

Tonga: 2006 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

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 2006 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 28, 2006, 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 May 17, 2006. 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 June 2, 2006 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Statistical Appendix

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TONGA

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with Tonga

Approved by Steven Dunaway and Anthony Boote

May 17, 2006

- The 2006 Article IV Consultation discussions were held in Nuku'alofa during March 15–28. The staff comprised Messrs. Singh (Head), Goldsworthy, and Ms. Fujita (all APD). Ms. Phang and Mr. Duong (both OED) also joined the discussions. The mission met with the Prime Minister Dr. Sevele, the Minister of Finance Hon. 'Utoikamanu, the Governor of the National Reserve Bank of Tonga, Ms. Mafi, and representatives of the civil service union and business community.
- The 2005 Article IV Consultation discussions were concluded on July 15, 2005. Executive Directors' views and comments can be found on <http://www.imf.org/np/sec/pn/2005/pn05119.htm>.
- Tonga is on a 12-month consultation cycle. It has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions.
- Tonga's data quality, coverage, and timeliness remain hampered by several deficiencies which complicate economic analysis and surveillance of policies.

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EXECUTIVE SUMMARY

Background

Tonga's economy has become increasingly vulnerable. Fiscal discipline has weakened, undermining macroeconomic stability and external viability. Some progress has been made recently in trying to restore fiscal balance, but at the same time efforts to strengthen governance and promote private sector activity have had negligible success.

Medium-term prospects have deteriorated since last year's consultation. Following a lengthy strike, civil servants were granted in September 2005 average wage increases of about 70 percent payable over the next two years. This decision has the potential to have significant negative consequences for macroeconomic and external stability.

Key Policy Recommendations

Against this background, the staff recommended that the authorities:

- **Achieve a sustainable fiscal adjustment** to restore macroeconomic stability. Substantial fiscal reforms are needed to offset the cost of the wage settlement, including downsizing the civil service, stepping up revenue collection efforts, improving public expenditure management, and advancing public enterprise reform.
- **Stand ready to tighten credit.** As higher public sector wages and the severance package could ease the currently tight liquidity conditions in the banking system, a further monetary tightening may be called for. Making full use of the flexibility allowed under the current basket peg arrangement to depreciate the pa'anga may also be needed to protect reserves.
- **Accelerate the pace of implementation of structural reforms** to enhance the role of the private sector and make the economy more dynamic.

I. INTRODUCTION

1. **Tonga is a small agriculture-based economy in the South Pacific with a population of about 100,000 and per capita income of US\$1,800.** It shares a number of common characteristics with other Pacific island countries including remoteness, openness, limited production diversification, and vulnerability to natural disasters. The population has remained broadly constant over the past decades, because of large-scale emigration mainly to Australia, New Zealand, and the United States. As a result, Tonga is one of the highest recipients of net remittances among developing countries, which amounted to more than 40 percent of GDP in 2004/05 (year ending June).
2. **Poor macroeconomic policies and deteriorating governance have increased the country's vulnerability.** Tonga's economic performance has been disappointing with respect to its comparators (Figure 1). Limited progress has been made over the past decades in broadening the narrow production and export base, reducing the dependence on external transfers, and strengthening a tax system heavily reliant on trade taxation. Furthermore, budget discipline has weakened, undermining macroeconomic stability and external viability. Progress in addressing the policy challenges identified by the Fund is mixed. The fiscal position improved in 2003/04 and 2004/05, but efforts to strengthen governance and promote private sector activity had negligible success.
3. **Economic prospects have deteriorated since last year's consultation, while political reform has gained momentum.** Following a lengthy strike, civil servants were granted in September 2005 average wage increases of about 70 percent (to be implemented over two years), a political decision with significant consequences for macroeconomic and external stability (Box 1). Following the settlement, the authorities stated their intention to respond to these circumstances by pushing ahead with key reforms to safeguard macroeconomic stability, improve governance, and enhance the role of the private sector. Meanwhile, the Prime Minister resigned in February 2006. The Minister of Labor was appointed Acting Prime Minister and was confirmed at the end of March, a move perceived by observers as positive for political reforms.¹ While the former Prime Minister is the King's youngest son, the new Prime Minister is a commoner and one of the few elected officials.

¹ Tonga is a constitutional monarchy in which substantial powers are assigned to the King and the nobility. Since the early 1990s, there has been a vocal movement pushing for a more democratic system whereby all 30 members of the Legislative Assembly would be elected, and the Cabinet and Prime Minister selected by the King from this elected body.

II. RECENT ECONOMIC DEVELOPMENTS

4. **Economic activity has slowed and inflation has eased.** According to preliminary information, the economy is expected to expand at a slower pace in 2005/06 than the 2½ percent gain in 2004/05, reflecting a poor squash season and slower growth in construction (Figure 3). Inflation declined to 9½ percent in 2004/05 compared to about 11½ percent in the previous year, and has since eased further to 5¼ percent during the year to February 2006, reflecting slower domestic food and import price increases.

5. **Steps are being taken to contain the fiscal impact of the first phase of the wage settlement, although severance payments could significantly widen the fiscal deficit.** An overall fiscal surplus of about 2½ percent of GDP was achieved in 2004/05, in marked contrast to the deficit of 2¼ percent of GDP envisaged in the budget, owing to lower-than-budgeted wages and capital spending, and stronger tax collection. In 2005/06, the original budget targeted a deficit of 1.8 percent of GDP, mostly covered by external concessional financing. However, available information for the first eight months of 2005/06 indicates that revenue performance was weaker than expected, mainly because of lower nontax and excise collection. Moreover, the unanticipated cost of the first phase of the wage increase is estimated to be about 3 percent of GDP. Savings have been carried out (mostly capital expenditure cuts and a hiring freeze) that are expected to offset this cost as well as the likely revenue shortfall. The authorities are also working on downsizing the civil service by the end of the fiscal year and the related severance payments could amount to about 5 percent of GDP.²

6. **Credit growth has picked up.** Liquidity in the banking system increased following the improvement in the government's net credit position with the domestic banking system and the repayment of loans by a major private utility company in 2003/04.³ These funds were used to finance a 21 percent expansion in net domestic credit in 2004/05, mainly driven by a rapid rise in housing and personal loans. To rein in this rapid credit expansion, the National Reserve Bank of Tonga (NRBT) reintroduced credit ceilings in January 2006.⁴ However, with liquidity conditions tightening in the banking system, pressure on the central bank to ease its monetary stance mounted, and reserve requirements were reduced in March (from

² The severance package for voluntary redundant civil servants being considered at the time of the mission amounted to a minimum of three months of salary with an additional two weeks for every year of service, up to a maximum of twelve months.

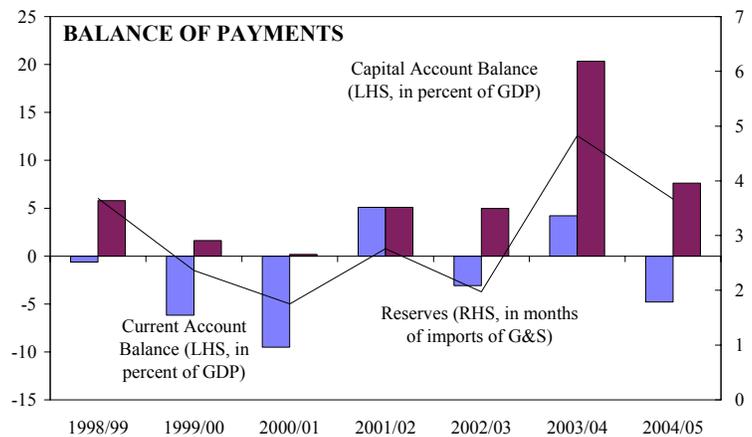
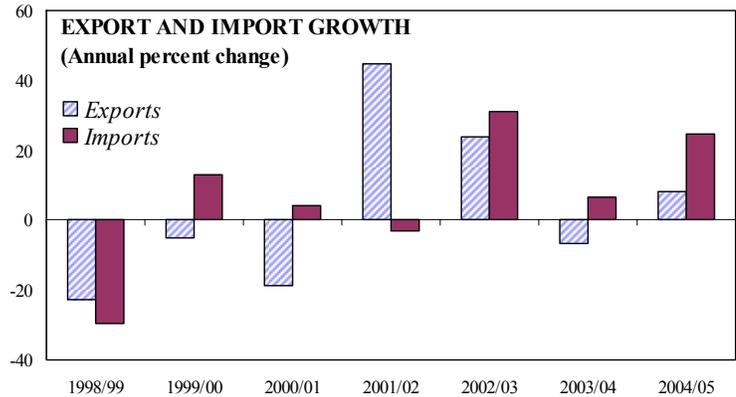
³ A telecommunication and power group owned by a member of the royal family reportedly borrowed from abroad the equivalent of about 8½ percent of GDP to refinance outstanding obligations to the domestic banking system.

⁴ The practice of announcing quarterly credit ceilings for individual banks had been discontinued in the second half of 2004.

15 percent to 12.5 percent).⁵ At the same time, the central bank started to auction notes for open market-type operations.⁶

7. A substantial increase in imports and lower capital inflows led to a decline in Tonga’s foreign exchange reserves. The trade balance deteriorated in 2004/05, as imports

expanded on the back of strong domestic demand, more than offsetting a rebound in exports. Despite a continued increase in net remittances (15 percent y/y), the current account shifted into a deficit of 4¾ percent of GDP in 2004/05 from a surplus of about 4¼ percent of GDP in the previous year. The capital account surplus declined to US\$16.4 million, from a record high of US\$37 million in 2003/04, as private capital inflows returned to a more normal level following the exceptional refinancing operation. Gross international reserves fell to 3¾ months of current year’s imports of goods and services. Recent data suggests that the current account remained in deficit in the first half of 2005/06 and reserve coverage declined to 3¼ months of imports as of end-March 2006.

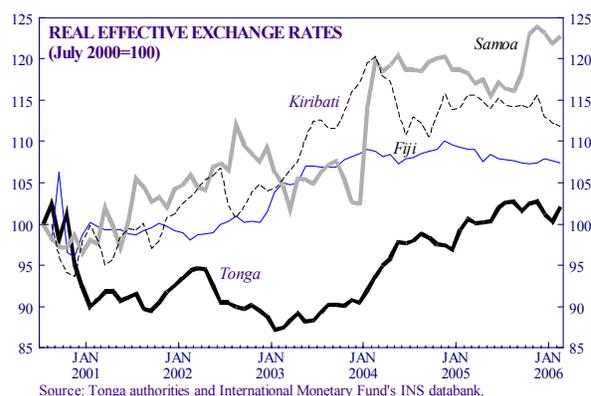


8. The pa’anga has remained stable relative to its basket. The value of the pa’anga is determined based on a weighted basket of currencies, including the U.S., Australian, and New Zealand dollars and the Japanese yen. The NRBT is allowed to adjust its value relative to the basket by up to 5 percent per month and aims at maintaining the level of foreign reserves above three months of imports. With foreign reserves remaining above this level, the NRBT has kept the Tongan currency broadly stable in nominal effective terms since 2004

⁵ The liquidity impact of this reduction is estimated to be about 5.3 million pa’anga (2.5 percent of total deposits).

⁶ The NRBT had introduced open-market type operations in 1993, but had to discontinue them in 2001 because of its weak financial position. Since then, steps have been taken to strengthen the bank’s balance sheet, such as allowing it to retain its net profits. For details, see Selected Issues Paper for the 2005 Article Consultation.

(Figure 4). Given the high inflation in Tonga relative to its main trading partners, this development translated into a real appreciation of the Tongan currency of about 11 percent from January 2004 to February 2006. However, regional competitiveness indicators, including export market share and tourist arrivals, do not clearly signal at this stage an overvaluation of the pa'anga nor do they suggest that Tonga has lost its competitiveness relative



to other countries in the region. Discussions with the private sector also indicated that the major obstacle for exports was not the current level of the exchange rate—given the relatively high import content of exports and the niche market for Tongan squash in Japan—but rather the country's lack of reliable infrastructure and unfavorable business climate.

III. POLICY DISCUSSIONS

A. Outlook and Risks

9. **Short-term economic prospects are highly uncertain and depend critically on the authorities achieving a proposed substantial downsizing of the civil service.** The swing in the fiscal position from surplus to deficit is expected to contribute to a widening of the current account deficit in 2005/06. Only if an expected government asset sale to foreign investors is completed will there be sufficient financing to maintain the reserve position, keep the exchange rate broadly stable, and prevent major inflationary pressures from emerging. In 2006/07, economic activity would be adversely affected by the proposed civil service downsizing. The payment of the severance package would cushion this effect somewhat, although it could also put pressure on reserves and the exchange rate.

10. **In the medium term, a sustained sound fiscal policy and structural reforms are needed to improve economic performance.** Following the wage settlement, the authorities should follow through on their stated commitment to push ahead with key reforms to safeguard macroeconomic stability, improve governance, and enhance the role of the private sector. While restoring fiscal balance will take a short-term toll on growth, achieving a more stable macroeconomic environment and promoting private sector activity would create a climate conducive to higher investment. Under these conditions, real GDP growth could reach about 3 percent over the medium term (Table 5).

11. **Should fiscal adjustment fail and reforms stall, the outlook would be much worse.** If the wage bill were to remain unchecked, fiscal deficits of the order of 4½ percent of GDP could materialize. With the civil service union trying to preserve the real income of its membership through additional wage increases, a wage-price spiral would be triggered, as the budget would have to rely on domestic financing (Table 6). The authorities also would not have the required fiscal resources to increase public capital expenditure, and unstable

macroeconomic conditions would not provide a business climate conducive to fostering private investment. In these circumstances, the economy would be expected to stagnate, with GDP growth slowing over the medium term to about 1 percent. Should such a scenario materialize, Tonga would be at a high risk of debt distress, its NPV of public external debt-to-exports ratio breaching the indicative threshold (Annex I).⁷ The country's debt profile would be particularly vulnerable to a sharp fall in net remittances or in the value of the currency.

B. Fiscal Policy

12. **The authorities are committed to fiscal adjustment.** Staff welcomed the authorities' prompt corrective measures in 2005/06 to contain the costs of the first phase of the wage settlement. However, relying mainly on capital expenditure cuts and a freeze in hiring provides only a limited and temporary solution to the problem. The authorities agreed that more sustainable savings needed to be identified. To achieve such savings and contain the costs of the second phase of the settlement, the authorities are working on reducing the civil service by a quarter by the end of 2005/06. This result is to be achieved by targeted and voluntary redundancies, with severances to be financed by government asset sales and donor assistance.⁸ The civil service union does not oppose this plan, as long as the redundancies

Fiscal Projections for the Wage Settlement, 2005/06–2006/07

| | 2005/06 | | | | 2006/07 | | | | |
|--|---------------------|-----------------|---------------------|-------------------|----------|-------------|-----------------|-------------------------|----------|
| | Original 1/ | Additional cost | Corrective measures | Severance package | Adjusted | Original 2/ | Additional cost | Savings from downsizing | Adjusted |
| | (In percent of GDP) | | | | | | | | |
| Total revenue and grants | 29.4 | ... | ... | ... | 29.4 | 29.0 | ... | ... | 29.0 |
| Total expenditure and net lending | 32.3 | ... | ... | ... | 36.1 | 28.0 | ... | ... | 30.5 |
| Total wage and salaries 3/ | 13.8 | 2.8 | -1.6 | 4.9 | 19.9 | 12.2 | 6.5 | -4.0 | 14.7 |
| Other current expenditure | 15.9 | ... | -1.1 | ... | 14.8 | 14.4 | ... | ... | 14.4 |
| Capital expenditure | 2.8 | ... | -1.2 | ... | 1.6 | 1.6 | ... | ... | 1.6 |
| Overall balance | -2.9 | ... | ... | ... | -6.7 | 1.0 | ... | ... | -1.5 |
| Financing | 2.9 | ... | ... | 4.9 | -6.7 | -1.0 | ... | ... | 1.5 |
| External | 1.8 | ... | ... | 0.0 | 1.8 | 1.3 | ... | ... | 1.3 |
| Domestic | 1.1 | ... | ... | 0.5 | 0.5 | -2.3 | ... | ... | 0.2 |
| Privatization receipts | 0.0 | ... | ... | 4.4 | 4.4 | 0.0 | ... | ... | 0.0 |

1/ Staff projections for 2005/06, excluding the wage settlement.

2/ Assumes the corrective measures related to wage and salaries in 2005/06 are carried over in 2006/07.

3/ Include retirement fund employer contribution.

remain voluntary. If the downsizing target is met by the end of the current fiscal year, the severance payments would widen the overall deficit for 2005/06 by about 5 percent of GDP to 6¾ percent, with the expectation that the deficit would be mostly financed externally. For

⁷ This represents a deterioration compared to last year's DSA, mainly because the medium-term macroeconomic framework has worsened.

⁸ Redundancy costs would be partly financed by the funds the ADB provided in 2003/04 for this purpose.

next fiscal year, the combination of a smaller civil service and continued expenditure restraint could limit the fiscal deficit to 1.5 percent of GDP.

13. **There are serious downside risks to this fiscal outlook and effective alternative measures need to be identified.** Given Tonga's relatively large civil service, staff supported the authorities' objective, but noted that the scale of the envisaged downsizing of the public service was unprecedented (Figure 2). Preliminary reactions of civil servants to the proposed severance package suggest that voluntary redundancies could fall well short of expectations or that the package would need to be significantly increased to achieve the desired objective. To increase the attractiveness of the severance package, the authorities noted that they intended to provide those leaving with business incentives and training, which would not only assist workers in finding alternative positions, but also strengthen the private sector. Staff also expressed concern that there would be insufficient financing for redundancy payments if the anticipated government asset sale were not to materialize. The authorities responded that discussions with foreign investors for the asset sale were well advanced and donors had been approached for possible assistance. Finally, with Tonga's expected accession to the WTO, tariff revenue will significantly decline and there is a risk of a revenue shortfall, if needed corrective tax policy and administration measures are not taken on time (Box 2). Should these risks materialize, the overall fiscal deficit for 2006/07 could amount to 4½ percent of GDP. Cutting capital and related current spending further will not be possible without disrupting the delivery of key social services and improvements in public infrastructure.

14. **The authorities recognized that their downsizing plan was ambitious, but did not see any alternative.** The authorities noted that they had initially considered the option of renegotiating the wage settlement, but were concerned about the prospect of another civil service strike. The idea of forced redundancies had met with similar concerns. The authorities therefore decided to put these options aside to avoid further social unrest and focus instead on a downsizing of the civil service based on voluntary redundancies. Discussions that staff had with the civil service union confirmed the union's unwillingness to revisit the wage settlement despite its macroeconomic implications.

