



Tonga

2011 ARTICLE IV CONSULTATION COVER

Tonga: 2011 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Alternate Executive Director for Tonga

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2011 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 29, 2011, 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 April 20, 2011. 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 supplement on the Joint IMF/World Bank Debt Sustainability Analysis
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 4, 2011 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Alternate Executive Director for Tonga.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: <http://www.imf.org>

**International Monetary Fund
Washington, D.C.**



TONGA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

April 20, 2011

KEY ISSUES

Overall setting: The economy is recovering from the effects of the global financial crisis, the domestic credit crunch, and adverse weather-related shocks. The risks to the outlook are on the downside. Macroeconomic policies need to focus on restoring the room for countercyclical policies, reducing the risks to Tonga's external and fiscal sustainability, and laying the foundations for higher potential growth.

Growth and inflation prospects: GDP growth is estimated to rebound to 1¼ percent in FY2010/11 on the back of stronger tourism activity and an expansionary fiscal policy financed by donor aid and previously contracted loans. Risks to the outlook are on the downside and relate to commodity prices, global growth, and Tonga's high public debt. Inflation will likely pick up but remain below 2007/08 levels.

Fiscal policy: The near-term fiscal stance should give priority to mitigating the risks to Tonga's fiscal sustainability. There is a need to prioritize expenditure and better align planned spending cuts with the government medium-term development objectives. This needs to be done in the context of a broader medium-term fiscal strategy aimed at achieving a primary surplus of 1 percent of GDP and avoiding new borrowing.

Monetary policy: NRBT should maintain its current stance given ample liquidity in the banking system, but should stand ready to tighten if inflation pressure from domestic sources or downward pressures on reserves materialize.

Structural reform: Reforms are needed to raise Tonga's medium-term growth prospects and reduce the country's vulnerability to shocks. Reforms should focus on improving the business environment and the institutional framework for secured lending.

Approved By
**Vivek Arora and
Thomas Dorsey**

Discussions took place in Nuku’Alofa on March 16–29, 2011. The staff team comprised P. N’Diaye (Head), N. Geng (APD), J. Matz (STA), and Y. Yang (Resident Representative). Ms. Budiman and Ms. Yeo (both OED), Ms. Horscroft (World Bank) and Messrs. Faletau and Tora (both World Bank and Asian Development Bank) joined the mission.

CONTENTS

INTRODUCTION	3
RECENT DEVELOPMENTS	3
OUTLOOK AND RISKS	5
POLICY DISCUSSIONS	6
STAFF APPRAISAL	20

Boxes

1. EXCHANGE RATE ASSESSMENT	12
2. THE INTEREST RATE CHANNEL OF THE MONETARY POLICY TRANSMISSION IN TONGA	13
3. BANK INTEREST RATES AND PROFITABILITY IN TONGA	15
4. MEDIUM-TERM BUDGET FRAMEWORK	18

Figures

1. ECONOMIC DEVELOPMENTS	4
2. EXCHANGE RATE AND FISCAL POLICY DEVELOPMENTS	8
3. MONETARY POLICY AND FINANCIAL SECTOR DEVELOPMENTS	11

Tables

1. SELECTED ECONOMIC INDICATORS	22
2. SUMMARY OF GOVERNMENT OPERATIONS	23
3. DEPOSITORY CORPORATIONS SURVEY	24
4. BALANCE OF PAYMENTS SUMMARY	25
5. MEDIUM-TERM SCENARIO	26
6. FINANCIAL SOUNDNESS INDICATORS	27
7. MILLENNIUM DEVELOPMENT GOALS	28

Appendix

I. DRAFT PUBLIC INFORMATION NOTICE	29
------------------------------------	----

INTRODUCTION

1. Context. The recession that began in 2008/09 continued in 2010 with declines in tourism, remittances, and exports. Financial conditions remained tight as banks raised lending standards following a large rise in nonperforming loans. In recent months, activity has bottomed out as growth has been supported by a recovery in tourism and expansionary fiscal policy financed by donor aid. Growth is likely to rise to 1¼ percent in FY2010/11 (year ending June) and to 1¾ percent in FY2011/12 and the medium term. Limited private

sector development, geographical isolation, and high public debt are key constraints to faster growth.

2. With the economy on the path to recovery, the time is right to focus on reducing the country's vulnerabilities and addressing the constraints to growth. Policies need to focus on restoring the room for countercyclical macroeconomic policies, reducing the risks to Tonga's external and fiscal sustainability, and laying the foundations for higher potential growth.

RECENT DEVELOPMENTS

3. Activity. GDP continued to contract in FY2009/10 (year ending June) as financial conditions remained tight and tourism and remittances inflows declined with the weak global economy, particularly the United States, Australia, and New Zealand—Tonga's main trading partners and sources of remittances and tourist activity.

4. Inflation. CPI inflation averaged 2 percent in 2009/10 and rose to 6½ percent y/y in February 2011, reflecting mainly rising global food and oil prices, higher excises on tobacco and alcohol, and a modest depreciation of the pa'anga against the New Zealand dollar. (New Zealand is a key source of imports.)

5. External position. The current account deficit narrowed to 7.8 percent of GDP in FY2009/10 as weak economic activity lowered imports while stepped up grants from donors

Key Macroeconomic Indicators			
	2007/08	2008/09	2009/10
Growth (percent)	2.0	-0.1	-0.5
Inflation (percent)	9.8	5.0	2.0
Current account (percent of GDP)	-8.9	-14.7	-7.8
Gross reserves (US\$ millions)	48.2	67.7	88.7
(in months of imports)	3.2	4.7	7.1
Real effective exchange rate (+ = appreciation)	2.1	6.3	0.0

increased transfers. Reserves have risen to near seven months of imports as of end-February 2011

6. Politics. In November 2010, Tonga held its first parliamentary elections under which a majority of seats were popularly elected. The elections led to a major cabinet reshuffle with the appointment of a new prime minister and government. The new government's main policy priorities are to pursue structural reforms to promote private sector activity and restore fiscal sustainability.

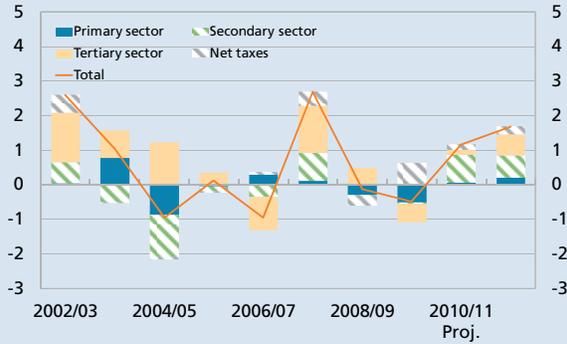
Figure 1 Tonga: Economic Developments

After two years of contraction, Tonga's economy is expected to expand in FY2010/11.

Growth is expected to be supported by strong construction and tourism activity.

Real GDP Product by Sector

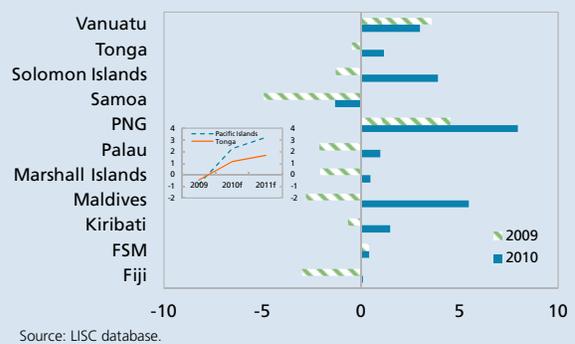
(Annual percent change, contributions to total)



The recovery is projected to be weaker than regional comparators.

Change in Real GDP

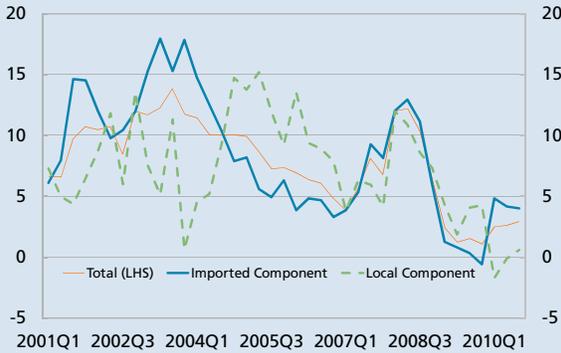
(In percent)



Inflation has picked up somewhat, mostly owing to one-off factors...

Inflation

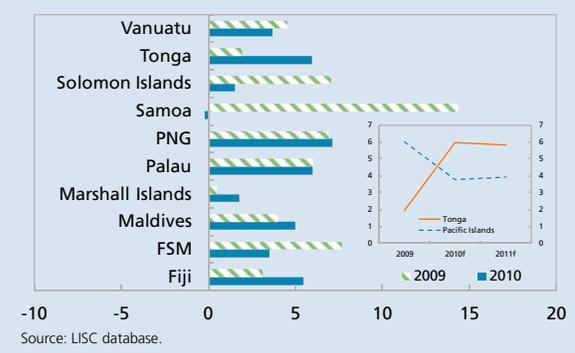
(Annual percent change)



...expected to rise above the average of Pacific islands

Consumer Price

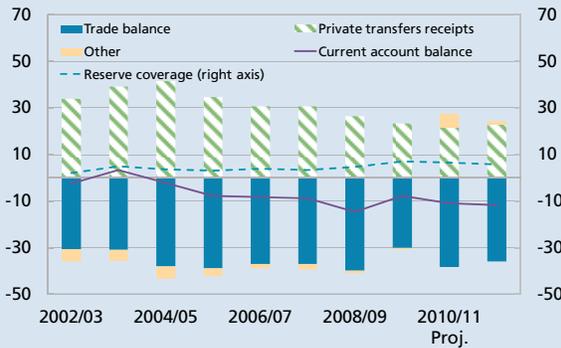
(Percent change, year-on-year)



Weak imports and significant grant inflows helped narrow the trade and current account deficits...

Balance of Payments

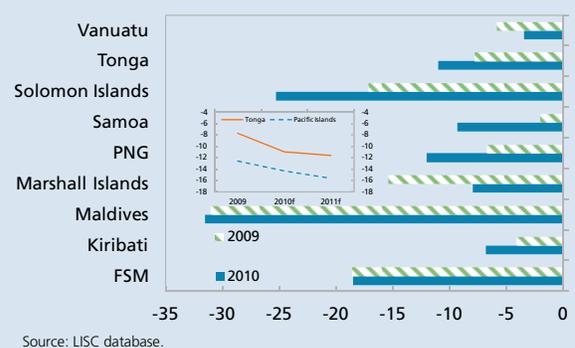
(In percent of GDP)



...below the average of Pacific islands.

Current Account Balance

(In percent of GDP)

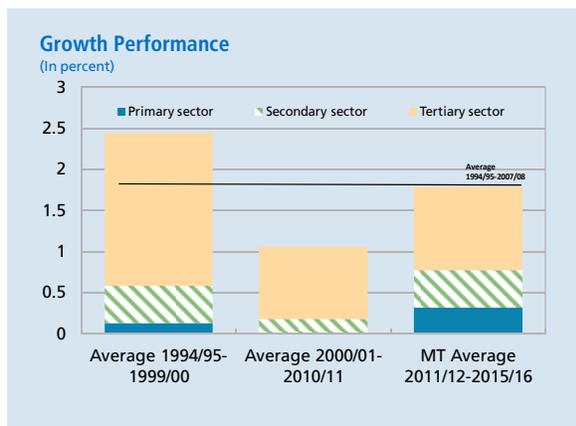


Sources: CEIC Data Company Ltd.; and Fund staff estimates.

OUTLOOK AND RISKS

Staff Views

7. Outlook. Growth is projected to recover to 1¼ percent in FY2010/11 on the back of stronger tourism activity and construction, as donor aid and previously contracted loans financed a fiscal expansion. However, this growth momentum is limited by continued domestic tight lending standards following the large rise in nonperforming loans over the past two years. Inflation will likely rise to around 6 percent, reflecting higher global fuel and other commodity prices, particularly food. Over the medium term, growth is expected to remain at around 1¾ percent—in line with the average of the past 15 years but about ¾ percentage points above the average of the past 10 years. This medium-term outlook assumes implementation of the government’s plans, including stepped up capital spending, structural reform, improved fiscal management to support fiscal consolidation, as well as continued high emigration. Growth is expected to be mainly driven by tourism and agriculture, consistent with medium-term development priorities.



8. Risks. A protracted rise in world commodity and food prices would hit Tonga’s economy hard, feeding through to inflation, growth, and the current account deficit. At the same time, if global growth falters, remittances, tourism, and exports could be hit, weakening economic activity and threatening reserves. In addition, Tonga’s high public debt leaves the country highly vulnerable to shocks and poses a risk to economic prospects. This, together with the limited effectiveness of monetary policy in the face of banks’ cautious approach to lending, means that Tonga would have little room to implement countercyclical macroeconomic policies if downside risks materialize. Mitigating the risks will necessitate further progress on structural reforms to raise growth potential, continued grants provision from donors, as well as steady fiscal consolidation.

Authorities’ Views

9. The authorities felt that the staff forecast for this year’s GDP growth was somewhat optimistic. The ministry of finance was expecting growth to remain negative in FY2010/11 at around -0.5 percent, as much of the the construction activity had little domestic impact. The construction materials are imported and there is little hiring of local workers. However, the ministry of finance indicated it is currently reviewing its growth forecast based on the statistics department’s revised historical national accounts, which show a higher contribution to

growth from current construction projects and include improved information on their execution, including related activity in the mining and quarrying industry and the treatment of Chinese workers brought in as part of the reconstruction program financed by China EXIM Bank. On inflation, the authorities shared the staff views, with the National Reserve Bank expecting CPI

inflation to reach 5¾ percent in FY2010/11 and ease to 4¼ percent in FY2011/12.

10. The authorities shared the staff assessment of the risks to the outlook. They emphasized the risks higher energy and food prices could pose to inflation, including through second round effects.

POLICY DISCUSSIONS

In FY2010/11, macroeconomic policies have remained loose to counter the effects of the global financial crisis, the credit crunch resulting from banks' attempts to restore the health of their balance sheets, and adverse weather-related shocks. With activity poised to recover and inflation projected to rise, macroeconomic policies need to focus on restoring the room for countercyclical policies, reducing the risks to Tonga's external and fiscal sustainability, and laying the foundations for higher potential growth.

A. Restoring Room for Countercyclical Macroeconomic Policies

Fiscal Policy—Advancing Fiscal Consolidation and Increasing Transparency

Background

11. In FY2010/11, stepped-up capital expenditure mainly financed by previously contracted loans, helped to offset weaknesses in private demand. At the same time, generous grant inflows from donors during FY2010/11 contributed to narrowing the fiscal deficit to an estimated 4¼ percent of GDP, (from about 5¾ percent of GDP in FY2009/10).

12. Despite the improvement in the fiscal position, Tonga's economy remains vulnerable to shocks. Tonga remains at a "high risk of debt

distress" according to this year's World Bank-IMF debt sustainability analysis (supplement to this report). Therefore, the near-term fiscal stance should give priority to mitigating the risks to Tonga's fiscal sustainability and create room to respond to future shocks. Reducing the country's vulnerabilities will require avoiding new borrowing, reducing current spending, a careful prioritization of spending, improving tax administration, and improving transparency. Notwithstanding these measures, the staff projects the overall deficit (including grants) to widen to around 5¼ percent of GDP in FY2011/12 as capital spending projects—financed through loans contracted during previous years—are rolled out and grants return to lower

levels. The primary deficit is expected to reach 4¼ percent of GDP.

Staff Views

13. The government's focus on reducing current spending is appropriate and will be key to a successful fiscal consolidation. The planned capital expenditure in FY2011/12 is needed, and the previously contracted loans do not add to current financing problems. At the same time, the government's plan to maintain the partial new hiring freeze in FY2011/12 at the level of the general government should help reduce wage pressure. However, limiting the deficit to 5¼ percent of GDP will require maintaining the wage bill at its 2010/11 level as the rapid rise in the wage bill since the 2006/07 redundancy program is hampering the provision of core public services and crowding out resources devoted to productive programs and social services provision. In addition, it is important for the salary structure of civil servants to adequately reflect performance and contribute to increasing service efficiency. The current performance-based system has only two ratings ("performing" vs. "nonperforming"), does not reflect the actual distribution of staff performance, and introduces an automatic annual increase of around 4 percent in the wage bill.

14. The reduction in spending will need to be accompanied by a careful prioritization of expenditures. Spending plans need to be aligned with the development priorities laid out in the National Strategy Planning Framework (NSPF) (see

below) and to ensure that line ministries adhere to budget plans and targets.

15. Improving revenue administration and collection will provide fiscal space for the delivery of core public services and promote fiscal consolidation. Improving revenue administration will require ensuring the proper classification and valuation of goods at customs, increasing compliance through the use of the unique tax identification number recently assigned to corporate taxpayers, and increased training of customs officers. In addition, with the introduction of self-assessment, completing the automation of customs processing will provide resources to strengthen auditing and tax collection. At the same time, improving revenue collection will also require expanding the tax base by streamlining tax exemptions. For better transparency and fiscal control, exemptions could be replaced by transfers and explicitly brought into the budget.

16. Further enhancing transparency in the government fiscal accounts will help secure donor financial support and alleviate the burden of adjustment that lies on the government's accounts. Steps toward increased transparency in fiscal accounts in the context of the Tonga Energy Road Map program, which aim to increase Tonga's use of renewable energy and energy efficiency, are appropriate and could apply to other fiscal activities. Greater details on the composition and distribution across line ministries of expenditure and revenue could be included in the budget papers for the upcoming fiscal year.

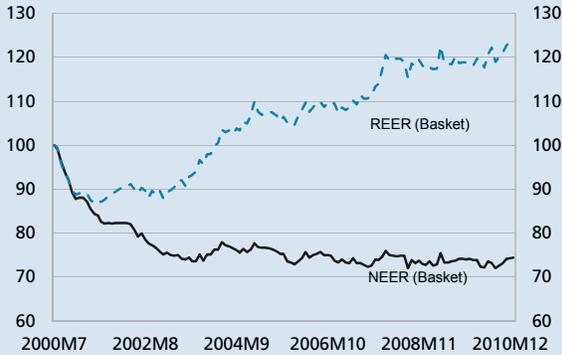
Figure 2 Tonga: Exchange Rate and Fiscal Policy Developments

The pa'anga has been broadly stable in real terms against the basket and the fiscal position improved.

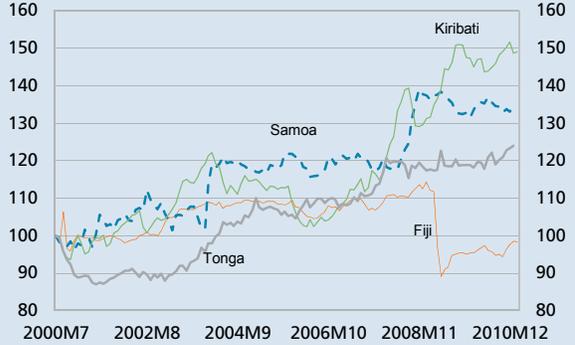
The nominal exchange rate also remained stable.

Tonga has maintained some competitiveness relative to other Pacific islands.

Effective Exchange Rates



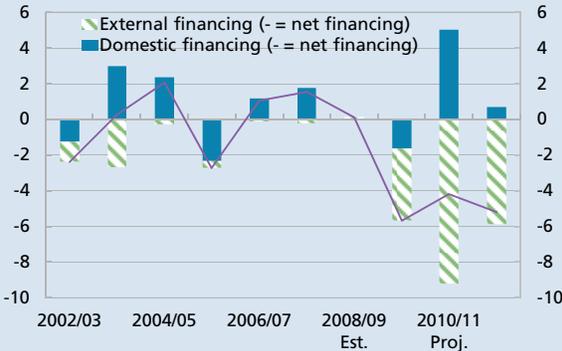
New Effective Exchange Rates, 2000-11
(Index July 2000=100)



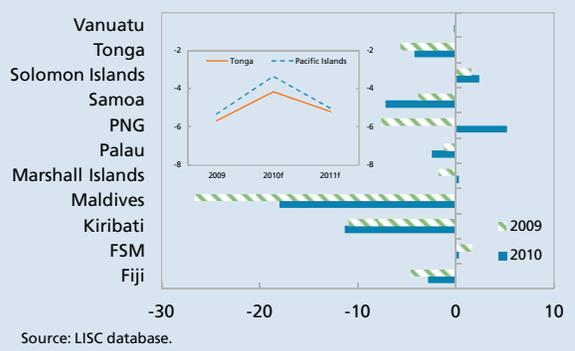
The fiscal balance is expected to deteriorate next year as infrastructure projects are rolled out...

...bringing the deficit back in line with the average of Pacific islands.

