

DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

**FOR
AGENDA**

SM/11/79

April 21, 2011

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is the staff report for the 2011 Article IV consultation with Tonga, 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. This staff report has been prepared using the new format for Article IV staff reports.

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, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

Att: (1)

Other Distribution:
Department Heads



TONGA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

April 20, 2011

KEY ISSUES

Overall setting: The economy is recovering from the effects of the global financial crisis, the domestic credit crunch, and adverse weather-related shocks. The risks to the outlook are on the downside. Macroeconomic policies need to focus on restoring the room for countercyclical policies, reducing the risks to Tonga's external and fiscal sustainability, and laying the foundations for higher potential growth.

Growth and inflation prospects: GDP growth is estimated to rebound to 1¼ percent in FY2010/11 on the back of stronger tourism activity and an expansionary fiscal policy financed by donor aid and previously contracted loans. Risks to the outlook are on the downside and relate to commodity prices, global growth, and Tonga's high public debt. Inflation will likely pick up but remain below 2007/08 levels.

Fiscal policy: The near-term fiscal stance should give priority to mitigating the risks to Tonga's fiscal sustainability. There is a need to prioritize expenditure and better align planned spending cuts with the government medium-term development objectives. This needs to be done in the context of a broader medium-term fiscal strategy aimed at achieving a primary surplus of 1 percent of GDP and avoiding new borrowing.

Monetary policy: NRBT should maintain its current stance given ample liquidity in the banking system, but should stand ready to tighten if inflation pressure from domestic sources or downward pressures on reserves materialize.

Structural reform: Reforms are needed to raise Tonga's medium-term growth prospects and reduce the country's vulnerability to shocks. Reforms should focus on improving the business environment and the institutional framework for secured lending.

Approved By
**Vivek Arora and
Thomas Dorsey**

Discussions took place in Nuku’Alofa on March 16–29, 2011. The staff team comprised P. N’Diaye (Head), N. Geng (APD), J. Matz (STA), and Y. Yang (Resident Representative). Ms. Budiman and Ms. Yeo (both OED), Ms. Horscroft (World Bank) and Messrs. Faletau and Tora (both World Bank and Asian Development Bank) joined the mission.

CONTENTS

INTRODUCTION	3
RECENT DEVELOPMENTS	3
OUTLOOK AND RISKS	5
POLICY DISCUSSIONS	6
STAFF APPRAISAL	20

Boxes

1. EXCHANGE RATE ASSESSMENT	12
2. THE INTEREST RATE CHANNEL OF THE MONETARY POLICY TRANSMISSION IN TONGA	13
3. BANK INTEREST RATES AND PROFITABILITY IN TONGA	15
4. MEDIUM-TERM BUDGET FRAMEWORK	18

Figures

1. ECONOMIC DEVELOPMENTS	4
2. EXCHANGE RATE AND FISCAL POLICY DEVELOPMENTS	8
3. MONETARY POLICY AND FINANCIAL SECTOR DEVELOPMENTS	11

Tables

1. SELECTED ECONOMIC INDICATORS	22
2. SUMMARY OF GOVERNMENT OPERATIONS	23
3. DEPOSITORY CORPORATIONS SURVEY	24
4. BALANCE OF PAYMENTS SUMMARY	25
5. MEDIUM-TERM SCENARIO	26
6. FINANCIAL SOUNDNESS INDICATORS	27
7. MILLENNIUM DEVELOPMENT GOALS	28

Appendix

I. DRAFT PUBLIC INFORMATION NOTICE	29
------------------------------------	----

INTRODUCTION

1. Context. The recession that began in 2008/09 continued in 2010 with declines in tourism, remittances, and exports. Financial conditions remained tight as banks raised lending standards following a large rise in nonperforming loans. In recent months, activity has bottomed out as growth has been supported by a recovery in tourism and expansionary fiscal policy financed by donor aid. Growth is likely to rise to 1¼ percent in FY2010/11 (year ending June) and to 1¾ percent in FY2011/12 and the medium term. Limited private

sector development, geographical isolation, and high public debt are key constraints to faster growth.

2. With the economy on the path to recovery, the time is right to focus on reducing the country's vulnerabilities and addressing the constraints to growth. Policies need to focus on restoring the room for countercyclical macroeconomic policies, reducing the risks to Tonga's external and fiscal sustainability, and laying the foundations for higher potential growth.

RECENT DEVELOPMENTS

3. Activity. GDP continued to contract in FY2009/10 (year ending June) as financial conditions remained tight and tourism and remittances inflows declined with the weak global economy, particularly the United States, Australia, and New Zealand—Tonga's main trading partners and sources of remittances and tourist activity.

4. Inflation. CPI inflation averaged 2 percent in 2009/10 and rose to 6½ percent y/y in February 2011, reflecting mainly rising global food and oil prices, higher excises on tobacco and alcohol, and a modest depreciation of the pa'anga against the New Zealand dollar. (New Zealand is a key source of imports.)

5. External position. The current account deficit narrowed to 7.8 percent of GDP in FY2009/10 as weak economic activity lowered imports while stepped up grants from donors

increased transfers. Reserves have risen to near seven months of imports as of end-February 2011

6. Politics. In November 2010, Tonga held its first parliamentary elections under which a majority of seats were popularly elected. The elections led to a major cabinet reshuffle with the appointment of a new prime minister and government. The new government's main policy priorities are to pursue structural reforms to promote private sector activity and restore fiscal sustainability.

Key Macroeconomic Indicators

	2007/08	2008/09	2009/10
Growth (percent)	2.0	-0.1	-0.5
Inflation (percent)	9.8	5.0	2.0
Current account (percent of GDP)	-8.9	-14.7	-7.8
Gross reserves (US\$ millions)	48.2	67.7	88.7
(in months of imports)	3.2	4.7	7.1
Real effective exchange rate (+ = appreciation)	2.1	6.3	0.0

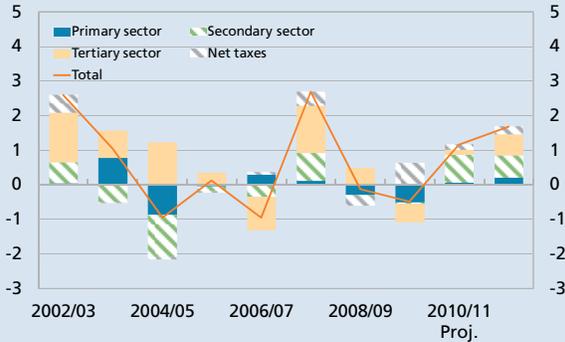
Figure 1 Tonga: Economic Developments

After two years of contraction, Tonga's economy is expected to expand in FY2010/11.

Growth is expected to be supported by strong construction and tourism activity.

Real GDP Product by Sector

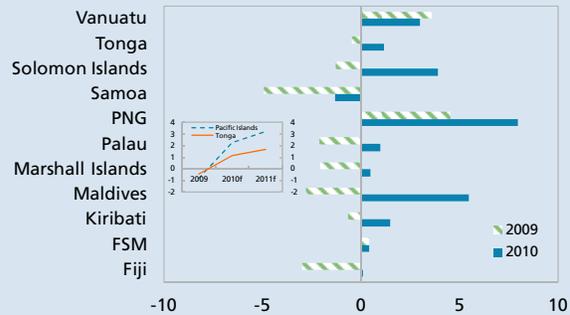
(Annual percent change, contributions to total)



The recovery is projected to be weaker than regional comparators.

Change in Real GDP

(In percent)

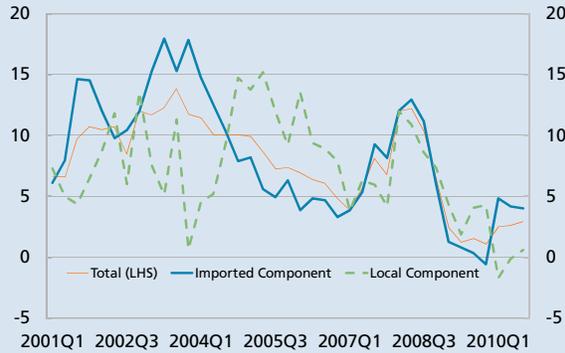


Source: LISC database.

Inflation has picked up somewhat, mostly owing to one-off factors...

Inflation

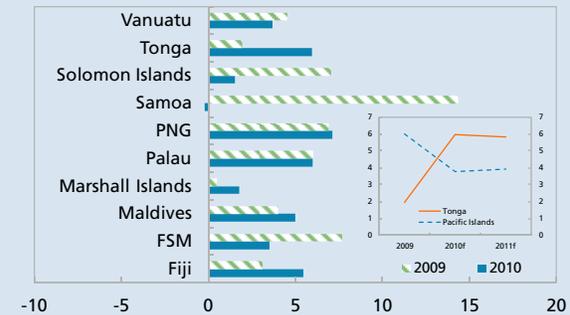
(Annual percent change)



...expected to rise above the average of Pacific islands

Consumer Price

(Percent change, year-on-year)

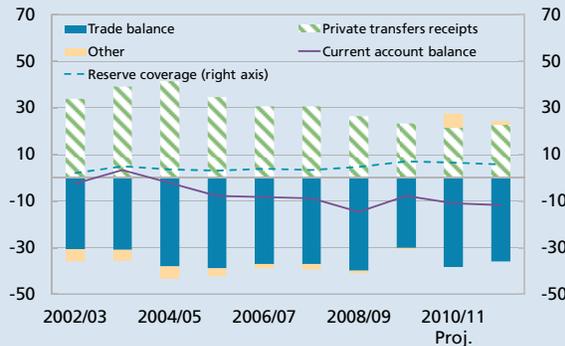


Source: LISC database.

Weak imports and significant grant inflows helped narrow the trade and current account deficits...

