually

1/ O-other irregular basis.
2/ A-direct reporting by the authority; N-official publication or press release.
3/ V-staff visits.
4/ Preliminary data.
5/ Unofficial data only, made by the NRBT. Official data is available only up to 1998/99.

Tonga: Relations with the World Bank Group[1]
(As of November 2002)

Since Tonga joined the World Bank Group in 1985, three credits and two grants have been approved. An IDA credit of US$2 million, cofinanced by the Asian Development Bank (ADB), was approved on June 2, 1987 for the Tonga Development Bank (TDB). The credit was designed to provide the TDB with long-term resources to meet investment demand—particularly in agriculture, industry, and tourism—as well as to support institutional development. A second TDB credit of US$3 million was approved on January 4, 1990 (also cofinanced by the ADB) to support interest rate reform as well as to provide financing for projects in the agricultural, industrial, and tourism sectors. A third IDA credit of US$5.85 million was approved in May 2002 to assist in recovering the standard of living of the population affected by a cyclone through the rehabilitation of the social infrastructure in selected affected areas. A further objective is to strengthen and upgrade the emergency and risk management capacity of the country through the improvement of its nationwide resilience to natural hazards, including the effects of climate change. In 1996, a grant of $US250,000 was approved to support the government's efforts in the medium term to improve and expand telecommunication facilities. In 1999, a grant of US$100,000 was approved to support Y2K planning.

Currently, there is one project in the pipeline for Tonga looking at health reform. The specific objective of the project is to support health reform by improving the capacity of the Ministry of Health to develop and implement health financing policy and collect, manage and use health information; and, by improving the functional and technical quality of Vaiola Hospital. There have also been some early discussions with the Tongan government concerning a possible education project.

The Bank's fifth Regional Economic Report (RER) for its Pacific Island member countries, including Tonga, was issued in September 2002. This report, *Embarking on a Global Voyage: Trade liberalisation and Complementary Reforms in the Pacific,* focuses on assisting Pacific Island countries (PICs) in their efforts to integrate more closely with the global economy. Given the PICs agreement to enter into a regional trade agreement, PICTA, the RER evaluates this strategy and also analyses the interaction of trade liberalisation with complementary reforms in taxation and the public sector.

In addition, country reports on Tonga have been prepared as part of the Bank's Pacific regional studies on post-secondary education, energy, health, and transportation. A public expenditure review was completed in 1997. A mission from the World Bank visited Tonga in April 2001 to discuss with the authorities possible bank support in the areas of public sector reform, and in the finance, health and agriculture sectors.

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[1]Prepared by World Bank staff.

IFC has provided support to Tonga through its Foreign Investment advisory Service (FIAS) and through the South Pacific Project Facility (SPPF) which provides small business advisory services to Pacific island member countries. In 2000, FIAS completed a report on regulatory modernization, including drafting guidelines, and undertook an investment incentives review. In November 2001, the implementation project for the Foreign Direct Investment Act commenced. SPPF has previously provided project support in the fisheries and agribusiness sectors.

Recent reports:

- Regional Economic Report 2002, "Embarking on a Global voyage: Trade Liberalisation and Complementary Reforms in the Pacific"
- Regional Economic Report 2000, "Cities, Seas and Storms: Managing Change in Pacific Island Economies"
- Enhancing the Role of Government in the Pacific Island Economies, 1998
- Tonga: Public Expenditure Review, 1997
- Pacific Island Economies, Building a Resilient Economic Base for the Twenty-First Century, 1996

World Bank Group Credits

	(In millions of U.S. dollars)
Total disbursed	4.34
Undisbursed	5.85
IFC investments	None

