September 2009
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Tonga: 2009 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Tonga.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2009 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 13, 2009, 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 August 14, 2009. 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 staff statement of September 4, 2009, updating information on recent developments.
- A statement by the Executive Director for Tonga.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 4, 2009 discussion of the staff report that concluded the Article IV consultation.

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

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TONGA

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Article IV Consultation with Tonga

Approved by Joshua Felman and Anthony Boote

August 14, 2009

- ***Discussions:*** Nuku'alofa, May 5–13, 2009. The team met with Minister of Finance Matoto, National Reserve Bank of Tonga Governor Mafi, and other senior government officials, as well as private sector representatives.

- ***Team:*** Mr. Davies (Head), Messes. Leony (APD) and Ogawa (OAP). Mr. Kartiyono (OED) and Mr. Faletau (Asian Development Bank) joined the discussions.

- ***Past surveillance:*** The 2008 Article IV Consultation was completed on July 17, 2008. Executive Directors' have stressed the importance of fiscal consolidation and a balanced policy mix in recent Article IV consultations. Improved governance and further progress on public sector reform have also been emphasized.

- ***Focus of discussions:*** Near-term macroeconomic policy discussions focused on responding to the reduction in growth without threatening medium-term sustainability. Medium-term policies need to focus on promoting private sector-driven growth and safeguarding debt sustainability.

- ***Outreach:*** The mission held a press conference, and also met with business, donor, and diplomatic representatives.

- ***Exchange rate:*** Basket peg with monthly adjustment band of ±5 percent.

- ***Exchange system:*** Accepted the obligations of Article VIII, Sections 2, 3, and 4. The authorities plan to retain the exchange restriction in the form of a tax certification requirement applied to various current international transactions. Board approval for this restriction expired on July 9, 2008. At this point, staff does not propose an approval of this restriction.

- ***Statistics:*** Data quality, coverage, and timeliness have been hampered by several deficiencies, including capacity constraints, which have complicated effective surveillance.

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EXECUTIVE SUMMARY

Background: Tonga is a small, remittance dependant, open economy vulnerable to domestic and external shocks. In common with many Pacific Island economies, the global economic slowdown has taken a toll on growth, halting the economy's rebound from the 2006/07 domestic disturbances and economic contraction.

Main issues: Growth is likely to be low in the near term as remittances remain constrained by global economic conditions and the domestic banking sector continues to consolidate. The reconstruction of the central business district and increased subsistence agriculture are likely to cushion the downward pressures. Risks are, however, tilted to the downside, mainly due to increasing unemployment in remittance sending economies and rising oil prices.

Staff's views: The government's policy space to respond to slowing growth without prejudicing medium term economic stability is constrained by the high risk debt position, the low level of international reserves and financial sector fragility.

- The 2008/09 budget targets a small surplus excluding loan-financed reconstruction. Achieving this will require strong expenditure prioritization given the budget's optimistic growth and revenue projections. Including reconstruction the fiscal deficit will widen significantly to around 4 percent of GDP.

- The drawdown of the large reconstruction loan will lead to high risk debt levels over the medium term. Any additional external borrowing should be strictly limited.

- The current cautious monetary policy stance is appropriate. However, if economic conditions deteriorate some easing should be considered provided the outlook for international reserves and inflation environment is benign.

- The exchange rate is consistent with external stability. The existing adjustment band could be used to gradually correct its modest overvaluation.

- Intensive supervision is required to monitor any further build up of bad loans and ensure strong risk management.

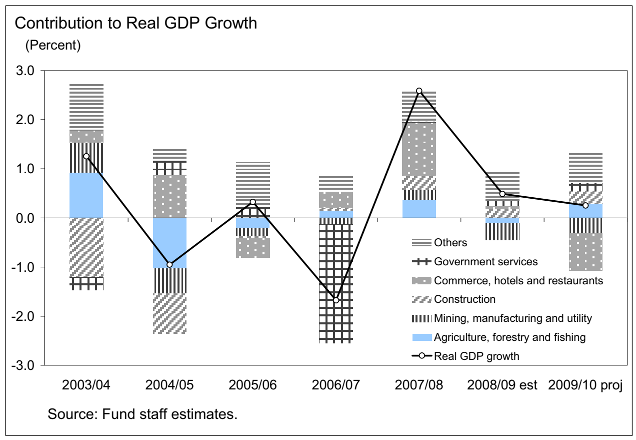
Authorities' views: The authorities have a more optimistic growth outlook than staff, but share the risk analysis and broadly agree with staff's policy recommendations. They intend to remain within the budget's macroeconomic targets and will reduce non-priority expenditure allocations if revenues fall short of targets. They are committed to ensuring high local content in the use of the reconstruction loan and to using the proceeds to finance high quality projects. They agree that maintaining a prudent fiscal stance and sustaining GDP growth are key to debt sustainability. Structural reforms to encourage private sector development are therefore central to their development strategy.

I. Context and Recent Economic Developments

1. **Tonga is a small open economy vulnerable to domestic and external shocks**. Domestic political disturbances in 2006 caused widespread damage in the capital, Nuku'alofa, and GDP contracted by around 1¾ percent in 2006/07.[1 2] The economy rebounded by 2½ percent the following year, leading up to the coronation of a new king in August 2008. However, given its reliance on imports (41 percent of GDP in 07/08) and remittances (31 percent of GDP) global economic developments over the last year have, in common with the rest of the Pacific (Box 1) renewed pressure on the economy.

2. **2008/09 has been a challenging year.**

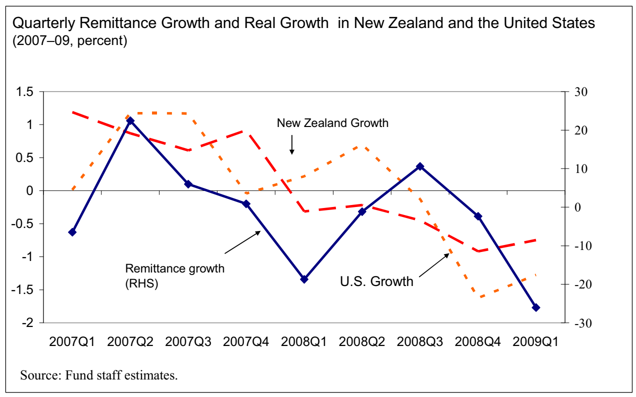
- Growth is estimated to be around ½ percent in 2008/09, as growth in the service and construction sectors, in part driven by the coronation, offset weakness in agriculture and manufacturing industries.



Source: Fund staff estimates.

- Inflation, driven by high international oil and food prices, peaked at 12 percent in mid-2008 but fell to 2 percent in mid 2009.

- Remittances fell by around 15 percent, reflecting the recessions in the two main source economies—the United States and New Zealand. The associated decline in import demand and retreats in international commodity prices reduced external pressures while unusually strong investment and capital flows in the latter half of 2008 allowed reserves to rise to US$60 million—above 4 months of import cover.



Source: Fund staff estimates.

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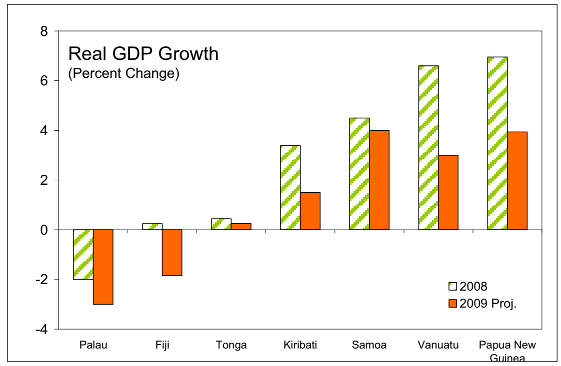
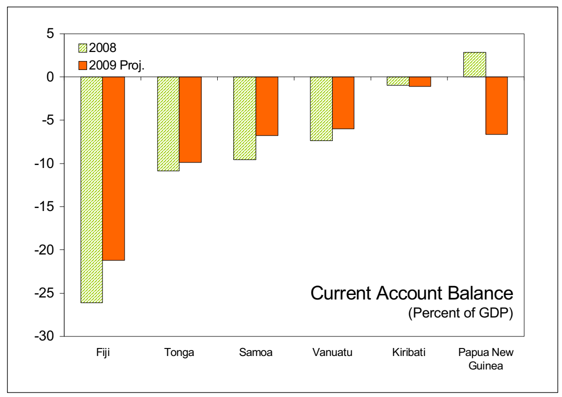
[1] The fiscal year is July 1 to June 30.

[2] GDP statistics were revised in 2009 with PFTAC support to improve coverage and compilation techniques. As a result levels of GDP have increased by 15–20 percent and historic growth rates have changed..

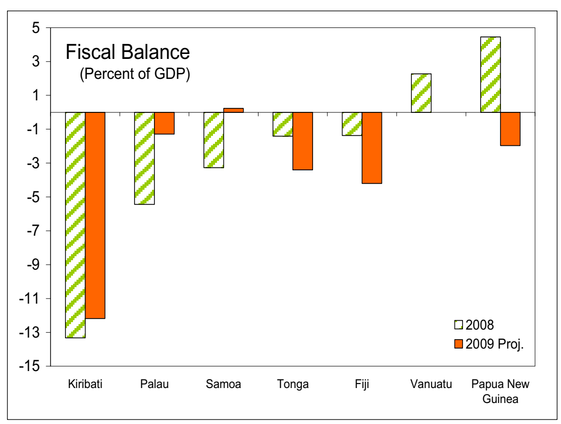
Box 1: The Impact of the Global Crisis on the Pacific Island Economies



The global financial crisis was slow to hit much of the Pacific. The main initial impacts stemmed from drops in world commodity prices and stock markets. Commodity price falls had a beneficial effect for many countries, easing external and inflationary pressures. However, commodity exporters (Papua New Guinea and Solomon Islands) and countries with large trust funds (Kiribati, Marshall Islands, Federated States of Micronesia) were immediately hit.



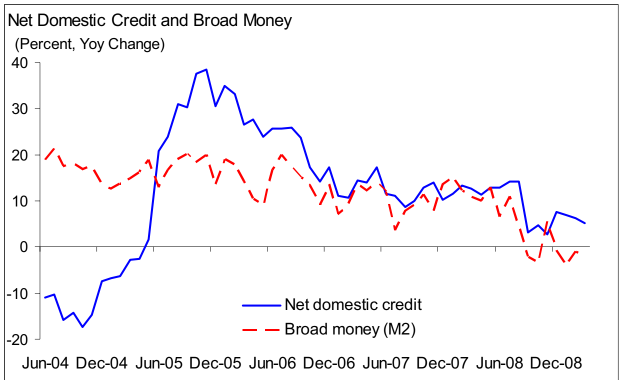
The global recession has, however, begun to affect growth and external sectors across the Pacific. Falls in demand and increases in unemployment in developed economies have suppressed remittances, a key external flow for many economies (Samoa and Tonga) and reduced tourism demand (Fiji, Palau). Exchange rate movements have also worked against tourism with island economies' rates appreciating against the key markets of Australia and New Zealand. Non commodity exports, although not significant in many countries, have also been affected (for example, automobile parts in Samoa).



Fiscal sectors have been particularly hard hit, particularly in countries with underlying structural problems. Declines in imports and consumption have reduced tax bases and growth outturns significantly below budget assumptions have resulted in cash shortages, expenditure cutbacks and significant increases in deficits in a number of countries (Solomon Islands, Fiji, Samoa, Tonga). These problems have been particularly severe in countries that were already grappling with structural issues before the onset of the global recession.

Financial sectors have, thus far, remained largely insulated. However, with real sectors coming under increasing pressure asset quality is deteriorating in a number of countries (Fiji, Tonga). Parent banks in Australia and the United States are less likely to provide liquidity support given the constraints they face in their home markets.

- Broad money growth slowed to around -1½ percent in March 2009 and the two dominant banks scaled back lending in response to a rapid increase in non-performing loans. Credit growth at March 2009 was below 5 percent, slowing significantly from 18 percent at the beginning of the year.



Source: Fund staff estimates.

- The exchange rate, which is a trade-weighted peg, appreciated around 6 percent in real effective terms in 2008.

II. Policy Discussions

A. Outlook

3. **Staff project that growth will remain low in the short term**. Growth is likely to be less than ½ percent in 2009/10 as remittances remain constrained by global economic conditions and the domestic banking sector continues to consolidate. The reconstruction of the central business district and increased subsistence agriculture are likely to cushion the downward pressures. International reserves are likely to fall to around 3.3 months of import coverage, due to weak remittances and higher construction imports. The likely peak in reconstruction and a recovery in remittances should support stronger growth in 2010/11 before it returns to trend in the medium term.

Medium Term Macroeconomic Framework

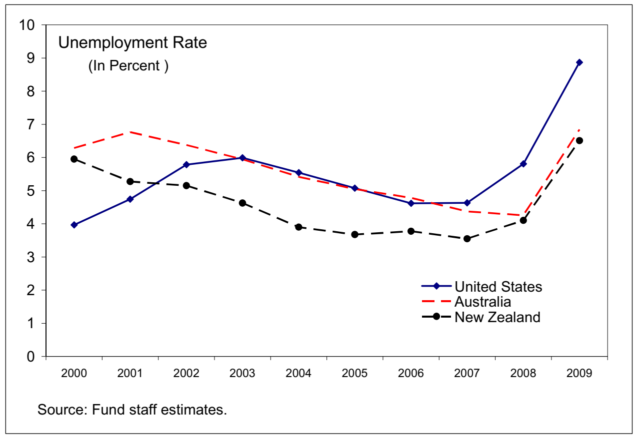
	2008/09	2009/10	2010/11	2011/12
	(annual percentage change)			
GDP Growth	0.4	0.3	2.3	1.7
Inflation (annual average)	4.7	1.7	3.3	4.0
	(percent of GDP)			
Overall fiscal balance (including grants)	1.3	-3.9	-3.5	-2.3
External current account balance	-6.5	-14.8	-12.4	-10.7
	(months of imports)			
International reserves	4.2	3.2	3.4	4.1
	(percent of GDP)			
External public debt	28.3	32.3	36.1	35.4

Source: Fund staff estimates.

4. **Risks are tilted to the downside.**

- Remittances are vulnerable to a sharper-than-projected fall if unemployment rates in the United States and New Zealand continue to increase. On the other hand, expansions of seasonal worker programs and initiatives to reduce transfer costs could provide some support.

- Recent increases in oil prices, if sustained, could renew pressures on the balance of payments, particularly if remittances remain suppressed.



- A more rapid scale up than projected of reconstruction with significant local inputs would lead to higher growth but also put pressure on inflation and complicate medium-term economic management.

5. **The authorities, however, are more sanguine**. They broadly shared staff's views on the risks to the outlook. However, with a more optimistic view on the impact of reconstruction and on sustained growth in domestic commerce the budget forecasts growth of 1¾ percent for 2009/10.

6. **Policy discussions focused on the space available to the authorities to respond to slowing growth without prejudicing medium term stability.** The authorities are conscious of the need to shield the population from the effects of the global economic downturn, particularly as a result of falling remittances. Staff agreed with the authorities that, given the exchange rate peg and weak transmission mechanism of monetary policy, fiscal policy was the principal instrument. Staff, however, noted two key constraints: the high risk debt position (see Box 2 and supplement), and; the vulnerability of international reserves.

B. Fiscal Policy

Background

7. **Fiscal management in 2008/09 was complicated by an overly ambitious budget.** Revenue increases of around 10 percent were targeted despite policy changes that reduced the tax base.[3] With growth failing to reach expectations and import volumes falling, revenue actually declined by around 10 percent due to significant shortfalls on sales and trade taxes.

8. **Nevertheless, tight expenditure control and high grants allowed a budget surplus.** The shortfall in revenue, together with pressures from the coronation and the purchase of a domestic power company (that was only partially offset by the sale of shares in one of the main commercial banks) pressured recurrent expenditure, including road

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[3] The 2008 tax reform consisted of converting ad valorem tariffs of vehicles, fuel, tobacco and alcohol into specific excises. In line with WTO accession commitments, remaining duty bands were reduced, lowering the effective tariff and capital goods were also exempted from trade tariffs. In addition, the corporate tax rate was reduced to 25 percent from 35 percent.

maintenance and operational expenditures. Significant increases in grants, driven by a large payment from China, allowed an increase in capital expenditure and a build up of cash balances, including 15 million pa'anga that will be placed in a newly established emergency and natural disaster fund . The overall budget surplus was around 1¼ percent of GDP, including initial expenditure from the reconstruction loan.

Box 2: Debt Sustainability and the Reconstruction of the Central Business District

The reconstruction of the Central Business District following the 2006 disturbances is mainly being financed by a US$63 million loan from the EXIM Bank China. The loan will be drawn down over the three years up to 2012 and repaid on concessional terms (2 percent interest) over 20 years (with a 5 year grace period). It will be used in part to finance public works in the capital; the remainder of the loan is being on-lent to the private sector for rebuilding offices and shops.