Balance of Payments

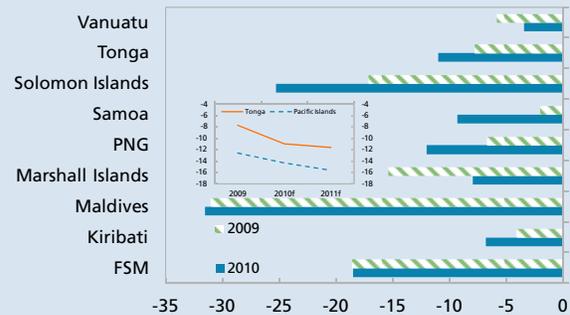
(In percent of GDP)



...below the average of Pacific islands.

Current Account Balance

(In percent of GDP)



Source: LISC database.

Sources: CEIC Data Company Ltd.; and Fund staff estimates.

OUTLOOK AND RISKS

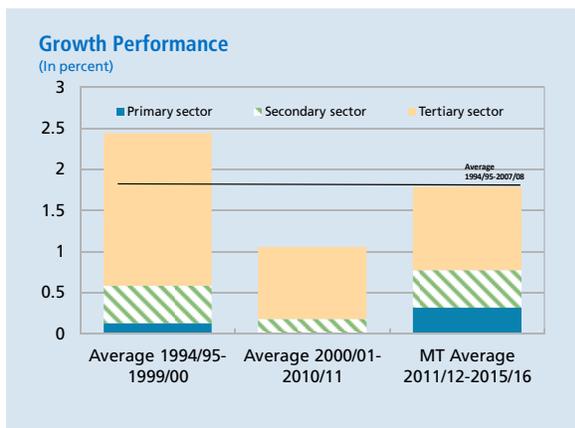
Staff Views

7. Outlook. Growth is projected to recover to 1¼ percent in FY2010/11 on the back of stronger tourism activity and construction, as donor aid and previously contracted loans financed a fiscal expansion. However, this growth momentum is limited by continued domestic tight lending standards following the large rise in nonperforming loans over the past two years. Inflation will likely rise to around 6 percent, reflecting higher global fuel and other commodity prices, particularly food. Over the medium term, growth is expected to remain at around 1¾ percent—in line with the average of the past 15 years but about ¾ percentage points above the average of the past 10 years. This medium-term outlook assumes implementation of the government’s plans, including stepped up capital spending, structural reform, improved fiscal management to support fiscal consolidation, as well as continued high emigration. Growth is expected to be mainly driven by tourism and agriculture, consistent with medium-term development priorities.

8. Risks. A protracted rise in world commodity and food prices would hit Tonga’s economy hard, feeding through to inflation, growth, and the current account deficit. At the same time, if global growth falters, remittances, tourism, and exports could be hit, weakening economic activity and threatening reserves. In addition, Tonga’s high public debt leaves the country highly vulnerable to shocks and poses a risk to economic prospects. This, together with the limited effectiveness of monetary policy in the face of banks’ cautious approach to lending, means that Tonga would have little room to implement countercyclical macroeconomic policies if downside risks materialize. Mitigating the risks will necessitate further progress on structural reforms to raise growth potential, continued grants provision from donors, as well as steady fiscal consolidation.

Authorities’ Views

9. The authorities felt that the staff forecast for this year’s GDP growth was somewhat optimistic. The ministry of finance was expecting growth to remain negative in FY2010/11 at around -0.5 percent, as much of the the construction activity had little domestic impact. The construction materials are imported and there is little hiring of local workers. However, the ministry of finance indicated it is currently reviewing its growth forecast based on the statistics department’s revised historical national accounts, which show a higher contribution to



growth from current construction projects and include improved information on their execution, including related activity in the mining and quarrying industry and the treatment of Chinese workers brought in as part of the reconstruction program financed by China EXIM Bank. On inflation, the authorities shared the staff views, with the National Reserve Bank expecting CPI

inflation to reach 5¾ percent in FY2010/11 and ease to 4¼ percent in FY2011/12.

10. The authorities shared the staff assessment of the risks to the outlook. They emphasized the risks higher energy and food prices could pose to inflation, including through second round effects.

POLICY DISCUSSIONS

In FY2010/11, macroeconomic policies have remained loose to counter the effects of the global financial crisis, the credit crunch resulting from banks' attempts to restore the health of their balance sheets, and adverse weather-related shocks. With activity poised to recover and inflation projected to rise, macroeconomic policies need to focus on restoring the room for countercyclical policies, reducing the risks to Tonga's external and fiscal sustainability, and laying the foundations for higher potential growth.

A. Restoring Room for Countercyclical Macroeconomic Policies

Fiscal Policy—Advancing Fiscal Consolidation and Increasing Transparency

Background

11. In FY2010/11, stepped-up capital expenditure mainly financed by previously contracted loans, helped to offset weaknesses in private demand. At the same time, generous grant inflows from donors during FY2010/11 contributed to narrowing the fiscal deficit to an estimated 4¼ percent of GDP, (from about 5¾ percent of GDP in FY2009/10).

12. Despite the improvement in the fiscal position, Tonga's economy remains vulnerable to shocks. Tonga remains at a "high risk of debt

distress" according to this year's World Bank-IMF debt sustainability analysis (supplement to this report). Therefore, the near-term fiscal stance should give priority to mitigating the risks to Tonga's fiscal sustainability and create room to respond to future shocks. Reducing the country's vulnerabilities will require avoiding new borrowing, reducing current spending, a careful prioritization of spending, improving tax administration, and improving transparency. Notwithstanding these measures, the staff projects the overall deficit (including grants) to widen to around 5¼ percent of GDP in FY2011/12 as capital spending projects—financed through loans contracted during previous years—are rolled out and grants return to lower

levels. The primary deficit is expected to reach 4¼ percent of GDP.

Staff Views

13. The government's focus on reducing current spending is appropriate and will be key to a successful fiscal consolidation. The planned capital expenditure in FY2011/12 is needed, and the previously contracted loans do not add to current financing problems. At the same time, the government's plan to maintain the partial new hiring freeze in FY2011/12 at the level of the general government should help reduce wage pressure. However, limiting the deficit to 5¼ percent of GDP will require maintaining the wage bill at its 2010/11 level as the rapid rise in the wage bill since the 2006/07 redundancy program is hampering the provision of core public services and crowding out resources devoted to productive programs and social services provision. In addition, it is important for the salary structure of civil servants to adequately reflect performance and contribute to increasing service efficiency. The current performance-based system has only two ratings ("performing" vs. "nonperforming"), does not reflect the actual distribution of staff performance, and introduces an automatic annual increase of around 4 percent in the wage bill.

14. The reduction in spending will need to be accompanied by a careful prioritization of expenditures. Spending plans need to be aligned with the development priorities laid out in the National Strategy Planning Framework (NSPF) (see

below) and to ensure that line ministries adhere to budget plans and targets.

15. Improving revenue administration and collection will provide fiscal space for the delivery of core public services and promote fiscal consolidation. Improving revenue administration will require ensuring the proper classification and valuation of goods at customs, increasing compliance through the use of the unique tax identification number recently assigned to corporate taxpayers, and increased training of customs officers. In addition, with the introduction of self-assessment, completing the automation of customs processing will provide resources to strengthen auditing and tax collection. At the same time, improving revenue collection will also require expanding the tax base by streamlining tax exemptions. For better transparency and fiscal control, exemptions could be replaced by transfers and explicitly brought into the budget.

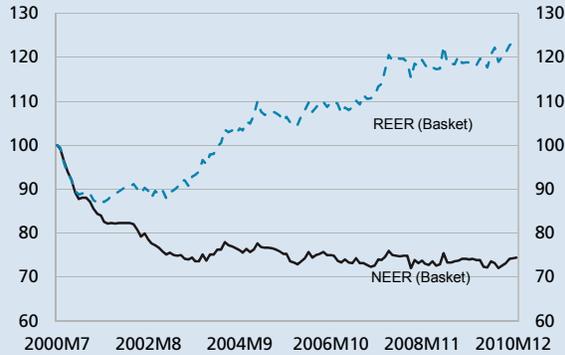
16. Further enhancing transparency in the government fiscal accounts will help secure donor financial support and alleviate the burden of adjustment that lies on the government's accounts. Steps toward increased transparency in fiscal accounts in the context of the Tonga Energy Road Map program, which aim to increase Tonga's use of renewable energy and energy efficiency, are appropriate and could apply to other fiscal activities. Greater details on the composition and distribution across line ministries of expenditure and revenue could be included in the budget papers for the upcoming fiscal year.

Figure 2 Tonga: Exchange Rate and Fiscal Policy Developments

The pa'anga has been broadly stable in real terms against the basket and the fiscal position improved.

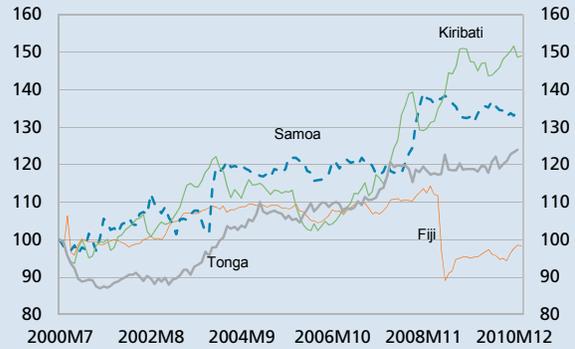
The nominal exchange rate also remained stable.

Effective Exchange Rates



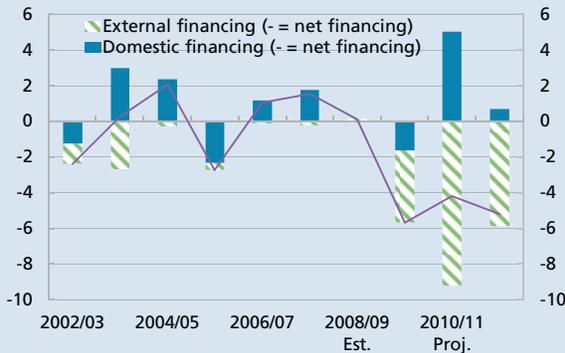
Tonga has maintained some competitiveness relative to other Pacific islands.