Tonga: Social Indicators

	Latest Single Year			Same Region/Income Group	
	1970–75	1980–85	1993–01	East Asia and Pacific	Lower-Middle-Income
Population					
Total population, mid-year (millions)	0.10	0.10	0.10	1240	1357
Growth rate (percent, annual average)	0.9	0.2	0.4	1.2	1.1
Urban population (percent of population)	24.3	29.9	42.4	33.0	40.4
Total fertility rate (births per woman)	..	4.7	4.0	2.1	2.2
Income					
GNP per capita (in U.S. dollar)	..	750	1,750	990	1,740
Consumer price index (1995=100)	17	51	109	134.5	145.9
Food price index (1995=100)	..	..	..	..	..
Public expenditure					
Health (percent of GDP)	..	..	..	4.3	4.6
Education (percent of GNP)	..	4.1	..	2.9	4.9
Social security and welfare (percent of GDP)		0.5	..	..	..
Access to safe water (Percent of population)					
Total	..	95	100	74.8	79.9
Urban	..	..	100	92.7	69.1
Rural	..	..	100	65.6	95.0
Immunization rate (Percent under 12 months)					
Measles	..	81	97	85.4	89.1
DPT	..	92	95	85.2	88.8
Life expectancy at birth (Years)					
Total	..	62	71	69.1	69.5
Male	..	61	69	67.3	67.4
Female	..	64	73	70.9	71.7
Mortality					
Infant (per thousand live births)	..	33	20	35.5	32.6
Under 5 (per thousand live births)	..	..	23	44.7	40.6
Adult (15–59)					
Male (per 1,000 population)	..	..	187	183.0	192.0
Female (per 1,000 population)	..	..	132	131.5	124.7

Source: *2002 World Development Indicators*, World Bank.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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February 24, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Tonga

On February 5, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.[1]

Background

Economic activity rebounded modestly in 2001/02, as real GDP growth accelerated from about ½ percent in 2000/01 (fiscal year July-June) to 1½ percent in 2001/02 (Table 1). Conditions in agriculture improved owing to record-high prices for squash and vanilla. Construction rebounded sharply with the assistance provided by the international community to rebuild structures destroyed by Cyclone Waka. Tourism and the service sector have been sluggish during most of the past two years, partly owing to the unwinding of the stimulus from the new millennium celebrations and the impact of September 11 events, but tourism has been recovering markedly in recent months.

Knock-on effects from external shocks and competing demands on the budget have exerted extensive pressure on fiscal policy in 2001/02. Over the past two fiscal years, annual budget deficits estimated at around 1½ percent of GDP, reflected primarily increased support to public enterprises and rapid growth in current expenditures, as public wages were adjusted by 20 percent for cost of living in 2000/01. The deficit was primarily financed through bonds with the banking system and some external borrowing.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Credit has expanded at a very rapid pace. The ratio of private sector loans to deposits has risen sharply since November 2001 and stood close to a five year high in September 2002. Credit to public sector enterprises also expanded rapidly, but represented only 5 percent of total banking sector credit by September 2002. Interest rates remained largely stable in nominal terms and have become increasingly stimulatory with the acceleration of inflation. The NRBT introduced indicative quarterly ceilings on banks' credit to the non-financial private sector in June 2002.

Expansionary macroeconomic policies have resulted in a marked decline in net foreign assets, a weaker pa'anga, and higher inflation. Net foreign assets of the banking system declined from US$20 million in November 2001 to US$12 million in September 2002. Gross official reserves were temporarily boosted to US$18 million in June 2002, mainly reflecting the disbursement of the first tranche of the Economic and Public Sector Reform Program supported by the Asian Development Bank. However, with sustained demand pressures, reserves fell to US$13 million by end-September 2002. The exchange rate continued to depreciate relative to the basket peg and contributed to keep inflation high. Following the sharp real depreciation of the pa'anga between July 2000 and November 2001, the pa'anga appreciated by 1½ percent against the U.S. dollar, but since then, it depreciated by 3 percent through September 2002. Nonetheless, since November 2001, the exchange rate depreciated by 5½ percent in nominal effective terms against the basket and by 1¾ percent in real effective terms, primarily reflecting the weakening of the U.S. dollar vis-à-vis the New Zealand and Australian dollars. During 2002, inflation accelerated to about 10 percent, and price pressures have become broad based.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They expressed concern about the deterioration of macroeconomic performance in Tonga in recent years, which reflected limited progress in dealing with long-standing structural weaknesses, difficulties in preserving macroeconomic stability, and adverse weather and global economic shocks. Official reserves have been depleted, the pa'anga has depreciated markedly, and public indebtedness and inflation have increased rapidly. At the same time, economic growth has been sluggish, and unemployment has become a serious concern. Directors noted that the loss of most assets in the Tonga Trust Fund has further hampered the economy's ability to buffer adverse shocks and left the economy in a vulnerable condition.