Reconstruction will be implemented on a turn-key basis by a Chinese construction company. They are, however, required to use Tongan labor, unless they can show that the skills required are not present within the local labor force. Government cabinet and technical committees will oversee loan implementation and select projects.

Loan drawdowns of US$15 million were made in 2008/09. However, construction only began in earnest in April 2009 and total 2008/09 expenditure is expected to be only around US$2.5 million, predominately on public works. A number of applications for private sector lending have been approved by the Cabinet committee and expenditure will commence on these in early 2009/10. These commercial and retail projects will rely on continued private-sector growth for their viability.

When loan drawdowns are completed, the net present value of Tonga's external debt will be around 40 percent of GDP and 290 percent of exports, considerably above the respective indicative risk thresholds of 30 percent and 100 percent. Although remittances will continue to provide a substantial cushion against external debt distress risks, stress tests indicate significant vulnerabilities.

Debt sustainability will rely on sustained GDP growth. This emphasizes the importance of loan financed projects adding to the economy's productive capacity.

2009/10 Budget

9. **The 2009/10 budget aims to provide a stimulus to the domestic economy while maintaining macroeconomic stability.**

- The budget aims to again run a small surplus (including grants but excluding reconstruction activities) while also significantly increasing expenditure. Including loan-financed reconstruction activities staff project an overall deficit of around 4 percent of GDP.

Fiscal aggregates (percent of GDP) 1/

	2008/09 Est.	2009/10 Budget	2009/10 Staff
Revenue	22.2	24.2	22.4
Grants	6.3	6.7	5.9
Current expenditure	23.4	26.9	24.7
Wages and Salaries	10.9	10.9	11.6
Other current expenditure	12.5	16.1	13.2
Capital expenditure	3.0	1.7	4.6
of which EXIM 2/	0.7	…	2.9
Net lending	0.9	-0.1	2.9
Overall balance (including grants)	1.3	2.4	-3.9
Overall balance (including grants; excluding reconstruction)	2.0	2.4	1.8

Source: Authorities and staff estimates
1/ Staff projected GDP
2/ Government budget does not include loan-financed reconstruction

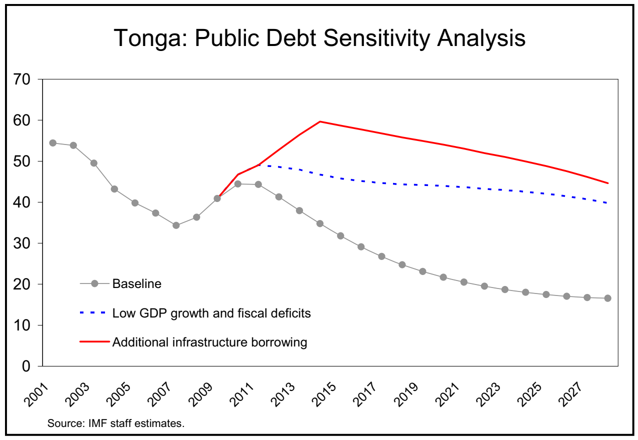
- Expenditure increases will be targeted to infrastructure, particularly road maintenance, social services and, to cushion the impact of the decline in remittances, accelerating new community development programs envisaged under the new Strategic Planning Framework.

- A 10 percent wage increase for the public sector is also incorporated. The wage increase, the first since the 70 percent increase in 2006/07, is intended to be an integral part of the ongoing reform of the public sector that aims to contain the wage bill through reducing the size of the public service, while improving performance through recognizing merit and flattening the grade structure. Progress has been made in reducing the size of the public service and attention is now shifting to improving performance. The current package, which has the support of the workforce. also includes linking annual salary increments to merit rather than seniority, reducing leave entitlements and abolishing vacancies.[4]

- Financing is projected to come from increased revenue, as a result of improved enforcement and economic activity, and external grants, including budget support of US$10 million from the Asian Development Bank. In view of economic circumstances the government decided not to increase tax rates.

[4] The 2008 Article IV Consultations covered these issues in detail. See Box 1 in Country Report 08/261.

10. **Staff stressed that projected debt levels leave limited room for maneuver on medium-term fiscal policy**. Fiscal planning should be based on deficits including reconstruction. Staff understood that loan-financed reconstruction was an irreversible government commitment. Nevertheless, they stressed that loan drawdowns should be limited to productive projects rather than targeting full loan utilization. Following the completion of reconstruction, maintaining broadly balanced budgets is important for debt sustainability given the sharp increase in debt stemming from the EXIM Bank loan.[5] This will require sustained improvements in revenue enforcement and careful expenditure prioritization, particularly with regard to personnel costs. Non-reconstruction deficits of just 1 percent of GDP, combined with slow GDP growth would see public debt above 40 percent of GDP in 2020, compared to staff's baseline projection of 21 percent. Additional future borrowing to finance infrastructure investment, such as the US$45 million infrastructure loan currently being discussed with China, will intensify debt sustainability concerns and would be better financed through improved government revenue, expenditure reprioritization or grants.



11. **Staff supported the 2008/09 budget's target of a modest non-reconstruction surplus but argued that additional policy actions would be needed**. A surplus of 1¾ percent of GDP (including grants but excluding reconstruction) is broadly appropriate given growth pressures and the need to keep the overall balance under control. However, with a significantly lower GDP growth forecast than the authorities, staff projects that revenue will be around 20 million pa'anga (2 percent of GDP) less than budgeted. As a result, planned expansions in non-wage expenditure will be impossible to achieve while remaining within the budget's macroeconomic framework. Significant cuts from 2009/10 levels will be required if grants fall short of projections. Staff advised the authorities to carefully prioritize expenditure allocations, including possibly phasing the public sector wage rise, and to step up effort in revenue enforcement. Tax increases were not advocated in the short-term given the pressures on the domestic economy.

12. **The authorities stressed their commitment to prudent fiscal policy**. They cited the budget surpluses achieved in recent years as evidence of their commitment to sound macroeconomic and budget management even in the face of significant revenue shortfalls. The authorities appreciated the fiscal risk of the public sector pay rise but stressed that it was

[5] See Box 2 and the Joint World Bank, IMF Debt Sustainability Analysis at Supplement 1 for further details.

essential to achieve broad support for the ongoing program of public sector reform that is central plank of the National Strategic Plan. They stressed their commitment to ensuring reconstruction spending is productive and expected full loan utilization.

13. **The authorities remain confident on revenue and grants, but are ready to take contingency measures**. A new customs management system is expected to provide scope for significant gains in enforcement. However, in the event of revenue shortfalls, the authorities stressed that the expenditure review committee chaired by the Prime Minister would ensure that priority areas, particularly the social sectors would be protected.

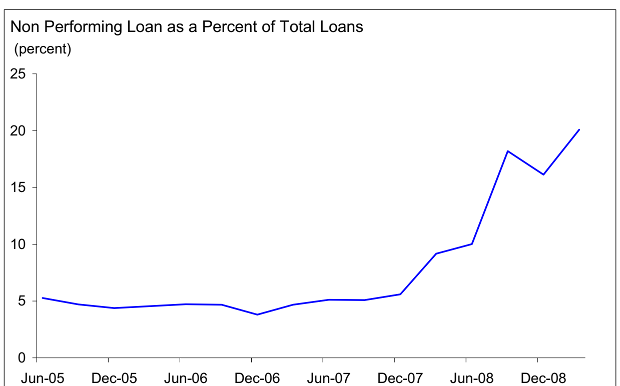
C. Monetary and Financial Sector Policies

Background

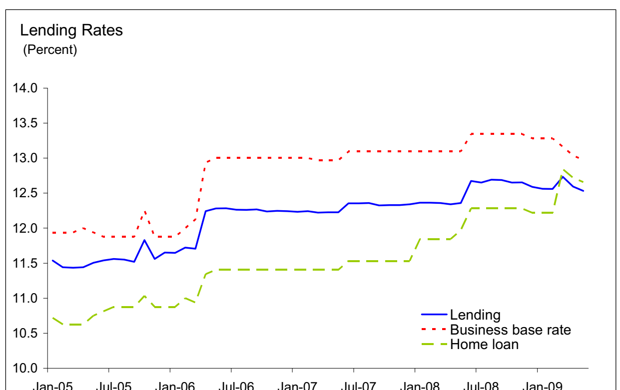
14. **2008/09 was a turbulent year for the financial sector.**

- At the beginning of the year banking sector liquidity was tight and lending growth was rapid (around 20 percent). As the year progressed, liquidity increased as pressures on reserves moderated; credit growth halted as banks tightened their lending requirements and NRBT withdrew excess liquidity to protect reserves and safeguard financial sector stability. Broad money declined as deposits were withdrawn in the face of worsening economic conditions. Interest rates declined from their late-2008 highs, but remain high.

- Reflecting in part the impact of slowing growth and remittances and also inadequate risk management in the banks during 2008's lending surge, bad debts began to build from mid-2008. The non-performing loan ratio stood at 20 percent in mid 2009. NRBT has ensured that the two main commercial banks have taken provisions and, reflecting their ongoing commitment to their Tonga operations, their foreign parents have injected capital to remain in line with prudential regulations.



Source: Fund staff estimates. estimates.



Source: Fund staff estimates.

Policy Discussions

15. **Staff supported the current cautious monetary policy stance, but encouraged easing should economic conditions worsen.** Given the exchange rate peg and with reserves likely to remain in the lower part of NRBT's comfort zone, restraining credit growth is appropriate, particularly given the increase in non-bank credit in the economy as a result of reconstruction activity. Should economic conditions worsen, staff suggested that NRBT should consider reducing or eliminating the sale of NRBT notes to allow a moderate pace of credit growth, providing the outlook for reserves and inflation environment is benign. However, the banking sector may not respond given its current highly cautious lending policies.

16. **The authorities stressed that a tight monetary policy was in line with their policy objectives—**international reserves, inflation and financial sector stability. Economic growth is not part of NRBT's objectives; nevertheless, given economic conditions easing remains an option they are considering. NRBT was concerned, however, that the transmission mechanism to growth was not clear, particularly given the strong correlation between credit and import growth. They also noted that past evidence suggested that current excess liquidity would feed into credit with a lag and were conscious of the importance for financial sector stability of not reigniting credit growth.

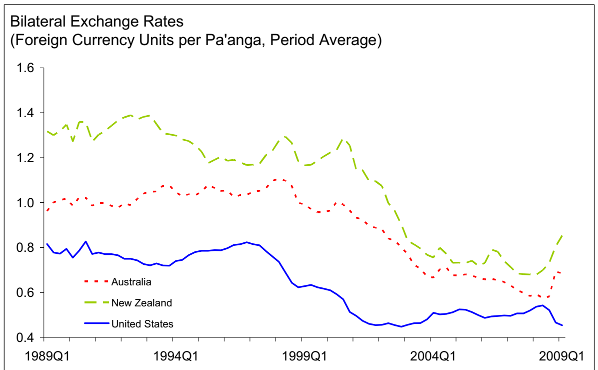
17. **Staff emphasized the importance of stepped up bank supervision in preventing a recurrence of the recent problems in the financial sector.** Recent events have shown that head office oversight of international banks cannot be relied upon to insulate the financial sector from problems. Despite the banks' recent aggressive measures to improve credit policies, a continuation of NRBT's more intensive supervision, including more frequent on-site inspections, will be crucial in monitoring and guarding against a further increase in non-performing loans. The recently approved new prudential regulations on banks' governance and other areas, when implemented, will help prevent a recurrence.

18. **The authorities agreed that supervision was crucial but stressed that it could not substitute for sound lending practices in commercial banks.** They emphasized the limited human resources in NRBT's banking supervision department. Nevertheless, when the deterioration in asset quality became apparent, NRBT took strong enforcement actions to ensure that banks remained compliant with its prudential regulations. NRBT is conscious of the need to learn from the experience and has commissioned an independent study of supervisory actions leading up to the episode. They are actively seeking, with staff's support, further technical assistance, including from MCM.

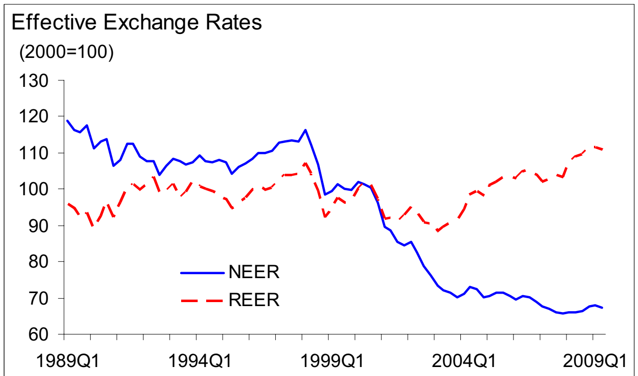
D. External Viability and Exchange Rate Policies

Background

19. **The pa'anga traded in line with its peg**. Reflecting the sharp changes in international alignments, the pa'anga depreciated against the US dollar, increasing the domestic value of US sourced remittances, and appreciated against Australia and New Zealand dollars, decreasing the domestic value of remittances but reducing the price of food imports that are predominately sourced from New Zealand. NRBT did not make use of the monthly adjustment band within the exchange rate peg.



Fund staff estimates.



Source: Fund staff estimates.

20. **The exchange rate is consistent with external stability.** Staff's estimates using a variety of techniques are limited by data deficiencies, but suggest that the pa'anga is modestly overvalued.[1] However, the external current account deficits projected over the medium term are in line with historical levels and can be financed by official and private capital inflows.

21. **Trade policy has been broadly stable following WTO accession in 2007**. The 2008/09 budget has however introduced some small policy changes to correct perceived anomalies caused by the 2008 abolition of duties on capital goods. Regional trade commitments will see tariff levels continue to decline in the coming years.

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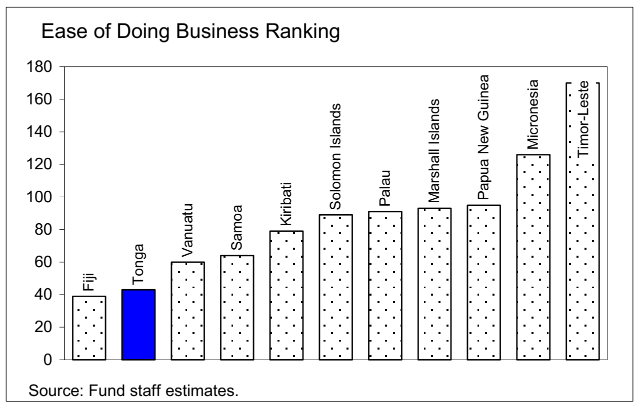
[1] The macroeconomic balance approach suggests a REER overvaluation of around 9½ percent, the equilibrium real exchange rate approach suggest overvaluation of about 12 percent. The external sustainability approach suggest that the REER is overvalued by about 2½ percent.

Policy Discussions

22. **Staff and the authorities agreed that the exchange rate peg provides a valuable policy anchor.** The authorities, however, hope, if technical assistance is available, to review the weights before the next Article IV consultation.

23. **The monthly adjustment band provides considerable flexibility for the authorities to respond to changing economic circumstances**. Staff encouraged the authorities to use this flexibility to gradually correct the modest overvaluation of the pa'anga, which would increase the local value of remittances, moderate current account pressures and lessen the burden on monetary policy. The authorities stressed that they stood ready to adjust the rate, particularly if renewed pressures came on reserves. They emphasized, however, that price competitiveness was not the major constraint to existing export sectors—that are more constrained by structural factors such as infrastructure, market access and quarantine regulations. In light of the import dependence of the economy, and the likely upward trend in commodity prices, the authorities intend to proceed cautiously on exchange rate flexibility.

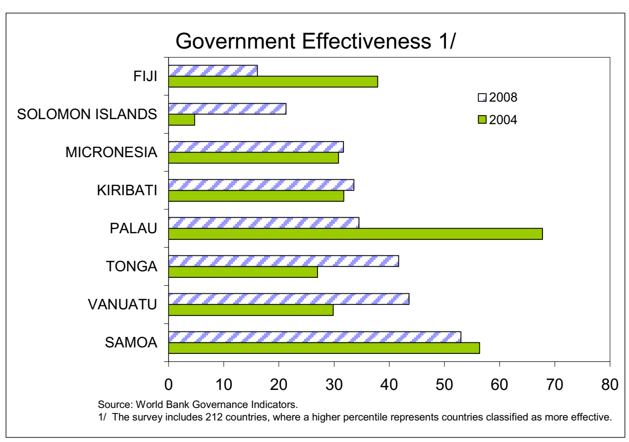
24. **Given the difficult external environment and budgetary situation the authorities do not see a removal of their tax clearance certification on current transactions as feasible in the short term.** Given the high degree of openness of the economy, the authorities see tax certification on external transactions as important for protecting fiscal revenue. The authorities did undertake, however, to continue discussions with staff to identify measures that would provide similar levels of comfort while becoming compliant with the provisions of the Articles of Agreement.



