MACROECONOMIC PERFORMANCE

A. Background

1. Tonga is composed of 176 small, remote islands in the South Pacific Ocean between Fiji and Niue. A population of 104,000 is dispersed among 36 inhabited islands across 5 island groups: Tongatapu (73% of the population), Vava'u (15%), Ha'apai (6%), 'Eua (5%), and Ongo Niua (1%). The national capital, Nuku'alofa, is on the main island of Tongatapu. The total land area is only about 750 square kilometers, but Tonga's exclusive economic zone spans 670,000 square kilometers and provides the country with valuable marine resources. Tonga is a middle-income country with gross national income of about $3,820 per person, and is also in the "middle human development" category, ranking second among Pacific economies included in the 2013 Human Development Report.[1]

2. Tonga's small size and remoteness have translated into a narrow economic base that is vulnerable to both external economic shocks and natural disasters. High costs of economic activity limit the competitiveness of Tonga's exports, which comprise mostly fish and agricultural products (e.g., root crops, squash) and also result in high dependence on imports. Remittances from Tongans employed overseas, and to a lesser extent tourism, are the main sources of foreign exchange. These factors leave the economy highly vulnerable to external shocks, while its geographical features expose it to natural disasters such as cyclones, undersea volcanic earthquakes, and tsunamis.

B. Economic Performance

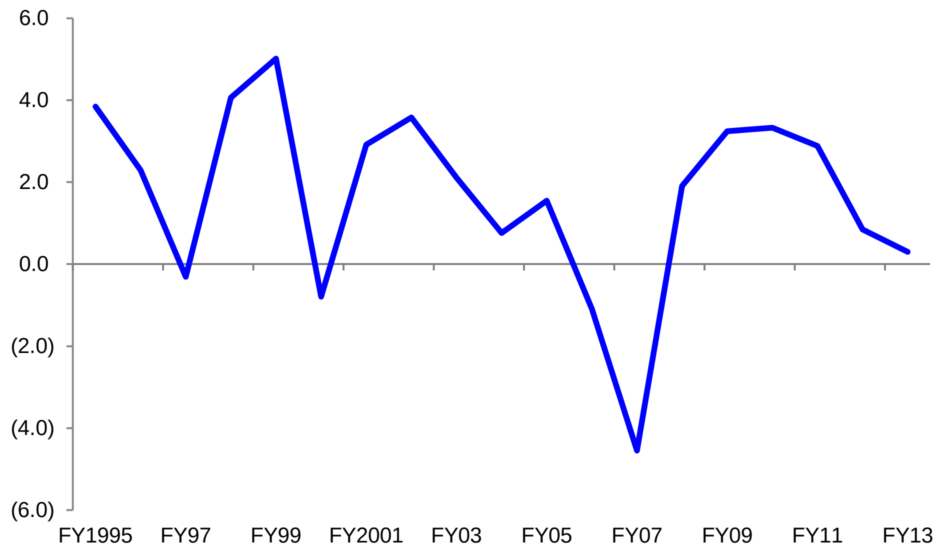
3. After 5 consecutive years of economic growth averaging 2.2%—from fiscal year (FY) 2001 (ended 30 June) to FY2005—Tonga's economy contracted by a cumulative rate of 5.6% over the next 2 fiscal years (Figure 1). The economic decline was primarily triggered by civil unrest in Nuku'alofa. In July 2005, public sector employees staged a prolonged strike after rejecting a proposed wage increase. The public service strike lasted for 6 weeks until the government finally acquiesced to employees' demands for wage increases ranging from 60% to 80%. In November 2006, pro-democracy demonstrations degenerated into violence targeted largely at businesses owned by Tonga's political leaders and Chinese entrepreneurs.[2] Estimates indicate that as much as 80% of Nuku'alofa's central business district (CBD) was burned down during this period of violence.