15. **The authorities stated their commitment to step up fiscal reforms to reduce downside risks.** Progress has been made in improving tax administration in the run-up to the introduction of the consumption tax in April 2005, such as the establishment of a large taxpayer unit and the initiation of computerization. Administrative capacity has also improved at customs, as key positions were filled by external experts. The authorities agreed, however, that strengthening the legal framework and tax enforcement, in particular for excise taxes, and building a taxpayer culture more generally were critical to offset the revenue decline in tariff revenue expected from Tonga's accession to the WTO. At the same time, further improvements in public expenditure management are required to raise the effectiveness of scarce public resources. Lack of funding and training is still holding up the extension of the accounting system to all ministries (only 7 ministries out of 30 are effectively connected to the system), but the authorities reiterated that achieving timely and

reliable financial reporting remained a priority. The authorities and staff also agreed that the introduction of a medium-term budget framework would help signal their commitment to a sustainable fiscal policy and foster donor support.

C. Monetary and Exchange Rate Policy

16. **The authorities and staff agreed that a further tightening of monetary policy may be needed in response to the wage settlement.** Staff welcomed the NRBT's decision to reintroduce credit ceilings to rein in the unsustainable credit growth experienced in the first half of 2005/06, but questioned the easing in March with the reduction in reserve requirements. In the period ahead, higher public sector wages and the payment of the severance package are likely to increase liquidity in the banking system and the NRBT agreed that it should stand ready to tighten its monetary stance.

17. **It is unclear that the NRBT will be in a position to pursue the required tight monetary policy.** Staff welcomed the introduction of open market-type instruments that should improve the central bank's control over monetary developments. However, at this stage, these new instruments remain untested. Although credit ceilings are rudimentary, the NRBT may need to continue to rely on them in the short run to contain lending growth. Staff also expressed concern about the ability of the central bank to maintain a tight monetary stance, given the bank's response to the recent pressure to reduce reserve requirements. The economic team fully shared this concern and were seeking to limit possible future interference by making the central bank more independent.

18. **To strengthen the NRBT, early enactment of the Amendments to the NRBT Act is critical.** Amendments to the NRBT Act, including provisions for doubling the NRBT's capital base and clarifying the profit transfer rule, failed to be approved by the Legislative Assembly. The authorities noted that they intended to continue to seek greater independence for the central bank and re-submit the amendments in the coming months with greater communication efforts to foster appropriate support. Staff supported this plan and recommended that such amendments should also include a strict limit on direct central bank credit to the government and a clarification of the objectives of the NRBT. The authorities agreed to examine these issues while revising the amendments.

19. **The authorities agreed that the exchange rate would have to be managed flexibly.** Given Tonga's vulnerability to natural disasters, terms of trade shocks, its lack of effective monetary policy, weak fiscal discipline, and low level of reserves, the current exchange rate arrangement was judged to have provided appropriate flexibility, although at the cost of higher inflation.⁹ With the wage settlement and the severance package likely to feed into higher imports, it may not be possible to tighten monetary policy enough to prevent

⁹ The benefits of Tonga's exchange rate arrangement have been analyzed in detail in the Selected Issues Paper for the 2002 Article IV Consultation.

downward pressure on the exchange rate from materializing. In this case, the flexibility provided by the current exchange rate arrangement should be fully utilized and the value of the pa'anga allowed to depreciate relative to the currency basket.

D. Structural Reforms and Other Issues

20. **The authorities and staff agreed that a more dynamic private sector offering alternative employment opportunities would facilitate the downsizing of the public sector.** As in other Pacific island countries, private sector activity has been constrained by the economy's remoteness from its main export markets and a limited pool of entrepreneurs.¹⁰

"Doing Business" Indicators

| | Tonga | Other Pacific Islands | East Asia |
|---|-------|-----------------------|-----------|
| Rigidity of employment (index 0–100) 1/ | 13.0 | 14.9 | 37.4 |
| Corporate disclosure (index 0–7) 1/ | 3.0 | 3.7 | 6.9 |
| Contract enforcement (days) 2/ | 510.0 | 445.0 | 380.2 |
| Starting a business (days) | 32.0 | 39.6 | 69.5 |
| Closing business (years) 3/ | 2.7 | 3.7 | 3.4 |
| Dealing with licenses (days) 4/ | 81.0 | 93.9 | 194.2 |

Source: The World Bank, *Doing Business Indicators*.

1/ Higher index indicates more rigidity / less disclosure.

2/ Measures the time of dispute resolution.

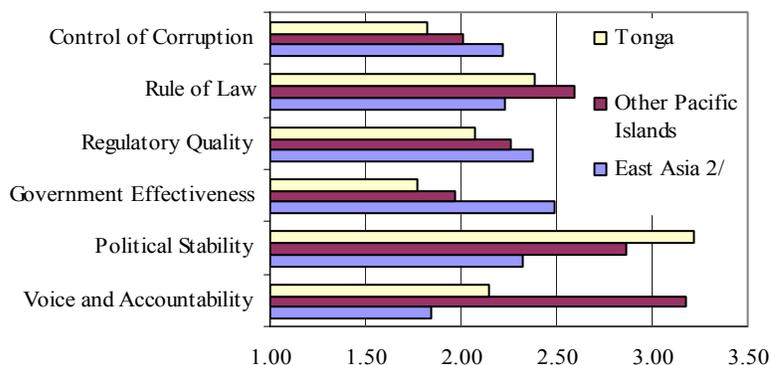
3/ Measures the time of bankruptcy resolution.

4/ Measures the time to build a warehouse and obtain all necessary licenses.

Nevertheless, there are a number of additional policy-related impediments, which if removed could contribute to developing a competitive private sector. Available indicators suggest that Tonga compares favorably with the region in terms of business regulation, but poorly in terms of governance. The authorities agreed that the business and investment climate needed to be improved and established a public-private sector task force, with the assistance of the World Bank, to identify and reduce critical impediments to private sector development. In addition, Tonga will repeal the Industrial Development Incentive Act (considered distortionary and ineffective), and reduce restrictions on business licensing and foreign direct investment in the run-up to its WTO accession. While welcoming these developments, staff encouraged the authorities to also make progress in amending the land regime to extend the duration of leases and eliminate the uncertainty stemming from frequent revisions to rents, strengthen regulatory agencies, and further corporatize and privatize public enterprises in order to better delineate the role of the state.

¹⁰ For a further discussion of private sector development in the Pacific, see Chapter II, Pacific Islands—Regional Issues.

GOVERNANCE INDICATORS (2004) 1/



Source: The World Bank, Governance Indicators.

1/ The indicators are measured in units ranging from 0 to 5, with higher values corresponding to better governance outcomes.

2/ ASEAN, China, Korea, and Timor-Leste.

21. **More needs to be done to further public enterprise reform and reduce contingent liabilities.** Substantial capacity constraints and political sensitivities continue to limit the pace of progress, with the authorities coming under political pressure to repurchase the power company.¹¹ Staff expressed concern about the fiscal implications of this lack of progress and strongly supported the authorities' efforts to draw on external expertise to untangle the financial and legal issues currently delaying the privatization or liquidation of public enterprises. The authorities added that they had no intention to renationalize the power sector and that potential private foreign investors were being sought for the power company.

22. **Further improvements in the effectiveness of NRBT's bank supervision is needed.** Although indicators of banking soundness have improved in 2004/05, the authorities agreed to continue to monitor credit developments closely to avoid a deterioration in asset quality in light of the recent rapid lending growth.¹² The amended Financial Institution Act became effective in April 2006, making the licensing and supervision of financial institutions consistent with Basle Core Principles, but the related prudential regulations and standards are still being finalized. Progress was also made in the area of AML/CFT, with the introduction of a database on the reporting of suspicious transactions and ongoing work to amend AML related legislation in line with Fund recommendations.

¹¹ A large telecommunication and power group owned by a member of the royal family has managed the power sector since 1998. Popular discontent following power tariff increases and reports of corporate mismanagement has recently led to calls on the authorities to repurchase these assets.

¹² Tonga's banking system is comprised of three foreign-owned commercial banks (Westpac Bank of Tonga, ANZ, and MBf) and one development bank (Tonga Development Bank).

23. **Shortcomings in statistics continue to affect policy analysis and formulation in Tonga.** The authorities agreed that there was an urgent need to improve the reliability, coverage, and timeliness of statistics, and noted that they intend to devote more resources to address these issues. On the national accounts, staff acknowledged the capacity constraints faced by Tonga's Statistics Department in improving the data, and welcomed the revisions that have been made in response to PFTAC's recommendations. On the balance of payments, the authorities continue to investigate the existing large errors and omissions. They also agreed that official capital flows needed to be reconciled on a regular basis with the external debt data to ensure consistency. On fiscal data, difficulties remained when reconciling above- and below-the-line items in the GFS format, but planned improvements in the financial management system should help to strengthen financial reporting in the future.

IV. STAFF APPRAISAL

24. **Economic prospects have deteriorated since last year's consultation.** The substantial civil service wage increase decided in September 2005 represents a marked departure from the more cautious fiscal policy that had been adopted over the past two years. The country's economic prospects are highly uncertain and will depend on the authorities' ability to adjust for the wage settlement. It is therefore urgent that the authorities follow through on their stated intentions to push ahead with key reforms to safeguard macroeconomic stability, improve governance, and enhance the role of the private sector.

25. **Prompt and effective corrective measures to contain the fiscal implications of the wage settlement are needed.** The authorities have acted to offset the initial impact of the wage settlement, but going forward more sustainable fiscal measures are required. In this regard, the authorities have formulated an ambitious plan to bring the civil service down to a more appropriate size, based on targeted and voluntary redundancies, and financed externally. At this stage, however, it is unclear whether it will be successful. Should voluntary redundancies fall short of expectations, alternative measures including potentially more difficult ones will need to be considered to maintain macroeconomic stability.

26. **Moreover, there are other serious downside risks to the fiscal outlook.** Building a taxpayer culture, and strengthening the legal framework and capacity for tax enforcement, in particular for excise taxes, will be critical to offset the revenue decline in trade taxes expected from Tonga's accession to the WTO. The accounting system also needs to be fully operationalized and rolled out to all ministries, and a medium-term budget framework introduced to signal the authorities' commitment to a sustainable fiscal policy and foster donor support. Political pressure for the government to get back into the power sector should be resisted, and the pace of public enterprise reform accelerated.

27. **Further monetary tightening in response to the wage settlement may be needed, and the full flexibility of the exchange rate system will have to be utilized.** The NRBT's ability to deliver such policies is, however, uncertain. The new open market-type instruments that the central bank started to auction in March are untested, and it may need to rely for some time longer on its more rudimentary credit ceilings. Moreover, to reduce political

pressure, greater central bank independence is required. Early enactment of the Amendments to the NRBT Act is critical in this regard.

28. **A larger and more dynamic private sector offering alternative employment opportunities would facilitate the downsizing of the public sector.** The business and investment climate needs to be improved, including by repealing the IDI Act and clarifying the boundaries between the private and public sectors so as to level the playing field. Stronger and more independent regulatory agencies would also be beneficial. In addition, the land regime should be amended to extend the duration of leases and eliminate the uncertainty stemming from frequent revisions to rents.

29. **While data provision for surveillance purposes is adequate overall, there is a need to improve the reliability, coverage, and timeliness of statistics.** In particular, the quality of the national, external, and public accounts should be improved to assist the authorities in conducting policies and implementing reforms.

30. **It is proposed that the next Article IV consultation with Tonga takes place on the standard 12-month cycle.**

Box 1. Tonga: The September 2005 Civil Service Wage Settlement

Substantial public wage increases are not uncommon in Tonga. The ability to recruit and retain qualified staff has been an ongoing concern, leading to instances of substantial adjustment in public wages and a combination of subsequent restraint and limits on hiring to priority positions to bring the wage bill back in line. The last major review of public compensation in 1989/90 resulted in a 50 percent increase in wages. A Public Service Commission, established in 2003 to design a more orderly mechanism for public sector employment and wages, proposed to introduce a new pay scale in 2005/06, better aligning compensation and skills. However, civil servants reacted negatively to its implementation and went on strike in July 2005.

The strike rapidly took on a political dimension. The strike was joined by various segments of the society expressing their dissatisfaction with the country's economic management and political regime, and the leaders of the movement started to call for a greater democratization of the Tongan political system in addition to substantial wage increases for all civil servants. After six weeks of negotiation, the government agreed to the following agreement:

- effective from July 2005, salaries of civil servants are increased by 60–80 percent, depending on their grade;
- the salary increase for 2005/06 will be paid in two phases: 60 percent of the increase in 2005/06 and 40 percent in 2006/07; and
- except for the ongoing tax reform, taxes cannot be increased to finance the wage settlement.

The fiscal and economic implications of the wage settlement are substantial. An increase in the wage bill of 1.6 percent of GDP had been included in the 2005/06 budget to finance the proposed pay scale, but additional corrective measures needed to be identified to cover the cost of the first phase of the settlement (estimated at 4 ½ percent of GDP). To enhance the sustainability of their fiscal adjustment and contain the cost of the second phase of the wage settlement, the authorities plan to downsize the relatively large civil service. 1,000 positions (25 percent of total civil servants) would be cut by the end of 2005/06. While substantial public sector downsizings are not uncommon in the Pacific, they have usually been spread over several years. In addition, even in these cases, the experience has been that insufficient attention had been paid to the effectiveness of public service delivery and the ability of the private sector to absorb redundant workers.¹

| Public Service Downsizing | | |
|------------------------------|-----------------|---------------------|
| | Percentage Fall | Period |
| Cook Islands | 57 | Mar. 1996–Oct. 1998 |
| Federal States of Micronesia | 37 | Jan. 1996–Jan. 1999 |
| Marshall Islands | 33 | Oct. 1995–Mar. 1999 |
| Solomon Islands | 6 | Jan. 1996–Mar. 1999 |
| Vanuatu | 10 | Jan. 1998–Feb. 1999 |

Source: Asian Development Bank.

| Fiscal Implications of the Wage Settlement | | |
|--|---------|---------|
| | 2005/06 | 2006/07 |
| (In millions of Pa'anga) | | |
| Cost related to the settlement | 19.8 | 45.3 |
| 60 % increase | 19.8 | ... |
| 40 % carryover from the previous year | ... | 12.8 |
| Full-year cost | ... | 32.6 |
| (In percent of GDP) | | |
| Budgeted wage and salaries 1/ | 13.8 | 13.8 |
| Additional cost related to the settlement 2/ | 2.8 | 6.5 |
| Identified corrective measures | 3.8 | ... |

1/ Include retirement fund employer contributions.
2/ For 2006/07, the additional costs are estimated by assuming that wage expenditures remain constant in percent of GDP compared to their level in the 2005/06 budget.

¹ Knapman and Saldanha, 1999, "Reforms in the Pacific—An Assessment of the Asian Development Bank's Assistance for Reform Programs in the Pacific," Asian Development Bank.

Box 2. Tonga's Accession to the World Trade Organization

Tonga's impending accession to the WTO represents a significant step in its efforts to liberalize trade. After ten years of negotiation, the terms of Tonga's membership, including the schedule of its commitments, were approved by the WTO in December 2005. If Tonga ratifies these terms by end-July, it will become the 150th member and the fourth Pacific islands country to join the institution (after Fiji, Papua New Guinea, and the Solomon Islands). In Tonga, accession to the WTO is seen as a way to enhance trade security, improve market access, and foster competitiveness. Accession to the WTO would also complement Tonga's regional efforts towards greater economic integration. Tonga has signed the Pacific Island Countries Trade Agreement, which is expected to bring a regional free trade zone by 2010–12, and the Pacific Agreement on Closer Economic Relations, which aims to liberalize trade with Australia and New Zealand. It is also negotiating with the European Union a new trade arrangement under the Economic Partnership Agreement.

| Share (in 2004 in percent of total) | Imports | Exports |
|-------------------------------------|---------|---------|
| Australia and New Zealand | 57.6 | 21.8 |
| European Union | 0.5 | 1.1 |
| Japan | 2.8 | 44.2 |
| Other Pacific islands 1/ | 13.9 | 0.9 |
| Other | 25.2 | 32.0 |

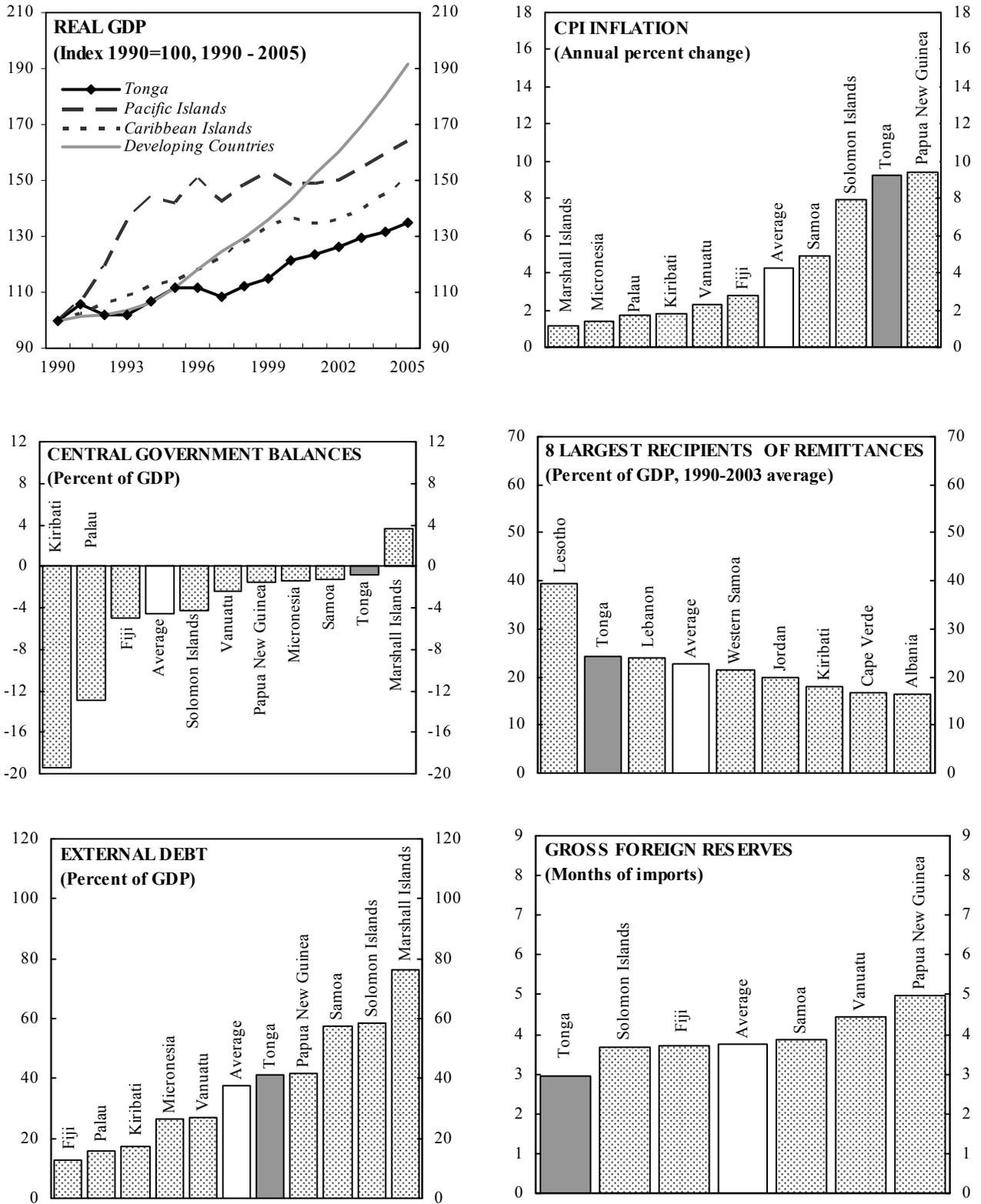
Sources: Tongan authorities and staff calculations.
1/ Adjusted for Fiji re-exports.