Against this background, Directors stressed the need to take rapid and decisive action to restore macroeconomic stability. They urged the authorities to adopt fiscal measures, including better monitoring and elimination of some exemptions on import duties for personal and household goods and petroleum products, broadening the sales tax base and increasing the rate of the tax, and reducing current expenditures, particularly the public wage bill. They noted that continued support to ailing public enterprises would further undermine the much-needed improvement in the budget balance.

Directors recommended changes to the monetary policy framework to stem rapid credit growth, contain inflation, and help restore official reserves. They viewed greater reliance on indirect instruments as the most effective means of conducting monetary policy. Directors noted that, in the transition to a new framework, credit ceilings need to be enforced strictly through penalties on breaches by commercial banks, or otherwise replaced with alternative instruments, such as higher reserve requirements. Directors supported a prompt recapitalization of the National Reserve Bank of Tonga to restore its ability to effectively conduct open market operations, and encouraged the authorities to ensure that interest rates remain positive in real terms. Directors also saw a need to protect the National Reserve Bank of Tonga's financial position through strict limits on lending to the government.

Directors observed that exchange rate policy should aim at preserving competitiveness and ensuring external viability. They commended the authorities for increasing the flexibility of the pa'anga in recent years, and urged them to resist pressures to fix the value of the pa'anga against the U.S. dollar in light of the low level of official reserves and weak macroeconomic fundamentals.

Directors welcomed the recent enactment of legislation to improve public financial management, strengthen the efficiency of the public service and public enterprises, simplify business licensing, and reduce impediments to foreign investment. Implementation of these reforms would be critical to provide a more simple, transparent, and predictable framework for public and private sector activities, enhance the institutional framework and governance in Tonga, and strengthen long-term growth prospects.

Directors emphasized that efforts to strengthen the fiscal position would pave the way for a major reform of the tax regime. Directors endorsed the basic thrust of the proposed tax reform, aimed at broadening the tax base, shifting the burden of taxation away from foreign trade and toward domestic sources, simplifying the tax structure, reducing exemptions, and minimizing loopholes. They stressed, however, that the proposed reform should not compromise the fiscal position.

Directors expressed concern about the rise in the loan concentration ratio at commercial banks in recent years, particularly to sectors that may be vulnerable to external shocks. They encouraged the authorities to strengthen prudential supervision through more frequent meetings with domestic institutions and foreign supervisory authorities, tighter single borrower limits and the introduction of an aggregate limit on loans to connected parties. In this regard, an amendment of the Financial Institutions Act would be helpful. Directors welcomed the progress Tonga has made in dealing with anti-money laundering and other related initiatives, and urged them to take necessary further steps to combat terrorist financing.

Directors noted the critical need to improve the reliability of statistics to conduct policies and surveillance in an effective manner. Directors encouraged the authorities to coordinate and reconcile data among agencies in a more systematic manner and to strengthen efforts to provide key data to the Fund on a regular basis. In this regard, Directors welcomed Tonga's decision to participate in the General Data Dissemination System.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Table 1. Tonga: Selected Economic Indicators, 1998/99-2001/02 1/

Nominal GDP (2001/2002): US$ 136.1 million
Population (2001): 100,673
GDP per capita (2001/02): US$1,352
Quota: SDR 6.9 million