Fiscal Balance
(In percent of GDP)



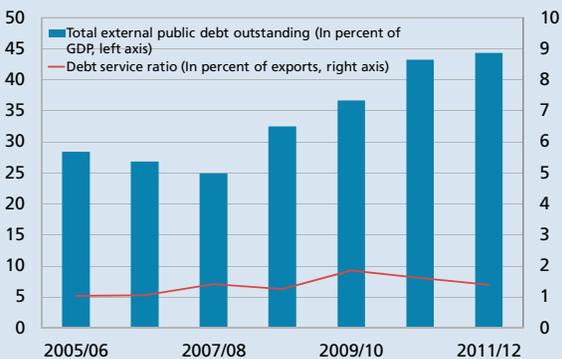
Government Overall Balance
(In percent of GDP)



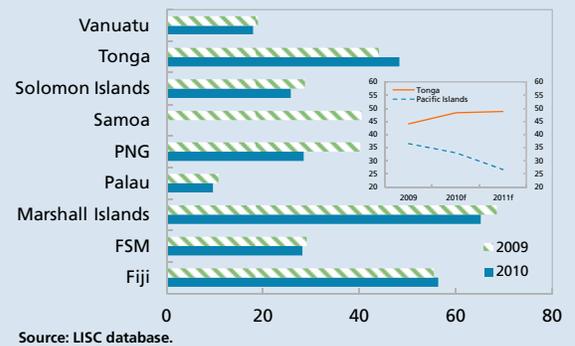
Tonga's high public debt continued to rise...

...putting the country in a more vulnerable situation than most Pacific islands.

Public Debt



Total Government Debt
(In percent of GDP)



Sources: CEIC Data Company Ltd.; and Fund staff estimates.

Authorities' Views

17. The authorities saw the task ahead as challenging, but were confident progress will be made. The authorities broadly agreed with staff recommendations. They noted the government commitment to maintaining the wage bill in FY2011/12 at its FY2010/11 level, but recognized it will be difficult. The authorities felt that the progress made in setting up a medium-term budgeting framework, especially with regard to the collaboration between the ministry of finance, line ministries, and the public service commission, would facilitate a prioritization of expenditure in line with the objectives set in the NSPF. In addition, they noted that the current performance-based system would be replaced during FY2011/12 with a 5-tiered system that allows for a better differentiation of performance and improved efficiency. With regard to revenue administration and collection, the authorities consider there is room for improvement and significant gains could be achieved through a better training of customs officers in assessing the value of goods and fully utilizing the new electronic system. The authorities emphasized that these efforts would be made with increased transparency in government operations. In addition, they noted the government commitment to improving the dialogue with development partners.

Monetary and Exchange Rate Policy— Maintain Current Stance and Stand Ready to Act

Background

18. Monetary policy is geared toward jumpstarting bank lending. In FY2010/11, the National Reserve Bank of Tonga (NRBT) remunerated banks' exchange settlement account balances over TOP 1 million and maintained adequate liquidity in the system. These measures contributed to slowing the pace of decline of credit to the private sector. Credit by commercial banks remains constrained, however, by banks' continued tight lending standards as they restore the health of their balance sheets and uncertainty about the economic outlook.

Staff Views

19. The staff recommended that NRBT maintain its current policy stance. With appropriate liquidity in the banking system, there is little need for further policy loosening. However, if bank lending was to normalize faster than anticipated, the existing liquidity overhang could exacerbate inflation and exert downward pressure on international reserves. Then monetary policy will need to be pre-emptively tightened through a combination of hikes in interest rates on the NRBT repo facility, the issuance of central bank paper, and reserve requirements. At the same time, higher global commodity prices could also cause inflation to rise above, and reserves to fall below, levels expected in the baseline outlook; but if core inflation remains stable, then there would be no

need for a tightening of monetary policy. Instead, the appropriate policy response would be to further advance fiscal consolidation, while providing targeted support to the poor.

In the past, a leading indicator of pressure on reserves and domestic inflation has been a firm recovery in Tonga's main trading partners. Developments in those economies and in global commodity markets need therefore to be monitored carefully.

20. The staff assesses the exchange rate to be broadly in line with fundamentals (Box 1).

Should downward pressures on reserves emerge, however, the NRBT will need to use the flexibility afforded by the pegged exchange rate within horizontal bands arrangement to gradually depreciate the pa'anga against the basket in order to safeguard external stability. Such depreciation would need to be accompanied by further fiscal restraint given the effects a weaker currency would have on the public debt. The pegged exchange rate within horizontal bands system has served the country well. While the staff consider the current weights in the currency basket as broadly

appropriate, these weights should be reviewed occasionally and updated in order to ensure that they are consistent with changes in trade patterns and the emergence of renminbi debt.

Authorities' Views

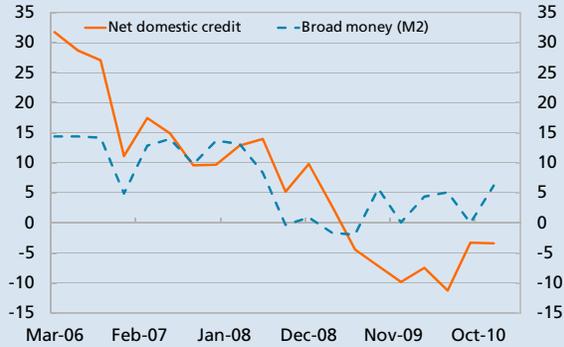
21. The authorities stand ready to act. The authorities intend to act pre-emptively to control inflation risks as well as maintain reserves levels above the NRBT comfort zone of 3–4 months of imports. In tightening monetary policy, NRBT will use all instruments at its disposal, with a greater use of direct instruments for monetary control, such as reserve requirements, given the limited impact indirect instruments have on credit growth (Box 2). NRBT agreed that downward pressure on reserves would warrant pre-emptive use of the flexibility of its current exchange rate regime to ensure external stability. The authorities are currently reviewing the conclusions of the Pacific Financial Technical Assistance Centre (PFTAC) technical assistance mission on the composition of the exchange rate basket and will introduce changes gradually so as to avoid undue volatility and disruptions in the functioning of the exchange system.

Figure 3 Tonga: Monetary Policy and Financial Sector Developments

Financial conditions remain tight as banks try to restore the health of their balance sheets.

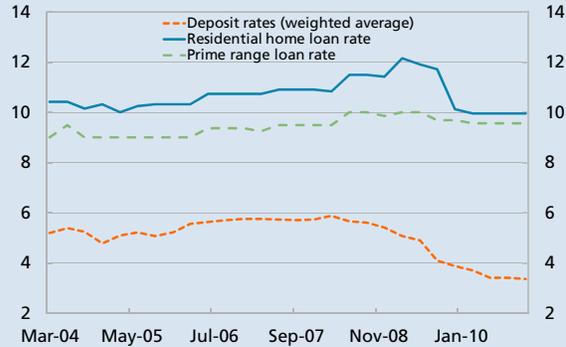
The decline in credit has slowed, but there remains ample liquidity in the system...

Net Domestic Credit and Broad Money
(In percent, year-on-year change)



...which contributed to lower lending and deposit rates. However, margins have widened.

Interest Rates
(In percent)



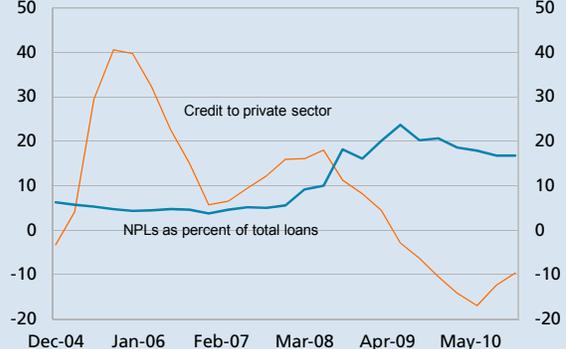
Notwithstanding NRBT's neutral stance, banks maintained tight lending standards...

Bank Lending
(In millions of pa'anga)



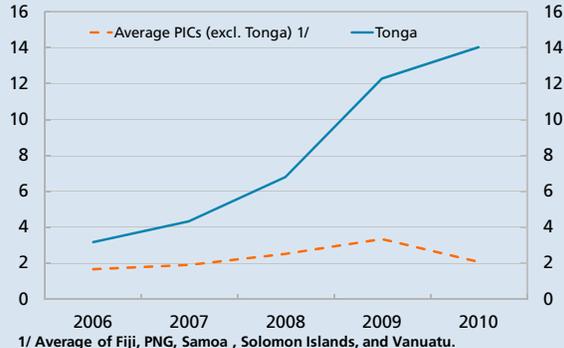
...amid high losses, but recent progress in cleaning balance sheets augurs well for credit going forward.

NPL vs Credit to Private Sector



Losses continue to rise,...

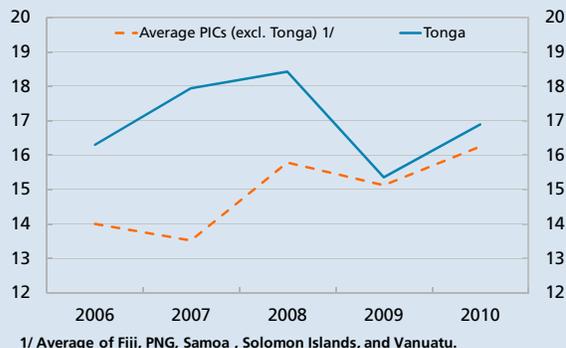
Provision Expense to Average Gross Loans
(In percent)



1/ Average of Fiji, PNG, Samoa, Solomon Islands, and Vanuatu.

...and to weigh on banks' balance sheets.

Equity to Assets
(In percent)



1/ Average of Fiji, PNG, Samoa, Solomon Islands, and Vanuatu.

Sources: CEIC Data Company Ltd.; and Fund staff estimates.

Box 1 Exchange Rate Assessment

Tonga's exchange rate is assessed to be broadly in line with levels suggested by medium-term fundamentals. This assessment is based on two standard analytical methods—the macroeconomic balance and the purchasing power parity. Other indicators also do not point to pressures from misalignment of the exchange rate.

Standard Exchange Rate Assessment Methods

The macroeconomic balance and the purchasing power parity approaches were employed based on a cross section of 184 economies, including those that rely heavily on aid and remittances.¹

- **The macroeconomic balance approach** indicates that the real exchange rate is around 10 percent above its medium-term value, with a confidence band of around -14 percent to around 40 percent. Underlying the point estimate is an estimated current account norm of around -4½ percent of GDP, which could be as low as -13½ percent of GDP in light of the important role of remittances and foreign aid.

- **The purchasing power parity approach** suggests that the real exchange rate is currently undervalued by around 5 percent.

Other Indicators

Other indicators of misalignment do not point to a large deviation of the real exchange rate from medium-term fundamentals.

- The *current account deficit* has been relatively stable in recent years, remaining around 8–9 percent in previous years. While a temporary rise in the deficit is expected in the next few years, this reflects both cyclical factors, as well as reconstruction-related imports, which are fully financed.

- *Domestic inflation* has picked up in recent months owing to one-off and global factors. However, there are no signs of sustained pressure on prices that would bring about either a change

¹ The approaches are limited by the availability of net foreign assets data.

in the real effective exchange rate. Moreover, inflation has also not been out of line with other Pacific island countries.

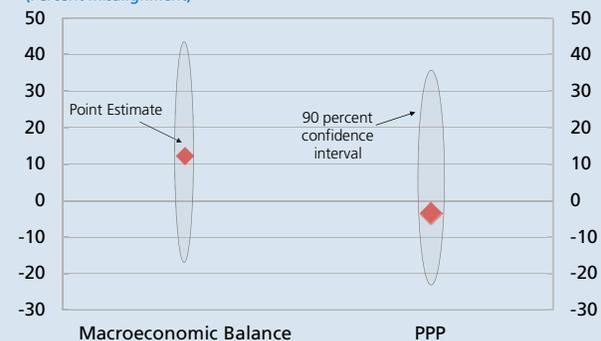
- *Foreign reserves* have been stable or rising in recent years, even after abstracting from disbursements under the EXIM Bank reconstruction loan. The NRBT intervened on both sides of the market, and was a net purchaser of foreign exchange in 2009/10, with net purchases around 10 percent of its total gross flows.

- The *number of tourists* has increased markedly in recent years. Tonga has gained market share as a tourist destination.

- *Goods market.* New export products, such as sea cucumber, have provided significant export earnings in the past year and helped offset the decline from squash export. Squash export to Japan was affected by additional supply from traditional squash exporters during Tonga's niche export period.

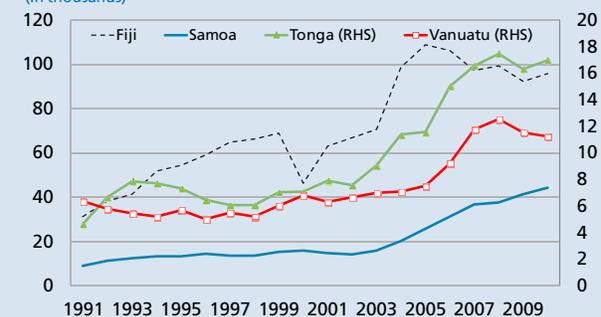
Equilibrium Real Exchange Rate Estimates

(Percent misalignment)



New Zealand Tourist to Selected Pacific Islands

(In thousands)



Source: New Zealand authorities.

Box 2 The Interest Rate Channel of the Monetary Policy Transmission in Tonga¹

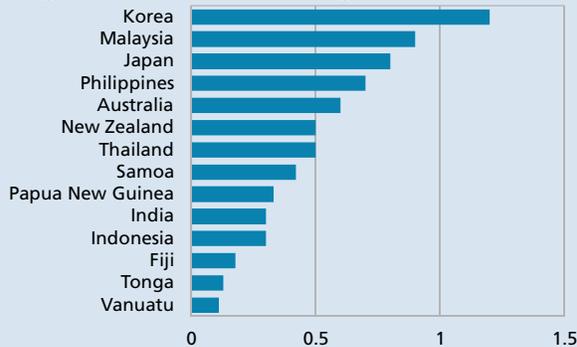
This box provides an assessment of the effectiveness of the interest rate channel of the monetary policy transmission in Tonga. The analysis uses a single equation reduced form model that links bank lending rates or credit growth to a policy rate, one-period lag of bank lending rate, a time trend, and a constant. The estimation is carried out using monthly data from 2000 to 2010, to gauge the impact of policy rates (proxied by repo rates) on bank lending rates and credit growth. For comparison purposes, the model is estimated for the remaining five Pacific island countries that have their own currencies (Fiji, Papua New Guinea (PNG), Solomon Islands, Samoa, and Vanuatu).

The results indicate that changes in NRBT interest rates affect both bank lending rates and the credit growth, but the impact is smaller than in many other Pacific islands. A one percentage point increase in the repo rate

raises the average bank lending rate about ¼ percentage points and reduces private sector credit growth by about 1½ percentage points. These effects are however smaller than in Pacific islands, such as PNG and Fiji, which in turn have weaker transmission mechanism than in more advanced economies because their financial markets are shallow.

Developing domestic financial markets could strengthen the monetary transmission mechanism. Measured by the ratio of broad money to GDP, Tonga’s domestic money market is shallow even compared with many of its Pacific neighbors. Collateralized interbank lending is not widely available, and secondary markets for government and central bank paper are non-existent. There is no market for commercial paper, corporate bonds, equity, and foreign exchange products. Developing a framework for secured lending could help increase the pass-through of the interest rates to bank lending rates and bank credit.

Long-Run Interest Rate Passthrough 1/



Source: Fund staff calculations.
1/ Not available for Solomon Islands.

Pacific Islands: Private Credit Long-Run Passthrough (In percent)



Source: IMF staff estimates.

¹ Prepared by Yongzheng Yang.

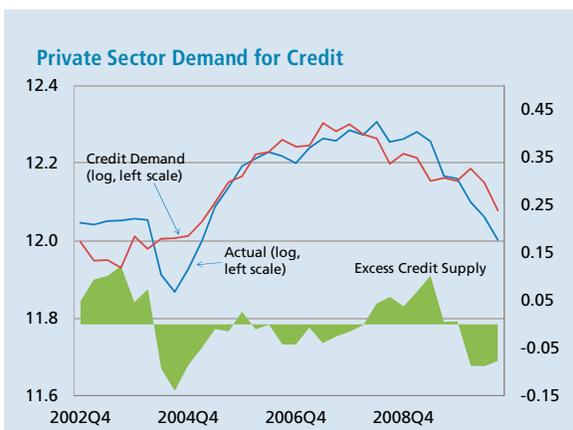
Banking System—Advancing Reforms to Reduce Borrowing Costs

Background

22. **Banks are making progress with repairing balance sheets.** Banks are well capitalized; profitability remains well below levels of the past years owing to high provisioning, but has improved somewhat in recent months; and NPLs are declining. Nevertheless, uncertainties on the outlook continue to restrain banks' lending with the notional demand for credit estimated by staff to be over 7 percent the supply of credit.

Banks' Key Financial Ratios

	2008	2009	2010
Pre-tax Net Profits (percent of assets)	4.9	-6.1	0.6
Operating Income (percent of assets)	11.9	11.1	3.1
Net Interest Income (percent of assets)	6.3	6.3	6.1
Non-Interest Income (percent of assets)	5.6	4.9	3.4
Loan-loss Reserve to Gross Loans 1/	6.4	9.6	14.1
Risk Weighted CAR	22.4	26.5	22.9



Staff Views

23. **In order for credit growth to normalize, further improvements will be needed in banks' balance sheets and in the institutional framework for lending.** The enactment of the Personal Property Security Act, which provides lenders with information on borrowers collateralized assets, will help reduce risks to bank lending. In addition, progress needs to be made in instituting a centralized credit bureau and modifying the legal framework to ensure timely registration and recovery of collateral, including a secured bankruptcy protection law. Implementation of such changes, together with effective supervision of banks to ensure financial stability, have the potential to reduce borrowing costs, improve access to finance, and lay the foundations for stronger economic growth. NRBT's efforts to step up regulation and supervision, such as its plan to adopt a standardized examination report format, are appropriate. PFTAC's technical assistance will continue to help NRBT's supervisory capacity, but longer-term donor-financed assistance will also be required.

24. **There continues to be increased pressure to administer deposit and lending rates.** However, bank profitability in Tonga, including interest rate spreads, is not excessive when compared with other South Pacific jurisdictions (Box 3). Several factors explain the level of lending rates, including the volatility of the macroeconomic environment, shallow financial markets, and limited collateralization. Intermediation could be improved and borrowing costs reduced by, in addition to measures listed

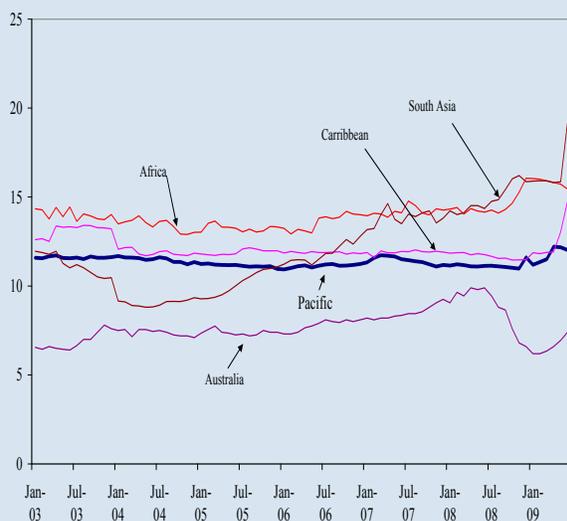
Box 3 Bank Interest Rates and Profitability in Tonga¹

Interest rates in Tonga reflect a wide range of factors. Interest rates are the centerpiece of commercial banks' core business of financial intermediation. They are the key price in the financial sector, the main transmission mechanism of monetary policy, the main vehicle for matching supply and demand and, normally, the key

the larger Pacific Islands. The average across all Pacific islands is around 12 percent, which is broadly similar to the average of the Caribbean but lower than average of sub-Saharan Africa and South Asia (around 15 percent).

Indicators of profitability show a mixed picture.

Lending rates for selected countries



determinant of profitability. Their level reflects banks' perception of risk (country and creditor), market liquidity conditions, and the depth of financial markets—which affects banks' ability to spread their risk, the cost of doing business, and the level of competition in the financial sector. Tonga, like other Pacific Island countries, has a relatively high risk and high cost of business environment and a shallow financial sector that may explain why interest rates would be higher than in more advanced economies.

Tonga's reported lending rates are broadly in line with comparable countries.² Lending rates in Tonga have recently averaged around 12 percent, lower than in the Solomon Islands 15 percent and similar to Samoa but higher than

- Net interest income—a conventional indicator of the contribution of core bank services to profitability—has **averaged around 6 percent of average assets, in line with other PICs but generally higher than emerging markets.** Although it is hard to quantify exactly, the differential between Tonga and emerging market economies is broadly in line with expectations given country risks and the greater size, sophistication and depth of financial markets in emerging economies.