Tonga has been carrying out tax reforms to minimize the revenue implications of its accession. As part of the WTO accession, Tonga is committed to reduce tariffs to a maximum of 20 percent (15 percent for some goods) by the beginning of 2007, and eliminate the tax and tariff exemptions allowed under the Industrial Development Incentive Act. To prepare for this move, a comprehensive tax reform was approved in 2002 to shift Tonga's tax system away from trade taxes and towards greater reliance on domestic taxation, coupled with efforts to strengthen overall tax compliance. A 15 percent consumption tax was introduced in April 2005 to replace the domestic sales tax and the ports and services tax. Most of the remaining tariff rates range now from 0–30 percent, but some products attract higher rates, such as motor vehicles (45 percent) and petroleum products (35 percent). The authorities plan to offset the resulting foregone revenue through higher excise collection and the introduction of a road tax. To achieve this objective, the legal framework and tax enforcement would need to be strengthened. The next step of the reform would be the introduction of a simplified income tax in 2007/08.

| WTO Accession: Revenue Impact (change in millions of pa'anga) 1/ | | |
|---|---------|-----------|
| | 2006/07 | Full year |
| Customs revenue foregone | 14.8 | 29.1 |
| Offsetting measures | | |
| Excise tax | 18.2 | 29.2 |
| Road tax | 1.5 | 3.0 |
| Total impact | 4.9 | 3.2 |

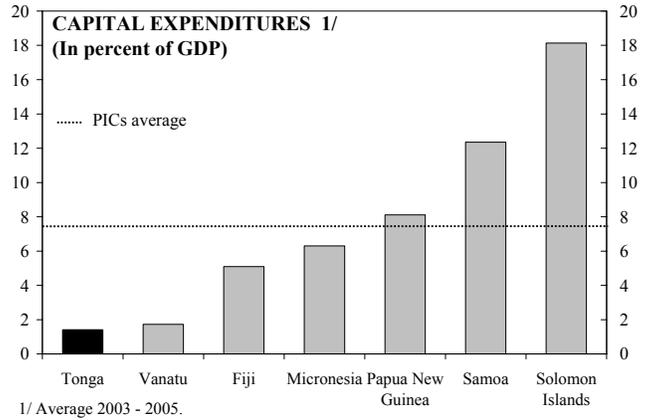
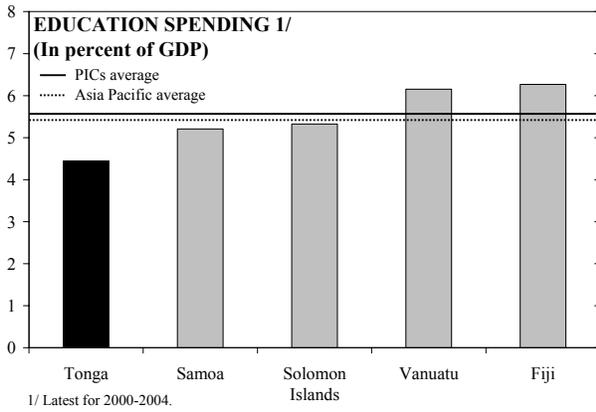
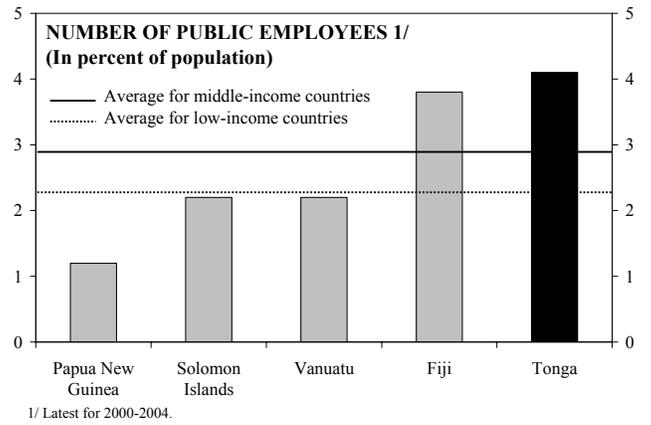
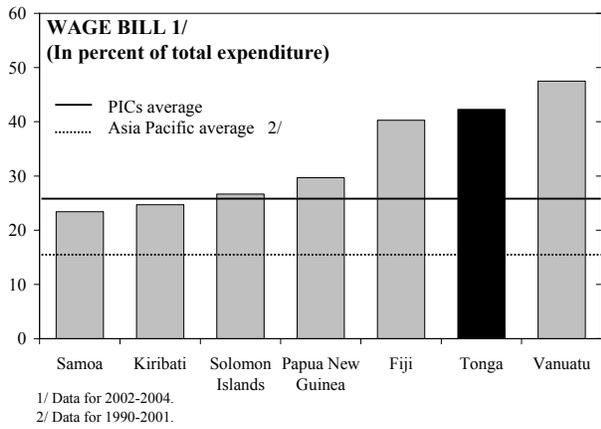
Source: Tongan authorities.
1/ Includes the effects of a narrower consumption tax base.

Figure 1: Tonga: Regional Comparators, (Averages, 2000–05)



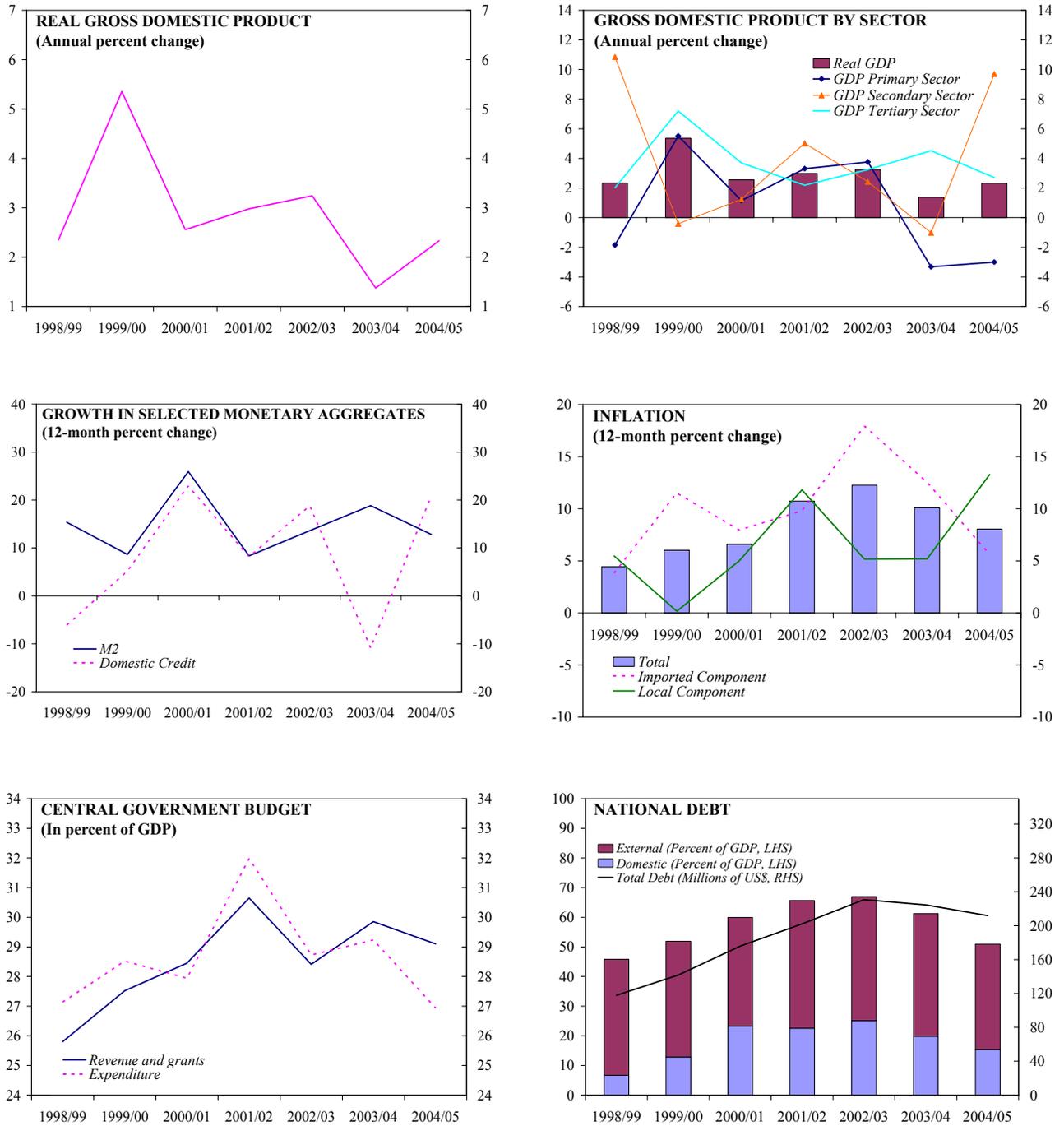
Sources: Data provided by the Tongan authorities; and Fund staff estimates.

Figure 2. Tonga: Regional Fiscal Comparisons



Sources: Fund staff estimates.

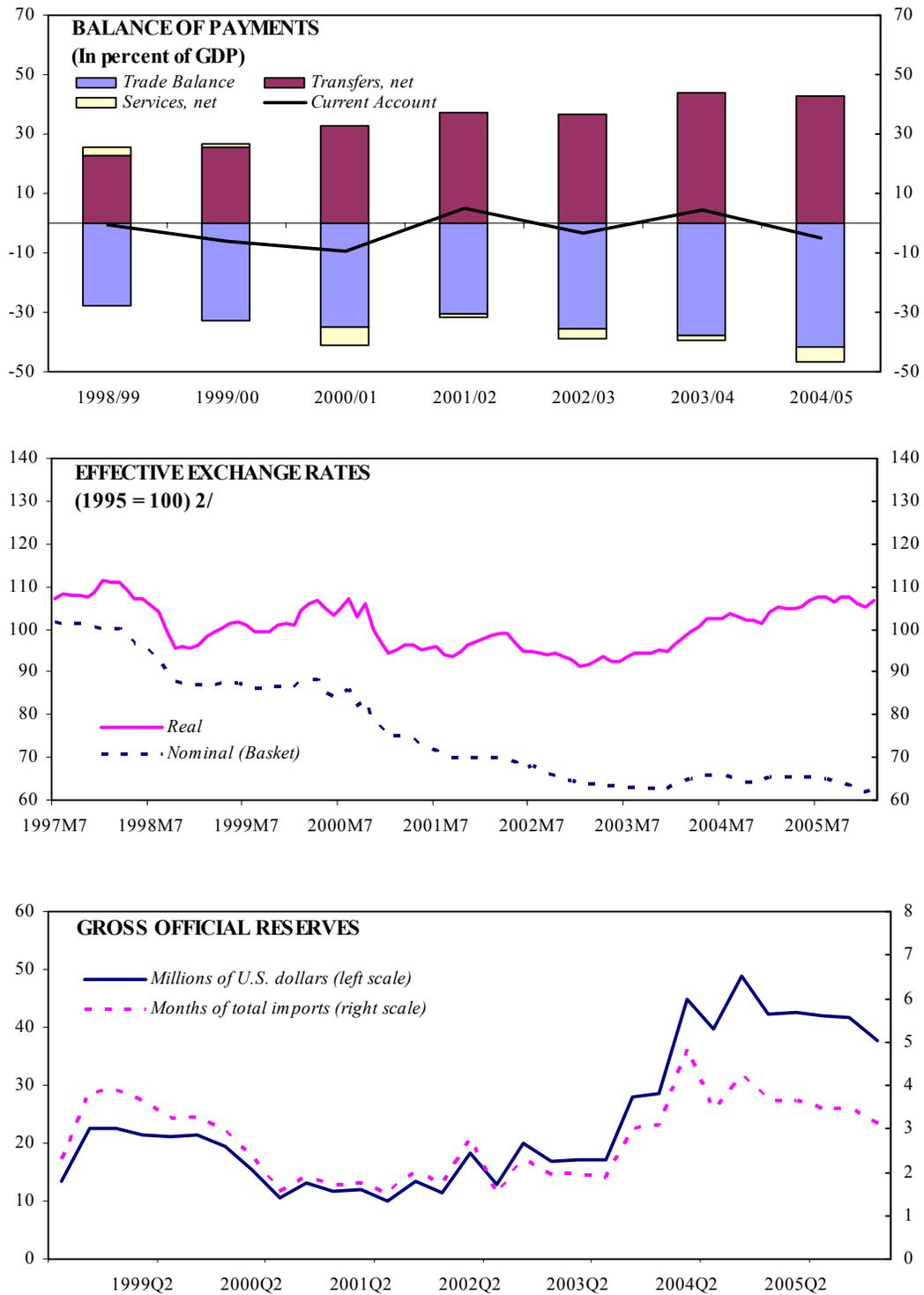
Figure 3. Tonga: Real, Fiscal, and Monetary Sector Developments, 1998/99–2004/05 1/



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

1/ Fiscal year ending June.

Figure 4. Tonga: External Indicators, 1998/99–2004/05 1/

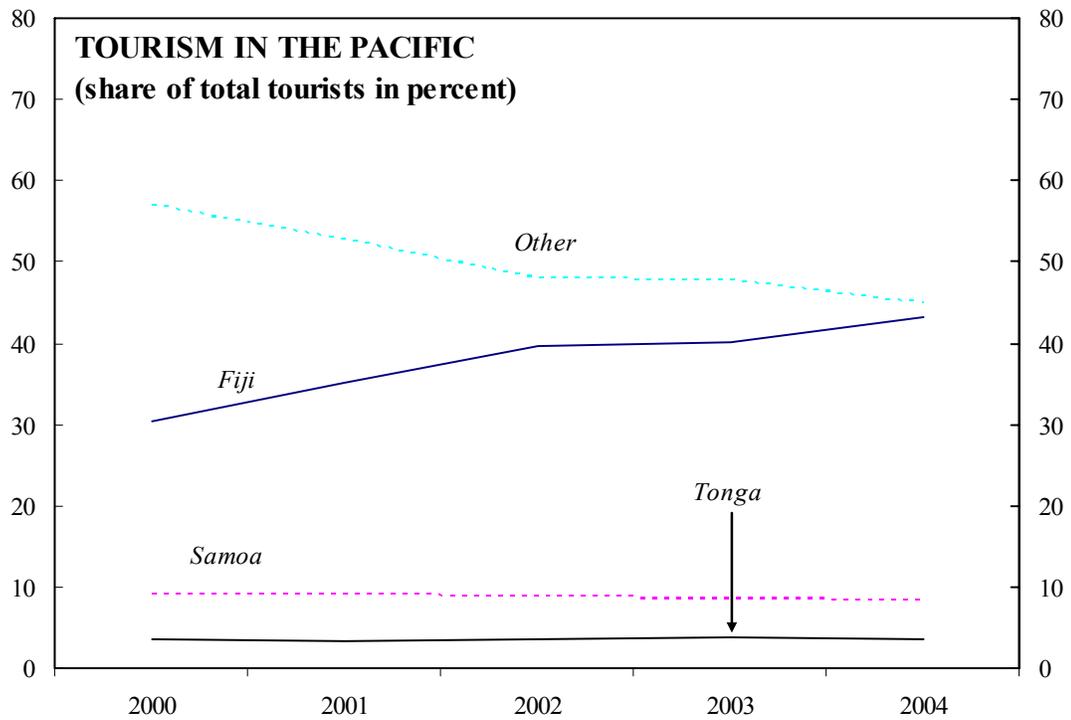
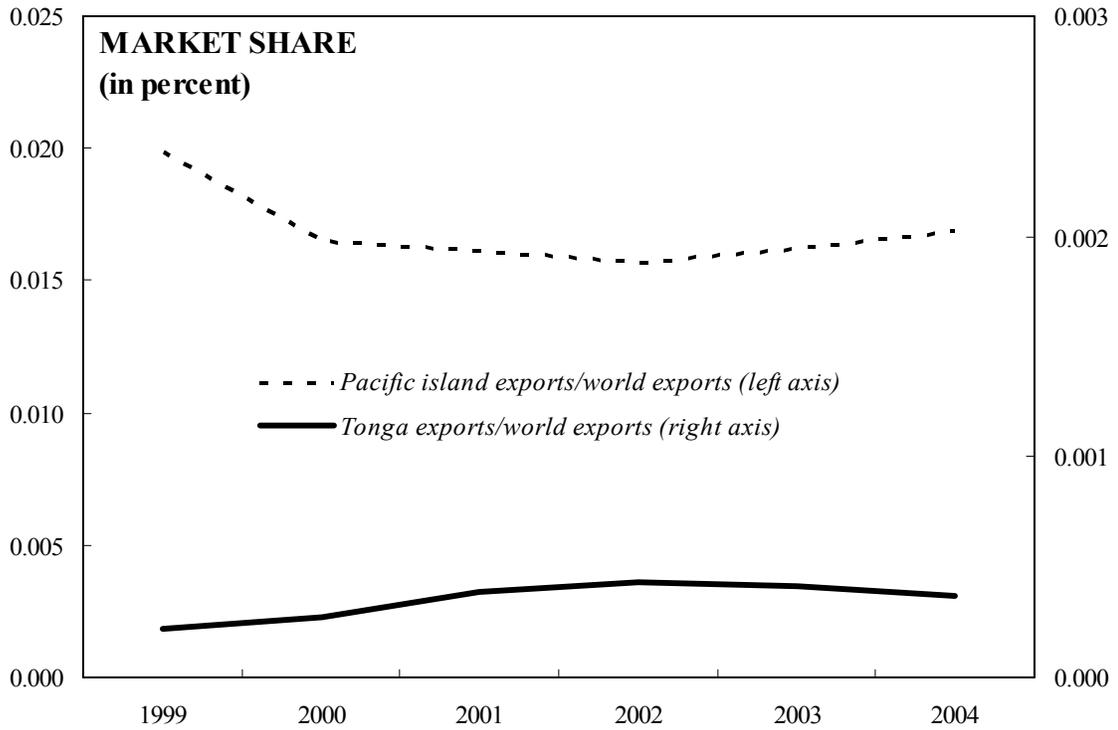


Sources: Data provided by the Tongan authorities; and Fund staff estimates.