E. Structural Policies

Background

25. **Tonga's growth has been frustrated by the lack of a dynamic private sector.** The public sector is large and state-owned enterprises have traditionally occupied sizable portions of the productive arena, controlling around 20 percent of fixed assets yet contributing only 6 percent to GDP. The government



is rationalizing its holdings in public enterprises and has recently divested its ownership of the duty-free retail operation and its shares in a commercial bank. It has, though, also taken into public ownership the power generation and distribution company. The private sector has been further constrained by excessive regulation and discretionary licensing requirements.

Policy discussions

26. **Staff and the authorities agreed on the critical importance of accelerated progress on structural reforms to promote private sector development.** The Government's Strategic Planning Framework places this at the centre of the agenda and some good progress has been made in recent years. Tonga now compares well with regional peers in the cost of doing business—however, it ranks very poorly on key indicators such as protecting investors, registering property and obtaining credit. Progress is being made however, which is reflected in improvements in its rating for government effectiveness and corruption in the World Bank Governance indicators. Priorities for further reform include commercial law reform and reintroducing the Companies Registry that was destroyed in the 2006 disturbances. Continued progress on divesting, rationalizing and improving the governance of public enterprises will also be important as will strengthening public financial management. Making further progress on the broader governance environment will enhance stability and increase investor confidence.

27. **Improved economic statistics will enhance policy making, particularly in the budget area**. The authorities have recently published a revised set of national accounts with broader coverage and improved estimation technique; improved balance of payments statistics are also being developed. However, resources are very limited and further improvements will require investment in source data. The authorities acknowledge this and are working with donors to make improvements in the resources available to the national statistics office while also improving the use of statistics in policy making. A key element of this is to bring a more structured basis to policy discussions by adopting common forecasting tools across all economic agencies.

III. Staff Appraisal

28. **Tonga's recovery from the 2006 disturbances has been hampered by global and domestic economic conditions**. Growth will likely slow to less than ½ percent in 2008/09 and 2009/10, as remittances decline and banks curtail credit in response to a build-up of bad loans. The decline in international food prices should, however, allow inflation to remain moderate and reserves adequate. Risks are tilted to the downside, particularly if remittances fall more sharply than projected due to prolonged high unemployment in the United States and New Zealand. A return to high world oil prices would renew external pressures. Reconstruction activities may provide additional support for growth, but could add to inflation.

29. **The authorities' ability to respond to the weak growth environment is limited**. High public debt limits the scope for fiscal stimulus and monetary policy is constrained by a weak transmission mechanism and relatively low international reserves.

30. **The 2009/10 budget takes a broadly appropriate macroeconomic stance, but is based on ambitious revenue projections.** Shortfalls are likely to occur against the budget's projections for revenue and grants. As a result, the increases to priority expenditure areas planned as part of the government's fiscal stimulus package will not be possible, particularly given the large public sector wage increase. Greater attention to improving revenue enforcement, especially in the customs, area will be crucial to budget implementation.

31. **The risk of debt distress will increase with the drawdown of the large reconstruction loan.** The planned disbursement profile is consistent with manageable—if high risk—debt dynamics, but this depends on continued GDP growth, broadly balanced budgets over the medium term and productive loan-financed expenditure. Careful vetting of proposed reconstruction projects is therefore vital. Additional borrowing, such as the large infrastructure loan that is being considered, could lead to unsustainable debt dynamics.

32. **With reserves likely to remain in the lower part of the Reserve Bank's comfort zone, the current cautious monetary policy stance is appropriate.** However, should economic conditions worsen, some monetary policy easing should be considered, providing the outlook for reserves and inflation remains benign. The banking sector may not respond, though, given its current caution on lending. Stepped up supervision will need to continue to guard against a further deterioration in banks' balance sheets and regulation needs to remain vigilant to further episodes of surges in high risk lending.

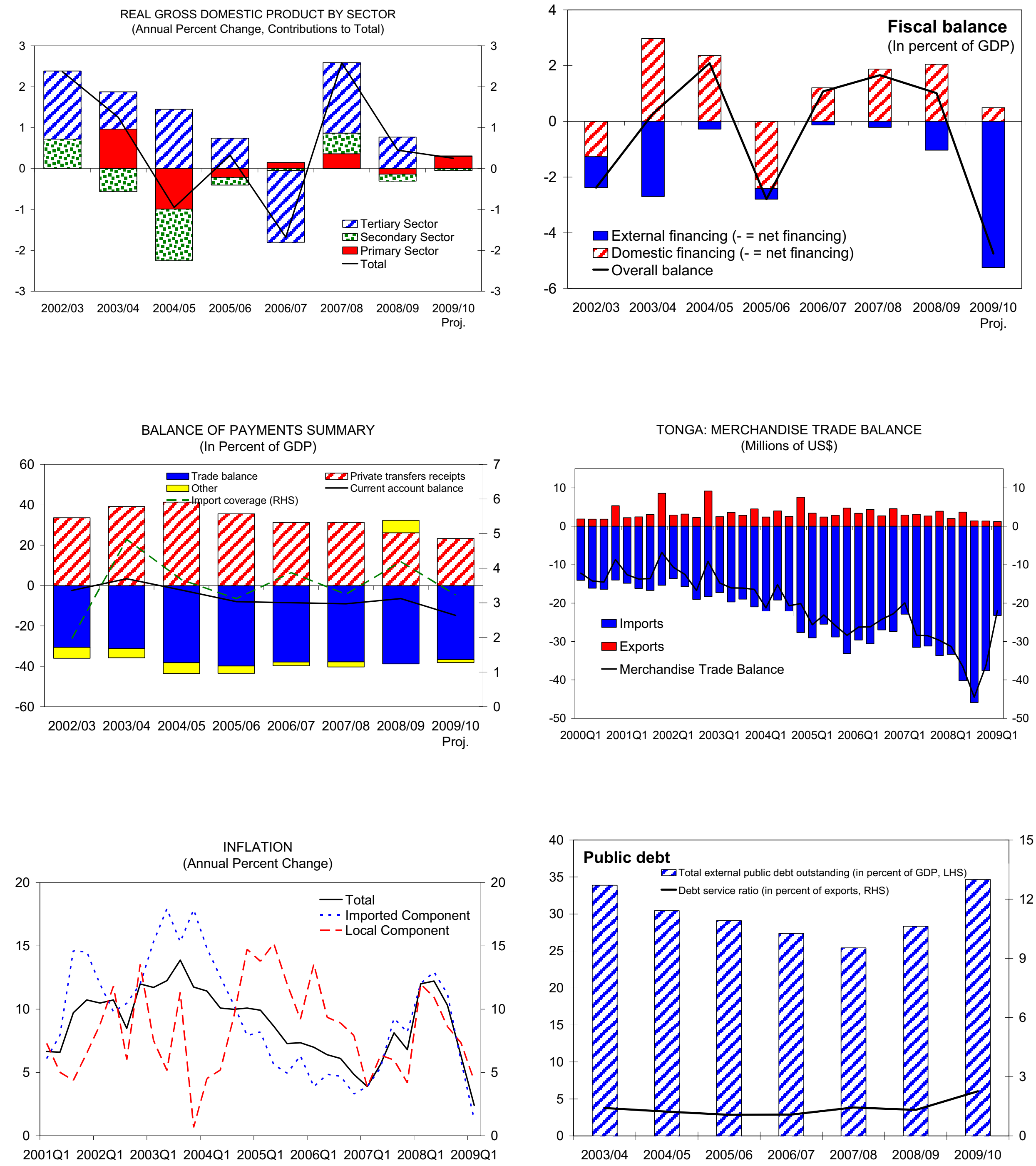
33. **The exchange rate remains consistent with external stability.** The projected external current account deficits are sustainable. However, gradual correction of the pa'anga's modest overvaluation by using the adjustment band around the peg could help safeguard reserve coverage and promote domestic commerce.

34. **Improving GDP growth and raising living standards over the medium term requires sustained attention to structural reform**. Rationalizing public enterprises, enhancing infrastructure and improving business regulation will help empower the private sector.

35. **Improving statistical capacity remains a priority, and continued technical assistance in this area is needed.** Improvements in underlying data are needed to take advantage of recent advances in compilation techniques.

36. It is recommended that the next Article IV consultation with Tonga should take place on a standard 12-month cycle.

Figure 1. Tonga: Economic Developments, 2002/03-2009/10



Source: IMF staff estimates and projections.

Table 1. Tonga: Selected Economic Indicators, 2003/04–2009/10 1/

Nominal GDP (2007/08): US$ 340.8 million
Population (2006): 101,991
GDP per capita (2007/08): US$ 3,341
Quota: SDR 6.9 million

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
						Proj.	
			(Annual percent change)				
Output and prices							
Real GDP 2/	1.3	-1.0	0.3	-1.7	2.6	0.4	0.3
Consumer prices (period average)	11.7	9.7	7.0	5.1	9.8	4.7	1.7
Consumer prices (end of period)	10.1	8.7	6.4	5.6	12.2	1.4	2.5
			(In percent of GDP)				
Central government finance							
Total revenue and grants	23.6	24.3	26.8	28.6	26.5	28.6	28.3
Total revenue	22.5	23.2	25.1	24.8	25.2	22.2	22.4
Grants	1.1	1.1	1.7	3.8	1.3	6.3	5.9
Total expenditure and net lending	23.3	22.2	29.6	27.5	24.9	27.3	32.2
Of which: Current expenditure	21.6	21.4	28.9	26.5	24.5	23.4	24.7
Capital expenditure	0.8	0.8	0.8	0.9	0.4	3.0	4.6
Overall balance	0.3	2.1	-2.8	1.1	1.7	1.3	-3.9
Overall balance (excl. reconstruction loan)	0.3	2.1	-2.8	1.1	6.5	2.9	2.1
External financing (net)	2.7	0.3	0.4	0.1	0.2	1.0	4.2
Domestic financing (net)	-3.0	-2.4	2.4	-1.2	-1.9	-2.3	-0.3
			(Annual percent change)				
Money and credit							
Total liquidity 3/	16.7	13.3	13.3	13.3	5.0	-0.5	2.4
Of which: Broad money (M2)	18.9	12.8	16.6	11.9	6.4	-1.0	2.5
Domestic credit	-10.9	20.9	25.8	11.6	12.8	-4.3	1.5
Of which: Private sector credit	-4.3	29.4	22.6	9.5	18.0	0.4	2.0
Interest rates (end of period)							
Average deposit rate 4/	4.6	5.1	5.2	5.6	5.7	5.1	...
Base lending rate 4/	9.0	9.5	9.0	9.4	10.0	10.0	...
			(In millions of U.S. dollars)				
Balance of payments							
Exports, f.o.b.	13.8	16.0	15.4	13.3	12.4	8.0	8.4
Imports, f.o.b.	-82.6	-105.4	-122.2	-108.6	-138.1	-126.4	-127.8
Services (net)	-2.8	-10.0	-7.8	-17.9	-3.3	-9.5	-4.8
Investment income (net)	-0.4	1.6	2.8	3.5	3.4	29.2	4.2
Services and investment income (net)	-3.2	-8.4	-5.0	-14.4	0.1	19.7	-0.6
Current transfers (net)	79.7	91.9	88.9	84.2	94.8	77.4	69.9
Of which: Private transfer receipts	90.1	107.4	102.0	93.3	106.7	86.2	78.8
Current account balance	7.7	-5.8	-22.8	-25.5	-30.8	-21.3	-50.1
Current account balance (excl. reconstruction loan)	7.7	-5.8	-22.8	-25.5	-30.8	-19.4	-34.3
(In percent of GDP)	3.4	-2.2	-8.0	-8.5	-9.0	-6.5	-14.8
Overall balance	25.9	-4.0	0.6	4.2	-1.3	11.3	-14.0
Terms of trade (annual percent change)	-13.4	15.7	-47.8	-8.5	-8.8	...	...
Gross official foreign reserves							
In millions of U.S. dollars	44.8	42.5	40.4	47.1	48.2	59.5	45.6
In months of goods and services imports	4.8	3.7	3.1	3.9	3.2	4.2	3.2
External debt (in percent of GDP)							
External debt	34.6	30.5	35.7	32.6	28.9	30.8	33.6
Debt service ratio	1.4	1.2	1.1	1.1	1.4	1.3	2.3
Exchange rates 5/							
Pa'anga per U.S. dollar (period average)	2.05	1.94	2.01	2.00	1.94	2.07	...
Pa'anga per U.S. dollar (end of period)	2.00	1.93	2.06	1.95	1.91	2.24	...
Nominal effective exchange rate (1990=100)	71.44	71.11	70.50	68.37	65.99	67.5	...
Real effective exchange rate (1990=100)	93.76	100.18	103.58	104.48	104.17	114.0	...
Memorandum item:							
Nominal GDP (millions of T$)	470.88	503.37	577.29	597.98	649.15	688.71	711.16

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.
4/ Through 1Q 2009.
5/ Through February 2009.

Table 2. Tonga: Summary of Government Operations, 2003/04-2009/10

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
					Prel.	Proj.	
			(In millions of pa'anga)				
Total revenue and grants	111.0	122.1	154.5	171.1	172.2	196.8	201.4
Total revenue	105.9	116.6	144.6	148.5	163.5	153.1	159.4
Current revenue	105.9	116.6	144.6	148.5	163.5	153.1	158.1
Tax revenue	86.1	98.4	122.2	126.2	139.0	128.6	130.7
Nontax revenue	19.7	18.2	22.4	22.3	24.5	24.5	27.4
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	1.3
Grants (in cash)	5.2	5.5	9.9	22.6	8.7	43.7	42.0
Total expenditure and net lending	109.8	111.6	170.7	164.7	161.4	188.0	228.9
Total expenditure	110.7	112.6	171.9	164.1	161.4	181.8	208.5
Current expenditure	101.7	107.9	167.0	158.5	158.8	160.9	176.0
Wages and salaries 1/	45.7	49.7	90.8	80.1	70.2	74.8	82.2
Retirement funds employer contribution	1.5	2.6	3.8	5.8	4.4	5.2	7.0
Interest expense	3.2	3.8	3.3	3.2	4.2	5.2	5.3
Other current expenditures	51.3	51.8	69.0	69.4	80.0	75.8	81.4
Purchases of goods and services	36.7	40.2	47.6	49.9	63.4	60.2	66.0
Subsidies and other transfers	10.4	9.4	10.7	19.5	14.5	15.5	15.4
Transfer to retirement funds 2/	4.1	2.1	10.7	5.8	1.7	0.0	1.0
Capital expenditure	3.9	4.3	4.6	5.6	2.6	20.9	32.5
Of which : PRC reconstruction loan 3/	…	…	…	…	…	5.1	20.8
Expenditure discrepancy	5.1	0.5	0.3	0.0	0.0	0.0	0.0
Total lending minus repayments	-0.9	-1.1	-1.2	0.6	0.0	6.2	20.3
Current balance	4.2	8.7	-22.3	-10.0	4.7	-7.9	-17.9
Overall balance (incl. grants)	1.3	10.5	-16.1	6.4	10.8	8.8	-27.4
Total financing	-1.3	-10.5	16.1	-6.4	-10.8	-8.8	27.4
External financing	12.7	1.4	2.3	0.8	1.4	7.1	29.7
Disbursements	17.8	6.1	6.9	5.8	8.4	38.2	42.0
Repayments	5.1	4.7	4.6	5.0	7.0	6.1	12.3
Net changes in cash balances 5/	0.0	0.0	0.0	0.0	0.0	25.0	0.0
Domestic financing 6/ 7/	-14.0	-11.9	13.9	-7.2	-12.2	-15.9	-2.3
			(In percent of GDP)				
Total revenue and grants	**23.6**	**24.3**	**26.8**	**28.6**	**26.5**	**28.6**	**28.3**
Total revenue	22.5	23.2	25.1	24.8	25.2	22.2	22.4
Current revenue	22.5	23.2	25.1	24.8	25.2	22.2	22.2
Tax revenue	18.3	19.5	21.2	21.1	21.4	18.7	18.4
Nontax revenue	4.2	3.6	3.9	3.7	3.8	3.6	3.9
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Grants (in cash)	1.1	1.1	1.7	3.8	1.3	6.3	5.9
Total expenditure and net lending	**23.3**	**22.2**	**29.6**	**27.5**	**24.9**	**27.3**	**32.2**
Total expenditure	23.5	22.4	29.8	27.4	24.9	26.4	29.3
Current expenditure	21.6	21.4	28.9	26.5	24.5	23.4	24.7
Wages and salaries 1/	9.7	9.9	15.7	13.4	10.8	10.9	11.6
Capital expenditure	0.8	0.8	0.8	0.9	0.4	3.0	4.6
Of which :PRC reconstruction loan 3/	…	…	…	…	…	0.7	2.9
Expenditure discrepancy	1.1	0.1	0.1	0.0	0.0	0.0	0.0
Total lending minus repayments	-0.2	-0.2	-0.2	0.1	0.0	0.9	2.9
Current balance	**0.9**	**1.7**	**-3.9**	**-1.7**	**0.7**	**-1.1**	**-2.5**
Overall balance (incl. grants)	**0.3**	**2.1**	**-2.8**	**1.1**	**1.7**	**1.3**	**-3.9**
Total financing	**-0.3**	**-2.1**	**2.8**	**-1.1**	**-1.7**	**-1.3**	**3.9**
External financing	2.7	0.3	0.4	0.1	0.2	1.0	4.2
Domestic financing 6/ 7/	-3.0	-2.4	2.4	-1.2	-1.9	-2.3	-0.3
Memorandum item:							
Nominal GDP (in millions of pa'anga)	470.9	503.4	577.3	598.0	649.2	688.7	711.2

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/ Includes an additional transfer of TOP 8.6 million associated to the redundancy program in 2005/06.
3/ Includes government onlending to private sector.
4/ Prior to 2008/09 items in that line were other capital expenditure.
5/ Reflects unspent balances of EXIM Bank reconstruction loan.
6/ In 2008/09 includes the implementation of the Natural desaster fund.
7/ Includes domestic net bond financing and net changes in government cash balance and investment.