New Effective Exchange Rates, 2000-11
 (Index July 2000=100)



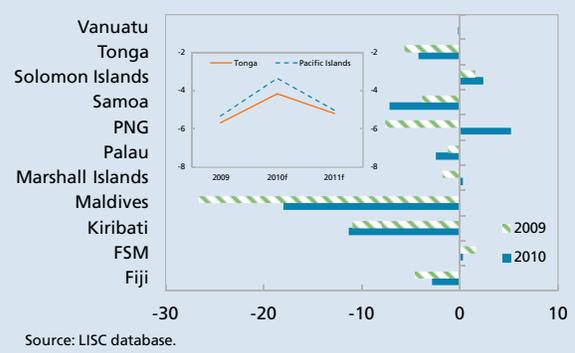
The fiscal balance is expected to deteriorate next year as infrastructure projects are rolled out...

Fiscal Balance
 (In percent of GDP)



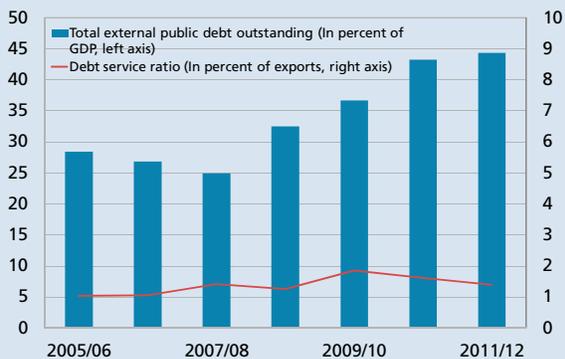
...bringing the deficit back in line with the average of Pacific islands.

Government Overall Balance
 (In percent of GDP)



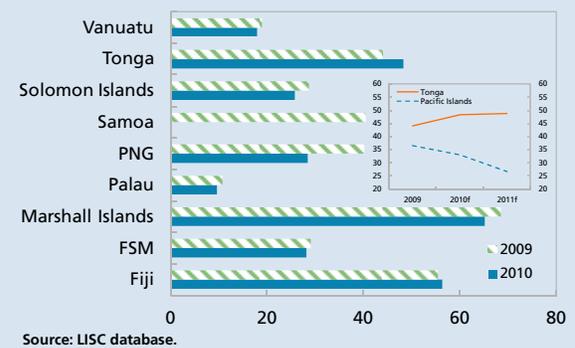
Tonga's high public debt continued to rise...

Public Debt



...putting the country in a more vulnerable situation than most Pacific islands.

Total Government Debt
 (In percent of GDP)



Sources: CEIC Data Company Ltd.; and Fund staff estimates.

Authorities' Views

17. The authorities saw the task ahead as challenging, but were confident progress will be made. The authorities broadly agreed with staff recommendations. They noted the government commitment to maintaining the wage bill in FY2011/12 at its FY2010/11 level, but recognized it will be difficult. The authorities felt that the progress made in setting up a medium-term budgeting framework, especially with regard to the collaboration between the ministry of finance, line ministries, and the public service commission, would facilitate a prioritization of expenditure in line with the objectives set in the NSPF. In addition, they noted that the current performance-based system would be replaced during FY2011/12 with a 5-tiered system that allows for a better differentiation of performance and improved efficiency. With regard to revenue administration and collection, the authorities consider there is room for improvement and significant gains could be achieved through a better training of customs officers in assessing the value of goods and fully utilizing the new electronic system. The authorities emphasized that these efforts would be made with increased transparency in government operations. In addition, they noted the government commitment to improving the dialogue with development partners.

Monetary and Exchange Rate Policy— Maintain Current Stance and Stand Ready to Act

Background

18. Monetary policy is geared toward jumpstarting bank lending. In FY2010/11, the National Reserve Bank of Tonga (NRBT) remunerated banks' exchange settlement account balances over TOP 1 million and maintained adequate liquidity in the system. These measures contributed to slowing the pace of decline of credit to the private sector. Credit by commercial banks remains constrained, however, by banks' continued tight lending standards as they restore the health of their balance sheets and uncertainty about the economic outlook.

Staff Views

19. The staff recommended that NRBT maintain its current policy stance. With appropriate liquidity in the banking system, there is little need for further policy loosening. However, if bank lending was to normalize faster than anticipated, the existing liquidity overhang could exacerbate inflation and exert downward pressure on international reserves. Then monetary policy will need to be pre-emptively tightened through a combination of hikes in interest rates on the NRBT repo facility, the issuance of central bank paper, and reserve requirements. At the same time, higher global commodity prices could also cause inflation to rise above, and reserves to fall below, levels expected in the baseline outlook; but if core inflation remains stable, then there would be no

need for a tightening of monetary policy. Instead, the appropriate policy response would be to further advance fiscal consolidation, while providing targeted support to the poor.

In the past, a leading indicator of pressure on reserves and domestic inflation has been a firm recovery in Tonga's main trading partners. Developments in those economies and in global commodity markets need therefore to be monitored carefully.

20. The staff assesses the exchange rate to be broadly in line with fundamentals (Box 1).

Should downward pressures on reserves emerge, however, the NRBT will need to use the flexibility afforded by the pegged exchange rate within horizontal bands arrangement to gradually depreciate the pa'anga against the basket in order to safeguard external stability. Such depreciation would need to be accompanied by further fiscal restraint given the effects a weaker currency would have on the public debt. The pegged exchange rate within horizontal bands system has served the country well. While the staff consider the current weights in the currency basket as broadly

appropriate, these weights should be reviewed occasionally and updated in order to ensure that they are consistent with changes in trade patterns and the emergence of renminbi debt.

Authorities' Views

21. The authorities stand ready to act. The authorities intend to act pre-emptively to control inflation risks as well as maintain reserves levels above the NRBT comfort zone of 3–4 months of imports. In tightening monetary policy, NRBT will use all instruments at its disposal, with a greater use of direct instruments for monetary control, such as reserve requirements, given the limited impact indirect instruments have on credit growth (Box 2). NRBT agreed that downward pressure on reserves would warrant pre-emptive use of the flexibility of its current exchange rate regime to ensure external stability. The authorities are currently reviewing the conclusions of the Pacific Financial Technical Assistance Centre (PFTAC) technical assistance mission on the composition of the exchange rate basket and will introduce changes gradually so as to avoid undue volatility and disruptions in the functioning of the exchange system.

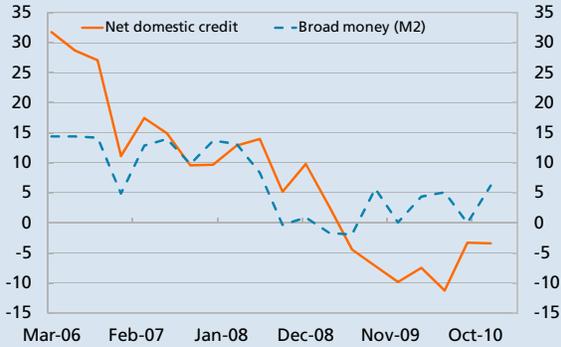
Figure 3 Tonga: Monetary Policy and Financial Sector Developments

Financial conditions remain tight as banks try to restore the health of their balance sheets.

The decline in credit has slowed, but there remains ample liquidity in the system...

Net Domestic Credit and Broad Money

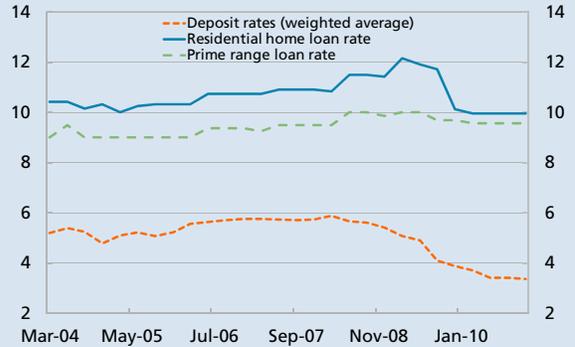
(In percent, year-on-year change)



...which contributed to lower lending and deposit rates. However, margins have widened.

Interest Rates

(In percent)



Notwithstanding NRBT's neutral stance, banks maintained tight lending standards...

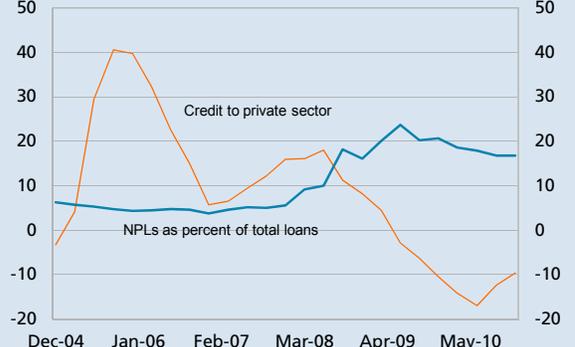
Bank Lending

(In millions of pa'anga)



...amid high losses, but recent progress in cleaning balance sheets augurs well for credit going forward.

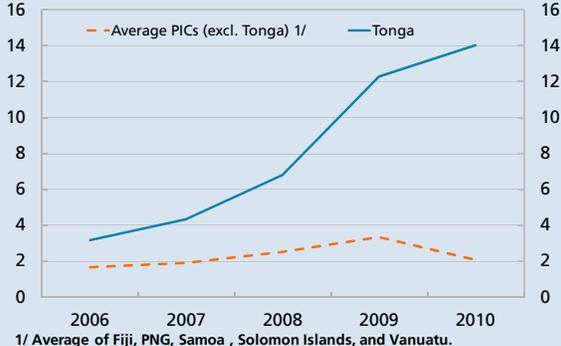
NPL vs Credit to Private Sector



Losses continue to rise,...

Provision Expense to Average Gross Loans

(In percent)

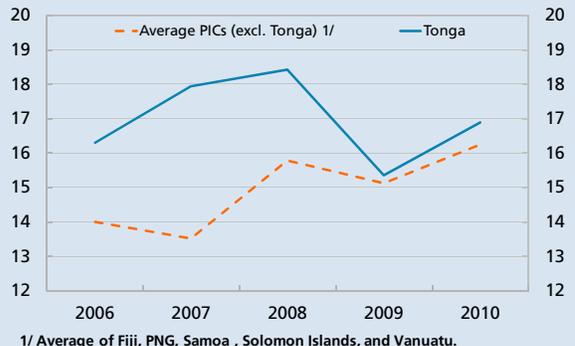


1/ Average of Fiji, PNG, Samoa, Solomon Islands, and Vanuatu.