1/ Fiscal year ending June. Monthly and quarterly charts are plotted in a calendar year basis.

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

Figure 5. Tonga: Regional Competitiveness Indicators, 1999–2004



Sources: Country authorities, World Bank, and Fund staff estimates.

Table 1. Tonga: Selected Economic Indicators, 2001/02–2006/07 1/

Nominal GDP (2003/2004): US\$ 182.1 million
 Population (2003): 101,405
 GDP per capita (2003/04): US\$1,796
 Quota: SDR 6.9 million

| | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 |
|---|---------|---------|---------|---------|---------|---------|
| | | | Prel. | | Proj. | |
| (Percent change) | | | | | | |
| Output and prices | | | | | | |
| Real GDP | 3.0 | 3.2 | 1.4 | 2.3 | 1.9 | 0.6 |
| Consumer prices (period average) | 10.4 | 11.1 | 11.7 | 9.5 | 7.2 | 10.3 |
| (In percent of GDP) | | | | | | |
| Central government finance | | | | | | |
| Total revenue and grants | 30.6 | 28.4 | 29.9 | 29.1 | 29.4 | 29.0 |
| Total revenue | 30.0 | 27.6 | 28.5 | 27.8 | 27.9 | 27.4 |
| Grants | 0.7 | 0.8 | 1.4 | 1.3 | 1.6 | 1.6 |
| Total expenditure and net lending | 32.2 | 31.4 | 29.0 | 26.7 | 36.1 | 30.5 |
| <i>Of which:</i> Current expenditure | 26.4 | 26.1 | 27.3 | 25.0 | 34.7 | 29.1 |
| Capital expenditure | 3.3 | 2.5 | 1.0 | 2.5 | 1.6 | 1.6 |
| Overall balance | -1.5 | -3.0 | 0.9 | 2.4 | -6.7 | -1.5 |
| External financing (net) | 4.5 | 1.4 | 2.9 | 0.4 | 1.8 | 1.3 |
| Domestic financing (net) | -2.9 | 1.6 | -3.8 | -2.8 | 0.5 | 0.2 |
| Privatization receipt | 0.0 | 0.0 | 0.0 | 0.0 | 4.4 | 0.0 |
| (Annual percentage change) | | | | | | |
| Money and credit | | | | | | |
| Total liquidity 2/ | 9.7 | 18.2 | 16.7 | 13.3 | 14.1 | 10.7 |
| <i>Of which:</i> Broad money (M2) | 8.4 | 13.6 | 18.9 | 12.8 | 14.6 | 10.9 |
| Domestic credit | 8.2 | 18.8 | -10.9 | 20.9 | 18.7 | 14.5 |
| <i>Of which:</i> Private sector credit | 14.6 | 12.7 | -4.3 | 29.4 | 17.0 | 13.3 |
| Interest rates (end of period) | | | | | | |
| Average deposit rate | 4.6 | 4.6 | 5.1 | 5.2 | ... | ... |
| Base lending rate | 9.0 | 9.0 | 9.5 | 9.0 | ... | ... |
| (In millions of U.S. dollars) | | | | | | |
| Balance of payments | | | | | | |
| Exports, f.o.b. | 17.8 | 17.6 | 13.8 | 16.0 | 15.9 | 16.9 |
| <i>Of which:</i> Squash | 3.3 | 5.4 | 6.9 | 4.2 | ... | ... |
| Imports, f.o.b. | -61.3 | -74.2 | -82.8 | -105.4 | -114.0 | -122.2 |
| Services (net) | -1.9 | -5.4 | -2.9 | -10.5 | -6.1 | -2.9 |
| Income (net) | -0.5 | -1.5 | -0.4 | -2.3 | 0.4 | 0.4 |
| Services and income (net) | -2.4 | -6.9 | -3.2 | -12.8 | -5.7 | -2.5 |
| Transfers (net) | 53.2 | 58.7 | 79.8 | 91.9 | 89.9 | 95.4 |
| <i>Of which:</i> Private transfer receipts | 65.2 | 68.2 | 90.3 | 107.4 | 105.1 | 111.0 |
| Current account balance | 7.2 | -4.9 | 7.7 | -10.3 | -13.8 | -12.3 |
| (In percent of GDP) | 5.1 | -3.1 | 4.2 | -4.8 | -6.2 | -5.2 |
| Overall balance | 6.5 | -1.2 | 27.3 | -3.6 | 2.5 | -5.4 |
| Terms of trade (percent change) | 40.9 | 71.2 | -16.2 | -35.5 | ... | ... |
| Gross international reserves (end of period) | | | | | | |
| In millions of U.S. dollars | 18.4 | 17.2 | 44.8 | 42.5 | 45.0 | 39.5 |
| In months of goods and services imports | 2.8 | 2.0 | 4.8 | 3.7 | 3.7 | 3.0 |
| External debt | | | | | | |
| External debt (in percent of GDP) | 43.0 | 41.8 | 41.4 | 35.5 | 35.7 | 34.7 |
| Debt service ratio 3/ | 4.6 | 6.0 | 8.7 | 8.4 | 7.1 | 8.0 |
| Exchange rates | | | | | | |
| Pa'anga per U.S. dollar (end of period) | 2.2 | 2.1 | 2.0 | 1.9 | ... | ... |
| Pa'anga per U.S. dollar (period average) | 2.2 | 2.2 | 2.0 | 1.9 | ... | ... |
| Real effective exchange rate (1990=100) 4/ | 93.1 | 89.9 | 93.7 | 100.2 | 103.1 | ... |
| Nominal effective exchange rate (1990=100) 4/ | 84.5 | 75.2 | 71.4 | 71.1 | 70.6 | ... |

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

1/ Fiscal year beginning July.

2/ From the *Banking Survey*, which includes the Tonga Development Bank.

3/ In percent of exports of goods and services.

4/ Through end-February 2006.

Table 3. Tonga: Banking Survey, 2001/02–2005/06 1/

| | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | | | |
|---|---------|---------|---------|---------|---------|-------|-------|------------|
| | | | | | Sep. | Dec. | Mar. | Jun. Proj. |
| (In millions of pa'anga; end of period) | | | | | | | | |
| Net foreign assets | 30.8 | 29.5 | 83.7 | 76.3 | 81.3 | 75.8 | 68.1 | 87.0 |
| Foreign assets | 44.6 | 49.2 | 109.3 | 91.8 | 96.9 | 94.4 | 86.1 | 102.5 |
| NRBT | 39.6 | 36.9 | 89.7 | 82.1 | 82.8 | 86.7 | 77.4 | 94.9 |
| DMBs | 5.0 | 12.2 | 19.6 | 9.7 | 14.0 | 7.6 | 8.7 | 7.6 |
| Foreign liabilities | -13.8 | -19.7 | -25.6 | -15.5 | -15.6 | -18.5 | -18.0 | -15.5 |
| NRBT | -0.2 | -0.2 | -0.8 | -3.2 | -5.7 | -5.7 | -7.1 | -5.7 |
| DMBs | -10.8 | -17.6 | -23.0 | -11.4 | -9.1 | -12.6 | -10.2 | -9.6 |
| TDB | -2.7 | -1.8 | -1.8 | -0.9 | -0.9 | -0.3 | -0.7 | -0.3 |
| Net domestic assets | 122.8 | 149.1 | 121.3 | 154.2 | 165.6 | 171.5 | 175.2 | 174.1 |
| Net domestic credit | 164.3 | 195.2 | 174.0 | 210.3 | 226.1 | 237.2 | 242.1 | 249.7 |
| Government (net) | -8.5 | -0.5 | -14.5 | -25.2 | -26.2 | -26.8 | -39.0 | -22.9 |
| Non-financial public enterprises | 10.2 | 12.5 | 13.2 | 8.6 | 8.1 | 8.0 | 7.4 | 7.2 |
| Private sector | 162.6 | 183.2 | 175.3 | 226.8 | 244.2 | 256.0 | 273.7 | 265.4 |
| Other items, net | -41.5 | -46.1 | -52.7 | -56.1 | -60.5 | -65.7 | -66.9 | -75.5 |
| Total liquidity | 143.2 | 169.2 | 197.4 | 223.7 | 240.2 | 240.7 | 237.1 | 255.3 |
| Broad money (M2) | 133.7 | 151.9 | 180.5 | 203.7 | 220.8 | 224.8 | 220.0 | 233.4 |
| Narrow money | 42.4 | 51.6 | 65.8 | 68.7 | 61.2 | 72.7 | 58.2 | 75.0 |
| Quasi money | 91.3 | 100.2 | 114.7 | 134.9 | 159.6 | 152.1 | 161.8 | 158.4 |
| Notes and bills 2/ | 9.5 | 17.3 | 16.9 | 20.1 | 19.4 | 15.9 | 17.1 | 21.9 |
| Government lending funds 3/ | 10.4 | 9.4 | 7.6 | 6.8 | 6.7 | 6.6 | 6.2 | 5.8 |
| (Annual percentage change) | | | | | | | | |
| Net foreign assets | 3.2 | -4.2 | 184.0 | -8.9 | -4.1 | -18.2 | -14.3 | 14.0 |
| Net domestic assets | 8.3 | 21.4 | -18.6 | 27.2 | 33.2 | 29.0 | 24.4 | 12.9 |
| Net domestic credit | 8.2 | 18.8 | -10.9 | 20.9 | 30.2 | 30.5 | 26.5 | 18.7 |
| Private sector | 14.6 | 12.7 | -4.3 | 29.4 | 40.5 | 33.8 | 32.3 | 17.0 |
| Total liquidity | 9.7 | 18.2 | 16.7 | 13.3 | 19.4 | 10.4 | 11.4 | 14.1 |
| Broad money (M2) | 8.4 | 13.6 | 18.9 | 12.8 | 20.2 | 13.4 | 14.3 | 14.6 |
| (In millions of U.S. dollars) | | | | | | | | |
| Net foreign assets | 14.3 | 13.7 | 41.8 | 39.5 | 41.2 | 36.8 | 33.2 | 41.4 |
| Foreign assets | 20.7 | 22.9 | 54.6 | 47.5 | 49.1 | 45.8 | 41.9 | 48.8 |
| NRBT | 18.4 | 17.2 | 44.8 | 42.5 | 42.0 | 42.1 | 37.7 | 45.2 |
| DMBs | 2.3 | 5.7 | 9.8 | 5.0 | 7.1 | 3.7 | 4.2 | 3.6 |
| Foreign liabilities | -6.4 | -9.2 | -12.8 | -8.0 | -7.9 | -9.0 | -8.8 | -7.4 |
| Memorandum items: | | | | | | | | |
| Velocity (GDP/average M2) | 2.3 | 2.5 | 2.2 | 2.2 | ... | ... | ... | 2.0 |
| Pa'anga per U.S. dollar (end of period) | 2.15 | 2.15 | 2.00 | 1.93 | 1.97 | 2.06 | 2.05 | ... |
| Average M2 (pa'anga millions) | 136.2 | 142.2 | 166.0 | 192.7 | 201.2 | 209.6 | 217.9 | 224.5 |
| Nominal GDP (pa'anga millions) | 310.8 | 349.4 | 371.9 | 416.8 | | | | 455.0 |

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

1/ Comprises the National Reserve Bank of Tonga (NRBT), the deposit money banks, and the Tonga Development Bank (TDB).

2/ Comprises bills and promissory notes issued by financial sector and held outside the sector.

3/ Represents borrowing by the Government from foreign sources for onlending to the TDB.

Table 4: Tonga: Balance of Payments Summary, 2001/02–2006/07

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

| | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 |
|---|---------|---------|---------|---------|---------|---------|
| | | | | | Proj. | |
| Trade balance | -43.5 | -56.7 | -68.9 | -89.3 | -98.0 | -105.2 |
| Exports, f.o.b. | 17.8 | 17.6 | 13.8 | 16.0 | 15.9 | 16.9 |
| Imports, f.o.b. | -61.3 | -74.2 | -82.8 | -105.4 | -114.0 | -122.2 |
| Services (net) | -1.9 | -5.4 | -2.9 | -10.5 | -6.1 | -2.9 |
| Receipts | 16.6 | 25.0 | 25.8 | 23.1 | 26.4 | 31.1 |
| Payments | -18.5 | -30.4 | -28.6 | -33.6 | -32.4 | -34.0 |
| Income (net) | -0.5 | -1.5 | -0.4 | -2.3 | 0.4 | 0.4 |
| Receipts | 2.3 | 2.2 | 2.8 | 3.4 | 3.5 | 3.5 |
| Payments | -2.8 | -3.7 | -3.1 | -5.7 | -3.1 | -3.1 |
| Current transfers (net) | 53.2 | 58.7 | 79.8 | 91.9 | 89.9 | 95.4 |
| Official transfers (net) | 0.4 | 0.0 | 0.3 | 0.0 | 0.9 | 1.0 |
| Private transfers (net) | 52.9 | 58.7 | 79.6 | 91.6 | 89.0 | 94.4 |
| Current account balance | 7.2 | -4.9 | 7.7 | -10.3 | -13.8 | -12.3 |
| (In percent of GDP) | 5.1 | -3.1 | 4.2 | -4.8 | -6.2 | -5.2 |
| Capital account balance | 7.3 | 7.9 | 37.0 | 16.4 | 16.3 | 6.9 |
| Official capital flows (net) | 5.1 | 7.7 | 13.8 | 4.8 | 5.8 | 4.9 |
| Private capital flows (net) | 2.1 | 0.2 | 23.2 | 11.6 | 10.5 | 2.0 |
| Errors and omissions | -8.0 | -4.2 | -17.4 | -9.7 | 0.0 | 0.0 |
| Overall balance 1/ | 6.5 | -1.2 | 27.3 | -3.6 | 2.5 | -5.4 |
| Memorandum items: | | | | | | |
| Gross official foreign reserves | 18.4 | 17.2 | 44.8 | 42.5 | 45.0 | 39.5 |
| In months of imports (goods and services) 2/ | 2.8 | 2.0 | 4.8 | 3.7 | 3.7 | 3.0 |
| Exchange rate | | | | | | |
| Pa'anga per U.S. dollar (period average) | 2.2 | 2.2 | 2.0 | 1.9 | ... | ... |
| Pa'anga per U.S. dollar (end of period) | 2.2 | 2.1 | 2.0 | 1.9 | ... | ... |

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

1/ Changes in the net official foreign reserves.

2/ The current year's imports.

Table 5. Tonga: Medium-Term “Reforms Proceed” Scenario, 2003/04–2010/11 1/

| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 |
|--|-------------------------------|---------|-------------|---------|---------|---------|---------|---------|
| | | | Projections | | | | | |
| | (Percent change) | | | | | | | |
| Output and prices | | | | | | | | |
| Real GDP | 1.4 | 2.3 | 1.9 | 0.6 | 1.6 | 2.2 | 2.7 | 3.0 |
| Consumer prices (period average) | 11.7 | 9.5 | 7.2 | 10.3 | 8.1 | 6.8 | 6.5 | 6.1 |
| | (In percent of GDP) | | | | | | | |
| Central government finance | | | | | | | | |
| Total revenue and grants | 29.9 | 29.1 | 29.4 | 29.0 | 29.2 | 29.4 | 29.6 | 29.7 |
| Total revenue | 28.5 | 27.8 | 27.9 | 27.4 | 27.6 | 27.7 | 27.8 | 27.9 |
| Grants | 1.4 | 1.3 | 1.6 | 1.6 | 1.6 | 1.7 | 1.8 | 1.8 |
| Total expenditure and net lending | 29.0 | 26.7 | 36.1 | 30.5 | 29.2 | 29.3 | 29.4 | 29.5 |
| Current expenditure | 27.3 | 25.0 | 34.7 | 29.1 | 27.3 | 27.4 | 27.4 | 27.3 |
| Capital expenditure | 1.0 | 2.5 | 1.6 | 1.6 | 2.1 | 2.1 | 2.2 | 2.3 |
| Expenditure discrepancy | 0.8 | -0.6 | ... | ... | ... | ... | ... | ... |
| Net lending | -0.3 | -0.3 | -0.2 | -0.2 | -0.2 | -0.2 | -0.2 | -0.1 |
| Overall balance | 0.9 | 2.4 | -6.7 | -1.5 | -0.1 | 0.0 | 0.1 | 0.2 |
| External financing (net) | 2.9 | 0.4 | 1.8 | 1.3 | 1.3 | 1.1 | 1.4 | 1.1 |
| Domestic financing (net) | -3.8 | -2.8 | 0.5 | 0.2 | -1.2 | -1.2 | -1.5 | -1.4 |
| Privatization receipt | 0.0 | 0.0 | 4.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | (In millions of U.S. dollars) | | | | | | | |
| Balance of payments | | | | | | | | |
| Exports, f.o.b. | 13.8 | 16.0 | 15.9 | 16.9 | 17.9 | 19.0 | 20.1 | 21.4 |
| Imports, f.o.b. | -82.8 | -105.4 | -114.0 | -122.2 | -123.7 | -127.0 | -131.6 | -136.9 |
| Services and income (net) | -3.2 | -12.8 | -5.7 | -2.5 | -1.7 | -0.6 | 0.1 | 0.2 |
| Transfers (net) | 79.8 | 91.9 | 89.9 | 95.4 | 101.0 | 105.0 | 108.9 | 111.2 |
| Current account balance | 7.7 | -10.3 | -13.8 | -12.3 | -6.4 | -3.7 | -2.4 | -4.1 |
| (In percent of GDP) | 4.2 | -4.8 | -6.2 | -5.2 | -2.5 | -1.4 | -1.2 | -1.9 |
| Capital account balance | 37.0 | 16.4 | 16.3 | 6.9 | 7.2 | 7.7 | 8.8 | 9.2 |
| Official capital flows (net) | 13.8 | 4.8 | 5.8 | 4.9 | 5.2 | 5.2 | 6.3 | 6.2 |
| Private capital flows (net) | 23.2 | 11.6 | 10.5 | 2.0 | 2.0 | 2.5 | 2.5 | 3.0 |
| Overall balance | 27.3 | -3.6 | 2.5 | -5.4 | 0.8 | 4.0 | 6.4 | 5.1 |
| Gross international reserves (end of period) | | | | | | | | |
| In millions of U.S. dollars | 44.8 | 42.5 | 45.0 | 39.5 | 40.4 | 44.4 | 50.7 | 55.8 |
| In months of imports (goods and services) | 4.8 | 3.7 | 3.7 | 3.0 | 3.0 | 3.3 | 3.6 | 3.8 |
| External debt | | | | | | | | |
| External debt (in percent of GDP) 2/ | 41.4 | 35.5 | 35.7 | 34.7 | 34.1 | 33.6 | 33.3 | 32.9 |
| Debt service ratio 3/ | 8.7 | 8.4 | 7.1 | 8.0 | 7.5 | 7.8 | 6.1 | 6.7 |
| Memorandum items: | | | | | | | | |
| Private transfers (net, in millions of U.S. dollars) | 79.6 | 91.6 | 89.0 | 94.4 | 100.0 | 103.7 | 107.5 | 109.5 |
| (In percent of imports, goods and services) | 71.4 | 65.9 | 60.8 | 60.4 | 62.8 | 63.3 | 63.3 | 61.7 |

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

1/ Fiscal year beginning July.