Table 3. Tonga: Banking Survey, 2004/05–2009/10 1/

	2004/05	2005/06	2006/07	2007/08	2008/09 Sep	2008/09 Dec	2008/09 Mar	2008/09 Proj.	2009/10 Proj.
	(In millions of pa'anga; end of period)								
Net foreign assets	76.3	71.9	81.1	79.3	116.2	114.3	107.1	105.5	83.9
Foreign assets	91.8	95.0	103.6	99.9	143.7	148.9	149.9	148.2	118.0
NRBT	82.1	83.2	91.6	89.1	128.5	123.9	130.6	129.0	98.7
DMBs	9.7	11.8	12.0	10.8	15.2	25.0	19.3	19.3	19.3
Foreign liabilities	-15.5	-23.1	-22.6	-20.6	-27.5	-34.6	-42.7	-42.7	-34.0
NRBT	-3.2	-7.1	-4.7	-3.1	-10.1	-12.1	-12.5	-12.5	-10.0
DMBs	-11.4	-15.3	-17.2	-16.9	-16.8	-17.2	-25.0	-25.0	-19.9
TDB	-0.9	-0.6	-0.6	-0.6	-0.6	-5.3	-5.2	-5.2	-4.1
Net domestic assets	154.2	186.1	211.4	222.2	174.1	192.4	185.7	194.6	223.4
Net domestic credit	210.3	264.5	295.2	332.9	317.3	330.1	328.0	318.7	323.6
Government (net)	-25.2	-18.9	-12.9	-30.9	-38.0	-29.0	-30.7	-46.8	-49.1
Nonfinancial public enterprises	8.6	5.4	3.7	4.7	4.6	4.3	4.6	5.0	5.0
Private sector	226.8	278.0	304.3	359.1	350.7	354.8	354.1	360.5	367.7
Other items (net)	-56.1	-78.4	-83.7	-110.7	-143.2	-137.6	-142.3	-124.1	-100.2
Total liquidity	223.7	253.4	287.1	301.5	290.3	306.7	292.9	300.1	307.4
Broad money (M2)	203.7	237.5	265.8	282.8	271.5	287.4	272.7	280.0	287.0
Narrow money	68.7	55.7	73.8	72.6	66.3	77.3	79.7	79.2	80.2
Quasi money	134.9	181.8	192.0	210.2	205.2	210.1	193.0	200.7	206.8
Notes and bills 2/	20.1	15.9	21.4	18.7	18.8	19.3	20.2	20.1	20.4
Government lending funds 3/	6.8	6.1	5.4	5.0	4.9	0.0	0.0	0.0	0.0
	(Annual percent change)								
Net foreign assets	-8.9	-5.8	12.7	-2.2	25.2	11.0	28.4	33.0	-20.4
Net domestic assets	27.2	20.7	13.6	5.1	-17.2	-9.4	-13.2	-12.4	14.8
Net domestic credit	20.9	25.8	11.6	12.8	3.1	7.6	5.1	-4.3	1.5
Private sector	29.4	22.6	9.5	18.0	11.0	8.2	4.5	0.4	2.0
Total liquidity	13.3	13.3	13.3	5.0	-2.5	-1.1	-1.5	-0.5	2.4
Broad money (M2)	12.8	16.6	11.9	6.4	-2.2	-0.8	-1.6	-1.0	2.5
	(In millions of U.S. dollars)								
Net foreign assets	39.5	34.9	41.7	42.9	58.6	53.6	49.5	…	…
Foreign assets	47.5	46.1	53.3	54.1	72.5	69.8	69.2	…	…
NRBT	42.5	40.4	47.1	48.2	64.8	58.1	60.3	…	…
DMBs	5.0	5.7	6.2	5.8	7.7	11.7	8.9	…	…
Foreign liabilities	-8.0	-11.2	-11.6	-11.2	-13.9	-16.2	-19.7	…	…
Memorandum items:									
Velocity (GDP/average M2)	2.6	2.6	2.4	2.3	…	…	…	2.4	2.5
Pa'anga per U.S. dollar (end of period)	1.93	2.06	1.95	1.85	1.98	2.13	2.17	…	…

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

1/ Comprises the National Reserve Bank of Tonga (NRBT), the deposit money banks, and the Tonga Development Bank (TDB).
2/ Comprises bills and promissory notes issued by financial sector and held outside the sector.
3/ Represents borrowing by the government from foreign sources for onlending to the TDB.

Table 4: Tonga: Balance of Payments Summary, 2003/04–2009/10 1/

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

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
						Proj.	
Trade balance	-68.8	-89.3	-106.7	-95.3	-125.7	-118.4	-119.4
Exports, f.o.b.	13.8	16.0	15.4	13.3	12.4	8.0	8.4
(Annual percent change)	-21.2	16.0	-3.8	-13.6	-7.3	-35.0	4.2
Imports, f.o.b.	-82.6	-105.4	-122.2	-108.6	-138.1	-126.4	-127.8
(Annual percent change)	11.3	27.5	15.9	-11.1	27.1	-8.4	1.1
Of which: PRC reconstruction loan	…	…	…	…	…	-2.0	-15.9
Services (net)	-2.8	-10.0	-7.8	-17.9	-3.3	-9.5	-4.8
Receipts	25.8	23.7	25.3	19.4	36.9	34.5	36.7
Payments	-28.6	-33.6	-33.2	-37.3	-40.1	-44.0	-41.5
Investment income (net)	-0.4	1.6	2.8	3.5	3.4	29.2	4.2
Receipts 2/	2.7	3.4	4.9	6.4	6.8	31.6	6.8
Payments	-3.1	-1.8	-2.1	-2.9	-3.5	-2.4	-2.6
Current transfers (net)	79.7	91.9	88.9	84.2	94.8	77.4	69.9
Official transfers (net)	0.3	0.0	0.0	0.0	0.3	1.0	1.1
Private transfers (net)	79.4	91.9	88.9	84.2	94.5	76.4	68.8
Current account balance	7.7	-5.8	-22.8	-25.5	-30.8	-21.3	-50.1
(In percent of GDP)	3.4	-2.2	-8.0	-8.5	-9.0	-6.5	-14.8
Capital and financial account balance	37.0	12.5	22.5	26.9	36.3	32.6	36.1
Official capital flows (net) 2/	13.7	4.8	8.4	9.8	12.0	2.0	22.3
Of which: PRC reconstruction loan	…	…	…	…	…	15.0	20.0
Private capital flows (net)	23.2	7.7	14.1	17.1	24.3	30.6	13.8
Errors and omissions	-18.8	-10.7	1.0	2.7	-6.8	0.0	0.0
Overall balance 3/	25.9	-4.0	0.6	4.2	-1.3	11.3	-14.0
Memorandum items:							
Gross official foreign reserves	44.8	42.5	40.4	47.1	48.2	59.5	45.6
In months of goods and services imports 4/	4.8	3.7	3.1	3.9	3.2	4.2	3.2
Exchange rate							
Pa'anga per U.S. dollar (period average)	2.05	1.94	2.01	2.00	1.90	2.09	2.10
Pa'anga per U.S. dollar (end of period)	2.00	1.93	2.06	1.95	1.95	1.99	2.09
Nominal GDP	230.2	259.7	287.4	298.6	340.8	329.8	338.4
Commodity price indexes (2005 = 100)							
Food	94.8	100.5	105.2	118.9	142.2	144.7	132.7
Fuel	63.8	86.2	109.6	125.5	158.1	150.8	128.6

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

1/ On OET base; projections include adjustments for imports related to reconstruction loan from China.
2/ Includes T$25m grants from China under investment receipt and related official capital outflow in 2008/09.
3/ Change in gross official foreign reserves.
4/ The current year's imports.

Table 5. Tonga: Medium-Term Scenario, 2005/06–2013/14 1/

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
						Proj.			
				(Annual percent change)					
Output and prices									
Real GDP	0.3	-1.7	2.6	0.4	0.3	2.3	1.7	1.7	1.7
Consumer prices (end of period)	6.4	5.6	12.2	1.4	2.5	4.0	4.0	6.0	6.0
Consumer prices (period average)	7.0	5.1	9.8	4.7	1.7	3.3	4.0	5.0	6.0
				(In percent of GDP)					
Central government finance									
Total revenue and grants	26.8	28.6	26.5	28.6	28.3	28.5	28.0	28.1	28.0
Total revenue	25.1	24.8	25.2	22.2	22.4	22.6	23.6	24.6	24.7
Grants	1.7	3.8	1.3	6.3	5.9	6.0	4.4	3.5	3.3
Total expenditure and net lending	29.6	27.5	24.9	27.3	32.2	32.1	30.3	29.1	28.9
Current expenditure	28.9	26.5	24.5	23.4	24.7	24.5	23.5	22.2	21.9
Capital expenditure	0.8	0.9	0.4	3.0	4.6	4.7	4.8	4.8	4.9
Expenditure discrepancy	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	-0.2	0.1	0.0	0.9	2.9	2.9	2.1	2.1	2.1
Overall balance	-2.8	1.1	1.7	1.3	-3.9	-3.5	-2.3	-1.0	-0.9
External financing (net)	0.4	0.1	0.2	1.0	4.2	5.5	4.4	0.0	0.9
Domestic financing (net)	2.4	-1.2	-1.9	-2.3	-0.3	-2.0	-2.1	-0.1	0.0
				(In millions of U.S. dollars)					
Balance of payments									
Exports, f.o.b.	15.4	13.3	12.4	8.0	8.4	8.6	8.9	9.2	9.6
(Annual percent change)	-3.8	-13.6	-7.3	-35.0	4.2	3.3	3.2	3.5	3.6
Imports, f.o.b.	-122.2	-108.6	-138.1	-126.4	-127.8	-131.6	-130.8	-121.0	-124.2
(Annual percent change)	15.9	-11.1	27.1	-8.4	1.1	3.0	-0.6	-7.5	2.6
Of which : Reconstruction loan	…	…	…	-2.0	-15.9	-16.1	-13.9	…	…
Services and investment income (net)	-5.0	-14.4	0.1	19.7	-0.6	3.7	3.8	3.9	4.1
Transfers (net)	88.9	84.2	94.8	77.4	69.9	76.0	79.5	82.3	85.1
Of which: Private transfer receipts	102.0	93.3	106.7	86.2	78.8	84.8	89.0	92.1	95.5
(Annual percent change)	-5.0	-8.6	14.4	-19.2	-8.5	7.5	5.0	3.5	3.6
Current account balance	-22.8	-25.5	-30.8	-21.3	-50.1	-43.3	-38.6	-25.5	-25.4
(In percent of GDP)	-8.0	-8.5	-9.0	-6.5	-14.8	-12.4	-10.7	-6.8	-6.6
Capital account balance	22.5	26.9	36.3	32.6	36.1	46.5	48.4	34.0	32.9
Official capital flows (net)	8.4	9.8	12.0	2.0	22.3	23.9	23.1	11.8	9.5
Of which : PRC reconstruction loan	…	…	…	15.0	20.0	20.0	5.0	…	…
Private capital flows (net)	14.1	17.1	24.3	30.6	13.8	22.6	25.3	22.2	23.5
Overall balance	0.6	4.2	-1.3	11.3	-14.0	3.2	9.8	8.5	7.5
Gross international reserves (end of period)									
In millions of U.S. dollars	40.4	47.1	48.2	59.5	45.6	48.8	58.6	67.1	74.7
In months of imports (goods and services)	3.1	3.9	3.2	4.2	3.2	3.4	4.1	4.9	5.3
External debt (in percent of GDP)									
Public sector external debt	29.1	27.4	25.4	28.3	32.3	36.1	35.4	33.2	30.6
Of which: PRC reconstruction loan	...	...	…	4.5	10.3	15.7	16.6	16.1	15.3
Debt service ratio	1.1	1.1	1.4	1.3	2.3	1.9	1.8	1.7	2.3
Of which: PRC reconstruction loan	…	…	…	0.09	0.20	0.29	0.30	0.28	0.42
Memorandum items:									
Private transfers (net, in millions of U.S. dollars)	88.9	84.2	94.5	76.4	68.8	74.8	78.8	81.5	84.5
(In percent of imports, goods and services)	57.2	57.7	53.1	44.8	40.6	43.4	45.6	49.6	49.9
Commodity price indexes (2005 = 100)									
Food	105.2	118.9	142.2	144.7	132.7	133.0	133.4	134.3	135.4
Fuel	109.6	125.5	158.1	150.8	128.6	143.3	148.1	150.8	152.9
Nominal GDP (millions of T$)	577.3	598.0	649.2	688.7	711.2	751.3	795.0	849.4	916.1

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

1/ Fiscal year beginning July.

Table 6. Tonga: Banking Sector Indicators, 2003–08 1/

(In percent; end of period)

	2003	2004	2005	2006	2007	2008
Capital adequacy						
Risk-weighted capital ratio	21.9	23.9	19.7	21.3	22.1	27.3
Total capital to total assets	18.5	16.3	16.3	17.3	18.0	19.8
Asset quality						
Nonperforming loan to total loans	9.6	5.9	4.2	3.7	5.3	15.0
Nonperforming loans to capital	39.1	24.4	20.2	16.1	22.9	57.7
Nonperforming loans net of provisions to total capital	14.2	0.1	3.0	0.6	3.5	36.3
Profitability						
Return on assets	5.8	6.0	6.6	5.4	4.5	-1.7
Return on equity	23.0	22.1	24.9	21.5	17.6	-9.7
Net interest margin	8.7	10.0	8.6	8.1	8.1	7.4
Net interest income to gross income	61.2	61.1	60.5	60.3	54.0	53.0
Other						
Liquid asset to total asset	8.8	12.8	6.4	7.9	10.6	10.2
Liquid asset ratio (LAR)	…	…	…	9.1	11.3	11.4

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

1/ Include the Tonga Development Bank.

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

TONGA

Joint IMF/World Bank Debt Sustainability Analysis 2009[1]

Prepared by the staffs of the International Monetary Fund and
The International Development Association

Approved by Joshua Felman and Anthony Boote (IMF)
and Vikram Nehru and Carlos Primo Braga (IDA)

August 14, 2009

The Low Income Country Debt Sustainability Analysis (LIC DSA) indicates that Tonga remains at a high risk of debt distress. Under the baseline scenario, the NPV-of-debt to GDP as well as the NPV-of-debt to export ratios remain above the country-specific indicative thresholds for a prolonged period. At the same time, Tonga benefits from very high remittance inflows (over 30 percent of GDP), which are by far the largest source of foreign exchange earnings and help mitigate liquidity risks. Tonga's overall public sector debt indicators, while elevated over the short term, 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.

The results of the debt sustainability analysis underscore the importance of maintaining broadly balanced budgets following the completion of reconstruction borrowing and sustaining growth near historical averages. Both are key to maintaining stable debt levels in the medium term and declining debt levels in the long term.

I. BACKGROUND

1. **The external and public debt sustainability analyses are based on the standard LIC DSA framework.**[2] The DSA presents the projected path of Tonga's external and public

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

[2]See "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."

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) declined to 34 percent of GDP in FY07/08 from 40 percent of GDP in 2005/06**. External debt to GDP fell as donor financing declined in real terms, while fiscal consolidation to limit domestic budget financing also contributed to a downward trend in domestic public debt to GDP.