...and to weigh on banks' balance sheets.

Equity to Assets

(In percent)



1/ Average of Fiji, PNG, Samoa, Solomon Islands, and Vanuatu.

Sources: CEIC Data Company Ltd.; and Fund staff estimates.

Box 1 Exchange Rate Assessment

Tonga's exchange rate is assessed to be broadly in line with levels suggested by medium-term fundamentals. This assessment is based on two standard analytical methods—the macroeconomic balance and the purchasing power parity. Other indicators also do not point to pressures from misalignment of the exchange rate.

Standard Exchange Rate Assessment Methods

The macroeconomic balance and the purchasing power parity approaches were employed based on a cross section of 184 economies, including those that rely heavily on aid and remittances.¹

- **The macroeconomic balance approach** indicates that the real exchange rate is around 10 percent above its medium-term value, with a confidence band of around -14 percent to around 40 percent. Underlying the point estimate is an estimated current account norm of around -4½ percent of GDP, which could be as low as -13½ percent of GDP in light of the important role of remittances and foreign aid.
- **The purchasing power parity approach** suggests that the real exchange rate is currently undervalued by around 5 percent.

Other Indicators

Other indicators of misalignment do not point to a large deviation of the real exchange rate from medium-term fundamentals.

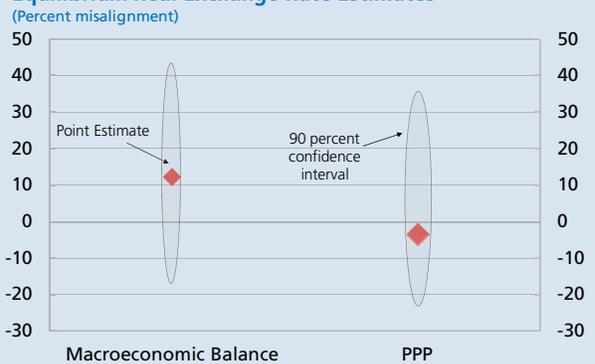
- The *current account deficit* has been relatively stable in recent years, remaining around 8–9 percent in previous years. While a temporary rise in the deficit is expected in the next few years, this reflects both cyclical factors, as well as reconstruction-related imports, which are fully financed.
- *Domestic inflation* has picked up in recent months owing to one-off and global factors. However, there are no signs of sustained pressure on prices that would bring about either a change

¹ The approaches are limited by the availability of net foreign assets data.

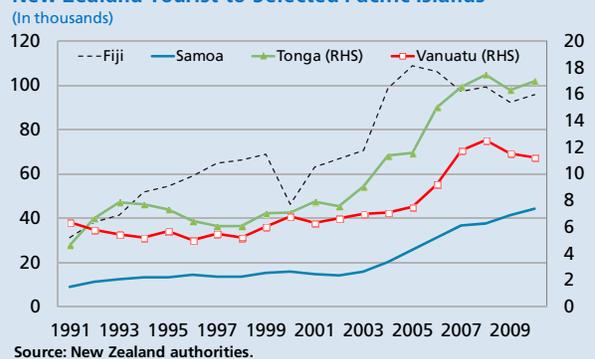
in the real effective exchange rate. Moreover, inflation has also not been out of line with other Pacific island countries.

- *Foreign reserves* have been stable or rising in recent years, even after abstracting from disbursements under the EXIM Bank reconstruction loan. The NRBT intervened on both sides of the market, and was a net purchaser of foreign exchange in 2009/10, with net purchases around 10 percent of its total gross flows.
- The *number of tourists* has increased markedly in recent years. Tonga has gained market share as a tourist destination.
- *Goods market.* New export products, such as sea cucumber, have provided significant export earnings in the past year and helped offset the decline from squash export. Squash export to Japan was affected by additional supply from traditional squash exporters during Tonga's niche export period.

Equilibrium Real Exchange Rate Estimates



New Zealand Tourist to Selected Pacific Islands



Box 2 The Interest Rate Channel of the Monetary Policy Transmission in Tonga¹

This box provides an assessment of the effectiveness of the interest rate channel of the monetary policy transmission in Tonga.

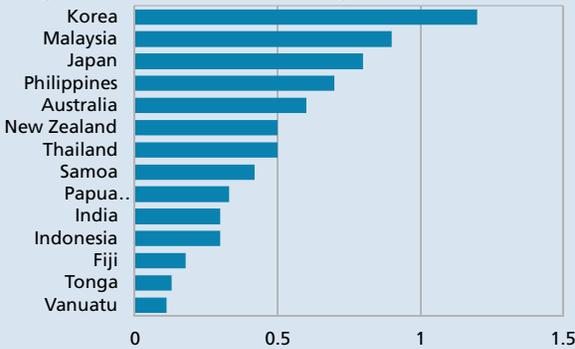
The analysis uses a single equation reduced form model that links bank lending rates or credit growth to a policy rate, one-period lag of bank lending rate, a time trend, and a constant. The estimation is carried out using monthly data from 2000 to 2010, to gauge the impact of policy rates (proxied by repo rates) on bank lending rates and credit growth. For comparison purposes, the model is estimated for the remaining five Pacific island countries that have their own currencies (Fiji, Papua New Guinea (PNG), Solomon Islands, Samoa, and Vanuatu).

The results indicate that changes in NRBT interest rates affect both bank lending rates and the credit growth, but the impact is smaller than in many other Pacific islands. A one percentage point increase in the repo rate

raises the average bank lending rate about ¼ percentage points and reduces private sector credit growth by about 1½ percentage points. These effects are however smaller than in Pacific islands, such as PNG and Fiji, which in turn have weaker transmission mechanism than in more advanced economies because their financial markets are shallow.

Developing domestic financial markets could strengthen the monetary transmission mechanism. Measured by the ratio of broad money to GDP, Tonga’s domestic money market is shallow even compared with many of its Pacific neighbors. Collateralized interbank lending is not widely available, and secondary markets for government and central bank paper are non-existent. There is no market for commercial paper, corporate bonds, equity, and foreign exchange products. Developing a framework for secured lending could help increase the pass-through of the interest rates to bank lending rates and bank credit.

Long-Run Interest Rate Passthrough 1/



Source: Fund staff calculations.
 1/ Not available for Solomon Islands.

Pacific Islands: Private Credit Long-Run Passthrough (In percent)



Source: IMF staff estimates.

¹ Prepared by Yongzheng Yang.

Banking System—Advancing Reforms to Reduce Borrowing Costs

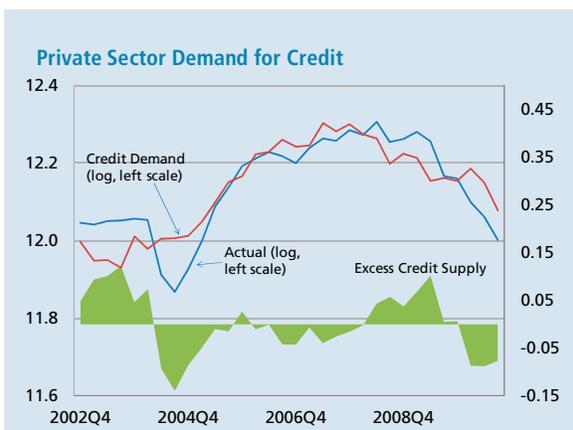
Background

22. **Banks are making progress with repairing balance sheets.** Banks are well capitalized; profitability remains well below levels of the past years owing to high provisioning, but has improved somewhat in recent months; and NPLs are declining. Nevertheless, uncertainties on the outlook continue to restrain banks' lending with the notional demand for credit estimated by staff to be over 7 percent the supply of credit.

Banks Key Financial Ratios

	2007/08	2008/09	2009/10
Pre-tax Net Profits (percent of assets)	4.9	-6.1	-1.6
Operating Income (percent of assets)	11.9	11.1	9.8
Net Interest Income (percent of assets) (percent of GDP)	6.3	6.3	6.6
Non-Interest Income (percent of assets)	5.6	4.9	3.3
Loan-loss Reserve to Gross Loans 1/	6.4	9.6	...
Risk Weighted CAR	22.4	26.5	22.2

1/ End of calendar year.



Staff Views

23. **In order for credit growth to normalize, further improvements will be needed in banks' balance sheets and in the institutional framework for lending.** The enactment of the Personal Property Security Act, which provides lenders with information on borrowers collateralized assets, will help reduce risks to bank lending. In addition, progress needs to be made in instituting a centralized credit bureau and modifying the legal framework to ensure timely registration and recovery of collateral, including a secured bankruptcy protection law. Implementation of such changes, together with effective supervision of banks to ensure financial stability, have the potential to reduce borrowing costs, improve access to finance, and lay the foundations for stronger economic growth. NRBT's efforts to step up regulation and supervision, such as its plan to adopt a standardized examination report format, are appropriate. PFTAC's technical assistance will continue to help NRBT's supervisory capacity, but longer-term donor-financed assistance will also be required.

24. **There continues to be increased pressure to administer deposit and lending rates.** However, bank profitability in Tonga, including interest rate spreads, is not excessive when compared with other South Pacific jurisdictions (Box 3). Several factors explain the level of lending rates, including the volatility of the macroeconomic environment, shallow financial markets, and limited collateralization. Intermediation could be improved and borrowing costs reduced by, in addition to measures listed

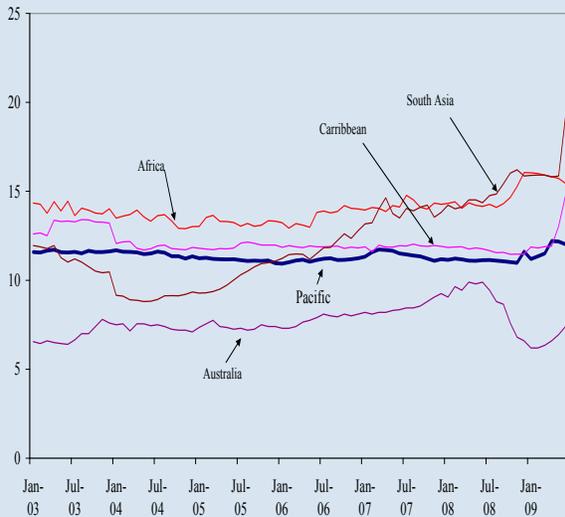
Box 3 Bank Interest Rates and Profitability in Tonga¹

Interest rates in Tonga reflect a wide range of factors. Interest rates are the centerpiece of commercial banks' core business of financial intermediation. They are the key price in the financial sector, the main transmission mechanism of monetary policy, the main vehicle for matching supply and demand and, normally, the key

the larger Pacific Islands. The average across all Pacific islands is around 12 percent, which is broadly similar to the average of the Caribbean but lower than average of sub-Saharan Africa and South Asia (around 15 percent).

