



## Tonga

**T**he performance of the Tongan economy in 1995 was generally less satisfactory than in the previous year. The rate of economic growth slowed down, the fiscal position worsened, the balance-of-payments deficit was significantly greater than it was a year before, and external reserves declined. Further pressure on the fiscal position is likely in 1996 as civil service wage demands are met. However, the external accounts should improve with better export performance and with the demand for imports kept in check by tighter monetary and credit conditions.

### Recent Trends and Prospects

Economic growth in 1995 slipped to 2.2 percent, less than half the rate achieved in 1994. Squash production for export was well down as a result of a combination of factors, such as the effects of the export quota on farming incentives and production management, problems of quality, and external competition. Other primary production for export as well as domestic consumption, such as vanilla, fish, and various food crops, fared better. In the industry sector, manufacturing output declined by 4.9 percent and construction contracted as some major projects were completed. The services sector as a whole showed virtually no growth in 1995.

The Government's fiscal outturn in 1995 was less satisfactory than in the previous year. Total current revenue increased slightly but current expenditure, especially for health and education, rose faster so that the current

surplus fell to 3.2 percent of GDP from 4.2 percent a year earlier. An increase in development expenditure from 17.5 percent of GDP to 22 percent shifted the overall balance to a deficit of 3.4 percent of GDP from a surplus equal to 1.4 percent of GDP in 1994.

The method of financing the fiscal deficit had important effects on monetary conditions which had become lax in 1994 and continued to be so in 1995. The Government's external borrowing and building up of deposits with the commercial banks (rather than repaying advances from the Central Bank) provided the basis for expanded commercial bank lending. Increased competition from the establishment of two new commercial banks obliged the Bank of Tonga to relax its very restrictive approach to lending. On the demand side, higher incomes in 1994 from squash production increased the demand for loans, especially for housing. Expectations of continued high incomes also stimulated loan demand in 1995. Consequently, there was a rapid increase in domestic credit to the private sector of 25 percent in 1994 and 43 percent in 1995. Broad money (M2), which had declined by nearly 5 percent in 1993, increased by 11 percent in 1994 and by a further 9 percent in 1995. The impact of these developments was manifested not in the rate of inflation, which was only 2.4 percent in 1994 and close to zero in 1995, but in the external accounts through a sharp rise in imports in both 1994 and 1995 and a consequent fall in international reserves.

The external accounts worsened considerably in 1995. Export earnings from squash

fell by 40 percent and, although exports of other products such as fish and vanilla improved, total export receipts were 19 percent lower than in 1994 and accounted for 17 percent of foreign exchange earnings in 1995 compared with 8 percent in 1990 (Figure 2.31). With import payments up by about 17 percent, the trade deficit increased to over \$51 million in 1995 from about \$37 million in 1994. With the surplus on services and transfers nearly the same as in the year before, the current account deficit widened from 0.3 percent of GDP in 1994 to over 8 percent in 1995. Allowing for net capital receipts, the overall deficit was about 5.7 percent of GDP; international reserves fell to three-and-a-half months of imports, about half of what they had been in 1993.

The outlook for the Tongan economy in the near future is very dependent on the speed and extent to which the authorities move to redress macroeconomic imbalances. Present prospects are for economic growth in 1996 to be much the same as in 1995 at 2 percent. The main sources of such growth are likely to be in agriculture with increases in output of various cash crops and fishing and some recovery of squash production. The fiscal balance is projected to worsen. With revenue growth modest and recurrent expenditure rising by nearly 10 percent (nearly all of which as a result of increased wages), the recurrent surplus is expected to decline to just over 1 percent of GDP. Development expenditure, at about the same level as in 1995, will push the overall deficit substantially higher than in 1995 to 5 percent of GDP. This is expected to be covered mostly by foreign loans and capital inflow, but some recourse to domestic financing from the banking system is in prospect, in contrast to the position in 1994 and 1995 when government balances were built up. Assuming that monetary policy is tightened to check the drain on external reserves, growth of domestic credit and money supply should be significantly lower than was the case during the past two years. Inflation should also remain at a low level. The balance of payments is expected to improve with imports restrained to 1995 levels, increased tourism earnings, and some recovery in squash exports. In consequence, the current account deficit is projected to fall to 3.4 percent of GDP, less than half of what it was in 1995. With loans and other

capital inflows more than sufficient to cover the deficit, a rise in external reserves to about four months of imports is in prospect.

### Policy and Development Issues

An urgent task is that of developing effective monetary policy instruments not only to deal with the immediate problem of excess credit creation and external reserve depletion, but also to establish a climate of macroeconomic stability conducive to the structural reforms that are necessary for the achievement of sustainable economic growth over the longer term. A fundamental need is to diversify the economy away from excessive dependence on a single export crop concentrated on one market as well as on flows of external grants and private remittances. Diversification calls for vigorous private sector involvement which at present is inhibited, among other things, by an uncertain and distortionary taxation structure and by the drain on resources of an inflated public sector. It is necessary to reduce the size of government, and improve its efficiency by reforms in budgetary management to require explicit evaluation of resource use against outcomes and policy objectives.