2/ Public sector external debt.

3/ In percent of exports of goods and services.

Table 6. Tonga: Medium-Term “Reforms Stall” Scenario, 2003/04–2010/11 1/

| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 |
|--|-------------------------------|---------|-------------|---------|---------|---------|---------|---------|
| | | | Projections | | | | | |
| | (Percent change) | | | | | | | |
| Output and prices | | | | | | | | |
| Real GDP | 1.4 | 2.3 | 1.9 | 2.7 | 1.4 | 1.2 | 1.0 | 1.0 |
| Consumer prices (period average) | 11.7 | 9.5 | 7.2 | 20.5 | 20.0 | 17.9 | 16.2 | 13.1 |
| | (In percent of GDP) | | | | | | | |
| Central government finance | | | | | | | | |
| Total revenue and grants | 29.9 | 29.1 | 29.4 | 27.7 | 25.1 | 25.1 | 25.0 | 25.0 |
| Total revenue | 28.5 | 27.8 | 27.9 | 26.4 | 23.9 | 23.9 | 23.9 | 23.9 |
| Grants | 1.4 | 1.3 | 1.6 | 1.3 | 1.2 | 1.2 | 1.2 | 1.1 |
| Total expenditure and net lending | 29.0 | 26.7 | 31.3 | 32.4 | 29.6 | 29.7 | 29.7 | 29.8 |
| Current expenditure | 27.3 | 25.0 | 29.9 | 31.2 | 28.6 | 28.7 | 28.7 | 28.7 |
| Capital expenditure | 1.0 | 2.5 | 1.6 | 1.3 | 1.1 | 1.1 | 1.1 | 1.1 |
| Expenditure discrepancy | 0.8 | -0.6 | ... | ... | ... | ... | ... | ... |
| Net lending | -0.3 | -0.3 | -0.2 | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 |
| Overall balance | 0.9 | 2.4 | -1.8 | -4.6 | -4.5 | -4.6 | -4.7 | -4.7 |
| External financing (net) | 2.9 | 0.4 | 1.8 | 0.9 | 0.6 | 0.2 | 0.3 | 0.0 |
| Domestic financing (net) | -3.8 | -2.8 | 0.0 | 3.7 | 3.9 | 4.4 | 4.3 | 4.8 |
| Privatization receipt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | (In millions of U.S. dollars) | | | | | | | |
| Balance of payments | | | | | | | | |
| Exports, f.o.b. | 13.8 | 16.0 | 15.9 | 16.2 | 16.5 | 16.7 | 16.9 | 17.1 |
| Imports, f.o.b. | -82.8 | -105.4 | -114.0 | -119.0 | -115.4 | -110.8 | -111.1 | -113.0 |
| Services and income (net) | -3.2 | -12.8 | -5.7 | -6.4 | -6.2 | -6.1 | -5.8 | -5.7 |
| Transfers (net) | 79.8 | 91.9 | 89.9 | 93.0 | 95.2 | 97.6 | 100.0 | 102.5 |
| Current account balance | 7.7 | -10.3 | -13.8 | -16.2 | -9.9 | -2.6 | 0.0 | 0.9 |
| (In percent of GDP) | 4.2 | -4.8 | -6.2 | -7.3 | -4.6 | -1.2 | 0.0 | 0.4 |
| Capital account balance | 37.0 | 16.4 | 6.3 | 1.4 | 0.5 | -0.5 | -0.2 | -1.0 |
| Official capital flows (net) | 13.8 | 4.8 | 5.8 | 3.4 | 2.5 | 1.5 | 1.8 | 1.0 |
| Private capital flows (net) | 23.2 | 11.6 | 0.5 | -2.0 | -2.0 | -2.0 | -2.0 | -2.0 |
| Overall balance | 27.3 | -3.6 | -7.5 | -14.8 | -9.4 | -3.0 | -0.2 | -0.1 |
| Gross international reserves (end of period) | | | | | | | | |
| In millions of U.S. dollars | 44.8 | 42.5 | 34.9 | 20.2 | 10.8 | 7.7 | 7.6 | 7.5 |
| In months of imports (goods and services) | 4.8 | 3.7 | 2.9 | 1.6 | 0.9 | 0.7 | 0.6 | 0.6 |
| External debt | | | | | | | | |
| External debt (in percent of GDP) 2/ | 41.4 | 35.5 | 35.8 | 37.3 | 38.9 | 39.4 | 40.0 | 39.1 |
| Debt service ratio 3/ | 8.7 | 8.4 | 7.1 | 9.3 | 9.4 | 10.3 | 8.6 | 9.7 |
| Memorandum items: | | | | | | | | |
| Private transfers (net, in millions of U.S. dollars) | 79.6 | 91.6 | 88.9 | 92.4 | 94.8 | 97.3 | 99.8 | 102.4 |
| (In percent of imports, goods and services) | 71.4 | 65.9 | 60.8 | 61.2 | 64.7 | 68.6 | 70.2 | 70.6 |

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

1/ Fiscal year beginning July.

2/ Public sector external debt.

3/ In percent of exports of goods and services.

Table 7. Tonga: Banking Sector Indicators, 2000–05 1/

(In percent; end of period)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|------|------|------|------|------|------|
| Capital Adequacy | | | | | | |
| Risk-weighted capital ratio | 18.1 | 24.7 | 21.9 | 21.9 | 23.8 | 19.7 |
| Total capital to total assets | 13.7 | 18.1 | 17.8 | 18.5 | 16.3 | 16.3 |
| Asset Quality | | | | | | |
| Non-performing loan to total loans | 9.3 | 6.3 | 7.7 | 9.6 | 5.9 | 4.2 |
| Non-performing loans to capital | 42.5 | 22.9 | 30.5 | 39.1 | 24.3 | 20.2 |
| Non-performing loans net of provisions to total capital | 7.2 | 1.2 | 6.4 | 14.2 | 0.1 | 3.1 |
| Profitability | | | | | | |
| Return on assets | 4.7 | 6.2 | 5.6 | 5.8 | 6.0 | 6.6 |
| Return on equity | 19.1 | 26.4 | 21.4 | 23.0 | 22.1 | 26.8 |
| Net interest margin | 5.6 | 7.0 | 8.8 | 8.7 | 10.0 | 8.6 |
| Net interest income to gross income | 48.2 | 51.8 | 64.5 | 61.2 | 61.1 | 60.6 |
| Other | | | | | | |
| Risk concentration ratio 2/ | 37.3 | 37.3 | 41.9 | 35.9 | 17.7 | 13.4 |
| Share of loans to non-financial corporations 3/ | 52.3 | 52.6 | 55.1 | 49.7 | 36.3 | 35.1 |

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

1/ Include the Tonga Development Bank.

2/ For commercial banks, the data are defined as the share of the largest 10 loans in total loans.

3/ Includes commercial banks.

TONGA: JOINT FUND / WORLD BANK DEBT SUSTAINABILITY ANALYSIS

This annex provides an updated debt sustainability analysis (DSA) for Tonga.¹³ The DSA was prepared jointly with the World Bank in accordance with the Debt Sustainability Framework for low-income countries approved by the Executive Boards of the IMF and IDA.¹⁴

Updated debt indicators imply that Tonga has moved into the category of low-income countries with a high risk of debt distress, representing a worsening of the situation since the last DSA. The scenario indicates a breach of the threshold for NPV of debt-to-exports from 2004/05 through 2016/17, which is exacerbated by stress tests. The remaining debt stock and debt service ratios are below indicative thresholds. Alternative scenarios and stress tests demonstrate that debt sustainability is critically dependent upon implementation of planned fiscal and private sector reforms.

A. Background

Tonga was found in March 2006 to have debt ratios below the HIPC Initiative thresholds. In line with the HIPC Initiative guidelines and the Boards' guidance, Tonga was not included in the list of countries potentially eligible for debt relief under the HIPC initiative.¹⁵

External public debt as a percent of GDP has declined over the past few years. External public debt fell in line with the decline in loan disbursements following the completion of

¹³ The last comprehensive DSA for Tonga was prepared in the context of the 2005 Article IV Consultation.

¹⁴ This is an abridged version of the joint DSA carried out by the Fund and the World Bank. The debt data underlying this exercise were updated jointly by the IMF and the World Bank using information provided by the Tongan authorities. The DSA was in part based on data generated by the joint Fund/Bank board paper "Review of Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries" (March 2006). This data was fully reconciled up to end-December 2004, as per the requirements of the ring-fencing exercise. For the current DSA, the debt service projections for the end-December 2004 data were adapted to the Tonga fiscal year, which adheres to the DSA cut-off date (i.e. end-June 2005). The data was also updated for disbursements that took place between January and June 2005.

¹⁵ See the joint Fund/Bank board paper "Review of Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries" (March 2006), page 7. The HIPC Initiative thresholds are 150 percent for the ratio of the net present value of debt (NPV) to exports of goods and services and 250 percent for the ratio of NPV to fiscal revenue. To qualify under the second criterion a country must have ratios of exports of goods and services to GDP and fiscal revenue to GDP above 30 percent and 15 percent, respectively.

large projects financed by the ADB. Private external debt increased in 2003/04 by an estimated \$25 million following the refinancing operation of a large private utility company.

A key feature of the LIC-DSA framework is that it compares debt burden indicators to indicative policy-based thresholds. The thresholds are based on the empirical finding that low-income countries with stronger policies and institutions tend to have a higher debt carrying capacity. At end 2004/05, the latest date for which comprehensive data is available, the stock of external public debt amounted to \$76.4 million, with a net present value of \$50.1 million. Tonga’s NPV of debt-to-exports ratio is estimated at 128.1 percent (the relevant policy-based indicative threshold is 100 percent).¹⁶ The ratio is expected to fall to 102.7 percent by 2015/16 and to 66.1 percent by 2025/26. Other relevant indicators, including the NPV of debt-to-GDP, remain below the thresholds throughout the projection period.

| External Public Debt Indicators | | |
|---|----------------------------|---------|
| | Indicative Threshold 1/ | 2004/05 |
| NPV of debt in percent of | | |
| <i>GDP</i> | 30 | 23.3 |
| <i>Exports</i> | 100 | 128.1 |
| <i>Revenues</i> | 200 | 79.8 |
| Debt service in percent of | | |
| <i>Exports</i> | 15 | 8.4 |
| <i>Revenues</i> | 25 | 7.0 |
| 1/ Shows policy indicative thresholds as used in the joint IMF-World Bank low-income country DSA framework for a poor policy performer. | | |

B. Medium-term Macroeconomic Framework

The medium-term framework assumes that the planned fiscal adjustment fails and other reforms stall. A continued fiscal deficit of between 4 and 4½ percent is projected in this case, with limited improvement in revenue administration and a continued high wage bill. As external assistance is expected to decline without reform efforts, the budget would have to rely on domestic financing, placing continued pressure on inflation, the current account and foreign reserves. In this environment, the authorities will not be able to increase public capital expenditure and improve the business climate needed to foster private investment. In addition, tight monetary conditions will be needed to contain credit growth, further hampering private sector activity. With limited public and private investment, GDP growth will remain at about 1 percent, below the historical average. A near-term decline in the real exchange rate should help to improve the current account and turn it into a small surplus by 2010/11.

¹⁶ The World Bank’s Country Policy and Institutional Assessment (CPIA) index summarizes the quality of a country’s policies. Based on this index, a country is categorized as a strong, medium or poor performer. The appropriate debt thresholds vary by category. In the latest CPIA (2005), Tonga is classified as a poor performer, the thresholds for which are: NPV of debt-to-exports (100 percent), GDP (30 percent) and revenues (200 percent); and debt service in percent of exports (15 percent) and revenues (25 percent).

Key Macroeconomic Assumptions
(In percent, unless stated otherwise)

| Period average | 2000/01-04/05 | 2005/06-10/11 | 2011/12-25/26 |
|--|---------------|---------------|---------------|
| Real GDP growth | 2.5 | 1.5 | 1.0 |
| Export growth | 15.1 | 1.7 | 3.5 |
| Current account (in percent of GDP) | -1.6 | -3.1 | 0.4 |
| Inflation | 9.9 | 16.3 | 14.6 |
| Overall fiscal balance (in percent of GDP) | -0.5 | -4.1 | -4.2 |

C. External Debt Sustainability Analysis

In the baseline scenario, the NPV of debt-to-exports breaches the policy-dependent threshold by a large margin and is sustained over the medium term. (Table 1). The NPV of external public debt to exports is expected to remain above indicative thresholds until 2016/17, but continue its decline to 66 percent by 2025/26 reflecting the limited availability of external finance without reform efforts. While this ratio is above the indicative threshold of 100 percent for much of the projection period, the high level of remittances has a countervailing effect.¹⁷ Tonga's external public debt as a percent of GDP is projected to increase slightly over the next few years and then decline steadily. The remaining indicators are projected to remain below indicative threshold levels.

Stress tests underscore that Tonga's debt profile is vulnerable to adverse shocks. (Table 2, Figure 1). One of the largest risks identified among the set of stress tests is a sharp fall in net transfers (historical average minus one standard deviation) in 2006/07–07/08. This scenario could arise if there is a sharp fall in net private remittances due to a recession in those countries where Tongans living abroad reside. If this were to occur, the debt stock indicators would rise well above threshold levels, although the debt service ratio would remain under the policy-dependent threshold. In contrast, a return of key variables to historical averages, which includes higher GDP growth than in the baseline scenario, would imply an improvement in all ratios.

D. Fiscal Debt Sustainability Analysis

The sizeable level of domestic debt poses an additional risk to fiscal sustainability (Table 3). At end-2004/05, domestic debt was 15.4 percent of GDP, bringing total public debt to 50.8 percent of GDP. Domestic public debt and, as a result, total public debt are projected to increase over the next five years due to the domestic financing of the fiscal deficit, reaching a high of 62.6 percent in 2010/11. The gradual build up of domestic public debt is projected to continue thereafter.

Alternative scenarios and stress tests highlight the vulnerability of the total public debt position (Table 4, Figure 2). A one-time 30 percent real depreciation or a 10 percent of GDP

¹⁷ In 2004/05, net remittances were over two times the value of exports.

increase in other debt-creating flows in 2006/07 would cause quite a sharp increase in the debt stock and debt service indicators. These scenarios could unfold if the National Reserve Bank of Tonga needs to devalue the currency, or if the government requires additional financing due to a further deterioration of revenue administration or expenditure management. On the other hand, a return of real GDP growth and primary fiscal balance to historical averages would see a marked improvement in all ratios.

E. Staff Assessment

Based on the LIC-DSA, staffs conclude that Tonga's external debt dynamics are subject to a high risk of debt distress. The NPV of debt-to-exports remains above the threshold by a large margin over much of the projection period in the baseline scenario, and is exacerbated by stress tests. In addition, the threshold for an additional debt stock indicator (i.e. NPV of debt-to-GDP) is breached by the alternative scenarios and stress tests. The remaining debt stock and debt service indicators remain below the indicative thresholds. While stress tests highlight some vulnerabilities to debt sustainability, including the risks around a sharp fall in net transfers or the value of the currency, the alternative scenarios, in contrast, show that a return of GDP growth and the primary balance to historical averages would strongly enhance debt sustainability. This further emphasizes the critical importance of fully implementing the planned fiscal and private sector reforms.

Table 1. Tonga: External Debt Sustainability Framework, Reforms Stial Scenario, 2002/03-2025/26 1/
(In percent of GDP, unless otherwise indicated)