Indicators of profitability show a mixed picture.

Lending rates for selected countries



determinant of profitability. Their level reflects banks' perception of risk (country and creditor), market liquidity conditions, and the depth of financial markets—which affects banks' ability to spread their risk, the cost of doing business, and the level of competition in the financial sector. Tonga, like other Pacific Island countries, has a relatively high risk and high cost of business environment and a shallow financial sector that may explain why interest rates would be higher than in more advanced economies.

Tonga's reported lending rates are broadly in line with comparable countries.² Lending rates in Tonga have recently averaged around 12 percent, lower than in the Solomon Islands 15 percent and similar to Samoa but higher than

Net interest income—a conventional indicator of the contribution of core bank services to profitability—has **averaged around 6 percent of average assets, in line with other PICs but generally higher than emerging markets.** Although it is hard to quantify exactly, the differential between Tonga and emerging market economies is broadly in line with expectations given country risks and the greater size, sophistication and depth of financial markets in emerging economies.

Non-interest income is high in Tonga. It has averaged over 5 percent of average assets in the last decade, broadly in line with levels in other PICs but considerably higher than in emerging and advanced markets. This income is mostly from foreign exchange activities, reflecting Tonga's highly open economy leading to a large volume of international trade and remittance transactions.

Bank profitability in Tonga has been high but recent losses illustrate market risks. Between 2000 and 2007 Tongan banks' average return on assets was around 6 percent. This was well above levels in other regions; for instance, in 2008 the average return in Australia was 1.4 percent and in sub-Saharan Africa it was 2.5 percent. However, foreign exchange earnings accounted for around 60 percent of returns and have underpinned the high levels of bank profitability. These non-interest earnings continued during 2008 and 2009 but were not sufficient to offset the large losses that were incurred on lending activities, leading to significant overall bank losses in Tonga.

¹ Prepared by Matt Davies (PFTAC).
² Data reported to the IMF Statistics Department; subject to definitional differences between countries.

above to enhance the legal framework for secured lending, promoting a more stable macroeconomic environment, increasing competition within an appropriate prudential and regulatory framework, and improving consumer protection and financial literacy.

Authorities' Views

25. The authorities shared the staff assessment on the status of the banking

system. They felt that NPLs had peaked and that lending should improve going forward, but a recovery in activity is key to strengthening the momentum. They agreed with the risks from regulating interest rates and noted there were ongoing discussions to create a credit bureau by the end of this financial year. Measures had been taken to ensure that banks comply with the prudential requirements and disclosure of effective interest rates charged to customers.

B. Reducing the Risks to Tonga's External and Fiscal Sustainability and Raising Medium-Term Growth

Medium-Term Fiscal Policy—Bringing the Debt Down to More Sustainable Levels and Improving Debt Management

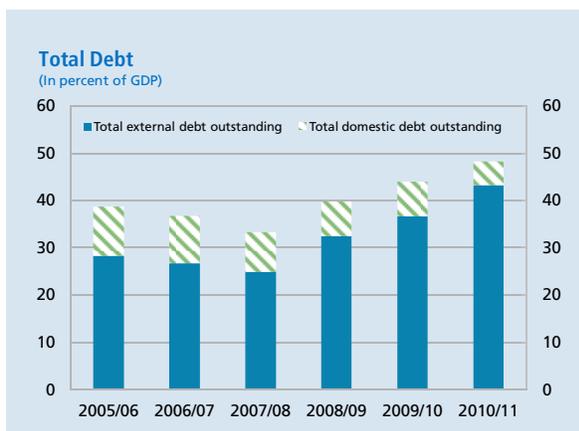
interest rate, 5-year grace period, and 20-year maturity.

Background

Staff Views

26. Tonga's indebtedness has increased markedly over the past two years, reflecting two loans from EXIM bank of China with a face value totaling around 30 percent of GDP. The loan commitments were signed in November 2007 (for reconstruction of the central business district) and in February 2010 (for roads), and bear a 2 percent

27. Setting up a comprehensive medium-term budget framework (MTBF) will facilitate fiscal consolidation. Over the medium term, a primary surplus of 1 percent of GDP would be needed to put the fiscal position on a more sustainable path, bringing down public debt to around 30 percent of GDP by the early 2020s. This could be achieved through continued expenditure restraint, as well as improved expenditure prioritization and revenue administration. Integrating within a single institutional medium-term budgeting framework this fiscal path, the annual budget, and the medium-term development objectives laid out in the NSPF, will help guide medium-term policy efforts, anchor expectations, build policy space to address shocks, and signal to the donor community Tonga's commitment to



restoring fiscal sustainability (Box 4). Given Tonga's vulnerability to shocks, implementation of such a comprehensive MTBF should start in the FY2011/12 budget.

28. A successful implementation of the MTBF will require improving fiscal management. This, in turn, will require better reporting by line ministries, as well as improved capacity, fiscal control, and communication among agencies. The government decision to modify the budget process and to allocate funds at more aggregated levels consistent with priorities set in the NSPF will help reduce cost and improve efficiency. However, to avoid loss of control, this new program could be implemented on a pilot basis by limiting it initially to better performing ministries.

29. Debt management also needs to be strengthened. A comprehensive debt management strategy is needed to limit the large credit and currency risks in the government balance sheet. The Fund stands ready to assist in developing such a strategy and expects to provide technical assistance organized by PFTAC during FY2010/11. Nevertheless, some gains could be made by proceeding cautiously with the selection of eligible private sector construction projects that will receive on-lent funds from the government (financed through the China EXIM loans) to limit credit risk to the government balance sheet and risk of excess capacity in some sectors of the economy. Limiting the credit risk and reducing the risk of excess capacity will free resources for development priorities set out in the NSPF.

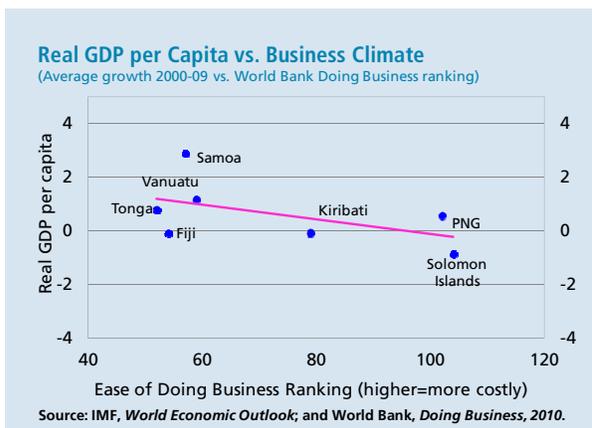
Authorities' Views

30. The authorities recognize the need to reduce the debt, and the benefits from implementing the MTBF. They noted that progress was being made in setting up the MTBF and were hopeful some indications of this process could be given in the upcoming budget. They have taken steps to improve fiscal management, such as the recent revision to the chart of accounts, the shift in monitoring of budget execution to a more aggregated level, and the consolidation of the government's numerous accounts to improve cash management.

Structural Reforms—Raising Medium-Term Growth Prospects

Background

31. Lifting medium-term growth prospects remains a key challenge for Tonga. Prospects are held back by Tonga's geographic isolation, its narrow export base, and unfavorable business environment. Staff expects medium-term growth to remain at around 1¾ percent. This medium-term outlook assumes implementation of the government's current plans to step up capital

