

# Chapter 2

## Recovering from Two Shocks to the Economy

**Constraint:** *The 2005 civil service strike and the 2006 destruction of part of the commercial district of Nuku'alofa have created a perception of risk, thereby discouraging investment.*

As mentioned in Chapter 1, recently two sets of events have contributed to the impression of heightened country risk among domestic and foreign investors. This impression has reduced investment and output. These events prompted questions about Tonga's economic and political stability. And until investors are convinced that long-term stability has returned, for investment to occur, expected returns will have to be higher than they would otherwise have needed to be.

### A. Two Shocks to the Tongan Economy

1. The first shock was the combination of the 2005 civil servants' strike and the subsequent large wage increase for public sector employees. These events raised concerns about the future stability of the economy and about what macroeconomic policy was going to be. There were fears that a budget deficit would rise to a level where inflationary forces would be uncontrollable. But the government handled the budgetary pressures skillfully. The upward pressure on spending was used as a catalyst for downsizing the civil service. There has been a 20% decline in public sector employment, with more to come. This reduction and plans for future cuts demonstrate the government's commitment to ensuring that public sector wage inflation does not jeopardize macroeconomic stability. They have had a reassuring effect. While fiscal concerns remain, the prompt response does indicate a degree of macroeconomic management that is evident in other Pacific islands.

Further downsizing will also reduce negative perceptions and serve the need to reduce the role of the state and the economy (Chapter 3).

2. Just when the country was recovering from the first shock, a greater one came. In November 2006 violent civil unrest broke out during which much of the central business district of the capital, Nuku'alofa, was destroyed. The destruction imposed a deadweight loss on the economy. The Tongan business community has indicated that 10 major businesses need to be rebuilt and 150 smaller ones were burned or looted, some of which also wish to rebuild. While the loss of output was mitigated by the flexibility that some businesses displayed in transferring to alternative premises, the owners of many smaller businesses had most of their inventory destroyed and had no alternative premises to move to. They cannot resume business until the rebuilding has taken place.

### B. The Benefits from Reconstructing Nuku'alofa

The economy will not recover fully from the civil disturbances until the central part of Nuku'alofa is reconstructed. Doing so can serve to indicate the return of political stability and the government's determination to press ahead with the transformation of the economy. The impact of the willingness of the government to reform is already being seen; a large international group of hotels has announced a substantial investment in the island of Vava'u, the first such investment in Tonga. Three new hotels are under construction in Nuku'alofa and at least one of them is planned for completion in the second half of 2008.

The manner of rebuilding can improve the perception of stability and bring other benefits as well. If local people are hired for the rebuilding, employment will increase, and it will assist in the development of the domestic workforce, enabling local workers and firms to acquire badly needed skills. In particular, local people will become more qualified to fulfill the contracting out (outsourcing) needs of government ministries, such as the Ministry of Works. The rebuilding has the potential to greatly expand employment in the country. It will also strengthen the private sector and allow a well-planned development that minimizes disruption and adverse economic consequences, such as overheating the domestic economy.

### C. Financing Reconstruction

The Tongan authorities have estimated the cost of reconstruction at US\$30 million–US\$50 million. The amount of capital needed to finance the rebuilding is beyond the capacity of the domestic financial market. Some financing will come from insurance payouts. Although the insurance companies initially contested the validity of the claims of those whose businesses were destroyed on the grounds that the damage was politically motivated, some have subsequently honored many of the claims. But much of the remaining funding will have to come from outside. Recently, agreements to provide long-term financing of the reconstruction were signed with several funding agencies, including:

- Australia and New Zealand, which have given grant funding amounting to A\$15 million.<sup>8</sup> These grants have been fully allocated to businesses wishing to reconstruct, but only a small amount has been actually drawn down. Both countries have signaled a willingness to consider additional grant funding, but only after the initial amounts have been fully used.

- The People's Republic of China, which recently signed a concessionary loan of CNY440 million (US\$60 million). Although the terms involve Chinese contractors supplying much of the materials and staffing, the loan also provides for commitments by builders to employ and train local labor. However, negotiations continue on how to ensure that the work performed will be of high quality and provide value for the amount spent.

Progress has been made formulating plans for rebuilding, with reports that the center of town will be expanded. Some headway with the actual rebuilding has already been made, but the bulk of the work has yet to be done. However, appropriate checks and balances regarding the quality of the new construction need to be in place. By carrying out the whole process with transparency, a positive perception of politics in Tonga will be created and the greatest return on funds invested in rebuilding will be generated. As with the aftermath of the great Chicago fire in the United States, the rebuilding of Nuku'alofa could turn a tragedy into a transformation. A combination of reform and reconstruction could jump-start the economy.

### D. Summary of Recommendations

- Rebuild Nuku'alofa as soon as possible.
- Use various methods and sources of financing: in-kind loans, donor grants, commercial banks, and development banks.
- Make sure that whatever combination of financing alternatives is used, it increases local employment and skills.
- Have the rebuilding program be fully transparent and competitive: Have the tendering process for the rebuilding contracts, including those involving foreign companies, be open. Have independent building experts certify that all construction work meets local construction codes and is of good quality.

<sup>8</sup> In the aftermath of the civil disturbances, Australia and New Zealand gave A\$5 million as a Business Recovery Facility to assist with business cash flow and restocking of businesses damaged or destroyed.