| | Actual | | | Historical Average 6/ Standard Deviation 6/ | Estimate | | | | | | | | | | 2011/12-25/26 Average |
|---|---------|---------|---------|--|----------|---------|---------|---------|---------|---------|--------------------------|---------|--|--|--------------------------|
| | 2002/03 | 2003/04 | 2004/05 | | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12-25/26 Average | 2025/26 | | | |
| External debt (nominal) 1/ | 41.8 | 55.1 | 45.8 | 44.2 | 44.4 | 44.4 | 43.3 | 42.0 | 39.1 | 32.1 | 21.5 | 21.5 | | | |
| o/w public and publicly guaranteed (PPG) | 41.8 | 41.4 | 35.5 | 35.8 | 37.3 | 38.9 | 39.4 | 40.0 | 39.1 | 32.1 | 21.5 | 21.5 | | | |
| Change in external debt | -1.2 | 13.3 | -9.4 | -1.5 | 0.1 | 0.1 | -1.1 | -1.3 | -2.9 | -1.2 | -0.9 | -0.9 | | | |
| Identified net debt-creating flows | -1.6 | -8.5 | -9.1 | 5.1 | 7.0 | 4.9 | 1.6 | 0.5 | 0.1 | 0.2 | 0.3 | 0.3 | | | |
| Non-interest current account deficit | 2.7 | -4.7 | 3.7 | 5.3 | 5.2 | 3.8 | 0.5 | -0.6 | -0.9 | -0.8 | -0.7 | -0.8 | | | |
| Deficit in balance of goods and services | 39.0 | 39.4 | 46.4 | 46.4 | 49.6 | 49.0 | 47.1 | 47.4 | 47.1 | 47.0 | 46.9 | 46.9 | | | |
| Exports | 26.7 | 21.8 | 18.2 | 18.8 | 18.8 | 19.0 | 19.4 | 19.8 | 19.9 | 19.9 | 19.8 | 19.8 | | | |
| Imports | 65.7 | 61.2 | 64.6 | 65.2 | 68.4 | 68.0 | 66.5 | 67.1 | 67.0 | 66.9 | 66.7 | 66.7 | | | |
| Net current transfers (negative = inflow) | -36.9 | -43.9 | -42.7 | -40.0 | -42.1 | -44.2 | -45.7 | -47.2 | -47.3 | -47.3 | -47.2 | -47.3 | | | |
| Other current account flows (negative = net inflow) | 0.6 | -0.3 | 0.0 | -1.1 | -1.0 | -1.0 | -0.9 | -0.8 | -0.7 | -0.6 | -0.4 | -0.4 | | | |
| Net FDI (negative = inflow) | -0.2 | 1.0 | -5.4 | -0.2 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | | | |
| Endogenous debt dynamics 2/ | -4.2 | -4.7 | -7.4 | 0.1 | -0.4 | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | | | |
| Contribution from nominal interest rate | 0.3 | 0.5 | 1.1 | 0.9 | 0.9 | 0.8 | 0.7 | 0.6 | 0.5 | 0.4 | 0.3 | 0.3 | | | |
| Contribution from real GDP growth | -1.3 | -0.5 | -1.1 | -0.8 | -1.2 | -0.6 | -0.5 | -0.4 | -0.4 | -0.3 | -0.2 | -0.2 | | | |
| Contribution from price and exchange rate changes | -3.2 | -4.8 | -7.4 | ... | ... | ... | ... | ... | ... | ... | ... | ... | | | |
| Residual (3-4) 3/ | 0.4 | 21.8 | -0.3 | -6.6 | -6.9 | -4.8 | -2.7 | -1.8 | -3.0 | -1.4 | -1.2 | -1.2 | | | |
| o/w exceptional financing | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | |
| NPV of external debt 4/ | ... | ... | 33.5 | 30.4 | 30.3 | 29.9 | 28.7 | 27.0 | 24.8 | 20.4 | 13.1 | 13.1 | | | |
| In percent of exports | ... | ... | 184.5 | 161.3 | 161.4 | 157.2 | 148.3 | 136.9 | 124.6 | 102.7 | 66.1 | 66.1 | | | |
| NPV of PPG external debt | ... | ... | 23.3 | 22.0 | 23.3 | 24.3 | 24.8 | 25.0 | 24.8 | 20.4 | 13.1 | 13.1 | | | |
| In percent of exports | ... | ... | 128.1 | 116.6 | 123.9 | 127.8 | 128.3 | 126.7 | 124.6 | 102.7 | 66.1 | 66.1 | | | |
| Debt service-to-exports ratio (in percent) | 6.0 | 8.7 | 19.6 | 17.4 | 19.9 | 20.1 | 21.0 | 19.1 | 19.9 | 8.4 | 6.3 | 6.3 | | | |
| PPG debt service-to-exports ratio (in percent) | 6.0 | 8.7 | 8.4 | 7.1 | 9.3 | 9.4 | 10.3 | 8.6 | 9.7 | 8.4 | 6.3 | 6.3 | | | |
| Total gross financing need (millions of U.S. dollars) | 6.7 | -3.4 | 4.1 | 18.7 | 24.5 | 18.5 | 11.7 | 8.7 | 8.6 | 4.6 | 5.4 | 5.4 | | | |
| Non-interest current account deficit that stabilizes debt ratio | 3.9 | -18.0 | 13.1 | 6.8 | 6.3 | 3.7 | 1.6 | 0.7 | 2.0 | 0.4 | 0.2 | 0.2 | | | |
| Key macroeconomic assumptions | | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | 3.2 | 1.4 | 2.3 | 1.9 | 2.7 | 1.4 | 1.2 | 1.0 | 1.0 | 1.5 | 1.0 | 1.0 | | | |
| GDP deflator in US dollar terms (change in percent) | 8.2 | 12.8 | 15.4 | 9.9 | 2.4 | -4.3 | -3.8 | -2.1 | -1.7 | -1.4 | 2.5 | 2.5 | | | |
| Effective interest rate (percent) 5/ | 0.9 | 1.4 | 2.3 | 2.1 | 1.9 | 1.7 | 1.6 | 1.4 | 1.2 | 1.7 | 1.2 | 1.4 | | | |
| Growth of exports of G&S (US dollar terms, in percent) | 23.7 | -6.9 | -1.4 | 8.2 | -1.8 | -1.4 | 0.8 | 1.4 | 2.9 | 1.7 | 3.5 | 3.5 | | | |
| Growth of imports of G&S (US dollar terms, in percent) | 31.1 | 6.5 | 24.8 | 17.7 | 3.2 | -3.0 | -3.1 | 0.3 | 2.0 | 0.8 | 3.5 | 3.5 | | | |
| Grant element of new public sector borrowing (in percent) | ... | ... | ... | 56.9 | 56.9 | 56.9 | 56.9 | 56.9 | 56.9 | 56.9 | 56.9 | 56.9 | | | |
| <i>Memorandum items:</i> | | | | | | | | | | | | | | | |
| Normal GDP (millions of US dollars) | 159.2 | 182.1 | 215.1 | 224.5 | 220.8 | 215.4 | 213.3 | 211.9 | 216.6 | 257.6 | 364.2 | 364.2 | | | |
| Source: Staff simulations. | | | | | | | | | | | | | | | |

1/ Includes both public and private sector external debt.
 2/ Derived as $[r - g - p(1+g)] / (1+g-p-gp)$ times previous period debt ratio, with r = nominal interest rate, g = real GDP growth rate, and p = growth rate of GDP deflator in U.S. dollar terms.
 3/ Includes exceptional financing (i.e., changes in arrears and debt relief), changes in gross foreign assets, and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
 4/ Assumes that NPV of private sector debt is equivalent to its face value.
 5/ Current-year interest payments divided by previous period debt stock.
 6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2005/06-2025/26
(In percent)

| | Estimate | | Projections | | | | | |
|--|----------|---------|-------------|---------|---------|---------|---------|---------|
| | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2015/16 | 2025/26 |
| NPV of debt-to-GDP ratio | | | | | | | | |
| Baseline | 22 | 23 | 24 | 25 | 25 | 25 | 20 | 13 |
| A. Alternative Scenarios | | | | | | | | |
| A1. Key variables at their historical averages in 2006/07-25/26 1/ | 22 | 19 | 17 | 16 | 16 | 15 | 13 | 11 |
| A2. New public sector loans on less favorable terms in 2006/07-25/26 2/ | 22 | 24 | 26 | 27 | 28 | 28 | 25 | 20 |
| B. Bound Tests | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2006/07-07/08 | 22 | 24 | 25 | 26 | 26 | 26 | 21 | 14 |
| B2. Export value growth at historical average minus one standard deviation in 2006/07-07/08 3/ | 22 | 25 | 29 | 29 | 30 | 30 | 25 | 16 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2006/07-07/08 | 22 | 25 | 27 | 28 | 28 | 28 | 23 | 15 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2006/07-07/08 4/ | 22 | 32 | 42 | 44 | 45 | 45 | 41 | 26 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 22 | 31 | 43 | 44 | 45 | 45 | 41 | 26 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2006/07 5/ | 22 | 34 | 35 | 36 | 36 | 36 | 30 | 19 |
| NPV of debt-to-exports ratio | | | | | | | | |
| Baseline | 117 | 124 | 128 | 128 | 127 | 125 | 103 | 66 |
| A. Alternative Scenarios | | | | | | | | |
| A1. Key variables at their historical averages in 2006/07-25/26 1/ | 117 | 103 | 91 | 85 | 80 | 78 | 66 | 57 |
| A2. New public sector loans on less favorable terms in 2006/07-25/26 2/ | 117 | 128 | 135 | 139 | 140 | 140 | 126 | 100 |
| B. Bound Tests | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2006/07-07/08 | 117 | 124 | 128 | 128 | 127 | 125 | 103 | 66 |
| B2. Export value growth at historical average minus one standard deviation in 2006/07-07/08 3/ | 117 | 161 | 226 | 227 | 226 | 223 | 192 | 123 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2006/07-07/08 | 117 | 124 | 128 | 128 | 127 | 125 | 103 | 66 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2006/07-07/08 4/ | 117 | 168 | 223 | 226 | 227 | 226 | 208 | 131 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 117 | 176 | 253 | 257 | 258 | 257 | 235 | 149 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2006/07 5/ | 117 | 124 | 128 | 128 | 127 | 125 | 103 | 66 |
| Debt service ratio | | | | | | | | |
| Baseline | 7 | 9 | 9 | 10 | 9 | 10 | 8 | 6 |
| A. Alternative Scenarios | | | | | | | | |
| A1. Key variables at their historical averages in 2006/07-25/26 1/ | 8 | 7 | 8 | 8 | 8 | 6 | 6 | 5 |
| A2. New public sector loans on less favorable terms in 2006/07-25/26 2/ | 8 | 7 | 10 | 10 | 11 | 9 | 9 | 9 |
| B. Bound Tests | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2006/07-07/08 | 8 | 7 | 9 | 9 | 10 | 8 | 8 | 6 |
| B2. Export value growth at historical average minus one standard deviation in 2006/07-07/08 3/ | 8 | 9 | 14 | 14 | 16 | 13 | 12 | 11 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2006/07-07/08 | 8 | 7 | 9 | 9 | 10 | 8 | 8 | 6 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2006/07-07/08 4/ | 8 | 7 | 10 | 11 | 12 | 10 | 9 | 11 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 8 | 8 | 12 | 13 | 13 | 11 | 10 | 13 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2006/07 5/ | 8 | 7 | 9 | 9 | 10 | 8 | 8 | 6 |
| <i>Memorandum item:</i> | | | | | | | | |
| Grant element assumed on residual financing (i.e., financing required above baseline) 6/ | 57 | 57 | 57 | 57 | 57 | 57 | 57 | 57 |

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Tonga: Public Sector Debt Sustainability Framework, Reforms Stall Scenario, 2002/03-2025/26
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Estimate | | | | | Projections | | | | |
|--|---------|---------|---------|-----------------------|-----------------------|----------|---------|---------|---------|---------|-------------|-----------------|-------------------------|--|--|
| | 2002/03 | 2003/04 | 2004/05 | Historical Average 5/ | Standard Deviation 5/ | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2010/11 Average | 2011/12-2025/26 Average | | |
| | | | | | | | | | | | | | | | |
| Public sector debt 1/ | | | | | | | | | | | | | | | |
| o/w foreign-currency denominated | 66.0 | 60.4 | 50.8 | | | 51.3 | 53.9 | 56.6 | 59.0 | 61.3 | 62.6 | 60.5 | 53.0 | | |
| Change in public sector debt | 41.0 | 40.6 | 35.4 | | | 37.2 | 38.7 | 40.3 | 40.9 | 41.5 | 40.6 | 32.3 | 21.6 | | |
| Identified debt-creating flows | 1.0 | -5.7 | -9.6 | | | 0.4 | 2.6 | 2.7 | 2.4 | 2.3 | 1.4 | -0.4 | -0.8 | | |
| Primary deficit | -3.1 | -9.4 | -12.0 | | | 0.4 | 2.7 | 2.8 | 2.4 | 2.3 | 1.4 | -0.3 | -0.8 | | |
| Revenue and grants | 2.4 | -1.7 | -3.3 | 0.2 | 2.1 | 1.0 | 3.8 | 3.6 | 3.5 | 3.4 | 3.4 | 2.1 | 0.4 | | |
| of which : grants | 28.4 | 29.9 | 29.1 | | | 29.4 | 27.7 | 25.1 | 25.1 | 25.0 | 25.0 | 25.0 | 25.0 | | |
| Primary (noninterest) expenditure | 0.8 | 1.4 | 1.3 | | | 1.6 | 1.3 | 1.2 | 1.2 | 1.2 | 1.1 | 0.5 | 0.1 | | |
| Automatic debt dynamics | 30.8 | 28.1 | 25.8 | | | 30.4 | 31.5 | 28.6 | 28.5 | 28.4 | 28.4 | 27.1 | 25.4 | | |
| Contribution from interest rate/growth differential | -6.6 | -5.8 | -6.8 | | | -0.6 | -1.1 | -0.7 | -1.0 | -1.0 | -1.9 | -2.4 | -1.2 | | |
| of which : contribution from average real interest rate | -4.1 | -1.9 | -2.9 | | | -0.6 | -1.1 | -0.7 | -1.0 | -1.0 | -1.9 | -2.4 | -1.2 | | |
| of which : contribution from real GDP growth | -2.1 | -1.0 | -1.5 | | | -1.0 | -2.4 | -2.3 | -2.0 | -2.0 | -1.6 | -1.7 | -0.5 | | |
| Contribution from real exchange rate depreciation | -2.0 | -0.9 | -1.4 | | | -0.9 | -1.4 | -0.8 | -0.7 | -0.6 | -0.6 | -0.6 | -0.5 | | |
| Other identified debt-creating flows | -2.5 | -3.9 | -3.9 | | | 1.4 | 2.6 | 2.4 | 1.7 | 1.5 | 0.3 | ... | ... | | |
| Privatization receipts (negative) | 1.2 | -1.9 | -1.8 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | |
| Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | |
| Debt relief (HIPC and other) | 1.2 | -1.9 | -1.8 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | |
| Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | |
| Residual, including asset changes | 4.0 | 3.7 | 2.4 | | | 0.0 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | 0.0 | 0.0 | | |
| NPV of public sector debt | | | | | | | | | | | | | | | |
| o/w foreign-currency denominated | ... | ... | 38.6 | | | 36.9 | 39.3 | 41.5 | 43.8 | 45.7 | 47.7 | 48.7 | 44.5 | | |
| o/w external | ... | ... | 23.2 | | | 22.8 | 24.2 | 25.2 | 25.8 | 26.0 | 25.7 | 20.5 | 13.1 | | |
| NPV of contingent liabilities (not included in public sector debt) | ... | ... | 23.2 | | | 22.8 | 24.2 | 25.2 | 25.8 | 26.0 | 25.7 | 20.5 | 13.1 | | |
| Gross financing need 2/ | 5.5 | 1.9 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | |
| NPV of public sector debt-to-revenue ratio (in percent) 3/ | ... | ... | 132.7 | | | 125.3 | 141.7 | 165.3 | 174.9 | 182.5 | 190.7 | 194.6 | 177.9 | | |
| o/w external | ... | ... | 79.8 | | | 77.3 | 87.1 | 100.4 | 102.7 | 103.7 | 102.6 | 81.8 | 52.5 | | |
| Debt service-to-revenue ratio (in percent) 3/ 4/ | 6.8 | 7.5 | 7.0 | | | 6.1 | 8.0 | 9.2 | 10.9 | 10.1 | 11.5 | 14.6 | 19.1 | | |
| Primary deficit that stabilizes the debt-to-GDP ratio | 1.4 | 3.9 | 6.2 | | | 0.5 | 1.2 | 0.8 | 1.1 | 1.1 | 2.0 | 2.5 | 1.2 | | |
| Key macroeconomic and fiscal assumptions | | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | 3.2 | 1.4 | 2.3 | 1.8 | 2.5 | 1.9 | 2.7 | 1.4 | 1.2 | 1.0 | 1.0 | 1.5 | 1.0 | | |
| Average nominal interest rate on forex debt (in percent) | 0.9 | 1.3 | 1.1 | 1.3 | 0.3 | 1.1 | 1.3 | 1.3 | 1.2 | 1.2 | 1.2 | 1.2 | 1.4 | | |
| Average real interest rate on domestic currency debt (in percent) | -6.7 | -3.3 | -6.0 | 7.0 | 5.2 | -3.6 | -13.5 | -13.3 | -10.6 | -9.3 | -6.8 | -9.5 | -1.4 | | |
| Real exchange rate depreciation (in percent, + indicates depreciation) | -6.2 | -9.7 | -10.0 | -2.6 | 20.3 | 4.1 | ... | ... | ... | ... | ... | ... | -3.3 | | |
| Inflation rate (GDP deflator, in percent) | 8.9 | 5.0 | 9.5 | -0.1 | 16.8 | 7.2 | 20.5 | 20.0 | 17.9 | 16.2 | 13.1 | 15.8 | 14.6 | | |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 1.1 | -7.4 | -6.2 | 10.1 | 29.3 | 20.3 | 6.5 | -7.8 | 0.8 | 0.7 | 0.8 | 3.5 | 0.4 | | |
| Grant element of new external borrowing (in percent) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | |

Sources: Country authorities; and Fund staff estimates and projections.
 1/ Central government. Debt is gross and includes government-guaranteed debt.
 2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
 3/ Revenues including grants.
 4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
 5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Tonga: Sensitivity Analysis for Key Indicators of Public Debt 2005/06-2025/26