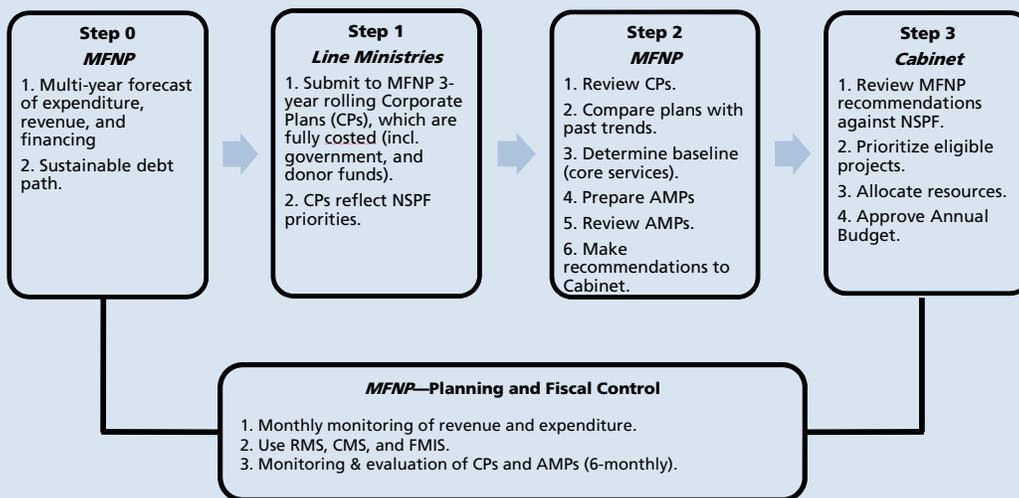


Box 4 Medium-Term Budget Framework¹

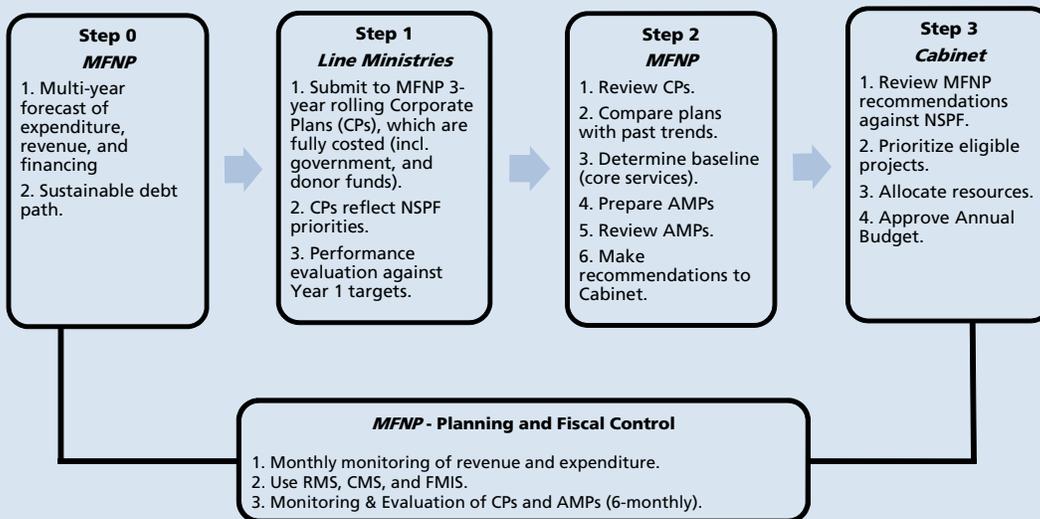
Tonga is in the process of setting up a comprehensive medium-term budget framework (MTBF), which will help Tonga ensure fiscal discipline and stability, and enable strategic allocation of resources in line with Tonga’s strategic priorities laid out in the national strategic planning framework (NSPF). The diagram below highlights the medium-term budgeting process over a two-year period, as well as the role of each participant at each step of this process. The ministry of finance and national planning (MFNP) is responsible for maintaining planning and fiscal control over the

fiscal period, and managing the overall process. Other ministries implement their three-year corporate plans (CP) and annual management plans (AMP) that are aligned to the NSPF, and linked directly to the annual budget. Good progress is being made in implementing other building blocks necessary to fully set up a MTBF, including improvements in macroeconomic and fiscal forecasting, budget formulation and monitoring, the recent revision to the chart of accounts, and the consolidation of the government’s numerous accounts to improve cash management.

Year 1



Year 2



¹ Prepared by Lai Tora (ADB).

spending, structural reform, improve fiscal management to support fiscal consolidation, as well as unchanged demographic trends, which have historically included a high emigration rate.

Staff Views

32. Raising medium-term growth requires promoting private sector activity—a key objective of the government NSPF. Promoting private sector activity will necessitate extending land leases to 99 years for all allotments and activities to encourage construction and investment, reduce the number of business licenses, and lower barriers to foreign investment. Improving efficiency in the delivery and generation of utilities, as currently envisaged, will reduce the cost of doing business. In this regard, the government adoption of the Tonga Energy Road Map should reduce Tonga's vulnerability to oil price shocks and improve the cost-effectiveness of energy.

33. Further progress with public sector enterprise reform could promote private sector activity. This will require leveling the playing field between public and private enterprises. There is also a need to move ahead with corporatization and privatization plans, while providing amendments to the regulatory structure to promote competition in goods and service markets and foster medium-term growth. In this regard, the recent government decision to publish the audited accounts of all public enterprises, change the composition of the boards, and make board members more accountable should improve corporate governance. However, for increasing efficiency and reducing risks to the budget, it is

important public enterprises are run on a commercial basis.

34. Accelerating reforms to lift Tonga's medium-term growth and advance fiscal consolidation will free up resources for social protection programs. The decline in remittances following the global financial crisis and rising food prices have contributed to increasing hardship in Tonga, particularly in the outer islands and outside the main urban center of Nuku'alofa. Moreover, preliminary results of the 2009 household income and expenditure survey show that hardship has been increasing in Tonga during the past decade. There is a need to develop social protection programs, such as establishing a contributory pension scheme and increasing coverage of health insurance and workers' compensation, and allow the government to focus on inequality and labor market policies. Failing to raise medium-term growth would increase Tonga's debt vulnerabilities (see attached debt sustainability annex) and means that Tonga will need to further reduce current and capital spending for projects and possibly reallocating some of the spending toward those projects deemed of higher priority.

Authorities' Views

35. The authorities agreed with the staff recommendations to lift private sector activity. They pointed to the need for Tonga to diversify and expand exports to reduce the country's dependency on remittances, but pointed to the difficulties capacity constraints pose. They also noted the difficulties in the discussions about a free trade agreement with Australia, because of the potential

losses of fiscal revenue such agreement could entail in the short run. With regard to the land regime, the authorities indicated that a review of the land

regime was currently being conducted and saw benefits in adopting a standard duration of contract for all types of allotments and activities.

STAFF APPRAISAL

36. Tonga's economy is recovering from the effects of the global financial crisis, the domestic credit crunch, and adverse weather-related shocks. Growth is estimated to recover to 1¼ percent in FY2010/11 and 1¾ percent in FY2011/12, helped by stronger tourism activity and a fiscal expansion financed by donor aid and previously contracted loans. Inflation is likely to average around 6 percent in FY2010/11 and in FY2011/12.

37. Risks to the outlook remain on the downside. A protracted rise in world commodity and food prices would hit Tonga's economy hard, feeding through to inflation, growth, and the current account deficit. At the same time, if global growth falters, remittances, tourism, and exports could be affected, weakening economic activity and threatening reserves. In addition, Tonga's high public debt limits the fiscal space for responding to shocks, including natural disasters, and for future spending on social and developmental priorities.

38. Fiscal consolidation is needed in the near term to mitigate Tonga's fiscal sustainability risks and expand fiscal space. Reducing Tonga's vulnerabilities will require avoiding new borrowing, reducing current spending, carefully prioritizing expenditure,

strengthening tax administration, and improving fiscal transparency.

39. Medium-term fiscal policy needs to aim at restoring sustainability. Over the medium term, a primary surplus of 1 percent of GDP would be needed to put the fiscal position on a more sustainable path, bringing down public debt to around 30 percent of GDP by the early 2020s. There is a need to integrate within a single institutional medium-term budgeting framework this fiscal path, the annual budget, and the medium-term development objectives laid out in the NSPF. Continued provision of grants from donors would be helpful for supporting these efforts.

40. A comprehensive debt management strategy is needed to limit the large credit and currency risks in the government balance sheet. Limiting the credit risk and reducing the risk of excess capacity will free resources for development priorities set out in the NSPF. Progress is expected to be made during FY2010/11 with technical assistance organized by PFTAC.

41. Monetary policy should maintain its current stance in the months ahead. NRBT's efforts to maintain adequate liquidity in the system are appropriately aimed at encouraging banks to

step up lending, and there is little need for further policy loosening. However, if monetary conditions were to normalize faster than anticipated, the existing liquidity overhang could exacerbate inflation and exert downward pressure on international reserves. In such a case, monetary policy will need to be pre-emptively tightened through a combination of hikes in interest rates on the NRBT repo facility, the issuance of central bank paper, and reserve requirements.

42. In order for credit growth to normalize, further improvements will be needed in banks' balance sheets, in Tonga's economic growth prospects, and in the institutional framework for lending. The enactment of the Personal Property Security Act will help reduce risks to bank lending but more efforts are needed. Progress needs to be made in instituting a centralized credit bureau and modifying the legal framework to ensure timely registration and recovery of collateral, including a secured bankruptcy protection law. In addition, increasing competition within an appropriate prudential and regulatory framework, and improving consumer protection and financial literacy could improve intermediation, reduce borrowing costs, and lay the foundations for stronger growth. In this regard, pressure to administer the level of interest rates should be resisted as administering interest rates could result in rationing credit and hampering banks' ability to price risk. NRBT's efforts to step up regulation and supervision, including adopting a standardized examination report format, are welcome. Technical assistance provided by PFTAC will continue to help

strengthen NRBT's supervisory capacity, but longer-term donor-financed assistance will also be required.

43. The exchange rate is broadly in line with fundamentals. Should downward pressures on reserves emerge, however, the NRBT will need to use the flexibility afforded by the current exchange rate arrangement to gradually depreciate the pa'anga against the basket within in order to safeguard external stability. Such depreciation would need to be accompanied by further fiscal restraint, given the effects a weaker currency would have on the public debt. Also, the weights in the currency basket need to be updated in order to ensure that they are consistent with changes in trade patterns and the emergence of renminbi debt.

44. Promoting private sector activity will strengthen medium-term growth prospects. There continues to be a need to extend land leases to 99 years for all allotments and activities to encourage construction and investment, make further progress with public enterprise reform to level the playing field between public and private enterprises, reduce the number of business licenses, and lower barriers to foreign investment. Speeding up reforms to lift Tonga's medium-term growth and advancing fiscal consolidation will free up resources for social protection programs and allow the government to focus on inequality and labor market policies.