- **Non-interest income is high in Tonga.** It has averaged over 5 percent of average assets in the last decade, broadly in line with levels in other PICs but considerably higher than in emerging and advanced markets. This income is mostly from foreign exchange activities, reflecting Tonga's highly open economy leading to a large volume of international trade and remittance transactions.

- **Bank profitability in Tonga has been high but recent losses illustrate market risks.** Between 2000 and 2007 Tongan banks' average return on assets was around 6 percent. This was well above levels in other regions; for instance, in 2008 the average return in Australia was 1.4 percent and in sub-Saharan Africa it was 2.5 percent. However, foreign exchange earnings accounted for around 60 percent of returns and have underpinned the high levels of bank profitability. These non-interest earnings continued during 2008 and 2009 but were not sufficient to offset the large losses that were incurred on lending activities, leading to significant overall bank losses in Tonga.

¹ Prepared by Matt Davies (PFTAC).

² Data reported to the IMF Statistics Department; subject to definitional differences between countries.

above to enhance the legal framework for secured lending, promoting a more stable macroeconomic environment, increasing competition within an appropriate prudential and regulatory framework, and improving consumer protection and financial literacy.

Authorities' Views

25. The authorities shared the staff assessment on the status of the banking

system. They felt that NPLs had peaked and that lending should improve going forward, but a recovery in activity is key to strengthening the momentum. They agreed with the risks from regulating interest rates and noted there were ongoing discussions to create a credit bureau by the end of this financial year. Measures had been taken to ensure that banks comply with the prudential requirements and disclosure of effective interest rates charged to customers.

B. Reducing the Risks to Tonga's External and Fiscal Sustainability and Raising Medium-Term Growth

Medium-Term Fiscal Policy—Bringing the Debt Down to More Sustainable Levels and Improving Debt Management

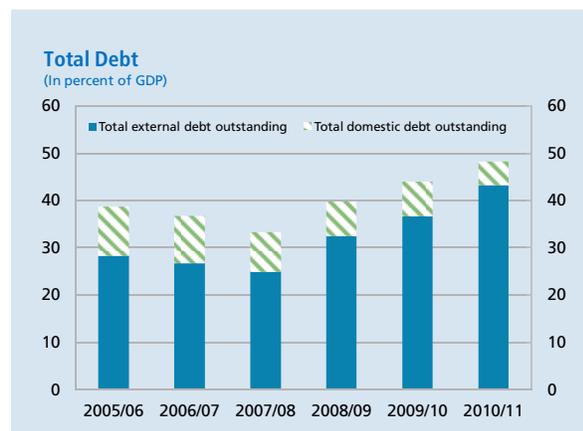
Background

26. Tonga's indebtedness has increased markedly over the past two years, reflecting two loans from EXIM bank of China with a face value totaling around 30 percent of GDP. The loan commitments were signed in November 2007 (for reconstruction of the central business district) and in February 2010 (for roads), and bear a 2 percent

interest rate, 5-year grace period, and 20-year maturity.

Staff Views

27. Setting up a comprehensive medium-term budget framework (MTBF) will facilitate fiscal consolidation. Over the medium term, a primary surplus of 1 percent of GDP would be needed to put the fiscal position on a more sustainable path, bringing down public debt to around 30 percent of GDP by the early 2020s. This could be achieved through continued expenditure restraint, as well as improved expenditure prioritization and revenue administration. Integrating within a single institutional medium-term budgeting framework this fiscal path, the annual budget, and the medium-term development objectives laid out in the NSPF, will help guide medium-term policy efforts, anchor expectations, build policy space to address shocks, and signal to the donor community Tonga's commitment to



restoring fiscal sustainability (Box 4). Given Tonga's vulnerability to shocks, implementation of such a comprehensive MTBF should start in the FY2011/12 budget.

28. A successful implementation of the MTBF will require improving fiscal management. This, in turn, will require better reporting by line ministries, as well as improved capacity, fiscal control, and communication among agencies. The government decision to modify the budget process and to allocate funds at more aggregated levels consistent with priorities set in the NSPF will help reduce cost and improve efficiency. However, to avoid loss of control, this new program could be implemented on a pilot basis by limiting it initially to better performing ministries.

29. Debt management also needs to be strengthened. A comprehensive debt management strategy is needed to limit the large credit and currency risks in the government balance sheet. The Fund stands ready to assist in developing such a strategy and expects to provide technical assistance organized by PFTAC during FY2010/11. Nevertheless, some gains could be made by proceeding cautiously with the selection of eligible private sector construction projects that will receive on-lent funds from the government (financed through the China EXIM loans) to limit credit risk to the government balance sheet and risk of excess capacity in some sectors of the economy. Limiting the credit risk and reducing the risk of excess capacity will free resources for development priorities set out in the NSPF.

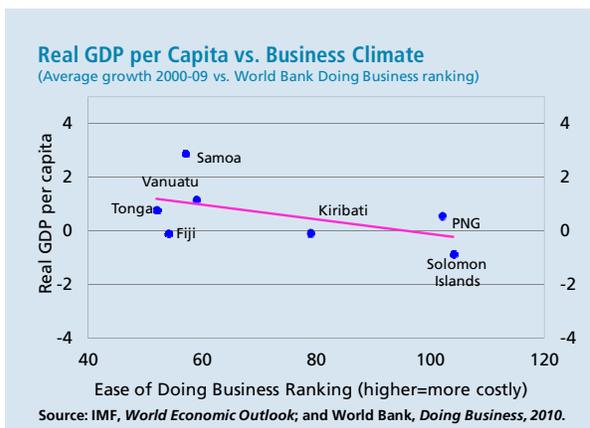
Authorities' Views

30. The authorities recognize the need to reduce the debt, and the benefits from implementing the MTBF. They noted that progress was being made in setting up the MTBF and were hopeful some indications of this process could be given in the upcoming budget. They have taken steps to improve fiscal management, such as the recent revision to the chart of accounts, the shift in monitoring of budget execution to a more aggregated level, and the consolidation of the government's numerous accounts to improve cash management.

Structural Reforms—Raising Medium-Term Growth Prospects

Background

31. Lifting medium-term growth prospects remains a key challenge for Tonga. Prospects are held back by Tonga's geographic isolation, its narrow export base, and unfavorable business environment. Staff expects medium-term growth to remain at around 1¾ percent. This medium-term outlook assumes implementation of the government's current plans to step up capital

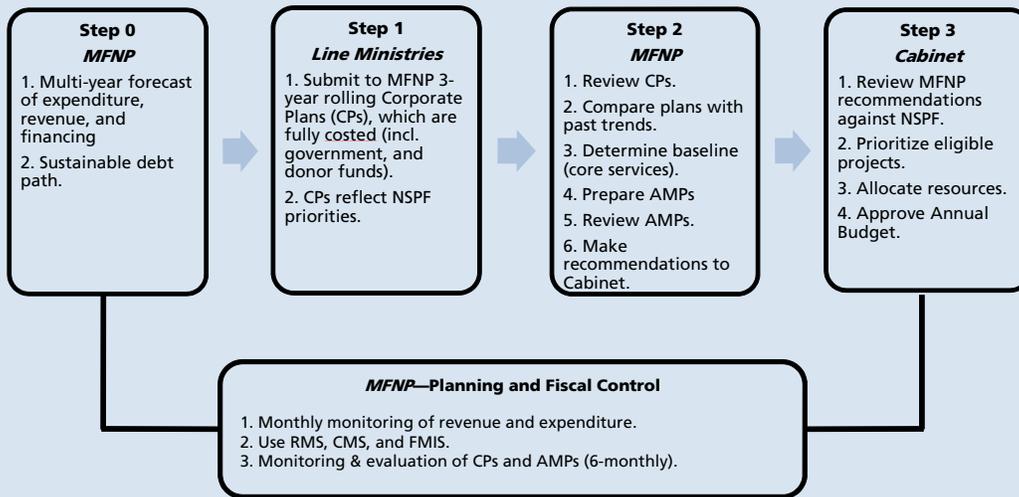


Box 4 Medium-Term Budget Framework¹

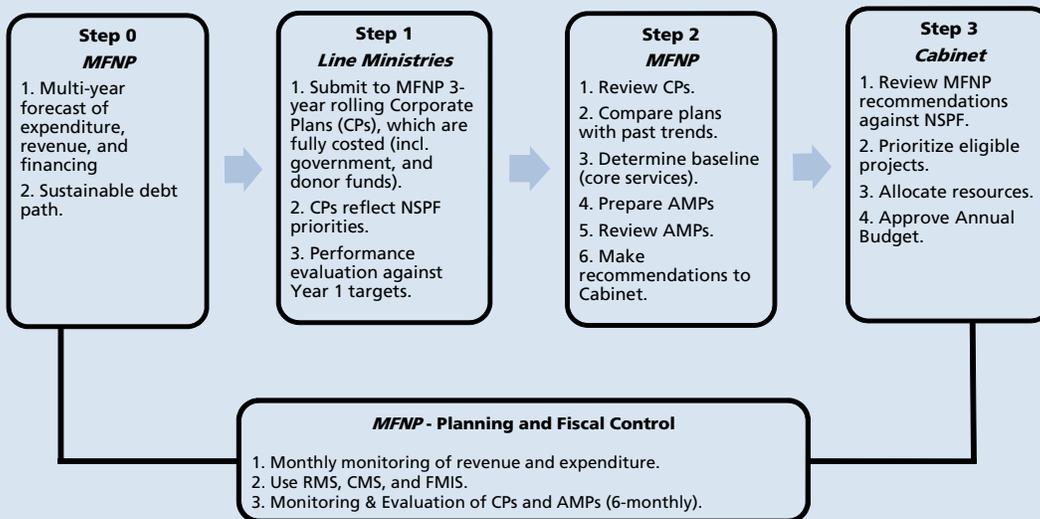
Tonga is in the process of setting up a comprehensive medium-term budget framework (MTBF), which will help Tonga ensure fiscal discipline and stability, and enable strategic allocation of resources in line with Tonga’s strategic priorities laid out in the national strategic planning framework (NSPF). The diagram below highlights the medium-term budgeting process over a two-year period, as well as the role of each participant at each step of this process. The ministry of finance and national planning (MFNP) is responsible for maintaining planning and fiscal control over the

fiscal period, and managing the overall process. Other ministries implement their three-year corporate plans (CP) and annual management plans (AMP) that are aligned to the NSPF, and linked directly to the annual budget. Good progress is being made in implementing other building blocks necessary to fully set up a MTBF, including improvements in macroeconomic and fiscal forecasting, budget formulation and monitoring, the recent revision to the chart of accounts, and the consolidation of the government’s numerous accounts to improve cash management.

Year 1



Year 2



¹ Prepared by Lai Tora (ADB).

spending, structural reform, improve fiscal management to support fiscal consolidation, as well as unchanged demographic trends, which have historically included a high emigration rate.

Staff Views

32. Raising medium-term growth requires promoting private sector activity—a key objective of the government NSPF. Promoting private sector activity will necessitate extending land leases to 99 years for all allotments and activities to encourage construction and investment, reduce the number of business licenses, and lower barriers to foreign investment. Improving efficiency in the delivery and generation of utilities, as currently envisaged, will reduce the cost of doing business. In this regard, the government adoption of the Tonga Energy Road Map should reduce Tonga's vulnerability to oil price shocks and improve the cost-effectiveness of energy.

33. Further progress with public sector enterprise reform could promote private sector activity. This will require leveling the playing field between public and private enterprises. There is also a need to move ahead with corporatization and privatization plans, while providing amendments to the regulatory structure to promote competition in goods and service markets and foster medium-term growth. In this regard, the recent government decision to publish the audited accounts of all public enterprises, change the composition of the boards, and make board members more accountable should improve corporate governance. However, for increasing efficiency and reducing risks to the budget, it is

important public enterprises are run on a commercial basis.

34. Accelerating reforms to lift Tonga's medium-term growth and advance fiscal consolidation will free up resources for social protection programs. The decline in remittances following the global financial crisis and rising food prices have contributed to increasing hardship in Tonga, particularly in the outer islands and outside the main urban center of Nuku'alofa. Moreover, preliminary results of the 2009 household income and expenditure survey show that hardship has been increasing in Tonga during the past decade. There is a need to develop social protection programs, such as establishing a contributory pension scheme and increasing coverage of health insurance and workers' compensation, and allow the government to focus on inequality and labor market policies. Failing to raise medium-term growth would increase Tonga's debt vulnerabilities (see attached debt sustainability annex) and means that Tonga will need to further reduce current and capital spending for projects and possibly reallocating some of the spending toward those projects deemed of higher priority.

Authorities' Views

35. The authorities agreed with the staff recommendations to lift private sector activity. They pointed to the need for Tonga to diversify and expand exports to reduce the country's dependency on remittances, but pointed to the difficulties capacity constraints pose. They also noted the difficulties in the discussions about a free trade agreement with Australia, because of the potential

losses of fiscal revenue such agreement could entail in the short run. With regard to the land regime, the authorities indicated that a review of the land

regime was currently being conducted and saw benefits in adopting a standard duration of contract for all types of allotments and activities.

STAFF APPRAISAL

36. Tonga's economy is recovering from the effects of the global financial crisis, the domestic credit crunch, and adverse weather-related shocks. Growth is estimated to recover to 1¼ percent in FY2010/11 and 1¾ percent in FY2011/12, helped by stronger tourism activity and a fiscal expansion financed by donor aid and previously contracted loans. Inflation is likely to average around 6 percent in FY2010/11 and in FY2011/12.

37. Risks to the outlook remain on the downside. A protracted rise in world commodity and food prices would hit Tonga's economy hard, feeding through to inflation, growth, and the current account deficit. At the same time, if global growth falters, remittances, tourism, and exports could be affected, weakening economic activity and threatening reserves. In addition, Tonga's high public debt limits the fiscal space for responding to shocks, including natural disasters, and for future spending on social and developmental priorities.

38. Fiscal consolidation is needed in the near term to mitigate Tonga's fiscal sustainability risks and expand fiscal space. Reducing Tonga's vulnerabilities will require avoiding new borrowing, reducing current spending, carefully prioritizing expenditure,

strengthening tax administration, and improving fiscal transparency.

39. Medium-term fiscal policy needs to aim at restoring sustainability. Over the medium term, a primary surplus of 1 percent of GDP would be needed to put the fiscal position on a more sustainable path, bringing down public debt to around 30 percent of GDP by the early 2020s. There is a need to integrate within a single institutional medium-term budgeting framework this fiscal path, the annual budget, and the medium-term development objectives laid out in the NSPF. Continued provision of grants from donors would be helpful for supporting these efforts.

40. A comprehensive debt management strategy is needed to limit the large credit and currency risks in the government balance sheet. Limiting the credit risk and reducing the risk of excess capacity will free resources for development priorities set out in the NSPF. Progress is expected to be made during FY2010/11 with technical assistance organized by PFTAC.

41. Monetary policy should maintain its current stance in the months ahead. NRBT's efforts to maintain adequate liquidity in the system are appropriately aimed at encouraging banks to

step up lending, and there is little need for further policy loosening. However, if monetary conditions were to normalize faster than anticipated, the existing liquidity overhang could exacerbate inflation and exert downward pressure on international reserves. In such a case, monetary policy will need to be pre-emptively tightened through a combination of hikes in interest rates on the NRBT repo facility, the issuance of central bank paper, and reserve requirements.

42. In order for credit growth to normalize, further improvements will be needed in banks' balance sheets, in Tonga's economic growth prospects, and in the institutional framework for lending. The enactment of the Personal Property Security Act will help reduce risks to bank lending but more efforts are needed. Progress needs to be made in instituting a centralized credit bureau and modifying the legal framework to ensure timely registration and recovery of collateral, including a secured bankruptcy protection law. In addition, increasing competition within an appropriate prudential and regulatory framework, and improving consumer protection and financial literacy could improve intermediation, reduce borrowing costs, and lay the foundations for stronger growth. In this regard, pressure to administer the level of interest rates should be resisted as administering interest rates could result in rationing credit and hampering banks' ability to price risk. NRBT's efforts to step up regulation and supervision, including adopting a standardized examination report format, are welcome. Technical assistance provided by PFTAC will continue to help

strengthen NRBT's supervisory capacity, but longer-term donor-financed assistance will also be required.

43. The exchange rate is broadly in line with fundamentals. Should downward pressures on reserves emerge, however, the NRBT will need to use the flexibility afforded by the current exchange rate arrangement to gradually depreciate the pa'anga against the basket within in order to safeguard external stability. Such depreciation would need to be accompanied by further fiscal restraint, given the effects a weaker currency would have on the public debt. Also, the weights in the currency basket need to be updated in order to ensure that they are consistent with changes in trade patterns and the emergence of renminbi debt.

44. Promoting private sector activity will strengthen medium-term growth prospects. There continues to be a need to extend land leases to 99 years for all allotments and activities to encourage construction and investment, make further progress with public enterprise reform to level the playing field between public and private enterprises, reduce the number of business licenses, and lower barriers to foreign investment. Speeding up reforms to lift Tonga's medium-term growth and advancing fiscal consolidation will free up resources for social protection programs and allow the government to focus on inequality and labor market policies.

45. It is recommended that the next Article IV consultation take place on a standard 12-month cycle.

Table 1 Tonga: Selected Economic Indicators, 2006/07–2011/12 1/

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			Prel.		Proj.	
	(Annual percent change)					
Output and prices						
Real GDP 2/	-1.0	2.7	-0.1	-0.5	1.2	1.7
Consumer prices (period average)	5.1	9.8	5.0	2.0	6.0	5.8
Consumer prices (end of period)	5.6	12.2	1.2	2.6	10.4	1.7
	(In percent of GDP)					
Central government finance						
Total revenue and grants	28.0	25.9	29.8	26.3	28.8	21.8
Total revenue	24.3	24.6	22.9	21.0	17.6	17.6
Grants	3.7	1.3	6.9	5.2	11.2	4.2
Total expenditure and net lending	26.9	24.3	29.6	31.9	33.0	27.0
Of which: Current expenditure	25.9	23.9	25.3	26.2	20.0	19.8
Capital expenditure	0.9	0.4	3.0	3.4	10.5	5.2
Overall balance	1.0	1.6	0.1	-5.7	-4.2	-5.2
Overall balance (excl. China's EXIM bank loans)	...	...	0.4	-3.3	0.8	-2.3
External financing (net)	0.1	0.2	-0.1	4.0	9.2	5.9
Domestic financing (net)	-1.2	-1.7	4.7	1.6	-5.0	-0.7
Privatization receipts	0.0	0.0	-4.7	0.0	0.0	0.0
	(Annual percent change)					
Money and credit						
Total liquidity 3/	13.3	6.7	-1.1	5.8	5.2	-0.9
Of which: Broad money (M2)	11.9	8.2	-1.8	5.1	5.7	-1.1
Domestic credit	12.2	13.9	-5.2	-11.5	-18.5	9.0
Of which: Private sector credit	9.5	17.1	-3.7	-15.6	-4.5	9.4
Interest rates (end of period)						
Average deposit rate	5.7	5.7	4.9	3.4	...	...
Base lending rate	9.5	10.0	10.0	9.6	...	...
	(In millions of U.S. dollars)					
Balance of payments						
Exports, f.o.b.	13.3	12.4	5.5	5.9	7.1	7.8
Imports, f.o.b.	-108.6	-138.1	-130.1	-108.2	-146.1	-140.0
Services (net)	-17.9	-3.3	-2.6	-4.1	-4.3	-5.6
Investment income (net)	3.5	3.4	4.6	2.7	2.7	2.6
Services and investment income (net)	-14.4	0.1	2.0	-1.3	-1.6	-3.0
Current transfers (net)	84.2	94.7	75.8	76.2	99.7	90.4
Of which: Private transfer receipts	93.3	106.7	84.0	81.7	79.2	87.1
Current account balance	-25.5	-30.9	-46.9	-27.4	-40.9	-44.8
(In percent of GDP)	-8.3	-8.9	-14.7	-7.8	-11.0	-11.7
Current account balance (excl. China's EXIM bank loans)	-25.5	-30.9	-45.4	-14.2	-11.1	-26.0
Overall balance	4.2	-1.4	22.6	17.7	15.3	-13.9
Terms of trade (annual percent change)	21.4	-0.6	0.1	...	...	...
Gross official foreign reserves						
In millions of U.S. dollars	47.1	48.2	67.7	88.7	104.0	90.1
In months of goods and services imports	3.9	3.2	4.7	7.1	6.5	5.8
External debt (in percent of GDP)						
External debt	26.8	24.9	32.5	36.6	43.3	44.3
Debt service ratio	1.1	1.4	1.2	1.8	1.6	1.4
Exchange rates						
Pa'anga per U.S. dollar (period average)	2.0	1.9	2.1	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...
Nominal effective exchange rate (1990=100)	99.1	101.1	107.5	106.5	...	...
Real effective exchange rate (1990=100)	99.1	101.1	107.5	107.5	...	...
Memorandum item:						
Nominal GDP (millions of T\$)	611.0	661.4	663.2	681.4	752.9	810.2
Gross Disposable Income (millions of T\$)	809.1	868.9	840.3	843.3	970.8	1018.4
Population (thousands)	102.0	102.4	102.9	103.3	103.7	104.1

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

1/ Fiscal year beginning July.