3. **Following the civil unrest in November of 2006, the government made a significant effort toward securing financing for the reconstruction of the capital city of Nuku'alofa**. This includes donor grants of about US$15 million, to be channeled through designated banks to business entities affected by the riots in the form of off-budget, low interest rate loans in the second half of 2007/08. The government also signed a long-term reconstruction loan from the EXIM Bank of China in November 2007. Disbursements of this loan were postponed, as the government sought to ensure it was used productively and negotiated for use of local inputs. The first drawdown was made in April 2009. Loan proceeds will be used in broadly equal measure to finance public works in the capital and to lend to the private sector for office and retail construction. The loan, which bears a 2 percent interest rate will be repaid over 20 years with a 5 year grace period.

4. **The 2009 DSA reinforces the findings of the previous analysis.** The main changes from the 2008 DSA are the lower short-term growth outlook as a result of the global economic crisis and more rapid assumed drawdowns of the EXIM Bank loan. In addition, the DSA incorporates the authorities' new GDP statistics. The new series has improved coverage and , includes estimates of the informal sector. This increases the level of GDP by 15–20 percent and causes some changes to historic growth rates. While the increase in the level of GDP reduces historic debt ratios, it has not led to a change in the assessment of Tonga's risk of debt distress.

Key Macroeconomic Assumptions

	Baseline 2008/09 2013-14	Baseline 2014/15 2028/29	10 year Historical Average
Real GDP growth (percent)	1.4	1.7	1.8
Growth of exports of goods and services (U.S. dollar terms)	1.8	4.7	5.0
Non-interest current account balance (in percent of GDP)	8.8	6.2	3.6
GDP deflator in U.S. dollar terms (annual percent change)	0.8	2.9	3.6
Primary deficit (in percent of GDP)	0.3	-0.4	-0.5

II. Baseline

5. **Tonga's DSA builds on the baseline scenario assumptions presented in Box 1.** It assumes that the real GDP growth rate will revert close to its historical average following a slowdown in 2008/09 and 2009/10. The reconstruction loan will be drawn down over four

years. Excluding reconstruction spending, public spending will be broadly limited to projected revenues and grants over the medium term, and will, thus, minimize additional external borrowing. Although exports are expected to remain constrained, 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 expected to remain an important external cushion over the medium term.

Box 1: Key Assumptions

- Real GDP growth is projected to average 1.2 percent over the period 2009/10–2014/15, reflecting a slowdown from the global financial crisis in the first two years and an average of 1¾ percent thereafter. This modest long-run growth outlook is in line with Tonga's historic growth rates, reflecting structural impediments, which will continue to constrain growth potential.
- Inflation as measured by the GDP deflator is projected to average 5 percent over the projection period 2009/10–2014/15.
- The non-reconstruction public sector budget is projected to remain broadly balanced. Fiscal revenue is projected to grow steadily before it stabilizes at around 26 percent of GDP, as improvements in tax administration bed in and compliance improves.
- Grants are projected to decline from current high levels, but remain significant at around 2 percent of GDP over the medium term. This reflects the importance of donor commitments given the relatively small size of the Tongan economy. The EXIM Bank reconstruction loan is assumed to be fully drawn down by 2012/13 and no major further infrastructure lending is assumed.
- Total expenditure is projected to remain below revenues and grants, yielding primary surpluses of around 1 percent of GDP, somewhat smaller than recent outturns.
- The external current account balance is projected to decline this year to 7.9 percent of GDP from 10 percent of GDP in 2007/08 driven largely by the drop in food and fuel prices. Over the medium term, the deficit should stabilize around 6 percent of GDP.
- FDI is projected to stabilize below recent levels at around 6–7 percent of GDP.
- The export base is projected to remain narrow and relatively undiversified, while remittances have recently dropped as a result of the decline in economic activity in the United States and New Zealand, from which the greater part of remittances emanate. They are, however, expected to recover as these economies rebound from the impact of the global economic slowdown, including seasonal worker programs in Australia and New Zealand.

III. EXTERNAL DSA

Baseline

6. **Under the baseline, the external debt trajectory breaches the policy-dependent threshold in 2009/10 before receding to below the threshold in 2018/19.** Public and publicly guaranteed (PPG) external debt averaged over 30 percent of GDP from 1998 to 2006, the indicative threshold level, but has decreased in recent years reflecting growth in nominal GDP and fiscal prudence. However, with the drawdown of the reconstruction loan the PV of PPG external debt is projected to increase to about 42 percent of GDP by 2012/13, 12 percent above the threshold, before dropping under the threshold in 2017 and declining to 11 percent of GDP by the end of the projection period.

7. **External debt remains well above the PV of debt-to-export distress threshold**. Reflecting Tonga's low exports, the NPV of PPG external debt-to-exports ratio is 243 percent, well above the indicative threshold of 100 percent, and is projected to remain above the threshold for an extended period. However, this is mitigated in part by the large remittances, which are the largest source of foreign exchange earnings (one half of Tongans live abroad, mostly in Australia, New Zealand, and the United States) and which have a countervailing effect by helping to reduce liquidity risks.

Tonga: External Public Debt Indicators

	Indicative Thresholds 1/	2008/09
NPV of external debt		
In percent of GDP	30	31
In percent of exports	100	243
In percent of revenues	200	141
Debt service		
In percent of exports	15	11
In percent of revenues	25	6

1/ Represents Low Income Country DSA indicative thresholds for Tonga that is classified as a poor performer under the World Bank's Country Policy and Institutional assessment.

8. **Debt and debt service are expected to stay above the exports threshold for the majority of the projection period**. The impact of the global economic crisis will make it harder for Tonga to expand its very narrow export base in the short term, aggravating solvency and liquidity risks. Remittances will decline in the short term, but they are expected to recover and stabilize at around 25 percent of GDP over the medium term, considerably below historical highs, but still providing a vital cushion against external debt distress and liquidity risks. Moreover, the ratio of debt and debt service to revenue remain well below the

thresholds of 200 percent and 25 percent, respectively, throughout the projection period (Figure 1a), albeit with a deterioration in the short- to medium term.

Alternative scenario and stress tests

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 reach 600 percent of exports and remain above the 100 percent threshold for the entire projection period. Similarly debt service to exports ratios rise even further above the 15 percent threshold, reaching over 40 percent in 2015. A one time depreciation causes the present value of debt to rise to 60 percent of GDP and remain above the 30 percent threshold until 2022. It also causes the present value of debt to revenue ratio to briefly breach threshold. Similarly public sector borrowing on less favorable terms would see debt levels remain above the indicative GDP threshold for a prolonged period and approach the revenue threshold.

IV. Public Sector DSA

Baseline

10. **The public sector DSA reinforces the conclusions of the external DSA**. In the last two fiscal years, Tonga's public debt to GDP ratio has declined to around 34 percent of GDP. However, the resumption of large scale public sector borrowing for reconstruction of the capital reversed the trend, with debt building up to 44 percent of GDP in 2010/11 before declining steadily thereafter under the baseline scenario. This reflects the importance of fiscal prudence, and a continued commitment to limit new public borrowing.

Alternative scenario and stress tests

11. **Stress tests reflect that vulnerabilities remain throughout the projection period, particularly to low GDP growth**. Among the stress tests performed, the permanent decline in GDP growth and a one-standard deviation decline in GDP growth show the strongest deterioration, with the PV of debt to GDP ratio rising above 50 percent of GDP in both cases. Further, the alternative scenario in the public sector DSA shows that the additional large public sector borrowing for infrastructure currently being envisaged causes prolonged increases in debt levels.

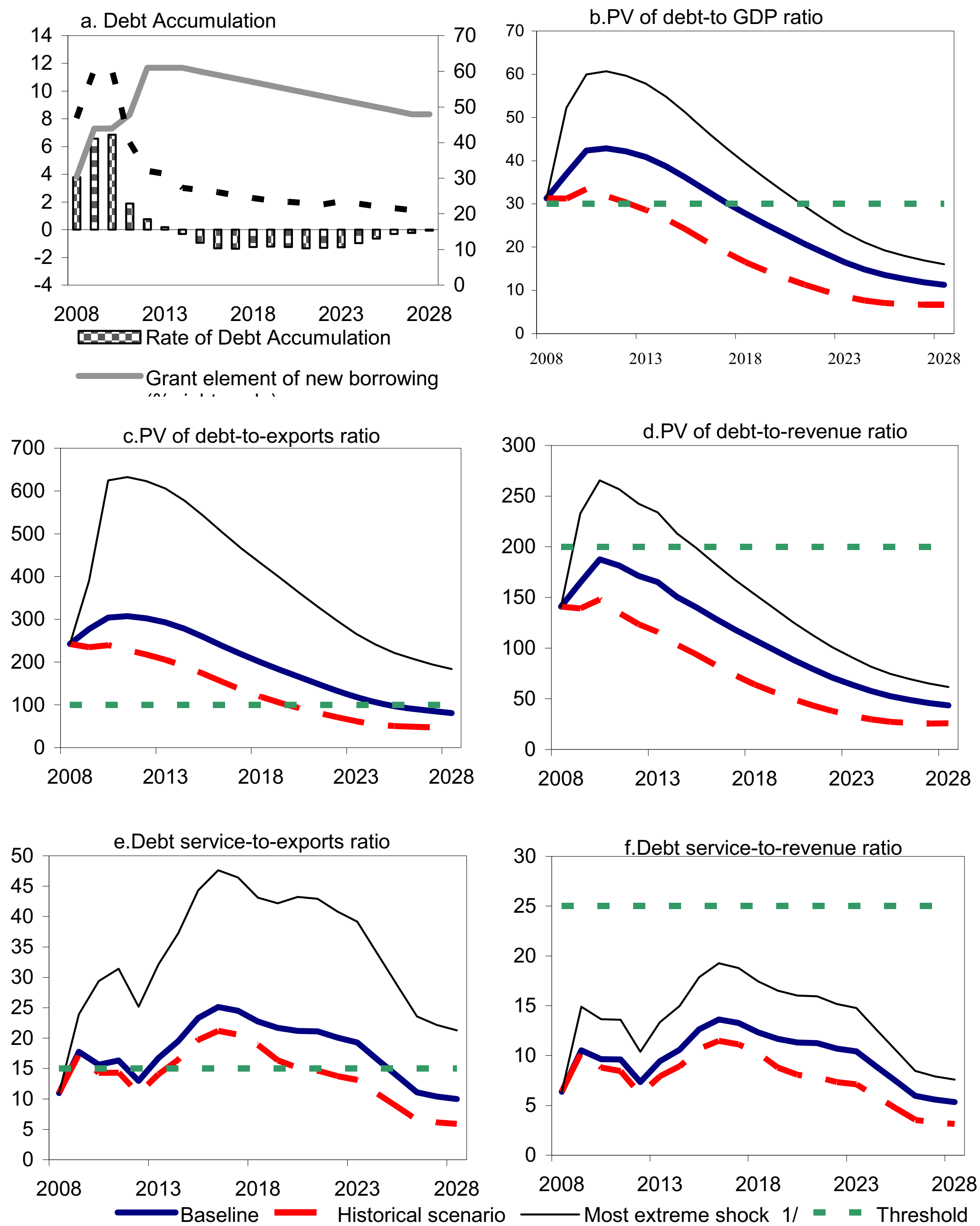
V. Staff Assessment

12. **Tonga remains at a high risk of external debt distress.** At the same time, Tonga benefits from very high remittance inflows, which are the largest source of foreign exchange earnings and have a countervailing effect by helping to mitigate liquidity risks. Moreover, Tonga's overall public sector debt dynamics, while elevated over the short term, shows a

decreasing trend over the longer run, suggesting that debt dynamics are manageable, but at high risk.

13. **Stress tests highlight key vulnerabilities to debt sustainability over the medium term, including lower GDP growth**, major external shocks, and borrowing on less concessional terms. This underscores the importance of sound macroeconomic policies to improve growth potential on a sustainable basis, export diversification, and continued efforts in fiscal consolidation. Moreover, increased utilization of donor grants and limiting recourse to concessional financing is necessary to maintain manageable public debt dynamics and reduce the risk of external debt distress. Sound public debt management, anchored in a medium-term debt management strategy (MTDS) 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 to help ensure debt service capacity in the future.

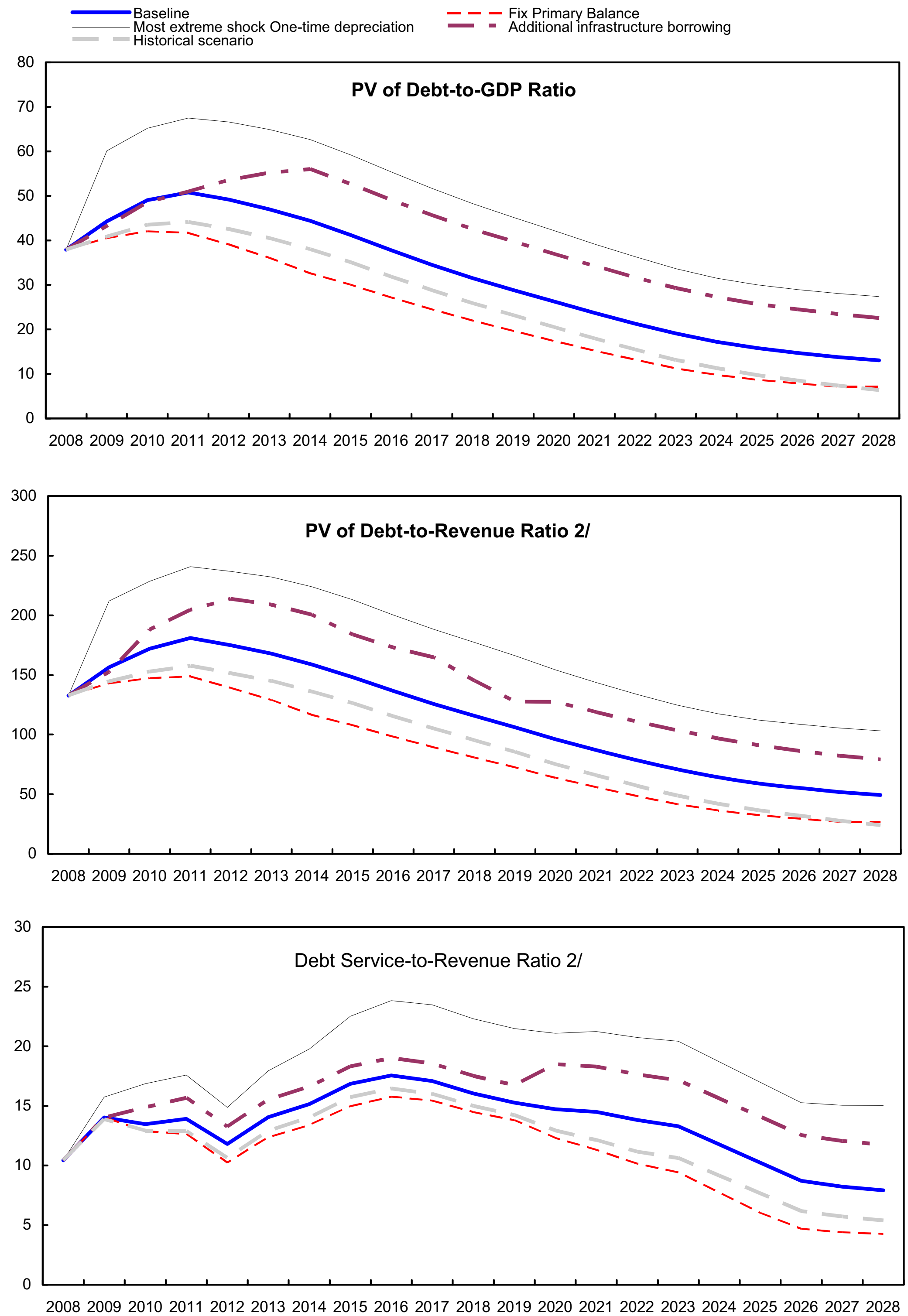
Figure 1. Tonga: Indicators of Public and Publicly Guaranteed External Debt
under Alternatives Scenarios, 2008-2028 1/



Source: Staff projections and simulations.

1/ The most extreme stress test is the test that yields the highest ratio in 2018. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in picture f. to a One-time depreciation shock

Figure 2. Tonga: Indicators of Public Debt Under Alternative Scenarios, 2008–28 1/



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

1/ The most extreme stress test is the test that yields the highest ratio in 2018.

2/ Revenues are defined inclusive of grants.