45. It is recommended that the next Article IV consultation take place on a standard 12-month cycle.

Table 1 Tonga: Selected Economic Indicators, 2006/07–2011/12 1/						
Nominal GDP (2009/10): US\$ 353.2 million						
Population (2009): 103,294						
GDP per capita (2009/10): US\$ 3,419						
Quota: SDR 6.9 million						
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			Prel.		Proj.	
	(Annual percent change)					
Output and prices						
Real GDP 2/	-1.0	2.7	-0.1	-0.5	1.2	1.7
Consumer prices (period average)	5.1	9.8	5.0	2.0	6.0	5.8
Consumer prices (end of period)	5.6	12.2	1.2	2.6	10.4	1.7
	(In percent of GDP)					
Central government finance						
Total revenue and grants	28.0	25.9	29.8	26.3	28.8	21.8
Total revenue	24.3	24.6	22.9	21.0	17.6	17.6
Grants	3.7	1.3	6.9	5.2	11.2	4.2
Total expenditure and net lending	26.9	24.3	29.6	31.9	33.0	27.0
Of which: Current expenditure	25.9	23.9	25.3	26.2	20.0	19.8
Capital expenditure	0.9	0.4	3.0	3.4	10.5	5.2
Overall balance	1.0	1.6	0.1	-5.7	-4.2	-5.2
Overall balance (excl. China's EXIM bank loans)	...	...	0.4	-3.3	0.8	-2.3
External financing (net)	0.1	0.2	-0.1	4.0	9.2	5.9
Domestic financing (net)	-1.2	-1.7	4.7	1.6	-5.0	-0.7
Privatization receipts	0.0	0.0	-4.7	0.0	0.0	0.0
	(Annual percent change)					
Money and credit						
Total liquidity 3/	13.3	6.7	-1.1	5.8	5.2	-0.9
Of which: Broad money (M2)	11.9	8.2	-1.8	5.1	5.7	-1.1
Domestic credit	12.2	13.9	-5.2	-11.5	-18.5	9.0
Of which: Private sector credit	9.5	17.1	-3.7	-15.6	-4.5	9.4
Interest rates (end of period)						
Average deposit rate	5.7	5.7	4.9	3.4	...	
Base lending rate	9.5	10.0	10.0	9.6	...	
	(In millions of U.S. dollars)					
Balance of payments						
Exports, f.o.b.	13.3	12.4	5.5	5.9	7.1	7.8
Imports, f.o.b.	-108.6	-138.1	-130.1	-108.2	-146.1	-140.0
Services (net)	-17.9	-3.3	-2.6	-4.1	-4.3	-5.6
Investment income (net)	3.5	3.4	4.6	2.7	2.7	2.6
Services and investment income (net)	-14.4	0.1	2.0	-1.3	-1.6	-3.0
Current transfers (net)	84.2	94.7	75.8	76.2	99.7	90.4
Of which: Private transfer receipts	93.3	106.7	84.0	81.7	79.2	87.1
Current account balance	-25.5	-30.9	-46.9	-27.4	-40.9	-44.8
(In percent of GDP)	-8.3	-8.9	-14.7	-7.8	-11.0	-11.7
Current account balance (excl. China's EXIM bank loans)	-25.5	-30.9	-45.4	-14.2	-11.1	-26.0
Overall balance	4.2	-1.4	22.6	17.7	15.3	-13.9
Terms of trade (annual percent change)	21.4	-0.6	0.1	...	...
Gross official foreign reserves						
In millions of U.S. dollars	47.1	48.2	67.7	88.7	104.0	90.1
In months of goods and services imports	3.9	3.2	4.7	7.1	6.5	5.8
External debt (in percent of GDP)						
External debt	26.8	24.9	32.5	36.6	43.3	44.3
Debt service ratio	1.1	1.4	1.2	1.8	1.6	1.4
Exchange rates						
Pa'anga per U.S. dollar (period average)	2.0	1.9	2.1	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...
Nominal effective exchange rate (1990=100)	99.1	101.1	107.5	106.5	...	...
Real effective exchange rate (1990=100)	99.1	101.1	107.5	107.5	...	...
Memorandum item:						
Nominal GDP (millions of T\$)	611.0	661.4	663.2	681.4	752.9	810.2
Gross Disposable Income (millions of T\$)	809.1	868.9	840.3	843.3	970.8	1018.4
Population (thousands)	102.0	102.4	102.9	103.3	103.7	104.1

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.

Table 2	Tonga: Summary of Government Operations, 2006/07–2011/12					
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
	Actual	Actual	Prel.		Proj.	
	(In millions of pa'anga)					
Total revenue and grants	171.0	171.2	197.4	178.9	216.7	176.9
Total revenue	148.4	162.5	151.9	143.3	132.3	142.6
Current revenue	148.4	162.5	151.9	143.3	132.2	142.6
Tax revenue	126.1	138.0	129.1	114.4	110.3	119.8
Taxes on income profits	26.4	26.8	40.3	27.9	23.4	26.0
Tax on property	0.1	0.1	0.1	0.1	0.1	0.1
Sales tax and Consumption tax	51.6	59.7	71.3	70.7	72.1	77.4
Trade taxes	47.5	51.4	16.1	14.9	14.6	16.0
Other taxes	0.5	0.0	1.4	0.7	0.1	0.4
Nontax revenue	22.3	24.5	22.8	29.0	21.9	22.8
Capital revenue	0.0	0.0	0.0	0.0	0.1	0.0
Grants (in cash)	22.6	8.7	45.5	35.6	84.4	34.3
Total expenditure and net lending	164.6	160.9	196.5	217.6	248.1	219.0
Total expenditure	164.0	160.9	187.6	201.5	229.7	202.1
Current expenditure	158.4	158.3	167.5	178.2	150.3	160.3
Wages and salaries 1/	80.1	70.2	76.4	81.4	83.5	81.4
Retirement funds employer contribution	5.8	4.4	5.2	6.9	8.0	8.6
Interest expense	3.2	4.2	5.2	5.6	6.1	7.1
Other current expenditures	69.4	79.6	80.7	84.4	52.7	63.1
Capital expenditure	5.6	2.6	20.1	23.3	79.4	41.8
Financed by China's EXIM bank loans 2/	...	...	2.3	16.2	59.7	32.7
Total lending minus repayments	0.6	0.0	8.9	16.1	18.4	16.9
Current balance	-10.1	4.2	-15.6	-34.9	-18.2	-17.6
Overall balance (incl. grants)	6.4	10.3	0.9	-38.7	-31.5	-42.1
Overall balance (excl. China's EXIM bank loans)	...	...	2.7	-22.2	5.8	-18.5
Total financing	-6.4	-10.2	-0.9	38.7	31.5	42.1
External financing	0.8	1.4	-0.9	27.5	69.3	47.7
Disbursements	5.8	8.4	41.8	49.3	57.6	38.2
Repayments	5.0	7.0	4.7	8.7	5.9	6.4
Net change in external cash balance 2/	0.0	0.0	-38.0	-13.1	17.6	15.8
Domestic financing 3/ 4/	-7.1	-11.6	31.5	11.2	-37.8	-5.6
Net bond financing	-1.6	-3.2	1.8	7.7	1.0	-2.0
Net bank loan financing	0.0	0.0	0.0	0.0	0.0	0.0
Net changes in cash balances	0.0	-12.5	2.3	-4.8	0.0	0.0
Other	-5.5	4.2	27.4	8.3	-38.8	-3.6
Privatization receipts	0.0	0.0	-31.4	0.0	0.0	0.0
Total revenue and grants	28.0	25.9	29.8	26.3	28.8	21.8
Total revenue	24.3	24.6	22.9	21.0	17.6	17.6
Current revenue	24.3	24.6	22.9	21.0	17.6	17.6
Tax revenue	20.6	20.9	19.5	16.8	14.6	14.8
Taxes on income profits	4.3	4.1	6.1	4.1	3.1	3.2
Tax on property	0.0	0.0	0.0	0.0	0.0	0.0
Sales tax and Consumption tax	8.4	9.0	10.7	10.4	9.6	9.6
Trade taxes	7.8	7.8	2.4	2.2	1.9	2.0
Other taxes	0.1	0.0	0.2	0.1	0.0	0.0
Nontax revenue	3.6	3.7	3.4	4.3	2.9	2.8
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0
Grants (in cash)	3.7	1.3	6.9	5.2	11.2	4.2
Total expenditure and net lending	26.9	24.3	29.6	31.9	33.0	27.0
Total expenditure	26.8	24.3	28.3	29.6	30.5	24.9
Current expenditure	25.9	23.9	25.3	26.2	20.0	19.8
Wages and salaries 1/	13.1	10.6	11.5	11.9	11.1	10.0
Retirement funds employer contribution	0.9	0.7	0.8	1.0	1.1	1.1
Interest expense	0.5	0.6	0.8	0.8	0.8	0.9
Other current expenditures	11.4	12.0	12.2	12.4	7.0	7.8
Capital expenditure	0.9	0.4	3.0	3.4	10.5	5.2
Total lending minus repayments	0.1	0.0	1.3	2.4	2.4	2.1
Current balance	-1.6	0.6	-2.4	-5.1	-2.4	-2.2
Overall balance (incl. grants)	1.0	1.6	0.1	-5.7	-4.2	-5.2
Overall balance (excl. China's EXIM bank loans)	...	...	0.4	-3.3	0.8	-2.3
Total financing	-1.0	-1.5	-0.1	5.7	4.2	5.2
External financing	0.1	0.2	-0.1	4.0	9.2	5.9
Disbursements	0.9	1.3	6.3	7.2	7.7	4.7
Repayments	0.8	1.1	0.7	1.3	0.8	0.8
Net change in external cash balance 2/	...	...	-5.7	-1.9	2.3	2.0
Domestic financing 3/ 4/	-1.2	-1.7	4.7	1.6	-5.0	-0.7
Memorandum item:						
Nominal GDP (in millions of pa'anga)	611.0	661.4	663.2	681.4	752.9	810.2

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

1/ Waqe bill for 2006/07 includes TOP 9.6 million of carryover payments from 2005/06.

2/ Reflects unspent balances of China's EXIM Bank loans.

3/ In 2008/09 includes the implementation of the natural disaster fund.

4/ Includes domestic net bond financing and net changes in government cash balance and investment.

