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**FOR
AGENDA**

SM/11/79
Supplement 1

April 21, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Tonga—Staff Report for the 2011 Article IV Consultation—
Informational Annex**

The attached informational annex is being issued as a supplement to the staff report for the 2011 Article IV consultation with Tonga (SM/11/79, 4/21/11), which is tentatively scheduled for discussion on **Wednesday, May 4, 2011**. At the time of circulation of this paper to the Board, the authorities of Tonga have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Publication will only proceed upon the receipt by the Fund of the member's explicit consent. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Mr. N'Diaye (ext. 39751) and Ms. Geng (ext. 34097) in APD, and Mr. Matz, STA (ext. 37978).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, April 29, 2011; and to the Asian Development Bank, and the European Commission, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. This supplement is not being disseminated in hard copy. It can be accessed in the Institutional Repository. A link to this document can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2011 ARTICLE IV

CONSULTATION—INFORMATIONAL ANNEX

April 20, 2011

Prepared By

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

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ANNEX I. TONGA: FUND RELATIONS¹

Membership Status:

Joined September 13, 1985; Article VIII.

General Resources Account:

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

SDR Department:

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

Outstanding Purchases and Loans: None.

Financial Arrangements: None.

Projected Obligations to Fund:*

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

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

Exchange Rate Arrangement:

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

Last Article IV Consultation:

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

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

¹ As of March 31, 2011.

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

Technical Assistance:

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

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

Resident Representative: None.

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

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

Public Financial Management (PFM)

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

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

Tax Administration and Policy

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

¹ As of March 2011.

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

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

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

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

Banking Sector Regulation and Supervision

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

Economic and Financial Statistics

In 2002, two reviews were undertaken in accordance with the GDDS and the Data Quality Assessment Framework; one on BOP statistics and the other on the wider statistical system. Subsequent missions in 2004 finalized GDDS metadata, provided training in BOP concepts and practices, developed a new BOP business survey, and reviewed national accounts data. In 2005 a partial update of the 2002 statistical system review was done, focused on outputs of the Statistics Division of the Ministry of Finance. Further assistance was provided to peer review GDP and BOP estimates prior to publication. GDDS metadata was approved and published in 2006 on the Data Dissemination Bulletin Board. TA missions on BOP statistics were undertaken in 2007, 2008, 2009 and 2010, resulting in revised BOP estimates based on the Balance of Payments Manual, 5th edition (BPM5) standards being compiled, along with

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

Macroeconomic Management

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

ANNEX III. TONGA: WORLD BANK–IMF COLLABORATION¹

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

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

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

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

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

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

¹ As of April 2011.

arrangement. This remains critical for safeguarding external stability.

- **Promoting private drivers of growth.**

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

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

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

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

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

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

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

ANNEX IV. TONGA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

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

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

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

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

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

¹ As of April 2011.

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

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

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

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

ANNEX V. TONGA: STATISTICAL ISSUES

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

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

Real Sector Statistics

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

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

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

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

Government Finance Statistics

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

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

External Sector Statistics

Official BOP statistics are compiled annually by the SD with long lags. Monthly trade figures, derived from customs data, are available with a three-month lag. Unofficially, the NRBT compiles monthly balance of payments statistics based on the Overseas Exchange Transactions records of the banking system with a 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. A follow-up mission took place in March 2010.

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

Monetary and Financial Statistics

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

Tonga: Table of Common Indicators Required for Surveillance

As of April 11, 2011

	Date of latest observation	Date received	Frequency of Data 6/	Frequency of Reporting 6/	Frequency of Publication 6/
Exchange Rates	Feb-11	Mar-11	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Feb-11	Mar-11	M	M	M
Reserve/Base Money	Jan-11	Mar-11	M	M	M
Broad Money	Jan-11	Mar-10	M	M	M
Central Bank Balance Sheet	Jan-11	Mar-11	M	M	M
Consolidated Balance Sheet of the Banking System	Jan-11	Mar-11	M	M	M
Interest Rates ²	Jan-11	Mar-11	M	M	M
Consumer Price Index	Jan-11	Mar-11	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Feb-11	Mar-11	M	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Feb-11	Mar-11	A	A	A
External Current Account Balance	Q4/2010	Mar-11	Q	Q	Q
Exports and Imports of Goods and Services	Q4/2010	Mar-11	Q	Q	Q
GDP/GNP	2009/10	Mar-11	A	A	A
Gross External Debt	2010	Mar-11	A	A	A
International Investment Position	NA	NA	NA	NA	NA

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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