Table 1a.: External Debt Sustainability Framework, Baseline Scenario, 2005-2028 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical 0 Average 0	Standard Deviation	Projections									
	2005	2006	2007			2008	2009	2010	2011	2012	2013	2008-2013 Average	2023	2028	2014-2028 Average
External debt (nominal) 1/	**35.7**	**32.6**	**28.9**			**30.8**	**33.6**	**36.1**	**35.4**	**33.2**	**30.6**		**15.7**	**14.5**	
o/w public and publicly guaranteed (PPG)	29.1	27.4	25.4			28.3	32.3	36.1	35.4	33.2	30.6		15.7	14.5	
Change in external debt	-3.3	-3.1	-3.6			1.9	2.7	2.6	-0.7	-2.2	-2.6		-0.6	0.0	
Identified net debt-creating flows	-0.7	1.5	-2.1			-2.9	10.6	5.2	3.1	0.3	-0.1		-0.4	-0.6	
Non-interest current account deficit	**7.7**	**8.3**	**8.7**	**3.6**	**5.0**	**5.9**	**14.2**	**11.5**	**9.7**	**5.9**	**5.6**		**6.3**	**6.4**	6.2
Deficit in balance of goods and services	39.9	37.9	37.8			38.8	36.7	35.4	34.0	30.1	29.8		29.8	29.8	
Exports	14.2	11.0	14.4			12.9	13.3	13.9	13.9	13.9	13.9		13.9	13.9	
Imports	54.0	48.9	52.3			51.7	50.0	49.3	47.9	44.0	43.7		43.7	43.7	
Net current transfers (negative = inflow)	-30.9	-28.2	-27.8	-27.9	5.6	-23.5	-20.6	-21.7	-22.0	-22.0	-22.0		-21.8	-21.8	-21.8
o/w official	0.0	0.0	-0.1			-0.3	-0.3	-0.3	-0.2	-0.2	-0.2		0.0	0.0	
Other current account flows (negative = net inflow)	-1.2	-1.4	-1.4			-9.4	-1.9	-2.1	-2.3	-2.2	-2.2		-1.7	-1.6	
Net FDI (negative = inflow)	**-4.9**	**-5.7**	**-7.1**	**-3.5**	**3.4**	**-9.3**	**-4.1**	**-6.5**	**-7.0**	**-6.0**	**-6.1**		**-6.9**	**-7.2**	-6.7
Endogenous debt dynamics 2/	**-3.5**	**-1.1**	**-3.7**			**0.4**	**0.5**	**0.1**	**0.4**	**0.4**	**0.4**		**0.2**	**0.1**	
Contribution from nominal interest rate	0.2	0.2	0.4			0.5	0.6	0.9	1.0	1.0	1.0		0.5	0.4	
Contribution from real GDP growth	-0.1	0.6	-0.7			-0.1	-0.1	-0.7	-0.6	-0.6	-0.6		-0.3	-0.2	
Contribution from price and exchange rate changes	-3.6	-1.9	-3.3			1.1	-0.7	-0.3	-0.5	-0.6	-0.6		-0.4	...	
Residual (3-4) 3/	**-2.5**	**-4.6**	**-1.5**			**4.8**	**-7.9**	**-2.6**	**-3.7**	**-2.5**	**-2.5**		**-0.2**	**0.6**	
o/w exceptional financing	-2.9	-4.7	-2.6			-11.6	-12.9	-12.8	-7.0	-5.8	-5.3		-3.5	-3.6	
PV of external debt 4/	...	...	30.0			33.8	38.2	42.4	42.9	42.1	40.8		16.5	11.3	
In percent of exports	...	...	207.8			262.1	286.8	304.0	307.7	302.5	293.1		118.4	80.9	
PV of PPG external debt	**...**	**...**	**26.5**			**31.3**	**36.9**	**42.4**	**42.9**	**42.1**	**40.8**		**16.5**	**11.3**	
In percent of exports	**...**	**...**	**183.5**			**242.7**	**277.4**	**304.0**	**307.7**	**302.5**	**293.1**		**118.4**	**80.9**	
In percent of government revenues	**...**	**...**	**105.2**			**140.9**	**164.6**	**187.6**	**181.4**	**171.4**	**165.3**		**64.2**	**43.4**	
Debt service-to-exports ratio (in percent)	**19.8**	**24.7**	**17.5**			**19.6**	**26.0**	**23.2**	**23.6**	**20.0**	**23.6**		**23.6**	**13.4**	
PPG debt service-to-exports ratio (in percent)	**10.8**	**13.4**	**10.0**			**11.0**	**17.8**	**15.6**	**16.3**	**13.0**	**16.7**		**19.3**	**10.0**	
PPG debt service-to-revenue ratio (in percent)	**6.1**	**5.9**	**5.7**			**6.4**	**10.5**	**9.6**	**9.6**	**7.3**	**9.4**		**10.4**	**5.4**	
Total gross financing need (Billions of U.S. dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Non-interest current account deficit that stabilizes debt ratio	11.0	11.4	12.3			4.1	11.4	8.9	10.4	8.1	8.2		6.9	6.4	
Key macroeconomic assumptions															
Real GDP growth (in percent)	0.3	-1.7	2.6	1.8	2.0	0.4	0.3	2.3	1.7	1.7	1.7	1.4	1.7	1.7	1.7
GDP deflator in US dollar terms (change in percent)	10.3	5.7	11.3	3.6	9.7	-3.7	2.4	1.0	1.4	1.8	1.9	0.8	2.9	2.9	2.9
Effective interest rate (percent) 5/	0.7	0.7	1.2	1.0	0.3	1.8	2.0	2.7	2.9	2.8	3.0	2.5	3.0	2.7	2.9
Growth of exports of G&S (US dollar terms, in percent)	2.6	-19.8	50.6	5.0	26.4	-13.6	5.8	8.2	3.2	3.5	3.6	1.8	4.7	4.7	4.7
Growth of imports of G&S (US dollar terms, in percent)	11.7	-6.1	22.1	7.5	17.5	-4.3	-0.7	1.9	0.3	-4.8	2.9	-0.8	4.7	4.7	4.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	30.4	43.9	44.0	47.8	61.0	61.0	48.0	52.0	48.0	54.0
Government revenues (excluding grants, in percent of GDP)	25.1	24.8	25.2			22.2	22.4	22.6	23.6	24.6	24.7		25.7	26.0	25.9
Grant-equivalent financing (in percent of GDP) 8/	...	3.8	1.3			8.0	11.6	11.5	6.3	4.3	4.0		2.1	1.4	2.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			67.5	61.5	62.0	75.4	90.2	89.5		74.3	60.0	74.8
Memorandum items:															
Nominal GDP (Billions of US dollars)	0.3	0.3	0.3			0.3	0.3	0.3	0.4	0.4	0.4		0.6	0.8	
Nominal dollar GDP growth	10.7	3.9	14.2			-3.2	2.6	3.3	3.2	3.5	3.6	2.2	4.7	4.7	4.7

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = 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, 2008-2028

(In percent)

	Projections											
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**2018**	2028
PV of debt-to GDP ratio												
Baseline	31	37	42	43	42	41	39	36	33	30	**28**	11
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2008-2028 1/	31	31	33	32	30	29	27	24	21	19	**17**	7
A2. New public sector loans on less favorable terms in 2008-2028 2	31	41	50	52	51	50	48	46	44	41	**39**	25
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	31	37	44	44	43	42	40	37	34	31	**29**	12
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	31	38	47	47	47	45	43	41	38	35	**32**	14
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	31	40	50	50	49	48	45	42	39	36	**33**	13
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	31	38	46	47	46	45	43	40	37	34	**32**	13
B5. Combination of B1-B4 using one-half standard deviation shocks	31	38	49	49	49	47	45	42	39	36	**33**	14
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	31	52	60	61	60	58	55	51	47	43	**39**	16
PV of debt-to-exports ratio												
Baseline	243	277	304	308	302	293	278	259	238	218	**199**	81
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2008-2028 1/	243	235	240	228	218	205	190	173	153	135	**118**	48
A2. New public sector loans on less favorable terms in 2008-2028 2	243	310	358	371	369	362	348	331	313	295	**278**	181
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	243	277	304	308	303	293	278	259	238	218	**200**	81
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	243	390	625	632	623	606	577	542	503	465	**431**	184
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	243	277	304	308	303	293	278	259	238	218	**200**	81
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	243	286	332	336	331	321	306	287	266	246	**227**	96
B5. Combination of B1-B4 using one-half standard deviation shocks	243	322	446	452	445	432	411	385	357	329	**304**	129
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	243	277	304	308	303	293	278	259	238	218	**200**	81
PV of debt-to-revenue ratio												
Baseline	141	165	188	181	171	165	151	140	129	118	**108**	43
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2008-2028 1/	141	139	148	134	123	116	103	93	83	73	**64**	26
A2. New public sector loans on less favorable terms in 2008-2028 2	141	184	221	219	209	204	188	179	169	160	**151**	97
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	141	165	193	187	176	170	155	144	133	122	**111**	45
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	141	172	208	201	190	184	168	158	147	136	**126**	53
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	141	179	220	213	201	194	177	164	151	139	**127**	51
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	141	170	205	198	187	181	166	155	144	133	**123**	52
B5. Combination of B1-B4 using one-half standard deviation shocks	141	171	217	209	198	192	175	164	152	140	**130**	54
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	141	233	266	257	243	234	213	199	183	167	**153**	62

Table 1b.Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2008-2028 (continued)

(In percent)

	Debt service-to-exports ratio											
Baseline	11	18	16	16	13	17	20	23	25	25	**23**	10
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2008-2028 1/	11	17	14	14	11	14	16	20	21	21	**19**	6
A2. New public sector loans on less favorable terms in 2008-2028 2	11	18	17	20	17	21	27	27	25	27	**27**	16
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	11	18	16	16	13	17	20	23	25	25	**23**	10
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	11	24	29	31	25	32	37	44	48	46	**43**	21
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	11	18	16	16	13	17	20	23	25	25	**23**	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	11	18	16	17	13	17	20	24	26	25	**23**	11
B5. Combination of B1-B4 using one-half standard deviation shocks	11	20	21	23	18	23	27	32	35	34	**31**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	11	18	16	16	13	17	20	23	25	25	**23**	10
	Debt service-to-revenue ratio											
Baseline	6	11	10	10	7	9	11	13	14	13	**12**	5
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2008-2028 1/	6	10	9	8	6	8	9	11	11	11	**10**	3
A2. New public sector loans on less favorable terms in 2008-2028 2	6	11	11	12	10	12	14	15	14	15	**15**	8
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	6	11	10	10	8	10	11	13	14	14	**13**	6
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	6	11	10	10	8	10	11	13	14	14	**13**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	6	11	11	11	9	11	12	15	16	16	**14**	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	6	11	10	10	8	10	11	13	14	14	**13**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	6	11	10	11	8	10	12	14	15	14	**13**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	6	15	14	14	10	13	15	18	19	19	**17**	8
Memorandum item:												
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	54	54	54	54	54	54	54	54	54	54	**54**	54

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 2a.Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, 2005-2028
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate			Projections					
	2005	2006	2007	Average	Standard Deviation	2008	2009	2010	2011	2012	2013	2008-13 Average	2028	2014-28 Average
Public sector debt 1/	39.8	37.3	34.4			36.4	39.8	43.3	43.9	40.9	37.6		16.5	
o/w foreign-currency denominated	29.1	27.4	25.4			28.3	32.3	36.1	35.4	33.2	30.6		14.5	
Change in public sector debt	-3.4	-2.5	-3.0			2.0	3.5	3.5	0.6	-3.0	-3.3		-0.2	
Identified debt-creating flows	-0.8	-4.0	-4.5			-2.8	4.1	1.8	0.7	-0.9	-1.0		-0.3	
Primary deficit	2.3	-1.5	-2.4	-0.5	1.6	-2.3	2.7	2.0	0.7	-0.5	-0.7	0.3	-0.1	-0.4
Revenue and grants	26.8	28.6	26.5			28.6	28.3	28.5	28.0	28.1	28.0		26.5	
of which: grants	1.7	3.8	1.3			6.3	5.9	6.0	4.4	3.5	3.3		0.5	1.3
Primary (noninterest) expenditure	29.1	27.1	24.1			26.3	31.0	30.6	28.7	27.6	27.3		26.4	
Automatic debt dynamics	-3.3	-2.5	-2.1			-0.5	1.4	-0.2	0.1	-0.4	-0.3		-0.2	
Contribution from interest rate/growth differential	-1.9	0.3	-1.1			0.0	0.3	-0.3	-0.1	-0.4	-0.2		0.1	
of which: contribution from average real interest rate	-1.8	-0.4	-0.2			0.2	0.4	0.6	0.6	0.4	0.5		0.4	
of which: contribution from real GDP growth	-0.1	0.7	-0.9			-0.2	-0.1	-0.9	-0.7	-0.8	-0.7		-0.3	
Contribution from real exchange rate depreciation	-1.4	-2.8	-1.0			-0.6	1.1	0.1	0.2	0.0	-0.1		...	
Other identified debt-creating flows	0.2	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	
Recognition of implicit or contingent liabilities	0.2	0.0	0.0			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	
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	
Residual, including asset changes	-2.6	1.5	1.5			4.8	-0.6	1.6	-0.1	-2.1	-2.4		0.1	
Other Sustainability Indicators														
PV of public sector debt	10.7	10.0	36.1			37.9	44.3	49.1	50.8	49.2	47.0		13.0	
o/w foreign-currency denominated	0.0	0.0	27.2			29.9	36.8	41.9	42.3	41.5	40.0		11.1	
o/w external	...	...	27.2			29.9	36.8	41.9	42.3	41.5	40.0		11.1	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	
Gross financing need 2/	5.4	1.4	0.5			0.7	6.7	5.9	4.6	2.8	3.2		2.0	
PV of public sector debt-to-revenue and grants ratio (in percent)	40.1	34.9	136.1			132.6	156.4	171.9	181.1	174.9	167.9		49.2	
PV of public sector debt-to-revenue ratio (in percent)	42.8	40.2	143.3			170.5	197.6	217.3	214.9	200.1	190.2		50.2	
o/w external 3/	…	…	107.9			134.4	164.1	185.6	179.2	168.7	162.0		42.7	
Debt service-to-revenue and grants ratio (in percent) 4/	11.4	10.3	10.9			10.4	14.0	13.5	13.9	11.8	14.1		7.9	
Debt service-to-revenue ratio (in percent) 4/	12.2	11.9	11.5			13.4	17.7	17.0	16.5	13.5	15.9		8.1	
Primary deficit that stabilizes the debt-to-GDP ratio	5.7	0.9	0.6			-4.3	-0.8	-1.4	0.1	2.5	2.6		0.1	
Key macroeconomic and fiscal assumptions														
Nominal GDP (local currency)	0.6	0.6	0.6			0.7	0.7	0.8	0.8	0.8	0.9		2.8	
Real GDP growth (in percent)	0.3	-1.7	2.6	1.8	2.0	0.4	0.3	2.3	1.7	1.7	1.7	1.4	1.7	1.7
Average nominal interest rate on forex debt (in percent)	0.9	0.9	1.5	1.1	0.2	2.1	2.2	2.8	2.9	2.8	3.0	2.6	2.7	2.9
Average real interest rate on domestic debt (in percent)	-10.7	-2.9	-1.8	-3.0	4.6	-0.2	3.6	5.1	4.8	1.6	2.9	3.0	5.4	4.4
Real exchange rate depreciation (in percent, + indicates depreciation)	-4.6	-9.3	-3.8	-2.9	12.2	-2.2	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	14.3	5.4	5.8	6.9	3.5	5.6	3.0	3.3	4.0	5.0	6.0	4.5	6.0	6.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.4	-0.1	-0.1	0.0	0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	…	…	30.4	43.9	44.0	47.8	61.0	61.0	48.0	48.0	...