	1998/99	1999/00	2000/01	Est. 2001/02
Output and prices		(Percent change)		
Real GDP	2.9	6.5	0.5	1.6
Consumer prices (period average)	3.9	5.3	6.9	10.4
Central government finance		(In percent of GDP)		
Revenue	26.1	27.0	28.2	31.4
Grants	0.5	0.4	0.9	0.7
Total expenditure and net lending	26.9	27.7	30.6	33.7
Current expenditure	26.7	27.1	26.2	27.2
Capital expenditure	1.3	1.3	1.1	3.4
Overall balance 2/	-0.2	-0.4	-1.6	-1.6
External financing (net)	1.4	-0.6	-0.2	4.4
Domestic financing (net)	-0.1	0.7	1.8	-2.8
Discrepancy	-1.1	0.3	0.0	0.0
		(Percent change)		
Total liquidity 3/	10.9	14.1	27.5	9.3
Of which: Broad money (M2)	15.3	8.4	26.5	7.8
Domestic credit	-6.1	5.3	23.0	8.2
Private sector credit	-5.6	4.1	17.4	14.6
Interest rates				
Average deposit interest rate (end-period)	4.7	4.8	4.8	4.6
Base lending rate (end-period)	9.0	9.0	9.0	9.0
Balance of payments		(In millions of U.S. dollars)		
Exports, f.o.b.	12.1	10.9	11.8	17.8
Imports, f.o.b.	-55.5	-62.6	-60.8	-65.9
Services (net)	4.3	1.9	-8.7	-1.9
Income (net)	2.9	-0.5	-1.1	-0.6
Services and income (net)	7.2	1.5	-9.8	-2.4
Transfers (net)	35.3	40.5	45.6	53.2
Of which: Private transfer receipts	40.2	48.0	53.6	65.2
Current account balance	-1.0	-9.7	-13.3	2.7
(In percent of GDP)	-0.6	-6.1	-9.7	2.0
Overall balance	7.2	-5.9	-3.5	6.5
Gross international reserves (end-period)				
In millions of U.S. dollars	21.4	15.6	12.0	18.4
In months of total imports	3.7	2.4	1.8	2.6
External debt		(In percent)		
External debt/GDP	42.0	42.0	42.7	49.1
Debt-service ratio 4/	10.6	9.7	17.2	6.0
Exchange rate (period average)				
T$ per US$ (end-period)	1.59	1.69	2.15	2.15
Real effective exchange rate (1990=100)	101.1	104.5	100.2	97.7

Sources: Data provided by the Tongan authorities; and IMF staff estimates and projections.

1/ Fiscal year beginning July.
2/ Government overall balance for 2000/01 and 2001/02 are staff estimates.
3/ From the Banking Survey, which includes the Tonga Development Bank.
4/ In percent of exports of goods and services.

Statement by Sri Mulyani Indrawati, Executive Director for Tonga
February 5, 2003

Introduction

The Tongan authorities wish to express their sincere appreciation to the staff for their constructive discussion during the last Article IV consultation, as well as the comprehensive report on recent economic developments and policy challenges in Tonga. The mission provided valuable advice on policy recommendations on the overall macroeconomic framework and gave the authorities the opportunity to reassess their strategies.

The Tongan economy recorded average growth of only one per cent during the last two years ending June 2002, partly because of external shocks like September 11 and the global economic slowdown, as well as natural disasters such as Cyclone Waka. More recently in January 2003, Cyclone Ami and Cyclone Cilla also hit Tonga, again highlighting the natural vulnerabilities faced by small island countries, which adversely affect infrastructure, agriculture, fishing and tourism. Inflation has also accelerated in Tonga in recent years, principally because of the sharp depreciation of the domestic currency, credit expansion and larger fiscal deficit. Another challenge faced by Tonga is the low level of foreign exchange reserves, which has made the economy vulnerable to further shocks.

The authorities are concerned about the recent weakening of economic performance and the considerable challenges ahead, and are fully committed to taking the necessary measures to preserve macroeconomic stability. The authorities agreed with the overall thrust of the policy advice given by the mission, on both macroeconomic and structural policies, and would like to clarify a few specific issues.

Structural Policies

The structural weaknesses in the economy continued to cause difficulties in preserving sound fiscal and monetary policies, thus affecting macroeconomic stability and external viability. The authorities have acted urgently by introducing economic and public sector reform programs that include modernizing public finance management and revenue administration, improving the efficiency of public service and enhancing the environment for foreign direct investments and private sector development.