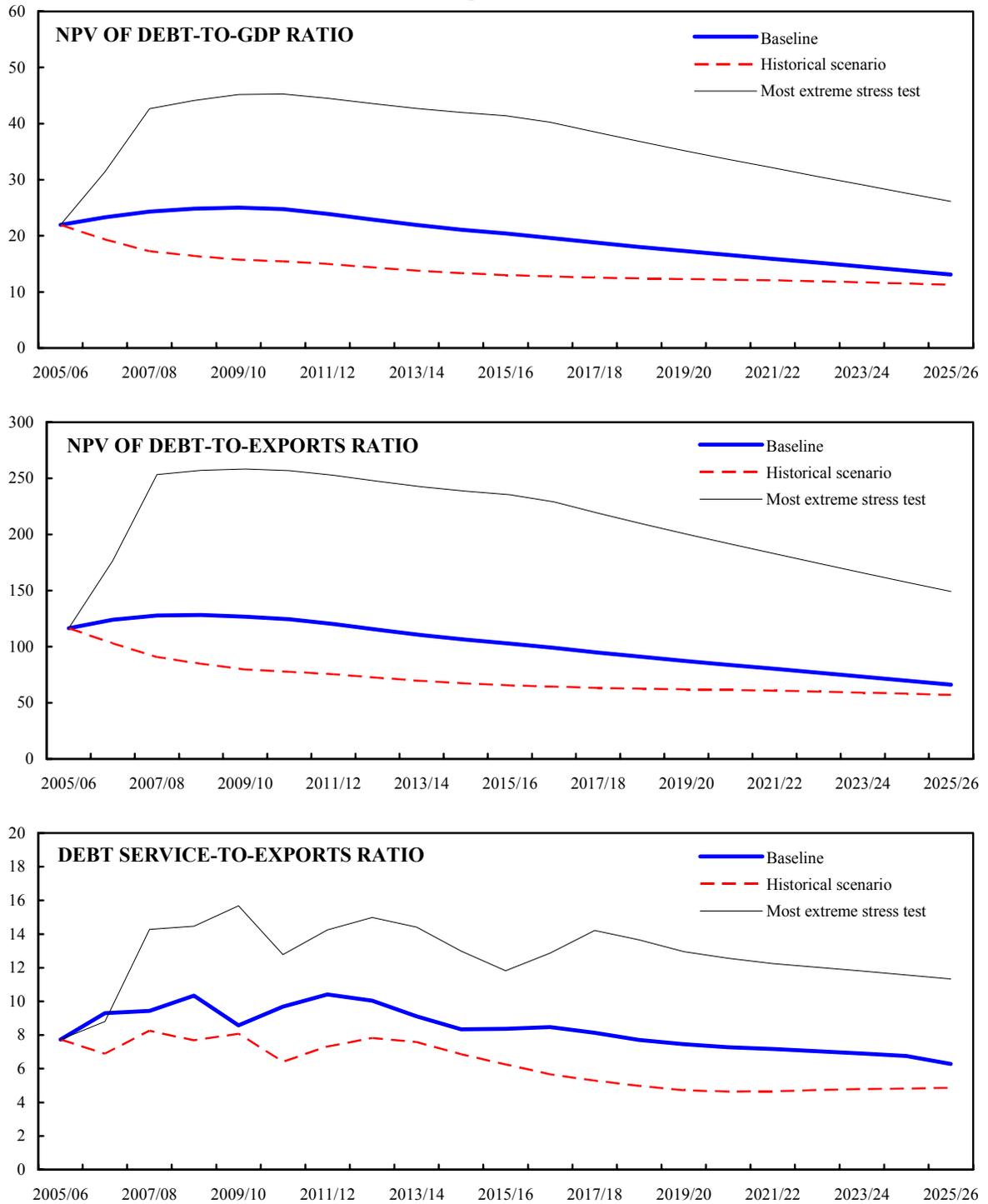
| | Estimate | | Projections | | | | | |
|---|----------|---------|-------------|---------|---------|---------|---------|---------|
| | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2015/16 | 2025/26 |
| NPV of Debt-to-GDP Ratio | | | | | | | | |
| Baseline | 37 | 39 | 41 | 44 | 46 | 48 | 49 | 45 |
| A. Alternative scenarios | | | | | | | | |
| A1. Real GDP growth and primary balance are at historical averages | 37 | 36 | 35 | 34 | 32 | 30 | 20 | 8 |
| A2. Permanently lower GDP growth 1/ | 37 | 40 | 42 | 45 | 48 | 51 | 58 | 77 |
| B. Bound tests | | | | | | | | |
| B1. Real GDP growth is at historical average minus one standard deviations in 2006/07-2007/08 | 37 | 41 | 46 | 49 | 53 | 56 | 64 | 73 |
| B2. Primary balance is at historical average minus one standard deviations in 2006/07-2007/08 | 37 | 38 | 39 | 41 | 43 | 45 | 46 | 41 |
| B3. Combination of B1-B2 using one half standard deviation shocks | 37 | 38 | 38 | 40 | 41 | 43 | 43 | 38 |
| B4. One-time 30 percent real depreciation in 2006/07 | 37 | 54 | 57 | 60 | 62 | 64 | 64 | 58 |
| B5. 10 percent of GDP increase in other debt-creating flows in 2006/07 | 37 | 49 | 51 | 54 | 57 | 59 | 61 | 58 |
| NPV of Debt-to-Revenue Ratio 2/ | | | | | | | | |
| Baseline | 125 | 142 | 165 | 175 | 182 | 191 | 195 | 178 |
| A. Alternative scenarios | | | | | | | | |
| A1. Real GDP growth and primary balance are at historical averages | 125 | 131 | 140 | 135 | 128 | 122 | 81 | 30 |
| A2. Permanently lower GDP growth 1/ | 125 | 143 | 168 | 180 | 191 | 202 | 231 | 307 |
| B. Bound tests | | | | | | | | |
| B1. Real GDP growth is at historical average minus one standard deviations in 2006/07-2007/08 | 125 | 149 | 182 | 197 | 210 | 224 | 253 | 293 |
| B2. Primary balance is at historical average minus one standard deviations in 2006/07-2007/08 | 125 | 137 | 155 | 164 | 171 | 179 | 182 | 164 |
| B3. Combination of B1-B2 using one half standard deviation shocks | 125 | 136 | 151 | 159 | 165 | 172 | 173 | 153 |
| B4. One-time 30 percent real depreciation in 2006/07 | 125 | 194 | 226 | 238 | 247 | 256 | 255 | 232 |
| B5. 10 percent of GDP increase in other debt-creating flows in 2006/07 | 125 | 175 | 204 | 217 | 227 | 237 | 244 | 230 |
| Debt Service-to-Revenue Ratio 2/ | | | | | | | | |
| Baseline | 6 | 8 | 9 | 11 | 10 | 11 | 15 | 19 |
| A. Alternative scenarios | | | | | | | | |
| A1. Real GDP growth and primary balance are at historical averages | 6 | 8 | 4 | 4 | 2 | 3 | 5 | 0 |
| A2. Permanently lower GDP growth 1/ | 6 | 8 | 9 | 12 | 11 | 13 | 18 | 33 |
| B. Bound tests | | | | | | | | |
| B1. Real GDP growth is at historical average minus one standard deviations in 2006/07-2007/08 | 6 | 8 | 11 | 14 | 13 | 15 | 20 | 32 |
| B2. Primary balance is at historical average minus one standard deviations in 2006/07-2007/08 | 6 | 8 | 7 | 8 | 9 | 11 | 14 | 17 |
| B3. Combination of B1-B2 using one half standard deviation shocks | 6 | 8 | 6 | 7 | 8 | 10 | 13 | 15 |
| B4. One-time 30 percent real depreciation in 2006/07 | 6 | 8 | 10 | 12 | 12 | 13 | 16 | 22 |
| B5. 10 percent of GDP increase in other debt-creating flows in 2006/07 | 6 | 8 | 23 | 17 | 14 | 14 | 17 | 27 |

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

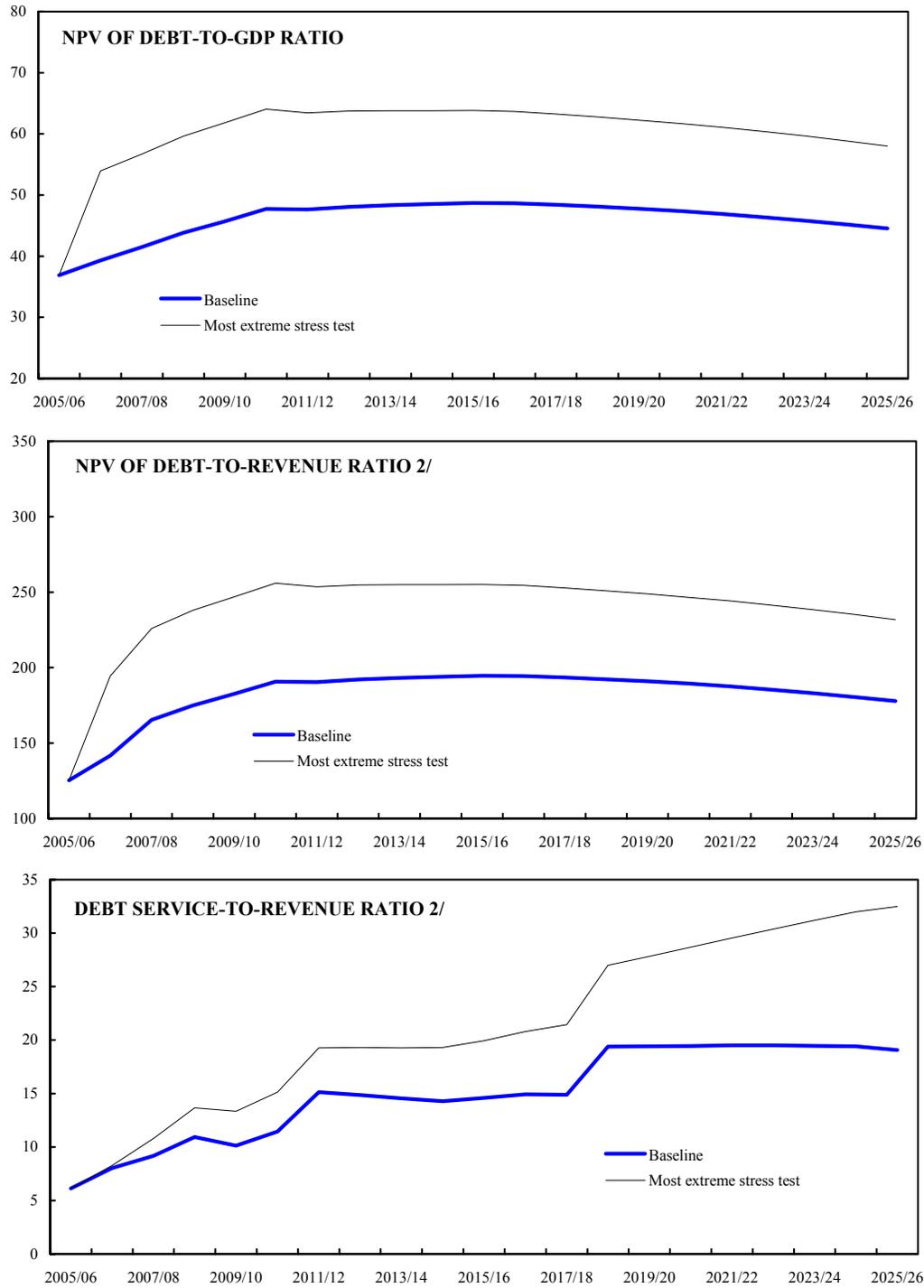
2/ Revenues are defined inclusive of grants.

Figure 1. Tonga: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005/06-2025/26 (In percent)



Source: Staff projections and simulations.

Figure 2. Tonga: Indicators of Public Debt Under Alternative Scenarios, 2005/06-2025/26 (In percent) 1/



Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2015/16.

2/ Revenue including grants.

TONGA: FUND RELATIONS
(As of April 30, 2006)

- I. **Membership Status:** Joined 9/13/85; Article VIII
- II. **General Resources Account:**
- | | SDR Million | % Quota |
|----------------------------|-------------|---------|
| Quota | 6.90 | 100.00 |
| Total holdings of currency | 5.19 | 75.20 |
| Reserve position in Fund | 1.71 | 24.81 |
- III. **SDR Department:**
- | | SDR Million | % Allocation |
|----------|-------------|--------------|
| Holdings | 0.30 | n.a. |
- IV. **Outstanding Purchases and Loans:** None.
- V. **Financial Arrangements:** None.
- VI. **Projected Obligations to Fund:** None.
- VII. **Exchange Rate Arrangement:**
- Since February 11, 1991, the value of the pa'anga is determined based on a weighted basket of currencies comprising the U.S., Australian, and New Zealand dollars, with the U.S. dollar as the intervention currency. In July 2000, the Japanese yen was added to the basket, and the monthly maximum adjustment limit was raised to 5 percent from 2 percent that had prevailed since March 1998, when the allowance for adjustment was introduced.
- VIII. **Last Article IV Consultation:**
- Staff discussions were held during March 30–April 13, 2005 and the Executive Board discussed the staff report on July 15, 2005.
- 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.

TONGA: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE¹⁸
(As of April 2006)

Assistance to Tonga since 2002 included 31 advisory missions, mostly on tax and customs administration and banking. During 2002–05, Tonga has sent 55 officials to the Centre’s regional seminars, workshops and training courses, and 6 attachments were organized.

Public Financial Management

Since 2003, PFTAC’s missions have focused on complementing the considerable assistance provided by other TA agencies, including through the introduction of a mid-year economic review and fiscal update, reconciliation of monetary and fiscal data, and changes in budget documentation. For the 2003–04 and 2004–05 budgets, assistance was provided in presenting the final aggregate budget figures on a GFSM2001 basis. In addition, in 2004 PFTAC arranged for a short-term secondment of two officials to the Samoan Ministry of Finance and one official to participate on a delegation of Pacific Island officials to the Australian Commonwealth Ministry of Finance. In late 2005, the PFTAC expert worked with the Ministry of Finance to assess the budgetary implications of the civil service wage increase.

Tax Administration and Policy

A tax reform package, including a new consumption tax, was designed by PFTAC in 2002. Follow-up missions in 2003 and 2004 were designed to assist in the preparations for the implementation of that package. At the end of January 2005, the Minister of Finance announced a substantially altered plan to implement a consumption tax and some other changes on April 1, 2005. PFTAC was not requested to assist in its implementation. The Centre will, however, provide assistance in the redrafting of the Customs legislation. In late 2005, NZAID offered additional financing to PFTAC to fund three short visits to Tonga to assist with revenue forecasting; the first of these missions took place in February 2006.

Banking Sector Regulation and Supervision

An assessment to determine compliance with the Basel Core Principles for Effective Banking Supervision (BCP) was conducted in 2002. It identified some shortcomings in Tonga’s legal framework and resulted in a review of the Financial Institutions Act (FIA). The enhanced FIA was enacted in late 2004. A TA mission provided assistance with drafting regulations and guidelines, and establishing procedures for their implementation in April 2005. Further assistance in supervision was provided in late 2005 and in February 2006, as PFTAC has participated more regularly in on-site examinations. Amendments to the NRBT Act, which will strengthen the central bank’s enforcement capacity, are still awaiting Parliament’s enactment. PFTAC also arranged, through funding provided in late 2005 by NZAID, for the

¹⁸ The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan, Korea, and New Zealand. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

renewal of the secondment of a central banking manager from the Reserve Bank of Fiji to serve as the Deputy Governor of the National Reserve Bank of Tonga.

Economic and Financial Statistics

In 2002, two reviews were undertaken in accordance with the GDDS and the *Data Quality Assessment Framework*; one on BOP statistics and the other on the wider statistical system. Subsequent missions in 2004 finalized GDDS metadata, provided training in BOP concepts and practices, developed a new BOP business survey, and reviewed national accounts data. In September 2005, a partial update of the 2002 statistical system review was done, focusing on outputs of the Statistics Division of the Ministry of Finance. Further assistance was provided to peer review draft GDP and BOP estimates prior to publication.

TONGA: RELATIONS WITH THE WORLD BANK GROUP¹⁹
(As of April 2006)

Since becoming a World Bank Group member in 1985, Tonga has received a total of five IDA credits totaling US\$23.6 million. The key components of the Bank's current program are:

- **Health:** The Health Sector Support Project, with an IDA credit of US\$11.6 million approved in mid-2003, was developed in cooperation with AusAID. The project is helping the government to improve the quality of health care on the most heavily populated island of Tongatapu.
- **Natural Hazard Management:** The Cyclone Emergency Recovery and Management Project, with an IDA credit of US\$6.7 million approved in 2002, is assisting Tonga in replacing and strengthening the resilience of social infrastructure and helping upgrade Tonga's emergency and risk management capacity to ensure it can cope better with future disasters and the risk posed by climate change.
- **Financial Management and Procurement:** An IDF grant of US\$200,000 was approved in December 2003 and is supporting public procurement reforms and procurement capacity building through the provision of technical assistance.
- **Private Sector Development:** The Bank has provided analytical and technical assistance in cooperation with FIAS to support the government's initiative to create a joint public-private tasks force as an effort to tackle regulatory impediments to private sector development. In collaboration with the Pacific Enterprise Development Facility (PEDF), the IFC has supported 18 projects in Tonga, 13 of them raising finance locally to start or expand local businesses in fisheries, agriculture, insurance, professional services, laboratory, manufacturing and port services. In 2004, IFC completed a piece of advisory work for the government on Royal Tongan Airlines.
- **Education System:** The Tongan Education Support Project with an IDA credit of US\$0.95 million and an NZAID trust fund of US\$3.8 million (managed by the Bank) was approved in June 2005. Together with NZAID, the Bank is helping to structure a sector-wide approach that would pool donor and government funding to comprehensively target education priorities, particularly: school curriculum development, non-salary resource allocations, teaching and learning materials, language policy, student assessment, and the supply and quality of teachers.
- **Transport Sector Reform:** The Bank has completed a Transport Sector Review Study that provides analytical assistance to support the government's commitment to improve the structure and efficiency of the sector, including assessing options for sustainable financing. An ongoing study of opportunities for public-private partnership in the airport sector is

¹⁹ Prepared by World Bank staff.

expected to be completed by end-April 2006. The Bank stands ready to assist the newly formed Ministry of Transport in meeting its sectoral needs as defined in the Transport Sector Review Study. There is a joint Pacific Infrastructure Report with the ADB, AusAid, and NZAid to discuss the sector situation, and this is expected to be completed by end-2006.

Recent reports:

- “Pacific Regional Strategy FY2006–09,” May 2005
- “East Asia and Pacific Update: Solid Growth, New Challenges,” March 2006
- “Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region,” 2006
- “The Pacific Infrastructure Challenge,” 2006
- “Opportunities to Improve Social Services: Human Development in the Pacific Islands,” forthcoming
- “The Economic Case for Promoting Labor Mobility in the Pacific Region,” forthcoming

World Bank Group Credits (in millions of U.S. dollars, as of April 18, 2006)

| | |
|-------------------|-------|
| ▪ Total disbursed | 13.74 |
| ▪ Undisbursed | 9.88 |
| ▪ Total | 23.60 |

TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK²⁰
(As of May 2005)

The Asian Development Bank (ADB)'s country program and strategy update for 2005-2006 focuses on (i) continuing assistance to the government's reform program to enhance sound economic and public sector management; (ii) addressing the emerging deterioration in some social indicators through targeted interventions that promote inclusive social development; and (iii) improving the enabling environment for private sector development.

The key projects under consideration aim at (i) providing assistance to develop a new strategic development plan, linked to a multi-year fiscal framework and an annual resource allocation process; (ii) providing continued support for public enterprise reforms, especially the privatization of selected public enterprises; (iii) addressing youth unemployment and associated social problems; (iv) improving basic infrastructure for drainage and sanitation in selected areas in the capital; and (v) supporting agriculture sector development through an enhanced policy environment and development of small and medium agriculture-based enterprises.

ADB has approved fifteen loans totaling \$57.8 million from the Asian Development Fund (ADF) to Tonga since it joined ADB in 1972. Fifty-two technical assistance projects with a value of \$14.4 million were also provided to improve capacity and strengthen institutional development in various sectors. Past ADB investments have focused on finance development and infrastructure development in transport, power, agriculture, and fisheries.

Active projects in the country portfolio include five TAs. Their objectives are to (i) contribute to private sector-led economic growth, increased income, and employment opportunities by promoting micro small and medium enterprise development, (ii) design a countrywide program for the development of youth microenterprises; (iii) improve the government's capacity for strategic and development planning; (iv) improve the environment for the private sector by rationalizing the government's portfolio of public enterprises, and (v) undertake a participatory process to address the current ad hoc approach to urban management by developing an urban planning and management strategy. The latest loan on Economic and Public Sector Reform was completed successfully in 2004. Another TA on strengthening pro-poor policy in the Pacific for Tonga for \$0.2 million is being implemented on a regional basis to support economic sector work and is not counted as country TA.

There was no lending program for 2005. One TA was approved for 2005 to prepare an integrated urban development project, while three new TAs and one loan were discussed during the country program mission for 2006. The proposed three TAs include (i) Public Enterprises Reform Phase III for \$0.4 million, (ii) Results-Based Management – Implementation of Strategic Development Plan Eight for \$0.55 million, and (iii) Population and Services Delivery for \$0.1 million. The planned loan was proposed under Urban Sector Basic Social Infrastructure for \$5 million. All these projects will be contingent upon confirmation with the government during country program confirmation mission in 2006.

²⁰ Prepared by Asian Development Bank staff.