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

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

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

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

Table 2b. Tonga: Sensitivity Analysis for Key Indicators of Public Debt 2008-2028

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
PV of Debt-to-GDP Ratio								
Baseline	38	44	49	51	49	47	32	13
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	38	41	44	44	43	41	26	6
A2. Primary balance is unchanged from 2008	38	41	42	42	39	36	22	7
A3. Permanently lower GDP growth 1/	38	45	50	52	51	49	38	36
A4. Alternative Scenario :Additional infrastructure borrowing	38	43	49	51	54	55	43	23
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	38	45	51	54	53	51	38	26
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	38	43	47	49	47	45	29	11
B3. Combination of B1-B2 using one half standard deviation shocks	38	42	46	48	46	44	30	13
B4. One-time 30 percent real depreciation in 2009	38	60	65	68	67	65	48	27
B5. 10 percent of GDP increase in other debt-creating flows in 2009	38	53	58	60	58	56	41	22
PV of Debt-to-Revenue Ratio 2/								
Baseline	133	156	172	181	175	168	116	49
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	133	145	153	158	152	145	95	24
A2. Primary balance is unchanged from 2008	133	143	147	149	139	129	81	25
A3. Permanently lower GDP growth 1/	133	157	174	185	181	176	140	135
A4. Alternative Scenario :Additional infrastructure borrowing	133	153	188	205	214	209	145	79
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	133	157	178	190	186	181	140	97
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	133	152	165	173	167	160	108	41
B3. Combination of B1-B2 using one half standard deviation shocks	133	148	160	170	164	158	109	50
B4. One-time 30 percent real depreciation in 2009	133	212	228	241	237	232	177	103
B5. 10 percent of GDP increase in other debt-creating flows in 2009	133	188	203	213	208	201	150	82
Debt Service-to-Revenue Ratio 2/								
Baseline	10	14	13	14	12	14	16	8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	10	14	13	13	11	13	15	5
A2. Primary balance is unchanged from 2008	10	14	13	13	10	12	14	4
A3. Permanently lower GDP growth 1/	10	14	14	14	12	14	17	13
A4. Alternative Scenario :Additional infrastructure borrowing	10	14	15	16	13	16	18	12
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	10	14	14	14	12	15	17	11
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	10	14	13	14	11	14	16	7
B3. Combination of B1-B2 using one half standard deviation shocks	10	14	13	13	11	14	16	7
B4. One-time 30 percent real depreciation in 2009	10	16	17	18	15	18	22	15
B5. 10 percent of GDP increase in other debt-creating flows in 2009	10	14	15	16	13	16	18	12

Sources: Country authorities; and Fund staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

TONGA

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2009 Consultation with Tonga

(In Consultation with Other Departments)

August 14, 2009

Contents Page

ANNEX I. TONGA: FUND RELATIONS
(As of June 30, 2009)

I. **Membership Status:** Joined September 13, 1985; Article VIII.

II. **General Resources Account:**

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

III. **SDR Department:**

	SDR Million	% Allocation
Holdings	0.49	N/A

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

V. **Financial Arrangements:** None.

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

VII. **Exchange Rate Arrangement:**

Since February 11, 1991, the value of the pa'anga is determined based on a weighted basket of currencies comprising the 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.

Tonga presently imposes an exchange restriction subject to approval under Article VIII, Section 2 (a). Board approval expired in June, 2008. This restriction consists of the tax certification requirement imposed by the authorities on the making of payments and transfers for certain current international transactions: (i) payments for oil imports; (ii) airline ticket sales; (iii) payments for specified charges/fees/services; (iv) insurance payments; (v) lease payments; (vi) payments for medical expenses incurred by residents; (vii) transfers by nonresidents of profits and dividends abroad; (viii) external loan payments; and (xi) maintenance payments including remittances for family living expenses.

VIII. **Last Article IV Consultation:**

Staff discussions were held during April, 2008 and the Executive Board discussed the staff report (IMF Country Report No. 08/261) on July 2, 2008.

IX. **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.

X. **Resident Representative:** None.

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

(As of June 2009)

Assistance to Tonga since 2006 included 23 advisory missions, mostly on all technical assistance (TA) sectors. During 2006–June 2009, Tonga has sent 50 officials to the Centre's regional seminars, workshops and training courses, and six attachments were organized.

Public Financial Management

Since 2003, PFTAC's missions have focused on complementing the considerable assistance provided by other TA agencies, including through the introduction of a 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.

Tax Administration and Policy

Tonga has improved revenue policy and administration over the last three years. Key outcomes are: the passing of new Income tax and Customs Acts, both self assessed; a post implementation review of the value-added tax (VAT) and substantial change to the tax administration principally with the introduction of self assessment. This progress has complemented the introduction of the consumption tax in 2005 and has seen tax revenues increase steadily to GDP in recent years. Ongoing assistance has been given through PFTAC, NZAID and AusAID, and the ADB.

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

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.

Informal discussions between PFTAC and Tongan revenue officials regarding the modernizing of stamp duties also Customs administration and processes where improvements to trade revenues can be made.

Banking Sector Regulation and Supervision

An assessment to determine compliance with the Basel Core Principles for Effective Banking Supervision (BCP) was conducted in 2002. It identified some shortcomings in Tonga's legal framework and resulted in a review of the Financial Institutions Act (FIA). The enhanced FIA was enacted in late 2004. A TA mission provided assistance with drafting regulations and guidelines, and establishing procedures for their implementation in April 2005. Further assistance in supervision was provided in late 2005 and again in February 2006, as the on-site examination process has been regularized with PFTAC assistance. Amendments to the NRBT Act, which will strengthen the central bank's enforcement capacity, are still awaiting Parliament's enactment. PFTAC also arranged, through funding provided in late 2005 by NZAID, for the renewal of the secondment of a central banking manager from the Reserve Bank of Fiji to serve as the Deputy Governor of the National Reserve Bank of Tonga. Peripatetic advisors for bank supevision are being provided by Monetary and Capital Markets Department (MCM). No visits have been conducted by the Advisor with the NRBT authorities. Recently, authorities have requested PFTAC to conduct research regarding interest and exchange rate spreads across the Pacific in comparison to those experienced in Tonga. The results of the requested research project will be presented to the 2009 South Pacific Reserve Bank Governor's meeting in December 2009.

[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.

Economic and Financial Statistics

In 2002, two reviews were undertaken in accordance with the GDDS and the *Data Quality Assessment Framework;* one on BOP statistics and the other on the wider statistical system. Subsequent missions in 2004 finalized GDDS metadata, provided training in BOP concepts and practices, developed a new BOP business survey, and reviewed national accounts data. In September 2005 a partial update of the 2002 statistical system review was done, 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. A TA mission in April 2007 provided further assistance with reviewing BOP statistics. Follow-up missions on BOP statistics were undertaken in April 2008 and March 2009, resulting in revised BOP estimates based on the *Balance of Payments Manual, 6^th^ edition* standards being compiled. In addition to the an advisory mission on revenue estimation and review of National Accounts Statistics (NAS) in mid-March 2008, a further TA advisory mission on NAS in March 2009 implemented significant improvements in methodology and use of source data, resulting in substantial improvements in the estimates and dissemination of an expanded rnge on NAS estimates. TA expert missions to develop producer price indexes were also undertaken in July 2008 and March 2009.

ANNEX III. TONGA: RELATIONS WITH THE WORLD BANK GROUP
(as of July 10, 2009)

Tonga became a member of the World Bank Group in 1985. Since that time, the World bank has approved six IDA credits and grants worth a total of SDR 18.6 million (equivalent to approximately USD 28 million based on exchange rates at the time of each loan approval).

Given Tonga's debt position, all new IDA support for Tonga is provided on grant terms. Tonga has an indicative IDA-15 (FY09–FY11) envelope of SDR 4.9 million (approximately USD 7.5 million), none of which has yet been committed.

In addition to the IDA-15 envelope, the World Bank is in FY10 anticipating committing approximately AUD 3 million in funds for Tonga provided through the Pacific Regional Infrastructure facility (PRIF), financed predominantly by Australia and New Zealand.

Key components of the World Bank's current engagement include:

- **Health**: The Tonga Health Sector Support Project (an IDA credit of USD 10.9 million equivalent approved in 2003) has successfully supported Tongan Government efforts to improve the performance of the health sector, particularly the functioning of Vaiola hospital in Nuku'alofa, as well as reforms to Tonga's health financing system. Health sector investments by the Bank has supported Tonga's own progress toward the MDGs of reducing child mortality and improving maternal health, both of which are likely to be achieved. The project is scheduled to finish shortly, and will be fully disbursed.

- **Education**: The Tonga Education Support Project (an IDA credit of U.S. dollars 1 million equivalent approved in 2005 in conjunction with a New Zealand grant of USD 4.1 million) has introduced a successful schools grants program. School grants, allocated on a capitation formula, have ensured funding has been allocated equitably and able to be used flexibly by schools for maintenance and educational materials. This program has supported Tonga's own progress toward universal primary education, where the country remains broadly on track.

- **Transport**: The Tonga Transport Sector Consolidation Project (an IDA grant of USD 5.4 million equivalent approved in July 2008) aims to assist the government to unify transport sector-policy, planning and regulation in the newly established Ministry of Transport. This is intended to improve civil aviation and maritime safety and security. With anticipated grant support through PRIF, the TSCP will also assist the government to directly contract local firms to undertake urgent and necessary road maintenance in a manner which ensures local participation and strengthening of the local industry as well as support maritime and air transport investments.

- **Private sector development**: The World Bank Group (including IFC and IDA) are collaborating to support the efforts of the Tongan government to streamline business enabling environment legislation and regulation and remove regulatory impediments to private sector growth.

- **Energy**: The Bank is currently working with the Tongan government and other development partners to develop a Tonga Energy Roadmap, as a series of integrated investments and reforms required to improve access and reduce the cost of electricity supply in Tonga, and minimize Tonga's vulnerability to oil price shocks, including by making greater use of renewable sources of energy. Leadership by the Tonga Government has ensured that this process has been a strong example of development coordination in the Pacific region. It is anticipated that the Bank will be able to support the final roadmap – with other development partners and potentially private sector investors – with current unallocated IDA resources, as well as with support through PRIF.

World Bank Credits and Grants

Total:	USD 28.2 million
Of which	
FY09 disbursements:	USD 0.5 million
Undisbursed:	USD 7.1 million
Of which:	
FY10 expected disbursement:	USD 6.0 million

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[3]

(As of June 2009)

The Asian Development Bank (AsDB) strategy for Tonga supported the Government's Strategic Development Plan Eight 2006/07–2008/09 (SDP-8) in alignment with the objectives of the 2005 Paris Declaration on Aid Effectiveness. The Country Partnership Strategy 2007–12 (CPS) focuses on poverty reduction by means of three intervention pillars—pro-poor, environmentally sustainable integrated urban infrastructure development; financing of pro-poor policies through effective, prudent macroeconomic and fiscal management; and private sector development—that address binding constraints on growth. Capacity strengthening and institution building will be among the key outcomes of the results-based CPS. The CPS outcomes expected are (i) improved fiscal governance, (ii) improved social services delivery in urban areas, and (iii) an improved private sector-enabling environment.

The SDP8 ended in June 2009 and Cabinet has endorsed a new National Strategic Planning Framework (NSPF), which takes a longer term strategic approach and focuses on a limited number of uniquely national or whole of government priorities – with the implementation details to be contained in the corporate plans of ministries and departments. The NSPF identified seven outcomes fundamental to producing sustained and more equitable economic growth – (i) community development, (ii) private sector growth, (iii) constitutional reform, (iv) improved provision and maintenance of infrastructure, (v) increased performance of technical and vocational training, (vi) improved health, and (vii) environmental sustainability and climate change. The three pillars of the AsDB's strategy for Tonga remain valid in light of the outcome objectives highlighted under NSPF.

AsDB has approved 15 loans and one grant totaling $69.1 million from the Asian Development Fund (ADF) to Tonga since it joined AsDB in 1972. Fifty-six technical assistance (TA) projects with a value of $16.5 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 one grant-financed project and four TA projects in the country portfolio. The grant-financed project supports enhancing living standards by improving urban infrastructure. The four ongoing TA projects focus on public enterprise reforms, youth micro-enterprise development, support for the implementation of SDP-8, and urban planning and management system. Tonga also benefits from a number of regional technical assistance projects in private sector development, economic management, infrastructure-related activities, public financial management, statistics and HIV/Aids prevention and capacity development.

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[3] Prepared by Asian Development Bank staff.

Tonga: Loan, Grant and Technical Assistance Approvals, 2004–08

	2004	2005	2006	2007	2008
Loan approvals					
Number	0	0	0	0	0
Amount (in millions of U.S. dollars)	0	0	0	0	0
Grant approvals					
Number	0	0	0	0	1
Amount (in millions of U.S. dollars)	0	0	0	0	11.3
Technical assistance approvals					
Number	3	1	2	1	1
Amount (in millions of U.S. dollars)	0.7	0.7	0.9	0.5	0.7

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/gddscountrycategorylist/?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 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 six-week 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. 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*.

Tonga: Table of Common Indicators Required for Surveillance
(As of July 30, 2009)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	*Frequency of publication*[6]
Exchange Rates	5/2009	July 24/2009	M	M	*M*
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/2009	July 24/2009	M	M	*M*
Reserve/Base Money	5/2009	July 24/2009	M	M	*M*
Broad Money	5/2009	July 24/2009	M	M	*M*
Central Bank Balance Sheet	5/2009	July 24/2009	M	M	*M*
Consolidated Balance Sheet of the Banking System	5/2009	July 24/2009	M	M	*M*
Interest Rates[2]	5/2009	July 24/2009	M	M	*M*
Consumer Price Index	5/2009	6/2009	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	06/2009	07/2009	M	Q	*Q*
Stocks of Central Government and Central Government-Guaranteed Debt[5]	6/2008	5/2009	A	A	*A*
External Current Account Balance	Q1/2009	5/2009	Q	Q	*Q*
Exports and Imports of Goods and Services	Q1/2009	5/2009	Q	Q	*Q*
GDP/GNP	2007/8	6/2009	A	A	*A*
Gross External Debt	6/2008	5/2009	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).

Statement by Mr. Matthew Davies, Staff Representative on Tonga
Executive Board Meeting 09/92
September 4, 2009

1. This statement provides additional information that has become available since the circulation of the staff report. The information does not change the thrust of the staff appraisal.

2. **Monetary policy has recently been eased**. The change follows discussions between the National Reserve Bank of Tonga (NRBT) and the banking association concerning the effect of worsening economic conditions on the ability of borrowers to continue servicing their bank loans. As a result, the NRBT announced that with effect from August 4, 2009, the Statutory Reserve Deposit (SRD) ratio would be reduced from 10 to 5 percent in order to reduce lending rates and ease the financial difficulties of borrowers. The change was also accompanied by agreement that the banks would voluntarily disclose the effective interest rate on their loans and reduce exchange rate spreads on telegraphic transfers.

3. **The authorities have recently announced agreement on the further large infrastructure loan**. The Prime Minister recently announced that in principle agreement had been reached with China on the US$45 million infrastructure loan from China (referenced in paragraph 10 of the staff report). When finalized the loan is expected to be on similar terms to the US$60 million loan for the reconstruction of Nuku'alofa.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/122
FOR IMMEDIATE RELEASE
September 22, 2009

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

IMF Executive Board Concludes 2009 Article IV Consultation with Tonga

On September, 4, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.[1]

Background

Tonga's recovery from the economic contraction and domestic political disturbance of 2006/07[2] has been halted by the global economic slowdown. Following a contraction of 1¾ percent in 2006/07, the economy rebounded by 2½ percent the following year, leading up to the coronation of a new king in August 2008. However, high international food and fuel prices followed by the global slowdown and tightening domestic financial conditions slowed growth and put pressure on international reserves.

Growth is estimated to have been less than ½ percent in 2008/09. Solid growth in the service and construction sectors was largely offset continued poor performance in manufacturing and agriculture sectors. Inflation, which reached 12 percent in mid-2008 as the economy struggled with high international prices, has moderated to around 2 percent.

Remittances fell by around 15 percent in 2008/09, reflecting the recessions in the two main source economies—the United States and New Zealand. The associated decline in import demand and declines in import prices reduced external pressures while

[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.

[2] Fiscal year begins in July.

unusually strong investment and capital flows in the latter half of 2008, both private and official, allowed reserves to increase slightly to over 4 months of import cover.

Fiscal revenue fell considerably below budget targets in 2008/09 as a result of reductions in tax rates, slowing growth and declines in imports. Tight expenditure control and significant increases in grants, however, enabled the government to deliver a fiscal surplus that will be used to establish a disaster and natural emergency fund. The 2009/10 budget aims to again achieve a surplus, excluding reconstruction borrowing, by improving revenue performance while raising public sector pay and increasing expenditure on infrastructure and social services. Loan-financed reconstruction of the central business district will, however, lead to an overall deficit of around 3 percent of GDP.

External debt declined to around 29 percent of GDP in 2007/08 as a result of fiscal consolidation and reduced donor disbursements. Initial drawdowns of a large reconstruction loan saw debt increase to around 31 percent of GDP at the end of 2008/09. Further loan utilization will see debt levels rise further in coming years.

2008/09 was a turbulent year for the financial sector. Following a period of rapid lending growth and tight liquidity, broad money began contracting in 2009 as deposits were withdrawn in response to worsening economic conditions. Credit growth halted as the Reserve Bank tightened monetary policy and commercial banks increased their lending requirements in response to an increase in bad loans. Interest rates have declined from their mid-2008 highs, but remain high. The exchange rate, which is a trade-weighted peg, appreciated around 6 percent in real effective terms during 2008.