4. As Tonga was just beginning to recover from internal disturbances, the global financial and economic crisis struck and hurt economic performance. Remittance inflows were affected the most and have yet to show any signs of recovery. From a peak of about $107 million—30% of gross domestic product (GDP)—in FY2008, remittances declined sharply in succeeding years and were at only $67 million (15% of GDP) by the end of FY2012. Tourism receipts fell by 5.5% from $27.2 million (9% of GDP) in FY2009 to $25.7 million (7.0% of GDP) in FY2010 (Figure 2).[3] Over the same period, export revenues decreased by 13.3%, from $8.3 million (2.7% of GDP) to $7.2 million (2.0% of GDP). While the decline in tourism receipts and exports was relatively

[1] United Nations Development Programme. 2013. *Human Development Report: The Rise of the South*. Geneva.
[2] At the time, Tonga was an absolute monarchy under King George Tupou V, but was moving toward democracy.
[3] Given the depreciation of the US dollar over this period, the decline in tourism receipts amounted to over 13% in Tongan pa'anga terms.

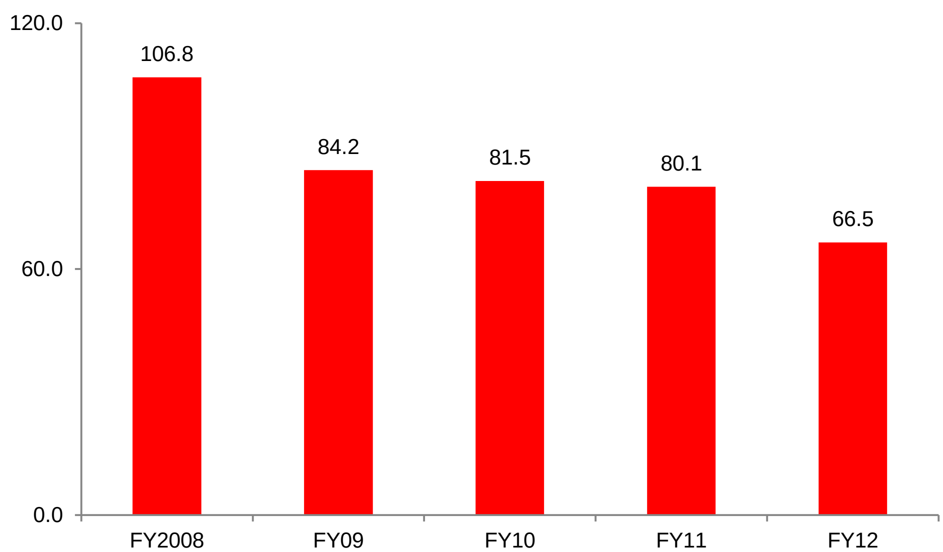
short-lived and both have recovered to pre-crisis levels, the most important source of foreign exchange income—remittances—remains on a prolonged downward spiral.

Figure 1: Gross Domestic Product Growth
(% per annum)



FY = fiscal year.
Source: Tonga Department of Statistics.

Figure 2: Private Remittances
($ million)



Sources: National Reserve Bank of Tonga and Tonga Ministry of Finance and National Planning.

5. Recent GDP growth figures mask the true extent of the impacts of the global financial and economic crisis on the Tongan economy. A series of large public investment projects,

mostly for reconstruction of the Nuku'alofa CBD and financed through loans from the Export-Import Bank of China, pushed overall GDP growth to an average 3.2% from FY2009 to FY2011. However, as construction activity wound down and projects were completed, growth slowed to 0.8% in FY2012, and to an estimated 0.5% in FY2013.

6. The waning of the stimulus from government expenditure on reconstruction efforts reveals a clear and lingering weakness in the private sector. This is illustrated by the continuing decline in private sector credit, which has been falling on an annualized basis since May 2009. While this decline is undoubtedly exacerbated by the ongoing reduction in remittance receipts that has constrained domestic demand and consumer spending, weak private sector conditions also have roots in the sharp and sudden increases in public sector wages from 2006. Fiscal pressure stemming from the substantial expansions in the public wage bill has resulted in (i) cuts in government purchases of goods and services from the private sector, (ii) increases in taxes and business license fees, and (iii) delays in consumption tax refunds, which hampers the cash flow of businesses. These factors have combined to discourage private sector activity and investment by making private business ventures more cumbersome and less profitable.[4] Further, the upward shift in public sector wages had knock-on effects on wages in the private sector, which weakened competitiveness throughout the economy.