2/ Including preliminary data.

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

Table 2 Tonga: Summary of Government Operations, 2006/07–2011/12

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
	Actual	Actual	Prel.		Proj.	
(In millions of pa'anga)						
Total revenue and grants	171.0	171.2	197.4	178.9	216.7	176.9
Total revenue	148.4	162.5	151.9	143.3	132.3	142.6
Current revenue	148.4	162.5	151.9	143.3	132.2	142.6
Tax revenue	126.1	138.0	129.1	114.4	110.3	119.8
Taxes on income profits	26.4	26.8	40.3	27.9	23.4	26.0
Tax on property	0.1	0.1	0.1	0.1	0.1	0.1
Sales tax and Consumption tax	51.6	59.7	71.3	70.7	72.1	77.4
Trade taxes	47.5	51.4	16.1	14.9	14.6	16.0
Other taxes	0.5	0.0	1.4	0.7	0.1	0.4
Nontax revenue	22.3	24.5	22.8	29.0	21.9	22.8
Capital revenue	0.0	0.0	0.0	0.0	0.1	0.0
Grants (in cash)	22.6	8.7	45.5	35.6	84.4	34.3
Total expenditure and net lending	164.6	160.9	196.5	217.6	248.1	219.0
Total expenditure	164.0	160.9	187.6	201.5	229.7	202.1
Current expenditure	158.4	158.3	167.5	178.2	150.3	160.3
Wages and salaries 1/	80.1	70.2	76.4	81.4	83.5	81.4
Retirement funds employer contribution	5.8	4.4	5.2	6.9	8.0	8.6
Interest expense	3.2	4.2	5.2	5.6	6.1	7.1
Other current expenditures	69.4	79.6	80.7	84.4	52.7	63.1
Capital expenditure	5.6	2.6	20.1	23.3	79.4	41.8
Financed by China's EXIM bank loans 2/	...	...	2.3	16.2	59.7	32.7
Total lending minus repayments	0.6	0.0	8.9	16.1	18.4	16.9
Current balance	-10.1	4.2	-15.6	-34.9	-18.2	-17.6
Overall balance (incl. grants)	6.4	10.3	0.9	-38.7	-31.5	-42.1
Overall balance (excl. China's EXIM bank loans)	...	...	2.7	-22.2	5.8	-18.5
Total financing	-6.4	-10.2	-0.9	38.7	31.5	42.1
External financing	0.8	1.4	-0.9	27.5	69.3	47.7
Disbursements	5.8	8.4	41.8	49.3	57.6	38.2
Repayments	5.0	7.0	4.7	8.7	5.9	6.4
Net change in external cash balance 2/	0.0	0.0	-38.0	-13.1	17.6	15.8
Domestic financing 3/ 4/	-7.1	-11.6	31.5	11.2	-37.8	-5.6
Net bond financing	-1.6	-3.2	1.8	7.7	1.0	-2.0
Net bank loan financing	0.0	0.0	0.0	0.0	0.0	0.0
Net changes in cash balances	0.0	-12.5	2.3	-4.8	0.0	0.0
Other	-5.5	4.2	27.4	8.3	-38.8	-3.6
Privatization receipts	0.0	0.0	-31.4	0.0	0.0	0.0
(In percent of GDP)						
Total revenue and grants	28.0	25.9	29.8	26.3	28.8	21.8
Total revenue	24.3	24.6	22.9	21.0	17.6	17.6
Current revenue	24.3	24.6	22.9	21.0	17.6	17.6
Tax revenue	20.6	20.9	19.5	16.8	14.6	14.8
Taxes on income profits	4.3	4.1	6.1	4.1	3.1	3.2
Tax on property	0.0	0.0	0.0	0.0	0.0	0.0
Sales tax and Consumption tax	8.4	9.0	10.7	10.4	9.6	9.6
Trade taxes	7.8	7.8	2.4	2.2	1.9	2.0
Other taxes	0.1	0.0	0.2	0.1	0.0	0.0
Nontax revenue	3.6	3.7	3.4	4.3	2.9	2.8
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0
Grants (in cash)	3.7	1.3	6.9	5.2	11.2	4.2
Total expenditure and net lending	26.9	24.3	29.6	31.9	33.0	27.0
Total expenditure	26.8	24.3	28.3	29.6	30.5	24.9
Current expenditure	25.9	23.9	25.3	26.2	20.0	19.8
Wages and salaries 1/	13.1	10.6	11.5	11.9	11.1	10.0
Retirement funds employer contribution	0.9	0.7	0.8	1.0	1.1	1.1
Interest expense	0.5	0.6	0.8	0.8	0.8	0.9
Other current expenditures	11.4	12.0	12.2	12.4	7.0	7.8
Capital expenditure	0.9	0.4	3.0	3.4	10.5	5.2
Total lending minus repayments	0.1	0.0	1.3	2.4	2.4	2.1
Current balance	-1.6	0.6	-2.4	-5.1	-2.4	-2.2
Overall balance (incl. grants)	1.0	1.6	0.1	-5.7	-4.2	-5.2
Overall balance (excl. China's EXIM bank loans)	...	...	0.4	-3.3	0.8	-2.3
Total financing	-1.0	-1.5	-0.1	5.7	4.2	5.2
External financing	0.1	0.2	-0.1	4.0	9.2	5.9
Disbursements	0.9	1.3	6.3	7.2	7.7	4.7
Repayments	0.8	1.1	0.7	1.3	0.8	0.8
Net change in external cash balance 2/	...	...	-5.7	-1.9	2.3	2.0
Domestic financing 3/ 4/	-1.2	-1.7	4.7	1.6	-5.0	-0.7
Memorandum item:						
Nominal GDP (in millions of pa'anga)	611.0	661.4	663.2	681.4	752.9	810.2

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

1/ Wage bill for 2006/07 includes TOP 9.6 million of carryover payments from 2005/06.

2/ Reflects unspent balances of China's EXIM Bank loans.

3/ In 2008/09 includes the implementation of the natural disaster fund.

4/ Includes domestic net bond financing and net changes in government cash balance and investment.

Table 3 Tonga: Depository Corporations Survey, 2006/07–2007/12 1/

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
				Prel.		Proj.
	(In millions of pa'anga; end of period)					
Net foreign assets	82.2	76.0	118.1	143.1	197.5	174.2
Claims on nonresidents	105.3	102.1	155.9	188.5	245.6	216.7
NRBT	92.9	90.7	137.7	171.9	221.7	192.7
Other depository corporations	12.4	11.4	18.3	16.6	23.9	23.9
Liabilities to Nonresidents	-23.0	-26.0	-37.9	-45.4	-48.1	-42.4
NRBT	-5.2	-3.4	-10.4	-29.5	-31.8	-28.1
Other depository corporations	-17.8	-22.6	-27.5	-15.9	-16.3	-14.4
Net domestic assets	204.6	230.0	184.5	177.1	139.4	159.8
Net domestic credit	290.6	331.1	314.0	277.8	226.4	246.8
Net claims on government	-18.3	-30.9	-34.7	-28.1	-65.9	-71.5
<i>of which: govt. lending funds 2/</i>	5.4	12.4	0.0	0.0	0.0	0.0
Claims on public nonfin. corps.	3.7	4.8	4.7	15.5	15.0	15.0
Claims on private sector	305.1	357.2	344.0	290.4	277.3	303.3
Other items, net	-85.9	-101.1	-129.5	-100.7	-87.1	-87.1
Total liquidity	286.9	306.0	302.6	320.2	336.9	334.0
Broad money (M2)	265.5	287.2	282.0	296.4	313.4	309.9
Narrow money	73.5	72.3	77.7	90.0	88.7	91.2
Quasi money	192.0	214.9	204.4	206.4	224.7	218.7
Securities other than shares 3/	21.4	18.7	20.6	23.8	23.5	24.1
	(Annual percentage change)					
Net foreign assets	12.0	-7.6	55.4	21.2	38.1	-11.8
Net domestic assets	13.8	12.4	-19.8	-4.0	-21.3	14.6
Net domestic credit	12.2	13.9	-5.2	-11.5	-18.5	9.0
Claims on private sector	9.5	17.1	-3.7	-15.6	-4.5	9.4
Total liquidity	13.3	6.7	-1.1	5.8	5.2	-0.9
Broad money (M2)	11.9	8.2	-1.8	5.1	5.7	-1.1
	(In millions of U.S. dollars)					
Net foreign assets	41.1	40.0	56.6	74.2	92.7	81.5
Claims on nonresidents	52.6	53.7	74.8	97.7	115.2	101.3
NRBT	46.4	47.7	66.0	89.1	104.0	90.1
ODCs	6.2	6.0	8.8	8.6	11.2	11.2
Liabilities to nonresidents	-11.5	-13.7	-18.2	-23.5	-22.6	-19.8
Memorandum items:						
Velocity (GDP/average M2)	2.4	2.3	2.4	2.3	2.4	2.6
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...

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

1/ Comprises the National Reserve Bank of Tonga (NRBT) and other depository corporations (ODCs), including the Tonga Development Bank (TDB).

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

2-3/ Comprises bills and promissory notes issued by financial sector and held outside the sector.

Table 4 Tonga: Balance of Payments Summary 2006/07–2011/12 1/

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

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			Prel.		Proj.	
Trade balance	-95.3	-125.7	-124.6	-102.3	-139.0	-132.2
Exports, f.o.b.	13.3	12.4	5.5	5.9	7.1	7.8
Imports, f.o.b.	-108.6	-138.1	-130.1	-108.2	-146.1	-140.0
Services (net)	-17.9	-3.3	-2.6	-4.1	-4.3	-5.6
Receipts	19.4	36.9	40.1	37.3	40.4	41.0
Payments	-37.3	-40.1	-42.7	-41.4	-44.7	-46.6
Investment income (net)	3.5	3.4	4.6	2.7	2.7	2.6
Receipts	6.4	6.8	6.2	7.6	8.0	8.3
Payments	-2.9	-3.5	-1.6	-4.9	-5.4	-5.6
Current transfers (net)	84.2	94.7	75.8	76.2	99.7	90.4
Official transfers (net) 2/	0.0	0.2	0.6	1.1	27.4	10.4
Private transfers (net)	84.2	94.5	75.1	75.1	72.3	80.0
Current account balance	-25.5	-30.9	-46.9	-27.4	-40.9	-44.8
(In percent of GDP)	-8.3	-8.9	-14.7	-7.8	-11.0	-11.7
Capital and financial account balance	26.9	36.3	55.6	29.9	56.2	32.0
Official capital flows (net)	9.8	11.9	17.7	14.7	45.6	26.2
<i>Of which:</i> China's EXIM bank loans	...	...	20.1	23.3	28.5	16.1
Private capital flows (net)	17.1	24.4	37.9	15.2	10.5	5.8
Errors and omissions	2.7	-6.7	13.9	15.3	0.0	0.0
Overall balance 3/	4.2	-1.4	22.6	17.7	15.3	-12.9
Memorandum items:						
Gross official foreign reserves	47.1	48.2	67.7	88.7	104.0	90.1
In months of goods and services imports 4/	3.9	3.2	4.7	7.1	6.5	5.8
Exchange rate						
Pa'anga per U.S. dollar (period average)	2.0	1.9	2.1	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...
Nominal GDP	305.1	348.0	318.0	353.2	372.8	383.4
Commodity price indexes (2005 = 100)						
Food	115.9	152.3	138.7	137.4	172.5	180.9
Fuel	117.7	177.0	128.8	137.4	147.0	193.7

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

1/ On OET base; projections include adjustments for imports related to two loans from China's EXIM Bank.

2/ Includes grants from ADB of US\$5 million in 2009/10 and 2010/11.

3/ Change in gross official foreign reserves.

4/ The current year's imports.

Table 5	Tonga: Medium-Term Scenario, 2008/09–2015/16 1/							
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
	Preliminary		Projections					
	(Annual percent change)							
Output and prices								
Real GDP	-0.1	-0.5	1.2	1.7	1.8	1.8	1.8	1.8
Consumer prices (end of period)	1.2	2.6	10.4	1.7	6.0	6.0	6.0	6.0
Consumer prices (period average)	5.0	2.0	6.0	5.8	3.9	6.0	6.0	6.0
	(In percent of GDP)							
Central government finance								
Total revenue and grants	29.8	26.3	28.8	21.8	21.0	20.2	21.9	21.7
Total revenue	22.9	21.0	17.6	17.6	16.8	17.3	19.0	19.1
Grants	6.9	5.2	11.2	4.2	4.2	2.9	2.9	2.6
Total expenditure and net lending	29.6	31.9	33.0	27.0	22.5	21.7	23.1	22.3
Current expenditure	25.3	26.2	20.0	19.8	18.9	18.8	18.3	18.0
Capital expenditure	3.0	3.4	10.5	5.2	3.5	2.9	3.8	3.6
Expenditure discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	1.3	2.4	2.4	2.1	0.0	0.0	1.0	0.7
Overall balance	0.1	-5.7	-4.2	-5.2	-1.5	-1.5	-1.3	-0.6
External financing (net)	-0.1	4.0	9.2	5.9	1.6	0.9	0.5	-1.0
Domestic financing (net)	4.7	1.6	-5.0	-0.7	-0.1	0.5	0.8	1.6
	(In millions of U.S. dollars)							
Balance of payments								
Exports, f.o.b.	5.5	5.9	7.1	7.8	8.5	9.4	10.5	11.9
(Annual percent change)	-55.6	7.9	20.8	8.9	9.1	10.2	12.5	12.8
Imports, f.o.b.	-130.1	-108.2	-146.1	-140.0	-132.7	-138.4	-144.1	-145.7
(Annual percent change)	-5.8	-16.8	35.0	-4.2	-5.2	4.3	4.1	1.1
Services and investment income (net)	2.0	-1.3	-1.6	-3.0	-4.2	-5.5	-6.8	-7.0
Transfers (net)	75.8	76.2	99.7	90.4	85.9	94.1	103.4	111.3
Of which: Private transfer receipts	84.0	81.7	79.2	87.1	94.5	102.4	110.7	118.8
(Annual percent change)	-21.3	-2.8	-3.0	9.9	8.5	8.4	8.1	7.3
Current account balance	-46.9	-27.4	-40.9	-44.8	-42.5	-40.5	-37.0	-29.5
(In percent of GDP)	-14.7	-7.8	-11.0	-11.7	-10.7	-9.9	-8.7	-6.8
Capital account balance	55.6	29.9	56.2	32.0	30.2	26.5	26.6	25.6
Official capital flows (net)	17.7	14.7	45.6	26.2	22.1	14.1	11.5	4.3
Private capital flows (net)	37.9	15.2	10.5	5.8	8.1	12.3	15.1	21.4
Overall balance	22.6	17.7	15.3	-13.9	-12.3	-14.0	-10.4	-3.9
Gross international reserves (end of period)								
In millions of U.S. dollars	67.7	88.7	104.0	90.1	77.8	63.8	53.4	49.5
In months of imports (goods and services)	4.7	7.1	6.5	5.8	5.2	4.1	3.3	3.0
External debt (in percent of GDP)								
Public sector external debt	32.5	36.6	43.3	44.3	45.3	44.4	41.9	39.7
Debt service ratio	1.2	1.8	1.6	1.4	1.4	2.4	2.3	2.4
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	75.1	75.1	72.3	80.0	87.2	94.9	103.1	111.0
(In percent of imports, goods and services)	43.5	50.2	37.9	42.8	48.2	50.4	52.6	55.8
Commodity price indexes (2005 = 100)								
Food	138.7	137.4	172.5	180.9	160.8	160.7	153.3	149.1
Fuel	128.8	137.4	147.0	193.7	191.6	188.6	188.0	189.1
Nominal GDP (millions of T\$)	663.2	681.4	752.9	810.2	856.8	924.7	998.0	1077.1

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

1/ Fiscal year beginning July.

Table 6	Tonga: Financial Soundness Indicators, 2004–10 1/						
	2004	2005	2006	2007	2008	2009	2010
Financial Sector	(In percent)						
Total loans/GDP	40.1	46.9	47.9	50.5	54.7	52.6	44.9
Other depository corporations	40.1	46.9	47.9	50.5	54.7	52.6	44.9
	(Year-on-year percent change)						
Bank loans							
Other non-financial corporations	-10.2	21.8	24.9	12.6	21.4	0.9	-17.2
Other resident sectors	14.0	47.8	8.3	2.6	6.2	-16.7	-10.0
Banks	(In percent)						
Capital adequacy ratio 2/	17.6	16.3	16.8	20.7	22.4	26.5	22.9
Net interest income to average assets 2/	7.3	6.5	6.1	6.6	6.3	6.3	6.1
	(In percent of total loans)						
Non-performing loans	6.3	5.3	4.7	5.1	10.0	23.7	17.9
Provision expense to gross loans	1.6	0.4	1.1	3.2	10.4	11.0	...
Loan loss reserves to gross loans	4.8	2.5	2.4	3.6	6.4	9.6	14.1

Source: National Reserve Bank of Tonga and IMF IFS database.

1/ Data are based on the end- fiscal year.

2/ Data are based on the end- calendar year.

Table 7 Tonga: Millennium Development Goals

	1990	1995	2000	2005	2008	2009
Goal 1: Eradicate extreme poverty and hunger						
Employment to population ratio, 15+, total (%)	..	..	..	..	..	..
Employment to population ratio, ages 15-24, total (%)	..	..	..	..	..	..
GDP per person employed (constant 1990 PPP \$)	..	..	..	..	..	..
Income share held by lowest 20%	..	..	..	..	..	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	..	..	..	..
Poverty gap at \$1.25 a day (PPP) (%)	..	..	..	..	..	..
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	..	..	..	..	..	..
Prevalence of undernourishment (% of population)	..	..	..	..	..	..
Vulnerable employment, total (% of total employment)	..	57	..	..	..	..
Goal 2: Achieve universal primary education						
Literacy rate, youth female (% of females ages 15-24)	..	99	..	100	100	..
Literacy rate, youth male (% of males ages 15-24)	..	99	..	100	100	..
Persistence to last grade of primary, total (% of cohort)	..	..	95	91	..	..
Primary completion rate, total (% of relevant age group)	133	114	104	137	100	..
Total enrollment, primary (% net)	..	..	96	99	..	..
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliaments (%)	0	0	0	3	3	3
Ratio of female to male enrollments in tertiary education	..	..	164	168	..	..
Ratio of female to male primary enrollment	98	99	97	96	95	..
Ratio of female to male secondary enrollment	104	..	110	104	104	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	35.7	..	38.6	..	..
Goal 4: Reduce child mortality						
Immunization, measles (% of children ages 12-23 months)	86	94	95	99	99	99
Mortality rate, infant (per 1,000 live births)	19	18	18	17	17	17
Mortality rate, under-5 (per 1,000)	23	21	20	20	19	19
Goal 5: Improve maternal health						
Adolescent fertility rate (births per 1,000 women ages 15-19)	..	..	21	22	22	..
Births attended by skilled health staff (% of total)	92	..	95	98	..	..
Contraceptive prevalence (% of women ages 15-49)	..	41	33	..	..	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	..	..	..
Pregnant women receiving prenatal care (%)	..	..	..	..	..	..
Unmet need for contraception (% of married women ages 15-49)	..	..	..	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	34	31	28	25	24	..
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	..	..
Prevalence of HIV, male (% ages 15-24)	..	..	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	..	..	..
Tuberculosis case detection rate (all forms)	72	67	88	71	53	..
Goal 7: Ensure environmental sustainability						
CO2 emissions (kg per PPP \$ of GDP)	0.4	0.4	0.4	0.3	..	..
CO2 emissions (metric tons per capita)	1	1	1	2	..	..
Forest area (% of land area)	5	5	5	5	..	..
Improved sanitation facilities (% of population with access)	96	96	96	96	96	..
Improved water source (% of population with access)	..	100	100	100	100	..
Marine protected areas, (% of surface area)	..	..	..	..	2	..
Goal 8: Develop a global partnership for development						
Debt service (PPG and IMF only, % of exports, excluding workers' remittances)	3	4	8	6	8	..
Internet users (per 100 people)	0.0	0.1	2.4	2.9	8.0	..
Mobile cellular subscriptions (per 100 people)	0	0	0	29	49	..
Telephone lines (per 100 people)	5	7	10	13	25	..
Other						
Fertility rate, total (births per woman)	5.0	4.0	4.0	4.0	4.0	..
GNI per capita, Atlas method (current US\$)	1,230	1,990	2,020	2,470	3,240	3,260
GNI, Atlas method (current US\$) (billions)	0.1	0.2	0.2	0.3	0.3	0.3
Gross capital formation (% of GDP)	18	26	22	22	26	26
Life expectancy at birth, total (years)	70	70	71	71	72	..
Literacy rate, adult total (% of people ages 15 and above)	..	99	..	99	99	..
Population, total (millions)	0.1	0.1	0.1	0.1	0.1	0.1
Trade (% of GDP)	99	73	62	80	70	72

Source: World Development Indicators database.