The following approved legislations are expected to guide the reform effort:

- Public Service Act
- Revenue Administration Act
- Public Enterprises Act
- Foreign Investment Act
- Business Licenses Act

The authorities are fully committed to the implementation of these legislations in order to expedite the progress of the reform efforts.

In addition, the Tonga authorities plan to take the following steps in order to facilitate the development of the private sector as an engine of growth:

- To reassess the government's functions and divest its non-core functions,
- To put into place new performance indicators to improve service delivery to the public,
- To undertake major reform in the tax system so as to assist growth of the private sector
- To undertake measures to lower the cost of doing business.

Consultations with all stakeholders are currently being conducted on the various facets of the reform program and the effect it will have on Tongans. It is envisaged that the reform program will restore fiscal and monetary policy stability, and a sustainable external position. Moreover, opportunities for private sector activities will establish the foundation for higher economic growth in the future, although the authorities would also like to emphasize that there are limits to which growth will be boosted, given the constraints faced by a small island economy like Tonga.

Monetary Policy

Efforts have been made in recent months to tighten monetary policy. The authorities agree with Fund staff that the credit ceiling needs to be enforced. The authorities are working to influence the growth in credit by linking penalties to breaches of the ceiling. Furthermore, under the new Financial Management Act, the government will authorize the National Reserve Bank of Tonga to issue Treasury bills for monetary purposes. This will support the efforts of the NRBT to modify credit growth. The authorities agree on the need to recapitalize the NRBT and legislation is being drafted for submission to the next session of the Legislative Assembly.

Exchange Rate Policy

The authorities recognize the difficulties faced by the economy and the weak position of the foreign exchange reserves. They will continue to maintain a flexible exchange rate regime which will support competitiveness and preserve foreign reserves.

Financial Sector

The authorities have given high priority to financial sector reform. In order to strengthen the regulatory and supervisory system, reforms are being formulated with the assistance of PFTAC. Accordingly, the authorities will introduce a new Financial Act to enhance the ability of the NRBT to carry out monetary supervision exercise. In addition, license fees of banks may be increased to cover the costs of supervision by NRBT.

Fiscal Policy

The authorities agree in principle with the proposed tax and expenditure measures that will help to achieve the fiscal target in conjunction with the aims of the reform program. The reform program continues to gain momentum with the approval of new legislations, the strengthening of the Government Revenue Services Departments (including the new taxation reform proposal), strengthening of the program budgeting, automation of the financial management system, and rationalization of the Civil Services. The authorities appreciate the financial and technical assistance from the Asian Development Bank, and the Australian and New Zealand governments in this respect.

Moreover, the authorities have been working closely with the PFTAC in designing the new tax regime, including drafting the needed legislations for tax administration and tax policy (tariff rates). It is expected that the tax policy legislation will be tabled in the next seating of the Legislative Assembly in the 2003.

The fiscal authorities have targeted a balanced operating budget over the medium term. However, they will face the immediate constraint of re-establishing infrastructure destroyed or damaged by the cyclones. Accordingly, it has targeted to return gradually to a more sustainable fiscal position over the next two years. In this regard, the Budget for FY 2002/03 includes the following measures:

- To reduce the share of wages and salaries to the total expenditure
- To privatize public enterprises
- To introduce and implement tax reform

The government has already approved the abolition of 158 current public sector positions, and decided against filling a further 425 vacant posts. It has also formulated plans to privatize public enterprises or commercialize portions of the public service in order to concentrate on areas where it has comparative advantage. For example, the government has approved the sale of its majority share in Sea Star Fishing Company Limited and is also seeking interested private investors for the Royal Tongan Airlines .

Statistical Issues

The authorities are enhancing economic and financial statistics with technical assistance from the PFTAC. In addition, the authorities have agreed to participate in the GDDS, which will further strengthen their statistical capabilities.

Conclusion

The Tongan authorities remain committed to undertake further reform, and in this regard have benefited from the technical assistance given by PFTAC, the World Bank, AsDB and the Fund. The authorities look forward to the next Article IV mission in 12 months' time.