C. Outlook and Risks

7. The outlook is for modest economic growth of about 1% per annum through FY2016. An improving global outlook is expected to support continuing recoveries in tourism receipts (up to $42.5 million or 9.3% of GDP by FY2012) and export revenue (up to $14.8 million or 3.2% of GDP). A more stable world economy is also seen to result in a reversal of the downturn in remittances, although these are projected to remain well below pre-crisis levels in the near term. Greater external demand and increasing remittance-fueled domestic consumer spending are expected to stimulate some renewal in private sector activity. However, structural impediments, as outlined above, will tend to limit private-sector-led growth to modest rates.

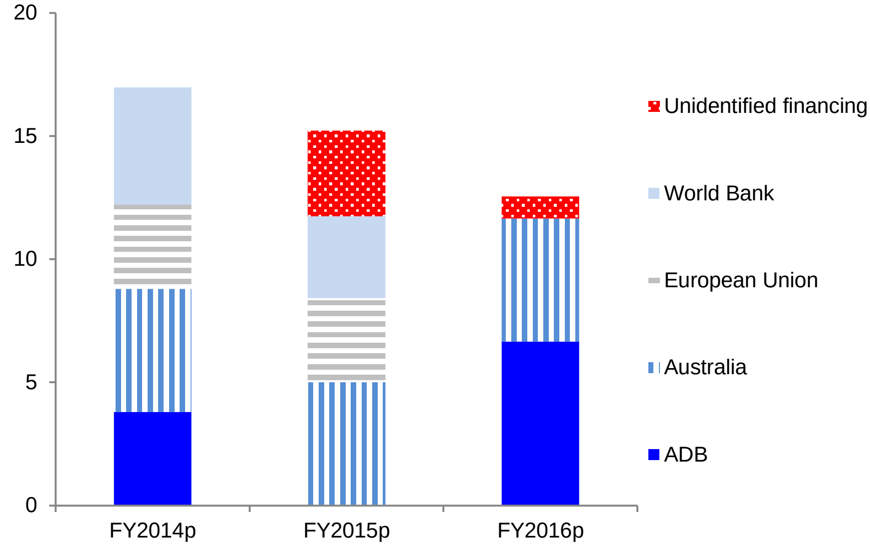
8. Any further stimulatory government spending is highly unlikely given the limited fiscal space. The ratio of public debt to GDP is estimated to have peaked at 45.8% in FY2012, and is projected to fall gradually to about 36.0% by FY2016. Although the 2013 International Monetary Fund (IMF)–World Bank Debt Sustainability Analysis rates Tonga to be at moderate risk of debt distress, significantly rising debt service payments due over the next 3 fiscal years strongly suggest that a continuation of the government's current no-new-borrowing policy is the most prudent course of action.

9. Latest government projections also show a total financing gap, or the shortfall between current revenue and current expenditure, of about $45 million over FY2014–FY2016 (Figure 3). The bulk of the financing gap will be met through committed budget support grants from development partners like the Asian Development Bank, Australian Agency for International Development, European Union, and the World Bank, but about $4.5 million is currently left unfunded.

---

[4] A detailed analysis of private sector development issues in Tonga is in ADB. 2012. *Continuing Reform to Promote Growth: Update of the Private Sector Assessment for Tonga*. Sydney.

Figure 3: Financing Gap
($ million)



ADB = Asian Development Bank, FY = fiscal year, p = projection.
Source: Tonga Ministry of Finance and National Planning.

Table 1: Economic and Fiscal Outlook, FY2013–FY2016

Item	**FY2013** (e)	**FY2014** (f)	**FY2015** (f)	**FY2016** (f)
Real GDP (% change)	0.5	1.0	1.1	1.1
Inflation (%)	2.7	2.7	3.0	2.8
Financing gap (% of GDP)	(3.7)	(3.5)	(3.0)	(2.3)
Personnel costs (% of total revenue)	63.1	61.7	60.4	60.1
Net change in cash reserves (million T$)	6.9	0.9	(11.4)	(11.9)
Public debt (% of GDP)	44.6	41.5	38.2	36.0
Nominal GDP (US$ million)	459.1	482.3	512.1	546.2

( ) = negative, (e) = estimate, (f) = forecast, FY = fiscal year, GDP = gross domestic product.
Source: International Monetary Fund. 2013. *Tonga: 2013 Article IV Consultation—Staff Report*. Washington, DC.