TONGA

STAFF REPORT FOR THE 2011 ARTICLE IV

CONSULTATION—INFORMATIONAL ANNEX

April 20, 2011

Prepared By

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

CONTENTS

I. TONGA: FUND RELATIONS	2
II. TONGA: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)	4
III. TONGA: WORLD BANK–IMF COLLABORATION	7
IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK	10
V. TONGA: STATISTICAL ISSUES	12

ANNEX I. TONGA: FUND RELATIONS¹

Membership Status:

Joined September 13, 1985; Article VIII.

General Resources Account:

	SDR Million	Percent Quota
Quota	6.90	100.00
Total holdings of currency	5.19	75.20
Reserve position in the Fund	1.71	24.81

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	6.58	100.00
Holdings	7.08	107.56

Outstanding Purchases and Loans: None.

Financial Arrangements: None.

Projected Obligations to Fund:*

(SDR million; based on existing use of resources and present holdings of SDRs)					
	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

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

Exchange Rate Arrangement:

Tonga has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international. Since February 11, 1991, the value of the pa'anga is determined based on a weighted basket of currencies comprising the United States, Australian, and New Zealand dollars, with the U.S. dollar as the intervention currency. In July 2000, the Japanese yen was added to the basket, and the monthly maximum adjustment limit was raised to 5 percent from 2 percent that had prevailed since March 1998, when the allowance for adjustment was introduced. Tonga has accepted the obligations of Article VIII, Sections 2, 3, and 4.

Last Article IV Consultation:

Staff discussions were held during March 2010 and the Executive Board discussed the staff report (IMF Country Report No. 10/112) on May 6, 2010.

Previous Fund recommendations: The staff and the authorities have continued to share comprehensive views in the past about policy priorities. During the 2010 consultation, Executive Directors have stressed the importance of fiscal consolidation, setting up a medium-term budget framework, and supportive monetary policy. But the authorities have

¹ As of March 31, 2011.

followed more moderate steps, primarily owing to capacity constraints and a change in government. Shortcomings continue to be mainly in the area of fiscal policy, where staff recommended carefully prioritizing current spending, improving revenue enforcement, especially at customs, and setting up a debt management strategy. Progress has been made in setting up a medium-term budget framework.

Technical Assistance:

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

Pacific Financial Technical Assistance Centre (PFTAC) has provided assistance on budgetary management; tax administration; banking legislation and supervision; and balance of payments and national accounts statistics.

Resident Representative: None.

ANNEX II. TONGA: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)¹

Assistance to Tonga since 2006 included 27 advisory missions across all technical assistance (TA) sectors. During 2006–March 2010, Tonga has sent 63 officials to the Centre’s regional seminars, workshops and training courses, and six attachments were organized.

Public Financial Management (PFM)

Since 2003, PFTAC’s missions have focused on complementing the considerable assistance provided by other TA agencies, including through the introduction of a midyear economic review and fiscal update, reconciliation of monetary and fiscal data, and changes in budget documentation. For the 2003/04 and 2004/05 budgets, assistance was provided in presenting the final aggregate budget figures on a GFSM 2001 basis. In 2004, PFTAC arranged for a Tongan official to participate on a delegation of Pacific Island officials to the Australian Commonwealth Ministry of Finance. During 2005, the PFTAC PFM Advisor participated in a joint donor/government Feasibility Study related to a proposed long-term Financial and Economic Management Program (FEMP), as well as worked with the Ministry of

Finance on assessing the financial implications of the proposed civil service wage increase. Since then assistance in the form of a peripatetic advisor has been provided in 2006, and again in 2007, to assist in revenue estimation work. The PFM Advisor has also delivered lectures on PFM to all CEOs in late April 2007. A joint PFTAC mission on revenue estimation visited Tonga in mid-March 2008 to further assist in these areas. A PFTAC mission on decentralization also visited Tonga in May 2008 and made several recommendations in this area. A scoping mission on Medium Term Budgeting (MTB) in Tonga took place in late March 2010 following which ADB initiated an MTB project in Tonga. The PFTAC PFM Advisor has since visited Tonga twice to work with the ADB team on MTB. In addition, he also delivered lectures on PFM to all line ministries in May 2010 and worked with the Australian Department of Finance to develop a training program for Tongan officials in Australia.

Tax Administration and Policy

Tonga has improved revenue policy and administration over recent years. Key outcomes are (1) the passing of new Income tax and Customs Acts, both self assessed; (2) a post implementation review of the value-added tax (VAT) and substantial change to the tax

¹ As of March 2011.

administration, principally with the introduction of self assessment. This progress has complemented the introduction of the consumption tax in 2005.

An IMF/PFTAC Tax Policy and Administration mission in March 2008 had the objective of reviewing tax policy issues in small Pacific island countries and in particular to consider the fiscal challenges posed by prospective trade liberalization and assess the experience with the VAT. The mission visited Fiji, Kiribati, Samoa, Solomon Islands, and Tonga. In Tonga, the mission found that the consumption tax was catalytic to the improvement of revenues collected in an environment of the political will to reform of the public sector and also dissatisfaction with the performance of some existing taxes.

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

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

Banking Sector Regulation and Supervision

During 2008 and 2009, assistance was provided by MCM peripatetic advisors intended to upgrade the prudential statements (regulations) to implement the FIA; strengthen the analysis of prudential returns; provide guidance on dealing with problem banks; upgrade the supervisory program for foreign exchange dealers, and provide staff training on relevant issues. In 2010, two missions were conducted by the PFTAC Advisor. The first visit in January focused on assisting the Financial Institutions Supervision Department in reviewing and assessing the level of bank profitability and interest rates. Assistance activities also included training in off-site analysis, including the identification of key ratios and numbers and use of levels and trends in monitoring and assessing CAELS components. The second visit, conducted in June, focused on harmonizing prudential returns with the reporting requirements of other Pacific Islands countries and reviewing the adequacy of off-site monitoring reports. Currently, PFTAC has arranged for two visits by a peripatetic advisor to enhance the capacity of the FID to conduct on-site examinations of banking institutions. The first visit under this program is scheduled to commence in March 2011 with the second visit in May 2011 at which time additional TA needs will be determined.

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 2005 a partial update of the 2002 statistical system review was done, focused on outputs of the Statistics Division of the Ministry of Finance. Further assistance was provided to peer review GDP and BOP estimates prior to publication. GDDS metadata was approved and published in 2006 on the Data Dissemination Bulletin Board. TA missions on BOP statistics were undertaken in 2007, 2008, 2009 and 2010, resulting in revised BOP estimates based on the Balance of Payments Manual, 5th edition (BPM5) standards being compiled, along with

improved methodology and use of source data. These statistics were also mapped to the BPM6 classification. On National accounts statistics, missions in 2008 (which also assisted on revenue estimation), 2009 and 2010 implemented significant improvements in NAS methodology and use of source data, resulting in substantial improvements in the estimates and an expanded range of NAS statistics. TA expert missions to develop producer price indexes were also undertaken in 2008 and 2009. A mission is planned for February 2011 to brief the new resident economic statistics advisor on TA that has been provided by PFTAC in recent years and to assist in planning ongoing developments.

Macroeconomic Management

PFTAC provided a short-term expert to assist the National Reserve Bank of Tonga review the weights in its currency basket in April 2010.

ANNEX III. TONGA: WORLD BANK–IMF COLLABORATION¹

The IMF team led by Mr. Papa N’Diaye (Mission Chief to Tonga) has a close working relationship with the Bank team led by Mr. Vivek Suri (Lead Economist, East Asia and the Pacific Region) and Mr. Robert Jauncey (Senior Country Officer). The teams have an ongoing dialog on a range of macroeconomic and structural issues.

The level of cooperation and coordination is good and includes the following:

- **Article IV consultation.** The World Bank participated in the 2009, 2010, and 2011 Article IV missions meetings with the authorities. This participation facilitated the discussions, especially in areas of mutual interest such as fiscal policy and structural reform. In addition, Bank and Fund staffs prepare jointly the Debt Sustainability Analysis appendix to the staff reports.
- **Economic updates.** Fund staff provided an “Assessment Letter” on Tonga’s macroeconomic situation. This public document was a key input to the Bank’s decision to provide budget support to Tonga.
- **Structural fiscal reforms.** Bank and Fund staffs have worked successfully to provide

technical assistance in public expenditure management and continue to collaborate on the ongoing analytical work on public expenditure, the medium-term macro-framework and general structural issues.

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

- **Putting public debt firmly on a downward path.** This will require progress on multiple fronts over the medium term, including stepping up revenue administration and expenditure control, prioritizing expenditure, limiting loan drawdown to finance projects that are productive, as well as structural reforms. The government’s fiscal efforts will need to be supplemented by continued provision of grants from donors.
- **Establishing a comprehensive debt management strategy** that aims at limiting the large credit and currency risks in the government balance sheet.
- **Making use of the flexibility afforded by the current exchange rate**

¹ As of April 2011.

arrangement. This remains critical for safeguarding external stability.

- **Promoting private drivers of growth.**

There is a need to (i) improve the institutional framework for lending—including the enforcement of creditor rights to collateral—as a means to increase access to finance and lower the cost of borrowing; (ii) improve the institutional framework for land leases to better meet the needs of potential investors, and streamline lease registration processes.; (iii) reduce the administrative burden placed on the private sector by the existing system of business licenses; and (iv) lower barriers to foreign investment.

Anticipated World Bank Group cooperation with Tonga was set out in a Country Assistance Strategy presented to the Board in October 2010. The Bank is significantly scaling up both analytical and financial support for Tonga. The Bank committed a total of US\$10 million in IDA grants to Tonga in FY11 for an energy sector development policy grant and to assist with reconstruction on the outlying Niua islands following the 2009 tsunami. In addition, the Bank committed approximately US\$9 million in trust fund resources from the Government of Australia to support employment-intensive local road maintenance.

Prior to these grants, the Bank had committed a total of \$30 million to Tonga since the country became a member in 1985. Over the next few years, the Bank's program is anticipated to continue increasing substantially, with potential investments to support a broadband cable, improve aviation safety, and support the Tonga energy roadmap. Given Tonga's risk of debt distress, all IDA-16 assistance is anticipated to be provided on grant terms.

The Bank and Fund teams will continue their close cooperation going forward, particularly in relation to Tonga's request from donor partners for development policy financing to support policy reform and to assist the Government to respond to current economic difficulties. The Bank is working with other partners to develop a coordinated approach to budget support requests from Tonga.

Appendix I details the specific activities planned by the two country teams over the September 2010–September 2012 period. It was also agreed that further details on collaboration, as necessary, will be agreed at the technical level as work progresses.

Appendix I. Tonga: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas (September 2010–September 2012)

	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • Possible Development Policy Operation #1 • Tonga Broadband Connectivity • Aviation Safety (Pacific Region) • Energy Roadmap Investment Operation • Possible Development Policy Operation #2 	<ul style="list-style-type: none"> • FY2012 • FY2012 • FY2012 • FY2012 • FY2013
Fund Work Program	<ul style="list-style-type: none"> • Cash Management • WCO diagnostic • Article IV Policy Note • Medium-Term Budgeting • Balance of Payments Statistics • National Accounts Statistics • Article IV Staff Report and Board Meeting 	<ul style="list-style-type: none"> • October 2010 • January 2011 • February 2011 • March 2011 • March 2011 • March 2011 • April 2011

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

The goal of the Asian Development Bank's (AsDB) Pacific Approach 2010–2014 of a sustained and resilient and improved standard of living aligns with the vision of Tonga's National Strategic Planning Framework 2009/2010–2014/2015 (NSPF) to create a society in which all Tongans enjoy higher living standards and a better quality of life. Similarly, as the Pacific Approach aims to achieve its goal through inclusive and environmentally sustainable growth, the NSPF aspires to achieve its vision through equitable and environmentally sustainable private sector-led economic growth. AsDB's country partnership strategy (CPS) 2007-12 for Tonga shares the same focus as the Pacific Approach and the NSPF.

AsDB's support to Tonga will be through infrastructure development; renewable energy; effective, prudent macroeconomic and fiscal management; and private sector development. The Pacific Approach focuses on the need to mitigate environmental impact and strengthen climate change resilience through development of renewable energy options; enhancing connectivity via multimodal networks and new technologies; and supporting urban development. Two key drivers of change to promote the focus of the Pacific Approach

include improved private sector environment and public sector management. The priority outcome objectives of the NSPF supported by AsDB are: (i) to support private sector through better engagement with government, appropriate incentives and streamlining rules and regulations, (ii) maintain and develop infrastructure to improve the everyday lives of people, and (iii) integrate environmental sustainability and climate change into all planning and executing of programs. AsDB's strategy for Tonga is therefore consistent with the Pacific Approach and the NSPF.

AsDB has approved 15 loans and 2 grants totaling \$79.1 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Sixty technical assistance (TA) projects with a value of \$18.1 million were also provided to improve capacity and strengthen institutional development in various sectors. Past AsDB investments have focused on finance development and infrastructure development in transport, power, agriculture, and fisheries.

Active projects include two grant-financed projects and three TA projects in the country portfolio. The grant-financed program approved in 2009 helped Tonga mitigate the impact of the global economic crisis, while establishing the basis for higher, more equitable and sustainable

¹ As of April 2011.

growth in the medium term and creating an economy more resilient to future shocks. Another grant-financed project supports enhancing living standards by improving urban infrastructure. Of the three ongoing TA projects, one focuses on economic and strategic management as well as the development of a public finance management roadmap and a medium-term budget framework. Two TA projects are supporting the preparation of the proposed Tonga-Fiji submarine cable project and the second phase of the integrated urban

development project. Tonga also benefits from a number of regional technical assistance projects in private sector development, economic management, energy efficiency, and public financial management. Assistance to climate change adaptation and mitigation activities will be made available, in particular, the pilot program for climate resilience will support the mainstreaming of climate change considerations into infrastructure development and through broader institutional strengthening.

Tonga: Loan, Grant, and Technical Assistance Approvals, 2006–10

	2006	2007	2008	2009	2010
Loan approvals					
Number	0.0	0.0	0.0	0.0	0.0
Amount (in millions of US\$)	0.0	0.0	0.0	0.0	0.0
Grant approvals					
Number	0.0	0.0	1.0	1.0	0.0
Amount (in millions of US\$)	0.0	0.0	11.3	10.0	0.0
Technical assistance approvals					
Number	2.0	1.0	1.0	2.0	2.0
Amount (in millions of US\$)	0.9	0.5	0.7	1.0	0.5

ANNEX V. TONGA: STATISTICAL ISSUES

While economic statistics are broadly adequate for surveillance, data deficiencies continue to complicate the monitoring of economic conditions and policy formulation. The Statistics Department (SD) and the Ministry of Finance (MOF) have received, on a regular basis, technical assistance in national accounts, government finance, and balance of payments (BOP) statistics from STA as well as the Pacific Financial Technical Assistance Centre (PFTAC); nevertheless, data provision to the Fund continues with long delays.

The two main sources of statistical information are the Quarterly Bulletin of the National Reserve Bank of Tonga (NRBT), and the annual and semi-annual budget reports from the MOF. The country has been participating in the GDDS since May 30, 2006. The metadata are posted on the Fund's Dissemination Standards Bulletin Board (<http://dsbb.imf.org/Applications/web/gdds/gdds/countrycategorylist/?strcode=TON>).

Real Sector Statistics

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

assistance of a statistical advisor from New Zealand to improve the quality of the national accounts and balance of payments statistics. The advisor is helping implement the recommendations of the PFTAC technical assistance mission and expects improvements in the classification and valuation of inputs into the national accounts data. The SD will also become part of the MOF over the next year, which will improve communication and coordination between the two agencies.

The Consumer Price Index is based on a basket of goods and services from the 2000/01 Household Income and Expenditure Survey. Technical assistance was provided in 2008 on the development of an import price index.

Labor market statistics are weak: employment statistics have not been compiled since 2003; and average earnings statistics are not available.

Government Finance Statistics

The FY 2002/03 Budget Statement introduced a presentation of fiscal data compiled according to the methodology of the 2001 Government Finance Statistics Manual. However, improvements are still needed to ensure accurate and reliable fiscal data. Proper classification of transactions is needed to permit reconciliation with monetary financing data. Lags in updating the accounting system should be shortened. Published data are often subject

to significant revisions. No data are reported for publication in the *IFS* or *GFS Yearbook*.

External Sector Statistics

Official BOP statistics are compiled annually by the SD with long lags. Monthly trade figures, derived from customs data, are available with a three-month lag. Unofficially, the NRBT compiles monthly balance of payments statistics based on the Overseas Exchange Transactions records of the banking system with a one-month lag. There are significant differences between the BOP estimates compiled by the two agencies. Moreover, large errors and omissions point to possible under recording of imports.

With PFTAC assistance in March 2009 the Statistics Department developed revised draft BoP statistics and methodology and made recommendations for further improvements in compilation techniques and source data. A follow-up mission took place in March 2010.

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

Monetary and Financial Statistics

NRBT reports data for the central bank, other depository corporations, and monetary aggregates using the standardized report forms (SRFs). These data were published for the first time in the March 2008 issue of *IFS* and *IFS Supplement on Monetary and Financial Statistics*. The NRBT will have to allocate resources to improve the quality of MFS by obtaining source data suitable for compilation of the SRFs in line with the recommendations of the *Monetary and Financial Statistics Manual*. Technical assistance in monetary and financial statistics will be needed to improve the classification and sectorization of accounts once the new prudential reporting system has been introduced.

Tonga: Table of Common Indicators Required for Surveillance

As of April 11, 2011

	Date of latest observation	Date received	Frequency of Data 6/	Frequency of Reporting 6/	Frequency of Publication 6/
Exchange Rates	Feb-11	Mar-11	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Feb-11	Mar-11	M	M	M
Reserve/Base Money	Jan-11	Mar-11	M	M	M
Broad Money	Jan-11	Mar-11	M	M	M
Central Bank Balance Sheet	Jan-11	Mar-11	M	M	M
Consolidated Balance Sheet of the Banking System	Jan-11	Mar-11	M	M	M
Interest Rates ²	Jan-11	Mar-11	M	M	M
Consumer Price Index	Jan-11	Mar-11	M	M	M
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	Feb-11	Mar-11	M	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Feb-11	Mar-11	A	A	A
External Current Account Balance	Q4/2010	Mar-11	Q	Q	Q
Exports and Imports of Goods and Services	Q4/2010	Mar-11	Q	Q	Q
GDP/GNP	2009/10	Mar-11	A	A	A
Gross External Debt	2010	Mar-11	A	A	A
International Investment Position	NA	NA	NA	NA	NA

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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



TONGA

JOINT IMF/WORLD BANK DEBT SUSTAINABILITY ANALYSIS 2011¹

April 20, 2011

Approved By

Vivek Arora and Thomas Dorsey (IMF)
Vikram Nehru and Jeffrey D. Lewis (IDA)

Prepared By

The International Monetary Fund and
The International Development Association

Tonga remains at a high risk of debt distress based on the joint IMF-WB low-income country debt sustainability assessment (LIC DSA). Both the PV-of-debt to GDP, as well as the PV-of-debt to export ratios remain above the country-specific indicative thresholds for a prolonged period under the baseline scenario. The two loans from the China EXIM Bank (one for reconstruction of the central business district and one for road construction) total over TOP\$200 million, close to 30% of GDP. The loans, denominated in renminbi, pose a currency risk to the government's balance sheet. Nonetheless, Tonga's very high and relatively stable remittance inflows (normally over 30 percent of GDP)—which are by far the largest source of foreign exchange earnings—help mitigate liquidity risks. Tonga's overall public sector debt indicators, are elevated in the short term, but are expected to show a decreasing trend over the longer run. Taking into account the cushion provided to the economy by the large workers' remittances, the projected debt profile is consistent with manageable—if high risk—debt dynamics. Additional debt will further heighten the already high risk of external debt distress, as well as risks to external sustainability, and significantly constrain the space available for social and developmental priorities, as outlined in the National Strategic Planning Framework (NSPF). These vulnerabilities underscore the importance of sound macroeconomic policies to improve Tonga's growth potential on a sustained basis, export diversification, and continued efforts in fiscal consolidation. The authorities have expressed a desire to receive technical assistance to develop a comprehensive debt management strategy.

¹ This DSA was prepared jointly with the World Bank, and in collaboration with the Asian Development Bank, in accordance with the Debt Sustainability Framework for low-income countries approved by the Executive Boards of the IMF and IDA. The debt data underlying this exercise were provided by the Tongan authorities.