Tonga: Loan and Technical Assistance Approvals, 2001–05

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|--------------------------------------|------|------|------|------|------|
| Loan approvals | | | | | |
| Number | 0 | 1 | 0 | 0 | 0 |
| Amount (in millions of U.S. dollars) | 0 | 10 | 0 | 0 | 0 |
| Technical assistance approvals | | | | | |
| Number | 1 | 1 | 3 | 3 | 1 |
| Amount (in millions of U.S. dollars) | 0.7 | 0.7 | 0.9 | 0.7 | 0.7 |

TONGA: STATISTICAL ISSUES

While economic statistics are broadly adequate for surveillance, data deficiencies continue to hamper economic analysis and policy formulation. The Statistics Department (SD) and the Ministry of Finance (MOF) have received, on a regular basis, technical assistance in national accounts, government finance, and BOP statistics from the Pacific Financial Technical Assistance Centre (PFTAC). The authorities, however, continue to report statistical data to the Fund with long lags.

The two main sources of statistical information are the Quarterly Bulletin of the National Reserve Bank of Tonga (NRBT), and the annual and semi-annual budget reports from the MOF. STA is currently reviewing the country's metadata to be posted on the IMF Data Standards Bulletin Board in the near future.

National Accounts and Prices Statistics

The national accounts estimates are mainly based on the production approach and only rough estimates are available on the expenditure components of GDP. The SD has completed the revision of the gross domestic product (GDP) figures with a new base period (2000/01), based on the results of a business establishment survey. This was done with the technical support and assistance from the Secretariat for the Pacific Community. However, there were still large inconsistencies in the data, especially for the agriculture, fishing and forestry, commerce, and hotels and restaurants sectors. These inconsistencies are related to differences in the estimated sectoral growth rates based on existing source data and the partial indicators used to derive sectoral value added. In August 2004, at the request of the Minister of Finance, PFTAC reviewed the system of national accounts, including the methodologies used in compiling the production-based estimates, expenditure on GDP, and the income-based estimates of GDP. The PFTAC mission made recommendations, including on ways to improve data sources and methodologies and to revise estimates of GDP for recent years.

The current Consumer Price Index is based on a basket of goods and services derived from the 1992/93 Household Income and Expenditure Survey. It has been recently rebased to November 2002, with PFTAC's assistance.

Government Finance Statistics

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 the fiscal data are accurate and reliable. Proper classification of transactions is needed to permit reconciliation with other available information (in particular, on domestic and external debt). The existing lags in updating the accounting system with recent information on government transactions need to be shortened. There are large discrepancies between budgetary figures from above and below the line and poor cross-checking with the monetary survey. Published data often are subject to large revisions.

Balance of Payments Statistics

Official BOP figures are compiled by the SD with long lags and are available only on an annual basis. Monthly trade figures derived from customs documents are available with a three-month lag. The NRBT compiles unofficial monthly BOP statistics based on the Overseas Exchange Transactions records of the banking system with a six-week lag. There are significant differences between the BOP estimates compiled by the two agencies. Moreover, large errors and omissions suggest possible under recording of imports. Work is needed to reconcile the data on stocks of reserve assets that are available from various data sources.

The MOF has put in place a system that provides detailed information on official sector external disbursements and debt service.

Monetary and Financial Statistics

Monetary data are reported to STA in a timely fashion and are shared with APD through an Integrated Database. In response to STA's request, the authorities submitted test data that were compiled using the new Standardized Report Forms (SRFs). These data have been approved for publication in the forthcoming *IFS Supplement*.

Tonga: Table of Common Indicators Required for Surveillance
(As of May 15, 2006)

| | Date of latest observation | Date received | Frequency of Data ⁶ | Frequency of Reporting ⁶ | Frequency of publication ⁶ |
|---|----------------------------|---------------|--------------------------------|-------------------------------------|---------------------------------------|
| Exchange Rates | 3/2006 | 5/2006 | Monthly | Monthly | Monthly |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹ | 3/2006 | 5/2006 | Monthly | Monthly | Monthly |
| Reserve/Base Money | 3/2006 | 5/2006 | Monthly | Monthly | Monthly |
| Broad Money | 3/2006 | 5/2006 | Monthly | Monthly | Monthly |
| Central Bank Balance Sheet | 3/2006 | 5/2006 | Annually | Annually | Annually |
| Consolidated Balance Sheet of the Banking System | 3/2006 | 5/2006 | Monthly | Monthly | Monthly |
| Interest Rates ² | 3/2006 | 5/2006 | Monthly | Monthly | Monthly |
| Consumer Price Index | 2/2006 | 4/2006 | Monthly | Monthly | Monthly |
| Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴ | NA | NA | NA | NA | NA |
| Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government | 3/2006 | 4/2006 | Monthly | Quarterly | Quarterly |
| Stocks of Central Government and Central Government-Guaranteed Debt ⁵ | 6/2005 | 1/2006 | Annual | Annual | Annual |
| External Current Account Balance | Q4/2005 | 4/2006 | Quarterly | Quarterly | Quarterly |
| Exports and Imports of Goods and Services | Q4/2005 | 4/2006 | Quarterly | Quarterly | Quarterly |
| GDP/GNP | 2004/05 | 1/2006 | Annually | Annually | Annually |
| Gross External Debt | 6/2005 | 1/2006 | Annually | Annually | Annually |

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

TONGA: MILLENNIUM DEVELOPMENT GOALS

| | 1990 | 1995 | 2000 | 2002 | 2004 | 2005 |
|--|--|------|-------|-------|-------|------|
| 1 Eradicate extreme poverty and hunger | <i>2015 target = halve 1990 \$1 a day poverty and malnutrition rates</i> | | | | | |
| Population below \$1 a day (in percent) | .. | .. | .. | .. | .. | .. |
| Poverty gap at \$1 a day (in percent) | .. | .. | .. | .. | .. | .. |
| Percentage share of income or consumption held by poorest 20 percent | .. | .. | .. | .. | .. | .. |
| Prevalence of child malnutrition (percent of children under 5) | .. | .. | .. | .. | .. | .. |
| Population below minimum level of dietary energy consumption (percent) | .. | .. | .. | .. | .. | .. |
| 2 Achieve universal primary education | <i>2015 target = net enrollment to 100</i> | | | | | |
| Net primary enrollment ratio (in percent of relevant age group) | .. | .. | 90.9 | .. | 97.9 | .. |
| Percentage of cohort reaching grade 5 (in percent) | .. | .. | 92.5 | .. | .. | .. |
| Youth literacy rate (percent ages 15–24) | .. | .. | .. | .. | 99.3 | .. |
| 3 Promote gender equality | <i>2005 target = education ratio to 100</i> | | | | | |
| Ratio of girls to boys in primary and secondary education (percent) | 99.9 | .. | 102.7 | 103.9 | .. | .. |
| Ratio of young literate females to males (percent ages 15–24) | .. | .. | .. | .. | 100.1 | .. |
| Proportion of seats held by women in national parliament (in percent) | 0.0 | .. | 0.0 | 0.0 | .. | 3.4 |
| 4 Reduce child mortality | <i>2015 target = reduce 1990 under 5 mortality by two-thirds</i> | | | | | |
| Under 5 mortality rate (per 1,000) | 32.0 | 29.3 | 26.4 | .. | 24.5 | .. |
| Infant mortality rate (per 1,000 live births) | 26.5 | 24.3 | 22.1 | .. | 20.4 | .. |
| Immunization, measles (percent of children under 12 months) | 86.0 | 94.0 | 95.0 | 90.0 | 99.0 | .. |
| 5 Improve maternal health | <i>2015 target = reduce 1990 maternal mortality by three-fourths</i> | | | | | |
| Births attended by skilled health staff (percent of total) | 92 | .. | 95 | .. | .. | .. |
| 6 Combat HIV/AIDS, malaria and other diseases | <i>2015 target = halt, and begin to reverse, AIDS, etc.</i> | | | | | |
| Prevalence of HIV, female (% ages 15–24) | .. | .. | .. | .. | .. | .. |
| Incidence of tuberculosis (per 100,000 people) | 51.9 | .. | .. | .. | 28.4 | .. |
| Tuberculosis cases detected under DOTS (percent) | .. | 49.3 | 98.5 | 163.0 | .. | .. |
| 7 Ensure environmental sustainability | <i>2015 target = various (see notes)</i> | | | | | |
| Forest area (percent of total land area) | 5.6 | .. | 5.6 | .. | .. | 5.6 |
| Nationally protected areas (percent of total land area) | .. | .. | 1.1 | 5.1 | .. | .. |
| CO2 emissions (metric tons per capita) | 0.8 | 1.1 | 1.2 | 1.0 | .. | .. |
| Access to an improved water source (percent of population) | .. | .. | .. | 100 | .. | .. |
| 8 Develop a Global Partnership for Development | <i>2015 target = various (see notes)</i> | | | | | |
| Fixed line and mobile telephones (per 1,000 people) | 46.4 | 71.3 | 98.6 | 143.8 | .. | .. |
| Personal computers (per 1,000 people) | .. | 6.1 | 13.0 | 19.7 | 49.0 | .. |

Source: World Development Indicators database, May 2006.

Note: In some cases the data are for earlier or later years than those stated.

Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.

Goal 8 targets: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.



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IMF Executive Board Concludes 2006 Article IV Consultation with Tonga

On June 2, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.¹

Background

According to preliminary information, the economy is expected to expand at a slower pace in 2005/06 than the estimated 2½ percent gain in 2004/05 (fiscal year July-June), reflecting a poor squash season and slower growth in construction. Inflation declined to 9½ percent in 2004/05 compared to about 11½ percent in the previous year, and has since eased further to 5¼ percent during the year to February 2006, reflecting lower domestic food and import price increases. A fiscal surplus of about 2½ of GDP was achieved in 2004/05, in marked contrast to the deficit of 2¼ percent of GDP envisaged in the budget, owing to lower-than-budgeted wages and capital spending, and stronger tax collection. Net domestic credit grew by 21 percent in 2004/05, mainly driven by a rapid rise in housing and personal loans. To rein in this rapid credit expansion, the National Reserve Bank of Tonga (NRBT) reintroduced credit ceilings in January 2006. However, with liquidity conditions tightening in the banking system, pressure on the central bank to ease its monetary stance mounted, and reserve requirements were reduced in March.

In 2005/06, the original budget targeted a deficit of 1.8 percent of GDP, mostly covered by external concessional financing. However, available information for the first eight months of 2005/06 indicates that revenue performance was weaker than expected, mainly because of lower nontax and excise collection. Moreover, following a lengthy strike, civil servants were granted in

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.

September 2005 average wage increases of about 70 percent. The salary increase will be paid over two years: 60 percent in 2005/06 and 40 percent in 2006/07. The unanticipated cost of the first phase of the wage increase is estimated to be about 3 percent of GDP. Savings have been carried out (mostly capital expenditure cuts and a hiring freeze) that are expected to more than offset this cost as well as the likely revenue shortfall. The authorities are also working on downsizing the civil service by a quarter by the end of the fiscal year, to be achieved by targeted and voluntary redundancies, and the related severance payments could amount to about 5 percent of GDP.

The trade balance deteriorated in 2004/05, as imports expanded on the back of strong domestic demand, more than offsetting a rebound in exports. Despite a continued increase in remittances, the current account shifted into a deficit. The capital account surplus declined from its record high in 2003/04, as private capital inflows returned to a more normal level. Gross international reserves fell to 3¾ months of current year's imports of goods and services. The pa'anga has remained stable relative to its basket since 2004. Given the high inflation in Tonga relative to its main trading partners, this development translated into a real appreciation of the Tongan currency of about 11 percent (January 2004–February 2006).

Short-term economic prospects are highly uncertain and depend critically on the authorities achieving the proposed substantial downsizing of the civil service. The swing in the fiscal position from surplus to deficit is expected to contribute to a widening of the current account deficit in 2005/06. Only if an expected government asset sale to foreign investors is completed, will there be sufficient financing to maintain the reserve position, keep the exchange rate broadly stable, and prevent major inflationary pressures from emerging. In 2006/07, economic activity would be adversely affected by the proposed civil service downsizing. The payment of the severance package would cushion this effect somewhat, although it could also put pressure on reserves and the exchange rate.

Executive Board Assessment

Executive Directors expressed concern about the deterioration in the economic outlook since the last Article IV consultation. They regretted that the large civil service wage increase in September 2005 marked a departure from the prudent fiscal policy that had been followed over the past years, and underscored that the increase could have significant negative consequences for macroeconomic and external stability.

Against this background, Directors considered that Tonga's economic prospects were highly uncertain and depended on the authorities' ability to manage the impact of the wage settlement. They urged the authorities to follow through on their stated intentions to contain the costs of the wage settlement, and push ahead with key reforms to safeguard macroeconomic stability, improve governance, and enhance the role of the private sector.

Directors welcomed the authorities' commitment to fiscal adjustment, and stressed that more sustainable fiscal measures were required. In this regard, they noted the ambitious plan formulated by the authorities to bring the civil service down to a more appropriate size, based on targeted and voluntary redundancies. Directors also noted, however, that the scale of the

envisaged downsizing was unprecedented, and cautioned that alternative measures may need to be considered, should the proposed plan not materialize as expected.

Directors called on the authorities to push ahead with other fiscal reforms. They stressed that strengthening the legal framework and capacity for tax enforcement would be critical to offset the revenue decline in trade taxes expected from Tonga's accession to the WTO. Directors added that a fully operationalized accounting system, including its rollout to all ministries, would be critical to improve public expenditure management. The introduction of a medium-term budget framework signaling the authorities' commitment to a sustainable fiscal policy would help foster donor support. In addition, Directors emphasized that the pace of public enterprise reform should be accelerated and, in particular, that the government should not renationalize the power sector.

Directors welcomed the authorities' resolve to further tighten monetary policy in response to the wage settlement, and utilize the full flexibility of the exchange rate system, if needed. In this regard, the introduction of open-market type instruments was seen as a useful step to improve the central bank's control over monetary developments. Directors noted, however, that these new instruments remained untested, and that the central bank might also need to rely on its more rudimentary credit ceilings in the near term.

Directors noted that indicators of banking soundness had improved, although the recent rapid expansion of credit was of some concern. In this regard, Directors encouraged the authorities to continue to monitor closely credit developments to avoid a deterioration in asset quality. They also called for an early enactment of the Amendments to the NRBT Act to strengthen central bank independence. The authorities were encouraged to build on the progress made in the area of Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT) to address the remaining issues.

Directors agreed on the need to create a more dynamic private sector in order to foster higher growth. In this context, they supported the authorities' decision to establish a public-private sector task force to identify and reduce critical impediments to private sector development. In particular, Directors called on the authorities to improve the business and investment climate by repealing distortionary tax incentives, reducing restrictions on business licensing and foreign direct investment, and strengthening the legal framework for securing property rights.

Directors encouraged the authorities to improve the reliability, coverage, and timeliness of statistics to strengthen economic analysis and assist the authorities in conducting policies and implementing reforms.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with Tonga is also available.

Tonga: Selected Economic Indicators, 2001/02–2006/07 1/

| | 2001/02 | 2002/03 | Prel. 2003/04 | Prel. 2004/05 | Proj. 2005/06 | Proj. 2006/07 |
|--|---------|---------|------------------|------------------|------------------|------------------|
| Output and prices (in percent change) | | | | | | |
| Real GDP | 3.0 | 3.2 | 1.4 | 2.3 | 1.9 | 0.6 |
| Consumer prices (period average) | 10.4 | 11.1 | 11.7 | 9.5 | 7.2 | 10.3 |
| Central government finance (in percent of GDP) | | | | | | |
| Total revenue and grants | 30.6 | 28.4 | 29.9 | 29.1 | 29.4 | 29.0 |
| Total expenditure and net lending | 32.2 | 31.4 | 29.0 | 26.7 | 36.1 | 30.5 |
| Overall balance | -1.5 | -3.0 | 0.9 | 2.4 | -6.7 | -1.5 |
| External financing (net) | 4.5 | 1.4 | 2.9 | 0.4 | 1.8 | 1.3 |
| Domestic financing (net) | -2.9 | 1.6 | -3.8 | -2.8 | 0.5 | 0.2 |
| Privatization receipt | 0.0 | 0.0 | 0.0 | 0.0 | 4.4 | 0.0 |
| Money and credit (in percent change) | | | | | | |
| Total liquidity 2/ | 9.7 | 18.2 | 16.7 | 13.3 | 14.1 | 10.7 |
| Of which: Broad money (M2) | 8.4 | 13.6 | 18.9 | 12.8 | 14.6 | 10.9 |
| Domestic credit | 8.2 | 18.8 | -10.9 | 20.9 | 18.7 | 14.5 |
| Private sector credit | 14.6 | 12.7 | -4.3 | 29.4 | 17.0 | 13.3 |
| Balance of payments (in millions of U.S. dollars) | | | | | | |
| Exports, f.o.b. | 17.8 | 17.6 | 13.8 | 16.0 | 15.9 | 16.9 |
| Imports, f.o.b. | -61.3 | -74.2 | -82.8 | -105.4 | -114.0 | -122.2 |
| Services (net) | -1.9 | -5.4 | -2.9 | -10.5 | -6.1 | -2.9 |
| Income (net) | -0.5 | -1.5 | -0.4 | -2.3 | 0.4 | 0.4 |
| Services and income (net) | -2.4 | -6.9 | -3.2 | -12.8 | -5.7 | -2.5 |
| Transfers (net) | 53.2 | 58.7 | 79.8 | 91.9 | 89.9 | 95.4 |
| Current account balance | 7.2 | -4.9 | 7.7 | -10.3 | -13.8 | -12.3 |
| (In percent of GDP) | 5.1 | -3.1 | 4.2 | -4.8 | -6.2 | -5.2 |
| Gross international reserves | | | | | | |
| In millions of US dollars | 18.4 | 17.2 | 44.8 | 42.5 | 45.0 | 39.5 |
| In months of total imports | 2.8 | 2.0 | 4.8 | 3.7 | 3.7 | 3.0 |
| External debt (in percent) | | | | | | |
| External debt (in percent of GDP) | 43.0 | 41.8 | 41.4 | 35.5 | 35.7 | 34.7 |
| Debt service ratio 3/ | 4.6 | 6.0 | 8.7 | 8.4 | 7.1 | 8.0 |
| Exchange rate (period average) | | | | | | |
| Pa'anga per U.S. dollar | 2.2 | 2.2 | 2.0 | 1.9 | ... | ... |
| Real effective exchange rate (1990=100) | 93.1 | 89.9 | 93.7 | 100.2 | ... | ... |
| Nominal effective exchange rate (1990=100) | 84.5 | 75.2 | 71.4 | 71.1 | ... | ... |

Sources: The Tongan authorities; IMF staff estimates and projections.

1/ Fiscal year beginning July.

2/ From the *Banking Survey*, which includes the Tonga Development Bank.

3/ In percent of exports of goods and services.