10. The highly politically charged nature of public wages and salaries adjustment means that cuts in the wage bill will be very difficult, but it will be important to at least gradually reduce the share of the public sector wage bill in total government expenditure. Proceeding with commercialization and privatization of state-owned enterprises is another crucial avenue toward freeing up fiscal space. Finally, revitalizing the private sector—through (i) reform and streamlining of business licensing and permit processes; (ii) administrative reform to expedite tax refunds; (iii) legislative action to complete the commercial legal framework (e.g., amending the Companies Act to allow for community companies, among others); and (iv) efforts to bring down the high cost of electricity—will result in rising government revenue collection from greater private sector activity and further help build much-needed fiscal space.

D. Policy Issues

11. With an urgent need for fiscal consolidation, the focus shifts toward the effective use of other government policy instruments to foster near-term growth. Sound economic management to solve key issues in the monetary and finance sector, as well as in the areas of external competitiveness and structural policy will be important.[5]

12. The National Reserve Bank of Tonga (NRBT) is the country's independent monetary authority charged with the conduct of monetary policy, exchange rate management, and finance sector regulation. While improving the monetary transmission mechanism through deepening and development of the finance sector is a long-term goal, the IMF recommends that the NRBT should, in the short term, reorient monetary policy toward ensuring financial stability, after recent efforts to stem the decline in private sector credit through liquidity injections.

13. The banking sector in Tonga, which is mostly dominated by two foreign banks, ANZ and Westpac, has been deleveraging since the advent of the global financial and economic crisis. High levels of nonperforming loans appear to be constraining credit supply, while weak private sector activity and limited investment opportunities curb credit demand, and these have combined to result in a sustained downturn in lending. As part of its response, the NRBT has increased risk-based supervision and improved the regulatory framework governing the finance sector. Such efforts need to be sustained to help reverse the credit decline and support an economic recovery. Further, plans to convert the Tonga Development Bank into a commercial bank may also facilitate a rebound in credit, particularly with its intended focus on lending to small and medium-sized enterprises.

14. The latest IMF assessment concludes that Tonga's real effective exchange rate remains broadly consistent with its medium-term macroeconomic fundamentals. Pegging the Tongan pa'anga to the current basket of currencies has provided an effective nominal anchor, and exchange rate flexibility (within a managed band) has helped mitigate external shocks. The IMF therefore projects that foreign reserves will remain above the NRBT's target level of 4 months of import cover. Exports are projected to grow by almost 10% per annum over the medium term, but will remain at only about 11%–12% of import levels, resulting in persistent trade and current account deficits that are offset by remittances and aid inflows.

15. Structural reform will be important to promote inclusive economic growth and alleviate fiscal and external account imbalances. Central to the reform agenda are measures to improve the business environment and boost both foreign and local investor confidence. Legal and administrative reforms to lower the cost of doing business and simplify licensing and regulatory procedures are relatively simple but effective means to encourage entrepreneurship. Complementary infrastructure upgrades, financed by development partners, to help strengthen market links both domestically and internationally (e.g., road networks, inter-island shipping, broadband connectivity) will also help develop the private sector.

16. A key issue is access to land. Land tenure in Tonga is based on royal tradition, and access to land for most domestic or foreign investment is problematic. Land records are incomplete or inaccurate, most land leases are informal, and overall investor protection is weak, resulting in higher costs and risks for land transactions. Recent progress has been made in this

[5] The discussion of monetary, financial and exchange rate issues draws from International Monetary Fund. 2013. *Tonga: 2013 Article IV Consultation—Staff Report*. Washington, DC.

area by allowing long-term leases of up to 99 years as part of the reconstruction of Nuku'alofa's CBD. Further progress to move Tonga's land tenure system closer to one that can support a fully functioning modern market economy will be crucial in building the foundations for broad-based, private-sector-led economic growth in Tonga over the long term.