BACKGROUND

1. The external and public debt sustainability analyses are based on the standard LIC DSA framework.² The DSA framework presents the projected path of Tonga's external and public sector debt burden indicators, and draws some conclusions on the forward-looking sustainability of debt.

2. Tonga's total public sector debt stock (including publicly guaranteed debt) is high and rose substantially during FY2008/09-FY2010/2011, reaching over 45 percent of GDP. Tonga contracted two loans from China's Exim Bank³ with a combined face value of around 30 percent of GDP during that period. Work on

²See "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications"

(<http://www.imf.org/external/np/pdr/sustain/2004/020304.htm> and IDA/SECM2004/0035, 2/3/04), "Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications" (<http://www.imf.org/external/np/pdr/sustain/2004/091004.htm> and IDA/SECM2004/0629, 9/10/04), and reference to "Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries" (<http://www.imf.org/external/pp/longres.aspx?id=4419>).

³ These loan commitments were signed in November 2007 (for reconstruction), and February 2010 (for roads), and bear a 2 percent interest rate, 5-year grace, and a 20-year maturity. The arrangement with the Chinese contractor performing the work associated with these loans requires an initial disbursement of 30 percent to cover the down payment, while outstanding disbursements are paid quarterly as work is completed and claims are filed.

Phase I of the reconstruction of the central business district has been completed and work on Phase II has begun. The loan financed two additional capital projects currently underway, an extension of the Royal Palace and the construction of a new wharf to attract cruise ships. Currently, the projection is for 60 percent of the reconstruction loan to be used to finance direct government capital spending while the remaining 40 percent will be on-lent to the private sector for office, residential, and retail construction. The road reconstruction loan agreement was signed in February 2010, and the first disbursement (30 percent) occurred shortly after the signing. The entire loan will be used to finance direct government capital spending on road improvements.

3. Despite the rise in overall debt, the government has continued to reduce its domestic debt level. Domestic debt has fallen from around 20 percent of GDP at the beginning of the decade to around a projected 5 percent of GDP by June 2011. All outstanding bank loans were repaid in 2007/08. This fiscal year, the government issued an additional, unplanned TOP\$7 million in short-term domestic debt to fund operations while waiting for donor support. The new debt is expected to be repaid during this fiscal year once donor funds are received, but has already been rolled over for an additional three months. The remaining domestic debt reflects mainly government guarantees and unfunded obligations to the Retirement Fund Board.

4. Tonga’s DSA builds on the baseline scenario assumptions presented in Box 1. It assumes that near-term GDP growth will recover to rates close to its 20-year historical average. The fiscal impulse provided by the two China loans has lifted growth in the short-term and the DSA conservatively assumes a return of private sector growth, remittance inflows, and bank credit activity in the long-term. The reconstruction and road infrastructure projects are assumed to take place over the period until 2014/15, although they will be drawn down over the period through 2012/13. Excluding reconstruction and road spending, public spending is assumed to grow more slowly than projected revenues and grants over the medium term, limiting the longer-term need for additional external borrowing. Remittances—which are the largest source of foreign exchange earnings (one-half of Tongans live abroad, mostly in Australia, New Zealand, and United States)—are assumed to recover in the medium and longer term and remain an important external cushion.

5. Post mortem analysis suggests a similar path for debt dynamics. As in the last DSA, Tonga is at high risk of debt distress, with the debt burden peaking early in the projection period and then gradually declining. The current DSA assumes similar longer-term growth and export prospects, but a better non-interest current account position due to smaller import base effects in 2009/10 and somewhat higher net transfers. Compared to last year, the current DSA assumes going forward that the Tongan government undertakes greater fiscal consolidation, resulting in a larger primary surplus and also undertakes less new borrowing as part of its medium-term fiscal strategy. Specifically, the current DSA assumes like last year primary surpluses of around 1 percent of GDP and new concessional external borrowing to finance capital construction of only US\$4 million a year over the period 2016/17–2030/31.

Key Macroeconomic Assumptions					
	Baseline		Historical	2010 DSA Baseline	
	2010/11-2015/16	2016/17-2030/31	Average	2009/10-2014/15	2015/16-2029/30
Real GDP growth (percent)	1.7	1.8	1.1	1.4	1.8
Growth of exports of goods and services (U.S. dollar terms)	4.0	4.7	6.4	3.8	4.9
Growth of remittance inflows (U.S. dollar terms)	6.5	4.5	4.0	5.9	5.2
Non-interest current account balance (in percent of GDP)	-9.0	-6.9	-4.9	-16.6	-10.4
GDP deflator growth (U.S. dollar terms)	1.9	2.8	5.0	0.5	2.9
Primary deficit (in percent of GDP)	1.0	-1.0	0.1	2.6	-0.9

EXTERNAL DSA

External Debt Indicators			
	Indicative Thresholds 1/	2009/10	2010/11
NPV of external debt			
In percent of GDP	30	31	37
In percent of exports	100	256	291
In percent of remittances and exports	90	89	109
In percent of revenue	200	149	211
Debt service			
In percent of exports	15	15	14
In percent of remittances and exports	14	5	5
In percent of revenue	25	9	10

1/ Represents Low Income Country DSA indicative thresholds for Tonga that is classified as a poor performer under the World Bank's Country Policy Institutional Assessment. The threshold for the ratios in percent of remittance and exports are modified by a 10 percent rule-of-thumb.

Baseline

6. Under the baseline, the external debt trajectory breaches several policy-dependent thresholds in 2010/11 before receding to lower levels over the medium term. The present value of public and publicly guaranteed (PPG) external debt is currently over 30 percent of GDP, the indicative threshold level. Given the drawdown of the Exim Bank loans the PV of PPG external debt is projected to increase to about 40 percent of GDP by 2012/13, 10 percentage points above the threshold, before dropping under the threshold by 2018/19 and declining to around 7 percent of GDP by 2030/31.

7. External debt remains well above the PV of debt-to-export distress threshold.

Reflecting Tonga's low exports, the PV of PPG external debt-to-exports ratio is almost three times the indicative threshold of 100 percent, and is projected to remain above the threshold well past 2020. The PV of debt-to-revenue ratio also breaches the threshold until around and below the

threshold thereafter. Tonga's remittances, which are the country's largest source of foreign exchange earnings (one half of Tongans live abroad), would help to reduce liquidity risks. Tonga's remittances have averaged more than twice export receipts over the past decade, and have provided a considerably more stable source of foreign exchange inflows.⁴ Relative to remittances and exports the PV of PPG debt is projected to exceed 100 percent in 2010/11–2013/14, and is projected to remain above the (lower) modified threshold until around 2015/16, 10 years sooner than when remittances are ignored. Therefore, scenario analysis that take into account remittances have been added.

8. Debt and debt service are expected to stay above the exports threshold for most of

⁴ Remittance income growth has historically been much more stable than export growth. The coefficient of variation of remittances has been 1.3, much lower than the coefficient of 2 for export receipts.

the projection period, but not when remittances are accounted for. Tonga will be unable to expand its very narrow export base in the short term, aggravating solvency and liquidity risks. The ratio of debt service to revenue remains well below the threshold of 25 percent throughout the projection period (Figure 1), albeit with a deterioration in the short to medium term. Relative to exports and remittances, external debt service remains well under 10 percent throughout the projection period to 2030/31. Remittances will decline in the short term, but they are expected to recover and stabilize at around 27 percent of GDP over the longer term. This level of remittances represents a recovery from the time of the global financial crisis but remains lower than the level of remittances received in the years before the crisis.

Sensitivity Analysis

9. Stress tests show the vulnerability of the debt position to a slowdown in exports or a significant depreciation. The export shock stress test causes the present value of debt to exceed 500 percent of exports and remain above the 100 percent threshold for the entire projection

period. Similarly, the debt service-to-exports ratio rises even further above the 15 percent threshold, reaching almost 40 percent in 2017. A large one-time depreciation causes the present value of debt to rise to around over 55 percent of GDP and remain persistently above the 30 percent threshold even after 2020. Similarly a large depreciation also causes the present value of debt-to-revenue ratio to persistently breach its threshold. Several other potential shocks would also see debt levels remain above the indicative GDP and export thresholds for a prolonged period. Similar stresses emerge when remittances are considered. The future scenario is more risky than the historical trends would indicate because the recent China EXIM loan and donor financed construction projects have caused a larger current account balance than in the past. If the current account deficit were at historical levels, debt could be reduced more quickly, although these smaller current account deficits are unlikely in coming years as the remaining construction projects are rolled out and the existing projects are completed.

PUBLIC SECTOR DSA

Baseline

10. The public sector DSA reinforces the conclusions of the external DSA. The recent high level of public sector borrowing for road building and reconstruction of the capital raises the

present value of debt to over 42 percent of GDP in 2011/12–2013/14 before it declines steadily thereafter under the baseline scenario. This highlights the importance of fiscal prudence, and a commitment to limit new PPG borrowing.

Alternative Scenario and Stress Tests

11. Stress tests indicate that vulnerabilities remain throughout the projection period, especially to a sizable depreciation. Among the stress tests performed, a 30 percent depreciation results in the largest rise in the overall public debt burden. The PV of public debt would rise and remain above 50 percent of GDP until 2017/18 and

would be at 18½ percent of GDP in 2031.⁵ Maintaining the primary balance at its 2010 level brings debt down faster because the defi given the large deficits implied by the Exim bank-financed construction. The externally financed capital expenditure will require larger longer-term primary surpluses (of around 1 percent of GDP) to ensure debt in line with our baseline.

STAFF ASSESSMENT

12. Tonga remains at a high risk of external debt distress. While Tonga benefits from very high and relatively stable remittance inflows, which clearly mitigate its liquidity risks, remittances are insufficient to limit risks from projected debt service payments. Additionally, the authorities have exposed themselves to a currency mismatch on the government's balance sheet which, if left unchecked, could pose an additional risk to Tonga's debt dynamics. Despite being at high risk, Tonga's debt dynamics are manageable. Tonga is able to service its current obligations, and the overall public sector debt situation, while elevated over the short term, shows a downward trend over the longer run assuming the authorities avoid taking on additional debt.

13. Key medium-term vulnerabilities include lower GDP growth, major external shocks, currency mismatches, and credit risks to the government's balance sheet, and borrowing on less concessional terms These vulnerabilities underscore the importance of sound

macroeconomic policies to improve Tonga's growth potential on a sustained basis, export diversification, and continued efforts in fiscal consolidation. Moreover, increased utilization of donor grants and avoiding further new borrowing until the debt is put on a downward path is necessary to reduce the risk of external debt distress. Sound public debt management, anchored in a medium-term debt management strategy and in line with the medium-term fiscal framework, is also essential to guide future development financing in Tonga. Priority should be given to projects which would help generate high growth and employment, especially in the context of the NSPF, to help ensure debt service capacity in the future.

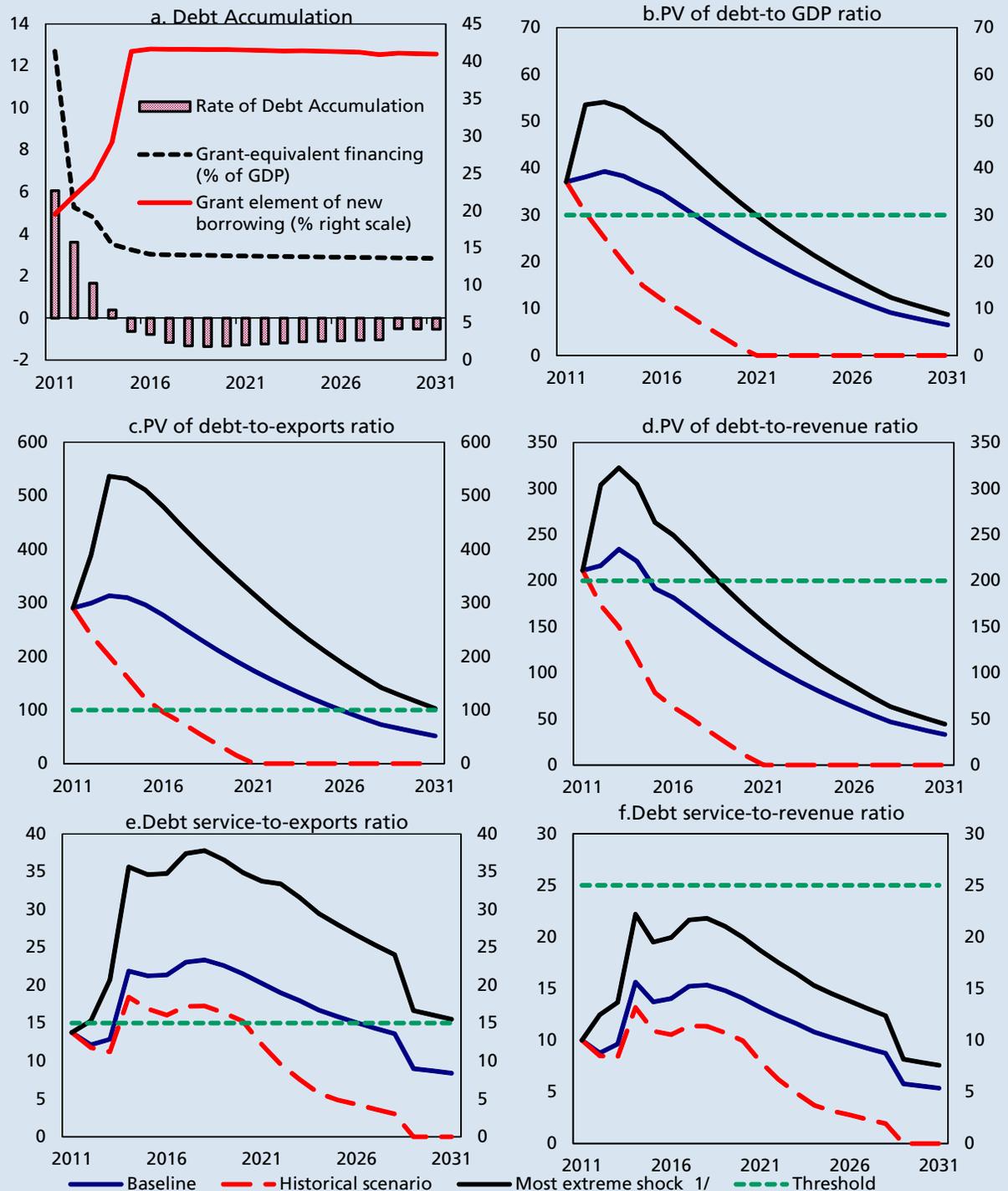
⁵ In the Fiscal Balance scenario, we assume a more ambitious medium-term fiscal program, where the primary surplus is kept at an average of 1 percent of GDP after 2010/11.

Box 1

Key Assumptions

- Real GDP growth is projected to average around 1.7 percent over the period 2010/11–2015/16, as the fiscal impulse provided by the two China loans is completed, the economy recovers from the global financial crisis, and remittances recover. Longer-term growth is expected to be marginally higher, reflecting a return on the ongoing capital projects but will remain around its long-run average because of structural impediments.
- As growth recovers, the current fiscal balance is assumed to narrow from a deficit about 2½ percent of GDP in 2010/11 to surplus of 1 percent by 2015/16. The surplus is projected to result from restraint in wage expenditures following the recent public sector restructuring, tax administration gains, and the alignment of government ministries under a medium-term budget framework. In addition, it is important for the government to ensure that the salary structure of civil servants adequately reflects performance and contributes to increasing efficiency in service delivery.
- A current fiscal balance of around 1 percent of GDP is assumed over the longer-term. Current revenue and expenditure are assumed to be broadly stable as a percent of GDP. The resulting primary fiscal balance will average around 1 percent of GDP.
- Grants are projected to decline from current high levels of 5¼ percent of GDP, but remain significant at around 2½ percent of GDP over the longer term. Donor commitments are extremely important given the relatively small size of the Tongan economy and its vulnerability to external shocks. These grants, together with projected disbursements from concessional loans are assumed to be spent entirely on development projects and associated maintenance. Following the last disbursement of the current China Exim Bank loan (in 2012/13), we assume all future external borrowing is from concessional IFI (AsDB and World Bank) facilities. On the domestic front it is assumed no new domestic borrowing until 2014/15 as consolidation advances and the debt is brought down. Domestic borrowing is thereafter limited to filling any financing gap.
- The external current account deficit is projected to reach 10¾ percent of GDP in 2012/13, up from 7¾ percent of GDP in 2009/10, driven primarily by the large construction-related imports. Over the medium term, the deficit should return to around 7½ percent of GDP.
- Net FDI is projected to stabilize at around 5½ percent of GDP.
- The decline in remittances appears to have bottomed out as economic activity in the United States, Australia, and New Zealand has begun to recover. These three countries are the source of the vast majority of Tonga's remittances. Remittances are expected to recover along with the economies in these three countries and as Australia reviews its seasonal worker program for Pacific Islanders to facilitate greater utilization of the scheme. The export base is projected to remain narrow and relatively undiversified with a focus on agricultural products. The proper operation of the fumigation facility should help gradually increase exports as the products will meet New Zealand's bio-security requirements.

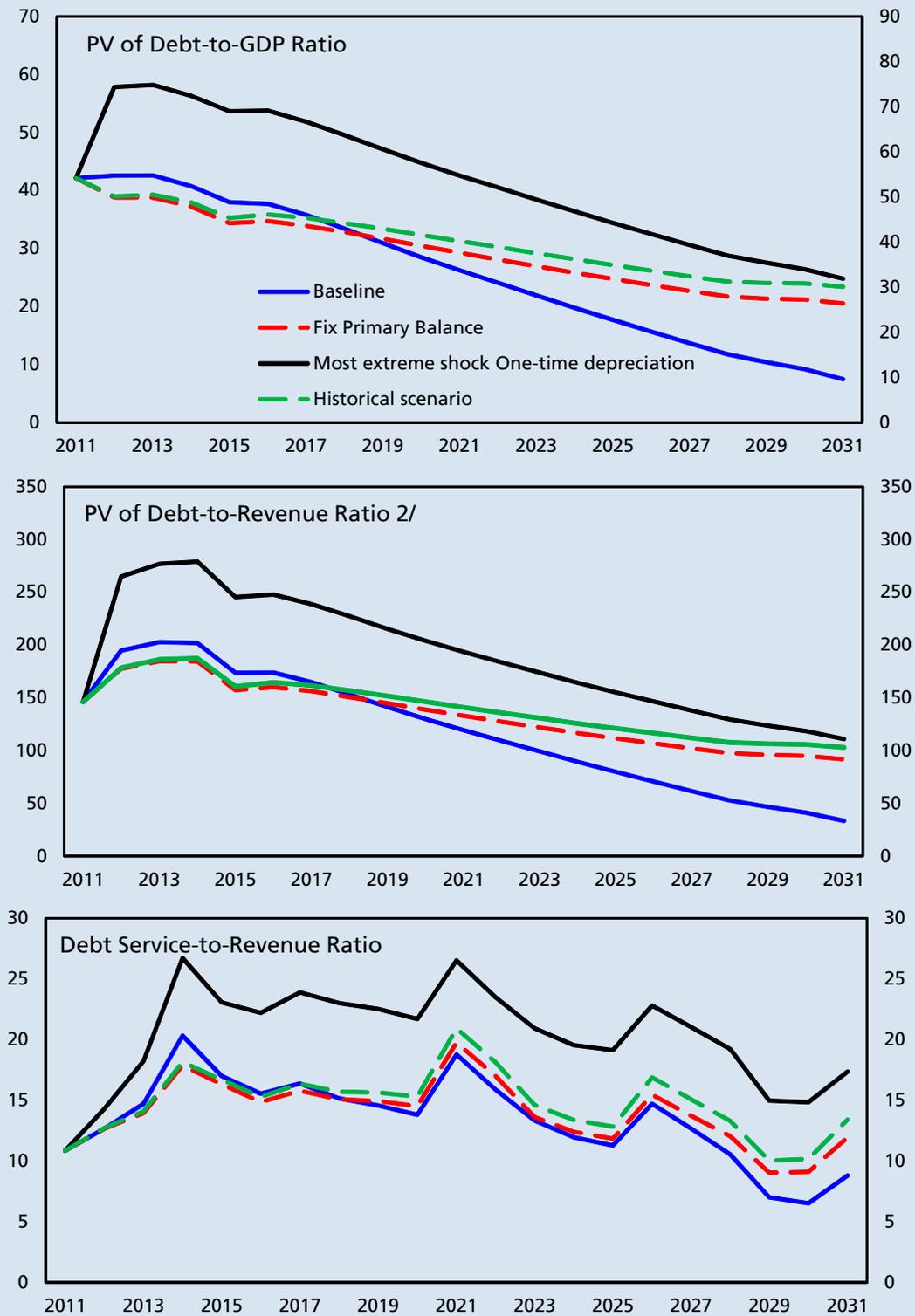
Figure 1 Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2011–31 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020. In figure b. it corresponds to a Non-debt flows shock; in c. to a Exports shock; in d. to a Non-debt flows shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock. Data refers to last date in fiscal year (e.g., 2011, refers to FY ending June 30, 2011).