Executive Board Assessment

Executive Directors observed that Tonga's recovery from the 2006 disturbances has been hampered by global and domestic economic conditions. Remittances are declining in the wake of the global downturn and domestic banks are curtailing credit in response to a build-up of bad loans. Downward risks arise from the probability of a sharper-than-projected decline in remittances.

Directors noted that the authorities' ability to respond to the downturn is limited. Fiscal policy is constrained by high public debt, while the scope for monetary expansion is circumscribed by relatively low international reserves. Against this background, Directors endorsed the authorities' strategy of pursuing reconstruction while aiming for a small surplus in the non-reconstruction budget, and relaxing reserve requirements to ease pressures on domestic borrowers. Continued donor support will be important to help the authorities address the difficult challenges ahead.

Directors cautioned that revenue shortfalls may compromise the planned stimulus spending. They encouraged the authorities to devote greater attention to improving revenue enforcement, especially customs collections. The government should also prioritize expenditures carefully, and consider a more gradual implementation of the planned public wage increases. Directors welcomed the authorities' contingency plan, in the event that revenues are lower than budgeted.

Directors noted that the large reconstruction loan will place a heavy debt burden on the country, which could be shouldered only if the loan-financed expenditure proves productive; GDP continues to grow over the medium term; and the budget remains balanced. Directors urged the authorities to vet proposed reconstruction projects carefully, approving only economically viable ventures. Financing for future infrastructure investments should rely as much as possible on domestic revenues and grants.

With reserves likely to remain in the lower part of the Reserve Bank's comfort zone, Directors encouraged the authorities to maintain a cautious monetary policy stance and to stand ready to tighten should credit growth re-accelerate and the outlook for reserves and inflation deteriorate. Directors noted the staff's assessment that the exchange rate remains consistent with external stability and that projected external current account deficits are sustainable. They welcomed the authorities' intention to use the adjustment band within the current exchange rate peg if needed to safeguard reserve coverage.

Directors encouraged the authorities to make further efforts to enhance banking supervision to prevent a further deterioration in banks' balance sheets. Regulation will need to remain vigilant to prevent further surges in high-risk lending.

Directors underscored the importance of structural reform for improving growth and raising living standards, guided by the authorities' Strategic Planning Framework. They congratulated the authorities on the recent steps to rationalize public enterprises, and encouraged them to make further progress in this area and to sustain efforts to improve the business climate.

Directors recommended strengthening the statistical framework, noting that the recent advances in compilation need to be matched by improvements in the underlying data.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2009 Article IV Consultation with Tonga is also available.

Tonga: Selected Economic Indicators, 2005/06–2009/10 1/

	2005/06	2006/07	2007/08	Proj. 2008/09	Proj. 2009/10
Output and prices (in percent change)					
Real GDP	0.3	-1.7	2.6	0.4	0.3
Consumer prices (period average)	7.0	5.1	9.8	4.7	1.7
Central government finance (in percent of GDP)					
Total revenue and grants	26.8	28.6	26.5	28.6	28.3
Total expenditure and net lending	29.6	27.5	24.9	27.3	32.2
Overall balance (incl. reconstruction loan)	-2.8	1.1	1.7	1.3	-3.9
Overall balance (excl. reconstruction loan)	-2.8	1.1	6.5	2.9	2.1
External financing (net)	0.4	0.1	0.2	1.0	4.2
Domestic financing (net)	2.4	-1.2	-1.9	-2.3	-0.3
Money and credit (in percent change)					
Total liquidity 2/	13.3	13.3	5.0	-0.5	2.4
Of which: Broad money (M2)	16.6	11.9	6.4	-1.0	2.5
Domestic credit	25.8	11.6	12.8	-4.3	1.5
Private sector credit	22.6	9.5	18.0	0.4	2.0
Balance of payments (in millions of U.S. dollars)					
Exports, f.o.b.	15.4	13.3	12.4	8.0	8.4
Imports, f.o.b.	-122.2	-108.6	-138.1	-126.4	-127.8
Services (net)	-7.8	-17.9	-3.3	-9.5	-4.8
Income (net)	2.8	3.5	3.4	29.2	4.2
Services and income (net)	-5.0	-14.4	0.1	19.7	-0.6
Transfers (net)	88.9	84.2	94.8	77.4	69.9
Current account balance (excl. reconstruction loan)	-22.8	-25.5	-30.8	-19.4	-34.3
Current account balance (incl. reconstruction loan)	-22.8	-25.5	-30.8	-21.3	-50.1
(In percent of GDP)	-8.0	-8.5	-9.0	-6.5	-14.8
Gross international reserves					
In millions of US dollars	40.4	47.1	48.2	59.5	45.6
In months of total imports	3.1	3.9	3.2	4.2	3.2
External debt (in percent)					
External debt (in percent of GDP)	35.7	32.6	28.9	30.8	33.6
Debt service ratio 3/	1.1	1.1	1.4	1.3	2.3
Exchange rate (period average)					
Pa'anga per U.S. dollar	2.0	2.0	1.9	2.1	...
Real effective exchange rate (1990=100) 4/	103.6	104.5	104.2	114.0	...
Nominal effective exchange rate (1990=100) 4/	70.5	68.4	66.0	67.5	...

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

1/ Fiscal year beginning July.

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

3/ In percent of exports of goods and services.

4/ Through end-February 2009.

Statement by Ms. Duangmanee Vongpradhip, Executive Director for Tonga and Mr. Dicky Kartikoyono, Senior Advisor to Executive Director
Executive Board Meeting 09/92
September 4, 2009

Introduction

On behalf of our Tongan authorities, we would like to express our gratitude to the mission team for the useful and constructive policy advice during their recent visit. Our Tongan authorities value this year's Article IV consultation during a time when the global economy is undergoing a severe economic strain. They broadly agree with the staff's assessment and appreciate its useful recommendations. The candid informative discussion has provided a clear perspective and policies' direction to the authorities to boost the Tongan economic performance over the medium term. Like other economies, Tonga has been suffering from the global turmoil as has been elaborated well by the staff report.

Recent Economic Developments and Outlook

Before the global economic crisis had sparked in the last quarter of 2008, Tonga's economy has just started its buoyant economic activities and been on a path of recovery. The main drivers of resurgence in the aftermath of November 2006 riots have been tourism and construction. Tourist numbers have shown strong growth over the last two years, and up until the first quarter of 2009, accounted for nearly five times the export revenue for merchandise imports. The construction activity, particularly in the tourism related sector has restored swiftly, which associated with increased construction for the retail, financial services and infrastructure sectors should provide the catalyst for growth in the future. While less obvious in terms of measurable growth, the benefits of domestic agriculture products as import substitution have also started to gain much wider recognition.

By having the above factors in perspective, the Ministry of Finance projection suggests the GDP will recover as much as 1.3 percent, from around 0.4 percent in 2008/09 to 1.7 percent in 2009/10. Not only would continued tourism growth underpin these dynamics, but also donor supported government reconstruction loans and increased government spending would be expected to contribute largely in fueling further momentum to boost growth.

Notwithstanding, the authorities realized that the fallout of global economic crisis on the Tongan economy has been unpreventable, albeit of its less reliance on global capital. As pointed out evidently by staff, the first and the foremost channel of external disruptions is through remittances income. With half of the population living and having worked outside the country, chiefly in United States, New Zealand and Australia, our authorities have been cognizant that the decline in remittances will pose significant challenges for Tonga. On the other hand, expansions of seasonal workers' scheme to Australia and in New Zealand could provide some support.

Inflation, as in many economies, has been volatile over the past year, heavily influenced by international food and fuel prices. Tonga's high dependence on fuel and food imports, which dominate the CPI basket, has contributed significantly to the large movement in inflation. At the end of June 2009, annual headline inflation fell significantly to 1.2 percent from 12 percent in mid 2008. Annual average inflation has been dropping fast to below 6% in June 2009, the lowest level since October 2007. A weakening New Zealand dollar against Tongan Pa'anga (TOP) contributed to restrain the surge of imported products, particularly food, and a rapid fall in the global oil prices brought domestic fuel prices down remarkably. Higher food and fuel prices also contributed to a widening current account deficit in 2008, though the sales of government assets, private capital and donor inflows have provided sufficient financing to enable foreign reserves to remain at a comfortable level (above 4 months of import cover).

Meanwhile, the government fiscal position for 2008/2009 was originally framed to provide an appropriate balance of budget spending and revenue to boost the economic performance. In this connection, our Tongan authorities have showed their strong determination to facilitate reconstruction and conduct structural reforms, particularly in the area of budget policy to restore business confidence and promote macro stability. On the other hand, they realized that the country's remittance income and imports have significantly lowered in the last quarter of 2008 and first quarter of 2009, thus these factors have driven trade and consumption taxes down below the target. In respond to this unfavorable development, the Tongan government has been ready to dampen the 2008/09 expenditures by around 30 percent, mainly by cutting down less prioritized government expenses and purchases as well as rescheduling the payments. This policy response is expected to result a minor overall deficit of around 1.25 percent of GDP.

Fiscal Policy

While Tonga's economic outlook has been clouded by high uncertainties, it is also anticipated in a contingency plan that revenue collection could be lower than the proposed budget, due to significant shortfalls on sales and trade taxes from the slowdown of economic and trade activity. Hence, the authorities increased focus on continuing structural reforms is key to strengthen the country's budget position. These include simplifying procedures for starting business and investment, improving certainty in land ownership and leasing, intensifying further transparency of the newly completed fiscal revenue reforms, and privatizing an adequate amount of the government shares in the designated public enterprises. Should revenues prove stronger than staff's estimates, then this would provide greater fiscal space to adopt additional and well-targeted measures.

Our authorities' are also cognizant that their economic programs which have already been in place since the beginning of this year to facilitate an orderly rebalancing of the economy to the adverse external environment, mitigating negative effects on growth and strengthening social safety net to the poor need to be implemented effectively to resist further GDP contraction in coming years. Hence, the government assumes the real GDP growth will fall slightly from 2.6 percent in 2008 to 1.7 percent in 2009, and rebound thereafter by an average of around 2%, though staff report suggests the risks of this forecast are slightly tilted to the downside.

Despite the financial pressure from the global economy which has affected the government's revenue collection capacity, the government designed a fiscal stimulus package which will be implemented in the 2009/10 financial year to counter any adverse impacts of the global downturn. Accordingly, the budget that was submitted to Parliament at the end of June 2009 envisaged an estimated surplus of 17.4 million pa'anga in 2009/10 resulting from total revenues and grants of 220.1 million pa'anga compared to 202.7 million in expenditure. This surplus will be utilized to pay off external debts of 12.3 million pa'anga, leaving a balance of 5.1 million pa'anga for infrastructure projects that are under construction.

To finance this estimated outturn, the government has lined up funding from extra external grants and concessional loans, amounted to 47.9 million pa'anga in cash and 39.4 million pa'anga in kind, which reflect continued donors' support for Tonga development program. Australia, New Zealand, European Union and the Asian Development Bank are Tonga's major donor partners. The Tongan authorities are also grateful and fortunate to receive assistance from the People's Republic of China including the concessional loan for the reconstruction of Nuku'alofa Central Business District (CBD). Other projects such as roads and drainage project are seen as projects that require a high local labor component leading to job creation and generating further economic activities in the Tongan economy.

Implementation of the 2009/10 budget spending therefore will be prudent, and the authorities stand ready to consider additional measures if needed to achieve the budgetary objectives. In its fiscal strategy of 2009/10, the government will focus and fortify their efforts in creating a wider fiscal space by intensifying collection of reformed revenue bills which include the Customs, Excise and Income Tax, reducing government purchases of goods and services and improving further the effectiveness of public expenditure reforms. These measures would be imperative to finance the increase in spending on wages and salaries that has been approved last year, as well as much needed higher capital expenditures.

Monetary Policy

As prices of major components of CPI, oil and food products, remain relatively below the level of 2008, the core and headline inflation will likely decelerate in 2009. The National Reserve Bank of Tonga (NRBT) has started to ease monetary policy in mid-2009 by ceasing the issue of NRBT notes and reducing Statutory Required Reserves to 5 percent from 10 percent. This easing move was mainly based on the outlook for the level of foreign reserves as well as the benign environment of inflation. However, they are aware that they would have to closely monitor credit growth to avoid the credit blow out that occurred in previous years and to protect the external balance.

External Sector

Despite the vain performance in the main export products of Tonga – squash and fish, attributed to limited market access, volatile market prices, lack of new technology, lack of cargo space in the airlines, and harsh weather condition, new initiatives are undertaken by the government to boost this sector including export diversification and gradual development of new markets.

Historically there has been a strong correlation between the level of remittances and the level of imports. The slowdown in remittances has resulted in a lower consumer import. Normally, remittances have represented 85% of imports, but it has been declining since last year. Moreover, there are likely to be substitution effects with Australian and New Zealand tourists switching from long-haul to short-haul destinations that would favor the Pacific region. Tonga may also benefit from a redirection of tourists, given the recent political disruptions and adverse weather conditions in some of Tonga's key competitor markets. To date, tourist arrivals have held up well. These factors may put downward pressure on the current account and narrow the deficit of Tongan balance of payments during these times of low remittances.

At the current juncture, foreign reserves have accumulated significantly equivalent to 5.4 months of imports at the end of July 2009, owing mainly to private capital inflow from the sales of government assets and capital injection into the banking system. The import payments were also in downward trend and are expected to remain at lower level as long as oil and food prices remain constant at the current level. Despite the threats of lower remittances, the NRBT has committed to maintain foreign reserves at an adequate level.

Meanwhile, Nominal Effective Exchange Rate has appreciated this year, mostly due to the pa'anga significant appreciation against NZD and AUD, as these two currencies depreciated swiftly when the global financial market has deleveraged its position to safe haven instruments. In its policy framework, the authorities aim to maintain the exchange rate flexibility around +/- 5% band supported by monetary operation to secure its competitiveness, sustainable macro stability and economic growth. The authorities broadly agree with the staff's assessment on the exchange rate and assure the Board members that the existing adjustment band would be used to maintain external stability. The authorities would also appreciate the Fund's assistance on reviewing the exchange rate basket.

Financial Sector

The authorities welcome staff's finding that the banking system remain struggling to consolidate their financial position after the sharp increase of impaired loans last year, while the NRBT will seek to further enhance its supervisory framework. Maintaining banking system stability remains a key priority and the NRBT will closely monitor bank balance sheets for signs of deteriorating asset quality in the wake of the reinforced loan assessment criteria during the last two years.

As a result, significant amount of bad debts were mandated to be charged in their provisions and their profit has dropped quite substantially. Two out of three commercial banks, which are foreign owned, currently, are running on reasonable amount of losses in their book, while the level of their capital remains sufficient. This prudential measure on account of the credibility of foreign banks is key to promote the financial stability and to ensure healthy lending process going forward. Meanwhile, the only domestic owned bank, Tonga Development Bank, is quite successful in managing its operation and merit a commendation since it has been able to maintain its profitable position for quite some time with a lesser support from the government.

On the supervision side, the NRBT has enhanced its banking supervision framework by issuing six new prudential statements to ensure strong risk management. In addition, banks compliance will be monitored offsite and more frequent onsite visits are planned to monitor the build up of bad loans. The authorities are cognizant of the need to build capacity in the banking supervision department. As most of the bank supervision staff are all new with less than 1 year experience, the authorities would continue to require technical assistance for capacity building.

Other developments

The China reconstruction program, which has already been delayed since the last couple of years, is projected to ramp up this year. At this point, the authorities have already been able to disburse quite a significant amount of loan from this program and to secure additional concessional loan amounted of USD 45 millions for infrastructure development recently. However, given the unprecedented postponement in the recent past, it is realized that the disbursement schedule needs to be modified to avoid the increase in risk of debt distress.

Correspondingly, the Chinese government has always been supportive and vigilant to discuss and renegotiate the term of loan as the economic condition remains challenged by growing uncertainties.

This program will apparently become the main inducement of economic growth, while the development in infrastructure and the enhancement of facilities would always be imperative to facilitate new investment and business in Tonga. However, as the materials and services related to this activity are ostensible to be mostly imported from China, there is such a risk that growth effect will be fairly limited in the short-term perspective. The authorities are mindful that this increasing tendency of import due to this reconstruction program will also influence the Tongan foreign reserves, especially in term of the months of import ratio, as the trade account will ramp up. Looking forward, it is acknowledged that the Tongan authorities need to improve their debt and reserves management capabilities in managing such a long-term program loan.

Final Remark

In conclusion, the authorities are aware of the challenges and the significant risks under the current global economic crisis. The road ahead will be challenging but with strong political will, and assistance from other countries, and multilateral institutions, the authorities are hopeful of addressing some of Tonga’s challenges and moving the economy forward.

Finally, our Tongan authorities express their sincere gratitude to the Pacific Financial Technical Assistance Center (PFTAC), the Fund and the Bank more generally, for the technical guidance received over the years.