Figure 2 Tonga: Indicators of Public Debt under Alternative Scenarios, 2011–31 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020. Data refers to last date in fiscal year (e.g., 2011, refers to FY ending June 30, 2011).

2/ Revenues are defined inclusive of grants.

Figure 3 Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2011–31 1/

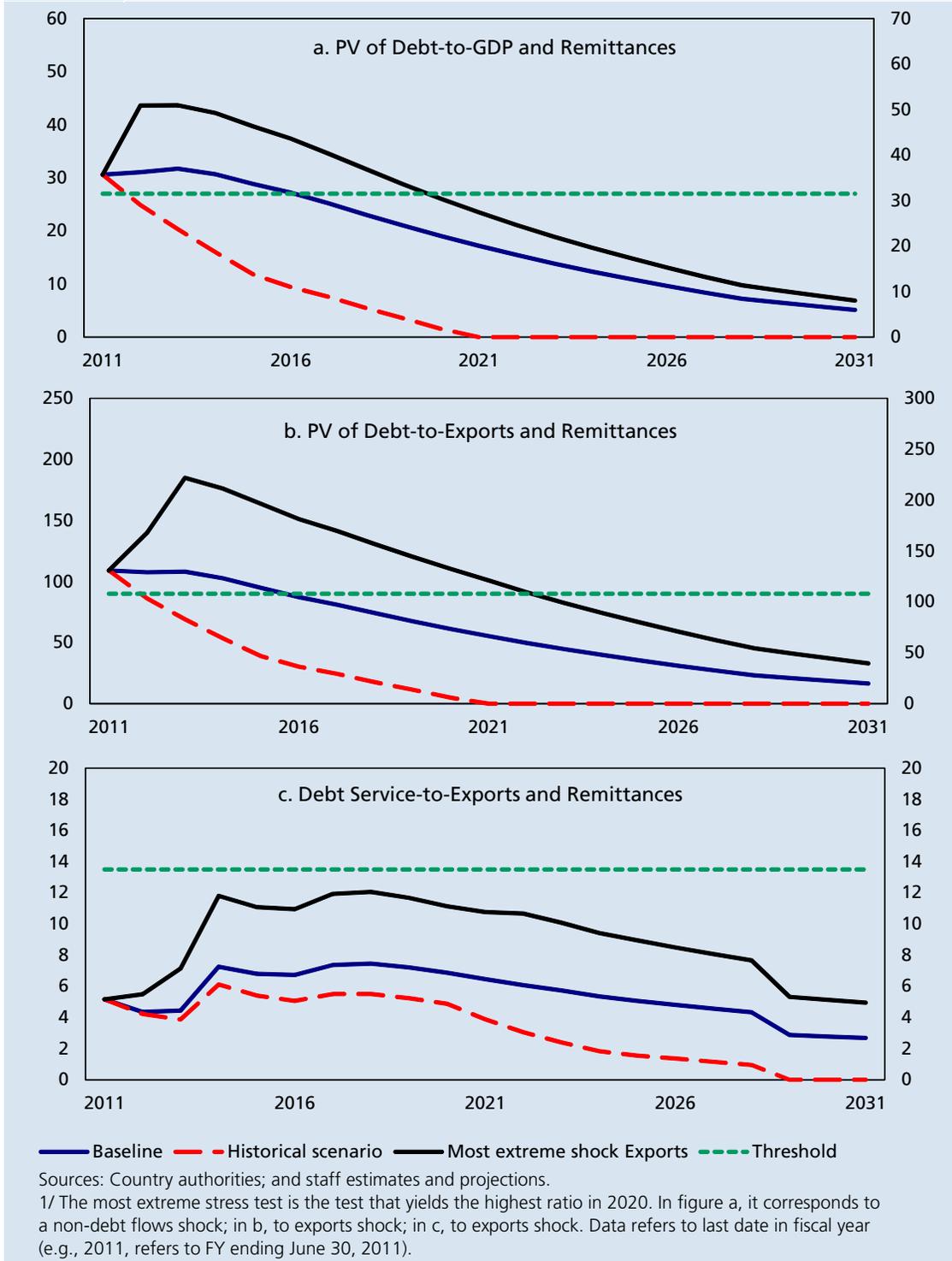
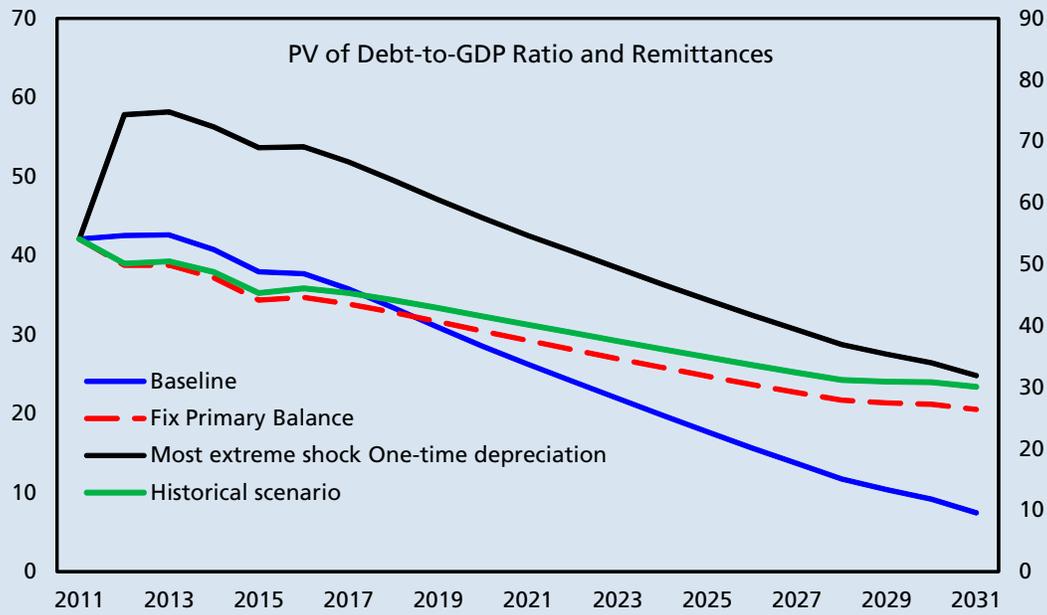


Figure 4 Tonga: Indicators of Public Debt under Alternative Scenarios, 2011–31 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020. Data refers to last date in fiscal year (e.g., 2011, refers to FY ending June 30, 2011).

Table 1a Tonga: External Debt Sustainability Framework, Baseline Scenario, 2008–31 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Projections						2011-2016 Average	2021	2031	2017-2031 Average
	2008	2009	2010			2011	2012	2013	2014	2015	2016				
External debt (nominal) 1/	23.7	31.1	35.3			42.0	43.1	44.2	43.3	40.8	38.7		24.4	9.2	
o/w public and publicly guaranteed (PPG)	23.7	31.1	35.3			42.0	43.1	44.2	43.3	40.8	38.7		24.4	9.2	
Change in external debt	-3.1	7.4	4.2			6.7	1.1	1.1	-0.9	-2.4	-2.1		-2.5	-0.8	
Identified net debt-creating flows	-1.4	5.1	0.3			7.8	9.5	7.9	6.1	4.4	1.2		1.0	1.7	
Non-interest current account deficit	8.5	14.2	7.2	4.9	5.8	10.2	10.9	9.9	8.9	8.0	6.0		6.7	7.4	6.9
Deficit in balance of goods and services	37.1	40.0	30.1			38.4	35.9	33.1	33.6	33.8	33.0		32.8	33.2	
Exports	14.2	14.3	12.2			12.8	12.7	12.5	12.4	12.3	12.5		12.6	12.6	
Imports	51.2	54.3	42.4			51.2	48.7	45.7	45.9	46.1	45.5		45.4	45.8	
Net current transfers (negative = inflow)	-27.2	-23.8	-21.6	-28.4	4.3	-26.8	-23.6	-21.7	-22.9	-24.3	-25.5		-24.7	-24.7	-24.7
o/w official	-0.1	-0.2	-0.3			-7.4	-2.7	0.3	0.2	-0.1	-0.1		0.3	0.3	
Other current account flows (negative = net inflow)	-1.3	-2.0	-1.3			-1.4	-1.4	-1.6	-1.8	-1.5	-1.5		-1.3	-1.0	
Net FDI (negative = inflow)	-7.0	-11.9	-4.3	-4.8	4.0	-2.8	-1.5	-2.1	-3.0	-3.6	-4.9		-5.8	-6	-5.8
Endogenous debt dynamics 2/	-3.0	2.8	-2.6			0.3	0.1	0.1	0.3	0.0	0.0		0.1	0.1	
Contribution from nominal interest rate	0.3	0.5	0.5			0.7	0.8	0.9	1.0	0.8	0.7		0.5	0.3	
Contribution from real GDP growth	-0.6	0.0	0.1			-0.4	-0.7	-0.8	-0.8	-0.8	-0.7		-0.5	-0.2	
Contribution from price and exchange rate changes	-2.7	2.2	-3.2			...	...	...	...	...	...		...	...
Residual (3-4) 3/	-1.7	2.4	3.9			-1.1	-8.4	-6.9	-7.1	-6.8	-3.3		-3.5	-2.5	
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	
PV of external debt 4/	...	...	31.3			37.1	38.1	39.3	38.3	36.4	34.6		21.8	6.5	
In percent of exports	...	...	255.9			290.6	299.6	313.6	309.9	296.4	276.9		173.2	51.8	
PV of PPG external debt	...	...	31			37.1	38.1	39.3	38.3	36.4	34.6		21.8	6.5	
In percent of exports	...	...	256			291	300	314	310	296	277		173	52	
In percent of government revenues	...	...	149			211	217	234	221	191	182		113	33	
Debt service-to-exports ratio (in percent)	10.0	8.7	15.0			13.8	12.1	12.9	21.9	21.3	21.4		20.2	8.4	
PPG debt service-to-exports ratio (in percent)	10.0	8.7	15.0			13.8	12.1	12.9	21.9	21.3	21.4		20.2	8.4	
PPG debt service-to-revenue ratio (in percent)	5.8	5.4	8.8			10.0	8.8	9.6	15.6	13.7	14.0		13.2	5.4	
Total gross financing need (Millions of U.S. dollars)	10.3	11.3	16.7			34.2	42.1	37.4	35.1	29.8	16.7		18.9	22.8	
Non-interest current account deficit that stabilizes debt ratio	11.6	6.8	3.0			3.6	9.8	8.8	9.8	10.4	8.2		9.3	8.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.7	-0.1	-0.5	1.1	1.9	1.2	1.7	1.8	1.8	1.8	1.8	1.7	1.8	1.8	1.8
GDP deflator in US dollar terms (change in percent)	11.1	-8.5	11.6	5.0	10.0	4.3	1.2	1.5	1.7	1.8	0.9	1.9	2.8	2.8	2.8
Effective interest rate (percent) 5/	1.5	2.0	1.9	1.2	0.5	2.2	2.0	2.1	2.4	1.8	1.9	2.0	2.1	3.0	2.4
Growth of exports of G&S (US dollar terms, in percent)	50.6	-7.4	-5.2	6.4	25.1	10.0	2.5	1.7	2.2	2.8	4.8	4.0	4.6	4.6	4.7
Growth of imports of G&S (US dollar terms, in percent)	22.2	-3.0	-13.4	7.5	14.7	27.5	-2.2	-3.1	4.1	4.0	1.5	5.3	4.6	4.8	4.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	19.5	22.0	24.4	29.1	41.3	41.6	29.7	41.5	41.0	41.3
Government revenues (excluding grants, in percent of GDP)	24.6	22.9	21.0			17.6	17.6	16.8	17.3	19.0	19.1		19.4	19.7	19.4
Aid flows (in Millions of US dollars) 7/	4.6	21.8	18.4			41.8	18.2	18.8	15.7	16.1	15.6		18.5	26.8	
o/w Grants	4.6	21.8	18.4			41.8	16.2	16.8	11.7	12.1	11.6		14.5	22.8	
o/w Concessional loans	0.0	0.0	0.0			0.0	2.0	2.0	4.0	4.0	4.0		4.0	4.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			12.7	5.3	4.8	3.5	3.3	3.0		3.0	2.8	2.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			67.3	58.8	73.1	68.6	85.2	84.9		87.2	90.9	88.3
Memorandum items:															
Nominal GDP (Millions of US dollars)	348.0	318.0	353.2			372.8	383.4	396.1	410.0	425.0	436.7		547.6	860.8	
Nominal dollar GDP growth	14.1	-8.6	11.1			5.5	2.9	3.3	3.5	3.6	2.8	3.6	4.6	4.6	4.6
PV of PPG external debt (in Millions of US dollars)	...	...	109.6			131.0	144.5	150.8	152.4	149.8	146.5		115.6	54.4	
(PVt-PVt-1)/GDPt-1 (in percent)	...	...	...			6.1	3.6	1.7	0.4	-0.6	-0.8	1.7	-1.3	-0.5	-1.1
Gross remittances (Millions of US dollars)	106.7	84.0	81.7			79.2	87.1	94.5	102.4	110.7	118.8		147.1	231.2	
PV of PPG external debt (in percent of GDP + remittances)	...	...	25.5			30.6	31.1	31.7	30.7	28.8	27.2		17.2	5.1	
PV of PPG external debt (in percent of exports + remittances)	...	...	88.6			109.0	107.6	108.0	102.6	94.9	87.2		55.3	16.5	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	5.2			5.2	4.4	4.4	7.2	6.8	6.7		6.5	2.7	

Sources: Country authorities; and staff estimates and projections.

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 PV 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.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1b Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011–31

(In percent)												
	2011	2012	2013	2014	2015	Projections						
	2016	2017	2018	2019	2020	2021	2031					
PV of debt-to GDP ratio												
Baseline	37	38	39	38	36	35	32	29	27	24	22	7
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2011-2031 1/	37	31	25	20	15	12	10	7	4	2	0	0
A2. New public sector loans on less favorable terms in 2011-2031 2	37	39	40	39	38	36	34	32	29	27	25	12
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	37	39	40	39	37	35	32	30	27	24	22	6
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	37	39	43	42	40	38	35	33	30	28	25	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	37	40	43	42	40	38	35	32	29	26	24	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	37	38	37	36	35	33	30	28	25	23	20	6
B5. Combination of B1-B4 using one-half standard deviation shocks	37	37	38	37	35	33	30	27	25	22	20	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	37	54	54	53	50	48	44	40	36	33	30	9
PV of debt-to-exports ratio												
Baseline	291	300	314	310	296	277	254	232	211	192	173	52
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2011-2031 1/	291	240	201	161	122	96	77	55	36	15	0	0
A2. New public sector loans on less favorable terms in 2011-2031 2	291	304	317	319	308	291	271	252	234	216	200	95
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	291	296	304	300	287	267	245	224	204	185	167	49
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	291	390	537	532	511	480	443	410	377	346	316	103
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	291	296	304	300	287	267	245	224	204	185	167	49
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	291	297	299	295	282	262	240	219	199	180	162	47
B5. Combination of B1-B4 using one-half standard deviation shocks	291	311	335	331	315	293	267	242	218	196	175	47
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	291	296	304	300	287	267	245	224	204	185	167	49
PV of debt-to-revenue ratio												
Baseline	211	217	234	221	191	182	168	153	138	125	113	33
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2011-2031 1/	211	173	150	115	78	63	51	36	23	10	0	0
A2. New public sector loans on less favorable terms in 2011-2031 2	211	220	237	227	199	191	179	166	153	141	130	61
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	211	219	238	225	195	185	170	155	140	127	114	33
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	211	223	254	241	209	200	186	171	157	143	130	42
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	211	228	258	244	210	200	184	168	152	137	123	36
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	211	214	223	211	182	172	159	144	130	117	105	30
B5. Combination of B1-B4 using one-half standard deviation shocks	211	211	224	211	182	172	157	142	128	114	102	27
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	211	304	322	305	263	250	230	209	190	171	154	44

Table 1b Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011–31 (continued)

(In percent)												
Debt service-to-exports ratio												
Baseline	14	12	13	22	21	21	23	23	23	22	20	8
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2011-2031 1/	14	12	11	18	17	16	17	17	16	15	12	0
A2. New public sector loans on less favorable terms in 2011-2031 2	14	12	12	22	22	22	23	22	22	20	19	8
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	14	12	13	22	21	21	23	23	23	22	20	8
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	14	15	21	36	35	35	37	38	37	35	34	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	14	12	13	22	21	21	23	23	23	22	20	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	14	12	13	22	21	21	23	23	23	21	20	8
B5. Combination of B1-B4 using one-half standard deviation shocks	14	13	15	25	25	25	27	27	26	25	23	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	14	12	13	22	21	21	23	23	23	22	20	8
Debt service-to-revenue ratio												
Baseline	10	9	10	16	14	14	15	15	15	14	13	5
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2011-2031 1/	10	8	8	13	11	11	11	11	11	10	8	0
A2. New public sector loans on less favorable terms in 2011-2031 2	10	9	9	16	14	14	15	15	14	13	12	5
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	10	9	10	16	14	15	16	16	16	15	14	6
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	10	9	10	16	14	14	16	16	15	14	14	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	10	9	11	18	16	16	17	17	17	16	15	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	10	9	10	16	14	14	15	15	15	14	13	5
B5. Combination of B1-B4 using one-half standard deviation shocks	10	9	10	16	14	15	16	16	15	15	13	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	10	12	14	22	19	20	22	22	21	20	19	8
<i>Memorandum item:</i>												
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	36	36	36	36	36	36	36	36	36	36	36	36
Sources: Country authorities; and staff estimates and projections.												
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 2a Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, 2008–31 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Average	Standard Deviation	Estimate					Projections				
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011-16 Average	2021	2031	2017-31 Average
Public sector debt 2/	32.2	38.5	42.8			47.0	47.6	47.5	45.7	42.4	41.8			28.8	10.1
o/w foreign-currency denominated	23.7	31.1	35.3			42.0	43.1	44.2	43.3	40.8	38.7			24.4	9.2
Change in public sector debt	-4.7	6.3	4.3			4.3	0.5	-0.1	-1.8	-3.3	-0.6			-2.4	-1.6
Identified debt-creating flows	-6.0	6.6	2.6			2.9	2.0	0.7	-0.3	-0.4	-0.6			-1.7	-1.2
Primary deficit	-2.3	-1.2	4.6	0.1	2.3	2.9	3.8	0.0	-0.3	0.1	-0.6	1.0		-1.0	-1.1
Revenue and grants	25.9	29.8	26.3			28.8	21.8	21.0	20.2	21.9	21.7			22.0	22.3
of which: grants	1.3	6.9	5.2			11.2	4.2	4.2	2.9	2.9	2.6			2.6	2.6
Primary (noninterest) expenditure	23.6	28.6	30.8			31.7	25.7	21.0	19.9	21.9	21.1			21.0	21.3
Automatic debt dynamics	-3.4	3.1	-0.8			0.3	-1.8	0.7	0.0	-0.5	0.0			-0.7	-0.1
Contribution from interest rate/growth differential	-1.4	0.7	0.8			-0.2	-0.2	-0.1	0.1	-0.5	-0.4			-0.4	0.0
of which: contribution from average real interest rate	-0.4	0.6	0.6			0.3	0.6	0.7	0.9	0.3	0.4			0.2	0.2
of which: contribution from real GDP growth	-1.0	0.0	0.2			-0.5	-0.8	-0.8	-0.8	-0.8	-0.8			-0.6	-0.2
Contribution from real exchange rate depreciation	-2.0	2.4	-1.7			0.5	-1.6	0.8	-0.1	0.0	0.4			...	...
Other identified debt-creating flows	-0.3	4.7	-1.2			-0.3	0.0	0.0	0.0	0.0	0.0			0.0	0.0
Privatization receipts (negative)	0.0	4.7	0.0			0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0
Recognition of implicit or contingent liabilities	-0.3	0.0	-1.2			-0.3	0.0	0.0	0.0	0.0	0.0			0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0			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	1.3	-0.2	1.7			1.4	-1.5	-0.7	-1.6	-2.9	0.0			-0.8	-0.4
Other Sustainability Indicators															
PV of public sector debt	8.5	7.4	38.8			42.1	42.5	42.6	40.7	37.9	37.7			26.2	7.5
o/w foreign-currency denominated	0.0	0.0	31.3			37.1	38.1	39.3	38.3	36.4	34.6			21.8	6.5
o/w external	...	...	31.3			37.1	38.1	39.3	38.3	36.4	34.6			21.8	6.5
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...			...	...
Gross financing need 3/	-0.5	1.6	8.0			6.0	6.6	3.1	3.8	3.8	2.8			3.1	0.9
PV of public sector debt-to-revenue and grants ratio (in percent)	32.8	24.9	147.6			146.3	194.8	202.8	201.9	173.6	173.8			119.3	33.4
PV of public sector debt-to-revenue ratio (in percent)	34.6	32.3	184.2			239.6	241.7	254.0	235.2	199.7	197.9			135.6	37.9
o/w external 4/	...	...	148.9			211.1	216.6	234.2	221.2	191.3	181.8			112.6	33.1
Debt service-to-revenue and grants ratio (in percent) 5/	6.9	9.5	13.0			10.8	12.7	14.7	20.3	17.0	15.6			18.8	8.8
Debt service-to-revenue ratio (in percent) 5/	7.2	12.4	16.2			17.8	15.7	18.4	23.7	19.5	17.7			21.4	10.0
Primary deficit that stabilizes the debt-to-GDP ratio	2.4	-7.5	0.3			-1.4	3.3	0.1	1.6	3.4	0.1			1.4	0.6
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	2.7	-0.1	-0.5	1.1	1.9	1.2	1.7	1.8	1.8	1.8	1.8	1.7	1.8	1.8	1.8
Average nominal interest rate on forex debt (in percent)	1.5	2.0	1.9	1.2	0.5	2.2	2.0	2.1	2.4	1.8	1.9	2.0	2.1	3.0	2.4
Average real interest rate on domestic debt (in percent)	-1.5	5.9	4.4	-2.4	5.7	-0.8	6.8	10.5	17.3	13.0	21.5	11.4	1.3	4.0	1.9
Real exchange rate depreciation (in percent, + indicates depreciation)	-7.7	10.1	-5.3	-1.8	11.5	1.3	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.4	0.4	3.2	6.4	4.8	9.2	5.8	3.9	6.0	6.0	6.0	6.2	6.0	6.0	6.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.1	0.2	0.1	0.1	0.1	0.0	-0.2	-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	19.5	22.0	24.4	29.1	41.3	41.6	29.7	41.5	41.0	...

Sources: Country authorities; and staff estimates and projections.

1/ Data refers to last date in fiscal year (e.g., 2011 refers to FY ending June 30, 2011).

2/ Data covers general government and nonfinancial public enterprises. Gross debt is used.

3/ 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.

4/ Revenues excluding grants.

5/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b Tonga: Sensitivity Analysis for Key Indicators of Public Debt, 2011–31 1/

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
PV of Debt-to-GDP Ratio								
Baseline	42	43	43	41	38	38	26	7
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	42	39	39	38	35	36	31	23
A2. Primary balance is unchanged from 2010	42	39	39	37	34	35	29	21
A3. Permanently lower GDP growth 2/	42	43	43	42	39	40	32	25
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	42	44	46	45	43	44	37	26
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	42	41	43	42	39	39	27	8
B3. Combination of B1-B2 using one half standard deviation shocks	42	40	42	41	39	39	30	17
B4. One-time 30 percent real depreciation in 2011	42	58	58	56	54	54	43	25
B5. 10 percent of GDP increase in other debt-creating flows in 2011	42	53	53	51	48	48	36	17
PV of Debt-to-Revenue Ratio 3/								
Baseline	146	195	203	202	174	174	119	33
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	146	178	186	187	161	165	141	103
A2. Primary balance is unchanged from 2010	146	178	185	184	157	160	133	92
A3. Permanently lower GDP growth 2/	146	196	205	206	179	182	143	110
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	146	201	217	221	196	201	165	116
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	146	188	207	206	177	178	123	37
B3. Combination of B1-B2 using one half standard deviation shocks	146	185	200	202	176	179	137	75
B4. One-time 30 percent real depreciation in 2011	146	265	277	279	245	248	193	111
B5. 10 percent of GDP increase in other debt-creating flows in 2011	146	241	252	253	221	222	166	77

Table 2b Tonga: Sensitivity Analysis for Key Indicators of Public Debt, 2011–31 1/ (continued)

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
Debt Service-to-Revenue Ratio 3/								
Baseline	11	13	15	20	17	16	19	9
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	11	13	14	18	17	15	21	13
A2. Primary balance is unchanged from 2010	11	13	14	18	16	15	20	12
A3. Permanently lower GDP growth 2/	11	13	15	21	17	16	20	14
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	11	13	15	22	19	17	22	15
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	11	13	14	20	18	16	19	9
B3. Combination of B1-B2 using one half standard deviation shocks	11	13	15	19	18	16	20	12
B4. One-time 30 percent real depreciation in 2011	11	14	18	27	23	22	27	17
B5. 10 percent of GDP increase in other debt-creating flows in 2011	11	13	17	27	19	18	21	14

Sources: Country authorities; and staff estimates and projections.

1/ Data refers to last date in fiscal year (e.g., 2011 refers to FY ending June 30, 2011).

2/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

3/ Revenues are defined inclusive of grants.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 11/54
FOR IMMEDIATE RELEASE
May 16, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with Tonga

On May 4, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.¹

Background

Tonga's economy is recovering, on the back of increased construction activity and improvements in the external environment. GDP growth is estimated to rebound to 1¼ percent in FY2010/11 on the back of stronger tourism activity and an expansionary fiscal policy financed by donor aid and previously contracted loans. Remittance inflows have stabilized in recent months and should provide additional impetus to growth during the remainder of the fiscal year. However, this growth momentum will likely be limited by continued tight domestic financial conditions as banks maintain tight lending standards following the large rise in nonperforming loans of the past two years.

CPI inflation rose to 6½ percent y/y in February 2011, reflecting mainly increases in global food and oil prices and one-off effects from higher excises on tobacco and alcohol. Inflation is likely to average around 6 percent in FY2010/11.

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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

The government's stepped up capital expenditure in FY2010/11 helped to offset weaknesses in private demand. At the same time, generous grant inflows from donors during FY2010/11 contributed to narrowing the fiscal deficit to an estimated 4¼ percent of GDP (from about 5¾ percent of GDP in FY2009/10). Nevertheless, Tonga remains at a "high risk of debt distress" according to this year's World Bank-IMF debt sustainability analysis.

Monetary policy was geared toward jumpstarting bank lending. In FY2010/11, the National Reserve Bank of Tonga (NRBT) remunerated banks' exchange settlement account balances over TOP 1 million and maintained adequate liquidity in the system to encourage banks to step up lending. However, credit to the private sector continued to fall, albeit at a slower pace.

The slower decline in bank lending reflects some improvements in banks' balance sheets. Banks are now well capitalized; and profitability has improved somewhat in recent months, but remains well below levels of the past years, owing to high provisioning. Nevertheless, banks are likely to maintain a cautious lending stance in FY2010/11 amid uncertainties on the outlook.

Executive Board Assessment

Executive Directors noted that Tonga's economy is recovering from the recent internal and external shocks on the back of stronger tourism activity and fiscal expansion. The policy challenge now is to reduce the country's vulnerabilities and to boost potential growth.

Directors stressed that in the near term, fiscal consolidation is necessary to ensure fiscal sustainability and expand fiscal space to respond to future shocks. They emphasized the importance of avoiding new borrowing, reducing current spending, especially by containing the wage bill, prioritizing expenditure, and strengthening tax administration.

For the medium term, Directors agreed that fiscal policy should aim at placing public debt on a downward path. This strategy should be integrated within a medium-term budget framework that is consistent with Tonga's development objectives. Directors also encouraged the authorities to set up a comprehensive debt-management strategy to limit the credit and currency risks in the government balance sheet. They commended the authorities' commitment to improve transparency in fiscal accounts, which will help secure continued grant financing to support the government fiscal consolidation efforts.

Directors considered the current monetary policy stance to be appropriate. However, if the liquidity overhang or higher global commodity prices exacerbate inflation and exert downward pressure on reserves, a preemptive tightening of monetary policy would be called for.

Directors welcomed recent measures to improve the institutional framework for lending and the efforts by the central bank to step up regulation and supervision. Further improving intermediation will require enhancing the legal framework for collateralized lending, increasing competition within an appropriate prudential and regulatory framework, and enhancing consumer protection and financial literacy. Directors encouraged the authorities to resist the

pressure to administer the level of interest rates to avoid possible significant credit rationing and hampering banks' ability to adequately price risks.

Directors noted the staff assessment that the exchange rate is broadly in line with fundamentals. To safeguard external stability, they encouraged the authorities to stand ready to use the flexibility within the bands of the pegged exchange rate to gradually depreciate the pa'anga. Any depreciation should be accompanied by further fiscal restraint, given the effects a weaker currency would have on the public debt.

Directors emphasized that promoting private sector activity is essential for strengthening the medium-term growth prospects. They underscored the importance of improving the land tenure system, making further progress in reforming public enterprises, reducing the number of business licenses, and lowering barriers to foreign investment.

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.

Table 1 Tonga: Selected Economic Indicators, 2006/07–2011/12 1/

Nominal GDP (2009/10): US\$ 353.2 million						
Population (2009): 103,294						
GDP per capita (2009/10): US\$ 3,419						
Quota: SDR 6.9 million						
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			Prel.		Proj.	
	(Annual percent change)					
Output and prices						
Real GDP 2/	-1.0	2.7	-0.1	-0.5	1.2	1.7
Consumer prices (period average)	5.1	9.8	5.0	2.0	6.0	5.8
Consumer prices (end of period)	5.6	12.2	1.2	2.6	10.4	1.7
	(In percent of GDP)					
Central government finance						
Total revenue and grants	28.0	25.9	29.8	26.3	28.8	21.8
Total revenue	24.3	24.6	22.9	21.0	17.6	17.6
Grants	3.7	1.3	6.9	5.2	11.2	4.2
Total expenditure and net lending	26.9	24.3	29.6	31.9	33.0	27.0
<i>Of which:</i> Current expenditure	25.9	23.9	25.3	26.2	20.0	19.8
Capital expenditure	0.9	0.4	3.0	3.4	10.5	5.2
Overall balance	1.0	1.6	0.1	-5.7	-4.2	-5.2
Overall balance (excl. China's EXIM bank loans)	...	...	0.4	-3.3	0.8	-2.3
External financing (net)	0.1	0.2	-0.1	4.0	9.2	5.9
Domestic financing (net)	-1.2	-1.7	4.7	1.6	-5.0	-0.7
Privatization receipts	0.0	0.0	-4.7	0.0	0.0	0.0
	(Annual percent change)					
Money and credit						
Total liquidity 3/	13.3	6.7	-1.1	5.8	5.2	-0.9
<i>Of which:</i> Broad money (M2)	11.9	8.2	-1.8	5.1	5.7	-1.1
Domestic credit	12.2	13.9	-5.2	-11.5	-18.5	9.0
<i>Of which:</i> Private sector credit	9.5	17.1	-3.7	-15.6	-4.5	9.4
Interest rates (end of period)						
Average deposit rate	5.7	5.7	4.9	3.4	...	
Base lending rate	9.5	10.0	10.0	9.6	...	
	(In millions of U.S. dollars)					
Balance of payments						
Exports, f.o.b.	13.3	12.4	5.5	5.9	7.1	7.8
Imports, f.o.b.	-108.6	-138.1	-130.1	-108.2	-146.1	-140.0
Services (net)	-17.9	-3.3	-2.6	-4.1	-4.3	-5.6
Investment income (net)	3.5	3.4	4.6	2.7	2.7	2.6
Services and investment income (net)	-14.4	0.1	2.0	-1.3	-1.6	-3.0
Current transfers (net)	84.2	94.7	75.8	76.2	99.7	90.4
<i>Of which:</i> Private transfer receipts	93.3	106.7	84.0	81.7	79.2	87.1
Current account balance	-25.5	-30.9	-46.9	-27.4	-40.9	-44.8
(In percent of GDP)	-8.3	-8.9	-14.7	-7.8	-11.0	-11.7
Current account balance (excl. China's EXIM bank loans)	-25.5	-30.9	-45.4	-14.2	-11.1	-26.0
Overall balance	4.2	-1.4	22.6	17.7	15.3	-13.9
Terms of trade (annual percent change)	21.4	-0.6	0.1	...	...
Gross official foreign reserves						
In millions of U.S. dollars	47.1	48.2	67.7	88.7	104.0	90.1
In months of goods and services imports	3.9	3.2	4.7	7.1	6.5	5.8
External debt (in percent of GDP)						
External debt	26.8	24.9	32.5	36.6	43.3	44.3
Debt service ratio	1.1	1.4	1.2	1.8	1.6	1.4
Exchange rates						
Pa'anga per U.S. dollar (period average)	2.0	1.9	2.1	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...
Nominal effective exchange rate (1990=100)	99.1	101.1	107.5	106.5	...	...
Real effective exchange rate (1990=100)	99.1	101.1	107.5	107.5	...	...
Memorandum item:						
Nominal GDP (millions of T\$)	611.0	661.4	663.2	681.4	752.9	810.2
Gross Disposable Income (millions of T\$)	809.1	868.9	840.3	843.3	970.8	1018.4
Population (thousands)	102.0	102.4	102.9	103.3	103.7	104.1

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

1/ Fiscal year beginning July.

2/ Including preliminary data.

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

**Statement by Aida Budiman, Alternate Executive Director for Tonga
and Peishan Yeo, Senior Advisor to the Executive Director
May 4, 2011**

1. On behalf of the Tongan authorities, we would like to thank staff for the constructive policy discussions and useful advice rendered during the recent Article IV consultation. The staff report succinctly identifies the short and medium term challenges confronting the Tongan economy, and sets out requisite actions to restore the country to a sustainable growth path. The Tongan authorities broadly agree with the appraisal in the report and will thoughtfully consider the recommendations therein.

Economic Developments in FY 2010/11

2. Our authorities agree with staff that the economy is showing some signs of improvement. The projected GDP growth for FY2010/11 is still being finalized but is expected to surprise on the upside and come into positive territory, compared to earlier estimates of -0.5%. The upward revision was mainly on account of a higher-than-expected contribution from construction activity, which was largely financed from overseas. That said, the authorities assessed that there has been limited immediate positive spillover to the indigenous economy, as these projects used imported materials and hired mostly foreign workers. Nonetheless, the resultant increase in capital stock – in terms of a reconstructed central business district and more and better roads – is expected to facilitate business activity over the longer term.
3. There are incipient signs of a turnaround with regard to other drivers of the Tongan economy. Remittance inflows, which constitute a key multiplier effect on domestic consumption, have stabilized in recent months. A resurgence in the near term is however unlikely, given the still uncertain external environment. Tourism receipts have picked up significantly since the year ended June 2010, although exports remained subdued. Looking ahead, GDP growth is expected to be driven mainly by the construction sector and recovery in remittances, although continued tightness in credit conditions is expected to weigh on growth.
4. Price pressures have picked up but the outlook remains moderate, although risks are on the upside. Tonga, like other small open island economies, is vulnerable to increases in global commodity prices. CPI inflation rose to 6.5 percent y-o-y in February this year on the back of rising food and oil prices and one-off effects from higher excises on imported tobacco and alcohol. The authorities' latest estimates show inflation to come in at 6.6% and 4.3% in FY2010/11 and 2011/12 respectively.

5. A new government was elected under Tonga's first parliamentary elections in November 2010. The government acknowledges the challenges faced by the Tongan economy, and is committed to advance reforms to promote private sector activity and diversify the economic base, reduce Tonga's reliance on remittances and restore the policy space for countercyclical responses in the event of future shocks. Much work lies ahead, and it would take time for reforms to be duly implemented and to bear fruit. Important policy discussions have already commenced, supplemented by the helpful advice rendered by the IMF team, and progress been made.

Fiscal Policy

6. The authorities broadly agree with staff's assessment on fiscal policy. Notwithstanding capacity constraints and the recent change in government, reforms in the right direction have continued. The authorities also recognize the need to rebuild fiscal headroom expeditiously, particularly given the forthcoming increase in debt service burden from FY2013/14.
7. Considerable efforts have been directed towards restoring public finances to health. These include initiatives to strengthen Public Financial Management (PFM), such as improving auditing and procurement, implementing a Treasury Manual to guide financial decision-making, consolidation of government accounts and strengthening macroeconomic forecasting. Tonga has rolled out new IT systems to computerize tax records and data, which should strengthen tax compliance and bolster revenue collection. Public Expenditure Reviews are also being undertaken with donor funding to analyze the effectiveness of the Government's resource utilization. Importantly, the Ministry of Finance, line ministries and the Public Service Commission have enhanced collaboration and coordination efforts to strengthen expenditure prioritization, in accordance with national objectives.
8. Looking ahead, efforts in the near term would be focused on restoring fiscal space to make allowance for the envisaged rise in debt servicing costs. The debt service burden would materially increase from FY2013/14 when principal repayments for the Reconstruction and Roads Projects with the EXIM Bank of China would commence. Our authorities are very mindful of the attendant external risks and are enacting measures to control public finances in the FY 2011/12 Budget, which is currently under preparation. These would include revenue measures, although Tonga's ability to generate revenue is contingent on economic conditions going forward. On the expenditure front, the Government is committed to reduce recurrent expenditure by, for example, endeavouring to contain the wage bill and linking resource allocation to core activities. In addition, the Government plans to undertake a review to rationalize public sector activities, which may result in staff redeployment and merging or relocation of ministries to reduce costs.

9. Over the longer term, the authorities concur with the need to establish a Medium Term Budgeting Framework (MTBF), and to integrate the processes therein to the national priorities in the National Strategic Planning Framework (NSPF). This would in turn lay the foundations for placing Tonga's public finances on a sustainable path. As noted by staff, good progress has been made. For instance, the ministries have started developing and implementing a budget planning and management structure that entails a three-year corporate plan (CP) and an annual management plan (AMP) that link directly to the annual budget, through which resources are allocated and fiscal constraints addressed. The authorities would continue to work with PFTAC on outstanding measures.

Monetary Policy

10. The National Reserve Bank of Tonga (NRBT) will stay vigilant to price developments and stands ready to respond to contain inflation risks. At present, however, credit remains constrained as banks continue to maintain tight lending standards in light of the spate of NPLs over the past two years and uncertainty over the economic outlook. To jumpstart bank lending, the NRBT paid 1% remuneration on banks' Exchange Settlement Account balances that are above 1 million pa'anga. The endeavour has had some success as bank interest rates declined by 0.25-1% since the policy took effect in January 2010. However, private sector credit growth (excluding loans from the EXIM bank of China) continued to decline by 7.1 % over the year ending March 2011, compared to -14.1% in the preceding year. The envisaged stimulus to economic activity, therefore, has yet to materialize.

Financial Sector

11. The authorities note staff's view that it is more effective to incentivize credit flow via measures that directly tackle the impediments to bank lending, as opposed to administering interest rates. The latter could entail distortionary effects such as hampering banks' ability to price risks and reducing the availability of credit for higher risk borrowers. Reforms such as the enactment of the Personal Property Security Act are envisaged to help bring down borrowing costs and enhance access to bank finance. To address public concerns that reductions in lending rates have been slower than that in deposit rates, the NBRT has required banks to disclose the Effective Interest Rates charged to clients.
12. On the supervisory front, the NRBT's oversight continues to focus on banks' credit risk management owing to the heightened level of NPLs. The spate of loose lending prior to the global financial crisis, economic malaise and the decline in remittances have contributed to the rise in NPLs over the past two years. Areas in credit risk management which were identified for improvement include strengthening the stress testing regime to reflect factors such as interest rates and commodity prices, and

updating outmoded asset valuation methods. Work is underway with the World Bank IFC to establish a credit bureau and promote electronic checks to strengthen credit assessment of clients. Tonga has also received technical assistance from the IMF and PFTAC to fortify its supervisory framework, such as in designing new prudential returns and enhancing offsite monitoring tools.

Structural Policy

13. The authorities share staff's assessment that lifting medium-term growth prospects remains a challenge in light of Tonga's geographic isolation and narrow economic base. Various measures have been implemented to promote private sector activity and broaden the sources of growth. For instance, to boost agricultural exports, the authorities have repaired the High Temperature Forced Air machine at the airport and established quarantine facilities to meet the import standards of overseas markets. Other initiatives include tourism marketing activities, the establishment of the Tonga Institute of Sports, and the Tonga Submarine Cable project which is envisaged to strengthen communication links with the external world. Further, the Tonga Energy Road Map endeavours to raise the efficiency of energy usage and identify options for non-renewable energy sources, which would help lower business costs and galvanise private sector activity.

Final Remarks

14. The Tongan economy has shown signs of improvement, but a recovery is yet to be entrenched. The new government is cognizant of the considerable challenges that lie ahead and is committed to advance the reform agenda, although results would take time to materialize. Importantly, given Tonga's capacity constraints, domestic efforts would need to be supplemented by support from multilateral institutions and other countries. In this light, our Tongan authorities would like to express their sincere gratitude to the Fund, the World Bank and PFTAC for their invaluable technical guidance over the years.