Table 3	Tonga: Depository Corporations Survey, 2006/07–2007/12 1/					
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
				Prel.		Proj.
	(In millions of pa'anga; end of period)					
Net foreign assets	82.2	76.0	118.1	143.1	197.5	174.2
Claims on nonresidents	105.3	102.1	155.9	188.5	245.6	216.7
NRBT	92.9	90.7	137.7	171.9	221.7	192.7
Other depository corporations	12.4	11.4	18.3	16.6	23.9	23.9
Liabilities to Nonresidents	-23.0	-26.0	-37.9	-45.4	-48.1	-42.4
NRBT	-5.2	-3.4	-10.4	-29.5	-31.8	-28.1
Other depository corporations	-17.8	-22.6	-27.5	-15.9	-16.3	-14.4
Net domestic assets	204.6	230.0	184.5	177.1	139.4	159.8
Net domestic credit	290.6	331.1	314.0	277.8	226.4	246.8
Net claims on government	-18.3	-30.9	-34.7	-28.1	-65.9	-71.5
<i>of which: govt. lending funds 2/</i>	5.4	12.4	0.0	0.0	0.0	0.0
Claims on public nonfin. corps.	3.7	4.8	4.7	15.5	15.0	15.0
Claims on private sector	305.1	357.2	344.0	290.4	277.3	303.3
Other items, net	-85.9	-101.1	-129.5	-100.7	-87.1	-87.1
Total liquidity	286.9	306.0	302.6	320.2	336.9	334.0
Broad money (M2)	265.5	287.2	282.0	296.4	313.4	309.9
Narrow money	73.5	72.3	77.7	90.0	88.7	91.2
Quasi money	192.0	214.9	204.4	206.4	224.7	218.7
Securities other than shares 3/	21.4	18.7	20.6	23.8	23.5	24.1
	(Annual percentage change)					
Net foreign assets	12.0	-7.6	55.4	21.2	38.1	-11.8
Net domestic assets	13.8	12.4	-19.8	-4.0	-21.3	14.6
Net domestic credit	12.2	13.9	-5.2	-11.5	-18.5	9.0
Claims on private sector	9.5	17.1	-3.7	-15.6	-4.5	9.4
Total liquidity	13.3	6.7	-1.1	5.8	5.2	-0.9
Broad money (M2)	11.9	8.2	-1.8	5.1	5.7	-1.1
	(In millions of U.S. dollars)					
Net foreign assets	41.1	40.0	56.6	74.2	92.7	81.5
Claims on nonresidents	52.6	53.7	74.8	97.7	115.2	101.3
NRBT	46.4	47.7	66.0	89.1	104.0	90.1
ODCs	6.2	6.0	8.8	8.6	11.2	11.2
Liabilities to nonresidents	-11.5	-13.7	-18.2	-23.5	-22.6	-19.8
Memorandum items:						
Velocity (GDP/average M2)	2.4	2.3	2.4	2.3	2.4	2.6
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...

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

1/ Comprises the National Reserve Bank of Tonga (NRBT) and other depository corporations (ODCs), including the Tonga Development Bank (TDB).

2/ Represents borrowing by the Government from foreign sources for onlending to the TDB.

2-3/ Comprises bills and promissory notes issued by financial sector and held outside the sector.

Table 4 Tonga: Balance of Payments Summary 2006/07–2011/12 1/

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

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			Prel.		Proj.	
Trade balance	-95.3	-125.7	-124.6	-102.3	-139.0	-132.2
Exports, f.o.b.	13.3	12.4	5.5	5.9	7.1	7.8
Imports, f.o.b.	-108.6	-138.1	-130.1	-108.2	-146.1	-140.0
Services (net)	-17.9	-3.3	-2.6	-4.1	-4.3	-5.6
Receipts	19.4	36.9	40.1	37.3	40.4	41.0
Payments	-37.3	-40.1	-42.7	-41.4	-44.7	-46.6
Investment income (net)	3.5	3.4	4.6	2.7	2.7	2.6
Receipts	6.4	6.8	6.2	7.6	8.0	8.3
Payments	-2.9	-3.5	-1.6	-4.9	-5.4	-5.6
Current transfers (net)	84.2	94.7	75.8	76.2	99.7	90.4
Official transfers (net) 2/	0.0	0.2	0.6	1.1	27.4	10.4
Private transfers (net)	84.2	94.5	75.1	75.1	72.3	80.0
Current account balance	-25.5	-30.9	-46.9	-27.4	-40.9	-44.8
(In percent of GDP)	-8.3	-8.9	-14.7	-7.8	-11.0	-11.7
Capital and financial account balance	26.9	36.3	55.6	29.9	56.2	32.0
Official capital flows (net)	9.8	11.9	17.7	14.7	45.6	26.2
<i>Of which:</i> China's EXIM bank loans	...	...	20.1	23.3	28.5	16.1
Private capital flows (net)	17.1	24.4	37.9	15.2	10.5	5.8
Errors and omissions	2.7	-6.7	13.9	15.3	0.0	0.0
Overall balance 3/	4.2	-1.4	22.6	17.7	15.3	-12.9
Memorandum items:						
Gross official foreign reserves	47.1	48.2	67.7	88.7	104.0	90.1
In months of goods and services imports 4/	3.9	3.2	4.7	7.1	6.5	5.8
Exchange rate						
Pa'anga per U.S. dollar (period average)	2.0	1.9	2.1	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...
Nominal GDP	305.1	348.0	318.0	353.2	372.8	383.4
Commodity price indexes (2005 = 100)						
Food	115.9	152.3	138.7	137.4	172.5	180.9
Fuel	117.7	177.0	128.8	137.4	147.0	193.7

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

1/ On OET base; projections include adjustments for imports related to two loans from China's EXIM Bank.

2/ Includes grants from ADB of US\$5 million in 2009/10 and 2010/11.

3/ Change in gross official foreign reserves.

4/ The current year's imports.

Table 5	Tonga: Medium-Term Scenario, 2008/09–2015/16 1/							
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
	Preliminary		Projections					
	(Annual percent change)							
Output and prices								
Real GDP	-0.1	-0.5	1.2	1.7	1.8	1.8	1.8	1.8
Consumer prices (end of period)	1.2	2.6	10.4	1.7	6.0	6.0	6.0	6.0
Consumer prices (period average)	5.0	2.0	6.0	5.8	3.9	6.0	6.0	6.0
	(In percent of GDP)							
Central government finance								
Total revenue and grants	29.8	26.3	28.8	21.8	21.0	20.2	21.9	21.7
Total revenue	22.9	21.0	17.6	17.6	16.8	17.3	19.0	19.1
Grants	6.9	5.2	11.2	4.2	4.2	2.9	2.9	2.6
Total expenditure and net lending	29.6	31.9	33.0	27.0	22.5	21.7	23.1	22.3
Current expenditure	25.3	26.2	20.0	19.8	18.9	18.8	18.3	18.0
Capital expenditure	3.0	3.4	10.5	5.2	3.5	2.9	3.8	3.6
Expenditure discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	1.3	2.4	2.4	2.1	0.0	0.0	1.0	0.7
Overall balance	0.1	-5.7	-4.2	-5.2	-1.5	-1.5	-1.3	-0.6
External financing (net)	-0.1	4.0	9.2	5.9	1.6	0.9	0.5	-1.0
Domestic financing (net)	4.7	1.6	-5.0	-0.7	-0.1	0.5	0.8	1.6
	(In millions of U.S. dollars)							
Balance of payments								
Exports, f.o.b.	5.5	5.9	7.1	7.8	8.5	9.4	10.5	11.9
(Annual percent change)	-55.6	7.9	20.8	8.9	9.1	10.2	12.5	12.8
Imports, f.o.b.	-130.1	-108.2	-146.1	-140.0	-132.7	-138.4	-144.1	-145.7
(Annual percent change)	-5.8	-16.8	35.0	-4.2	-5.2	4.3	4.1	1.1
Services and investment income (net)	2.0	-1.3	-1.6	-3.0	-4.2	-5.5	-6.8	-7.0
Transfers (net)	75.8	76.2	99.7	90.4	85.9	94.1	103.4	111.3
<i>Of which:</i> Private transfer receipts	84.0	81.7	79.2	87.1	94.5	102.4	110.7	118.8
(Annual percent change)	-21.3	-2.8	-3.0	9.9	8.5	8.4	8.1	7.3
Current account balance	-46.9	-27.4	-40.9	-44.8	-42.5	-40.5	-37.0	-29.5
(In percent of GDP)	-14.7	-7.8	-11.0	-11.7	-10.7	-9.9	-8.7	-6.8
Capital account balance	55.6	29.9	56.2	32.0	30.2	26.5	26.6	25.6
Official capital flows (net)	17.7	14.7	45.6	26.2	22.1	14.1	11.5	4.3
Private capital flows (net)	37.9	15.2	10.5	5.8	8.1	12.3	15.1	21.4
Overall balance	22.6	17.7	15.3	-13.9	-12.3	-14.0	-10.4	-3.9
Gross international reserves (end of period)								
In millions of U.S. dollars	67.7	88.7	104.0	90.1	77.8	63.8	53.4	49.5
In months of imports (goods and services)	4.7	7.1	6.5	5.8	5.2	4.1	3.3	3.0
External debt (in percent of GDP)								
Public sector external debt	32.5	36.6	43.3	44.3	45.3	44.4	41.9	39.7
Debt service ratio	1.2	1.8	1.6	1.4	1.4	2.4	2.3	2.4
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	75.1	75.1	72.3	80.0	87.2	94.9	103.1	111.0
(In percent of imports, goods and services)	43.5	50.2	37.9	42.8	48.2	50.4	52.6	55.8
Commodity price indexes (2005 = 100)								
Food	138.7	137.4	172.5	180.9	160.8	160.7	153.3	149.1
Fuel	128.8	137.4	147.0	193.7	191.6	188.6	188.0	189.1
Nominal GDP (millions of T\$)	663.2	681.4	752.9	810.2	856.8	924.7	998.0	1077.1

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

1/ Fiscal year beginning July.

Table 6	Tonga: Financial Soundness Indicators, 20047–10 1/						
	2004	2005	2006	2007	2008	2009	2010
Financial Sector	(In percent)						
Total loans/GDP	40.1	46.9	47.9	50.5	54.7	52.6	44.9
Other depository corporations	40.1	46.9	47.9	50.5	54.7	52.6	44.9
	(Year-on-year percent change)						
Bank loans							
Other non-financial corporations	-10.2	21.8	24.9	12.6	21.4	0.9	-17.2
Other resident sectors	14.0	47.8	8.3	2.6	6.2	-16.7	-10.0
Banks	(In percent)						
Capital adequacy ratio	17.6	16.3	16.8	20.7	22.4	26.5	22.9
Net interest income to average asse	7.3	6.5	6.1	6.0	5.8	4.9	...
	(In percent of total loans)						
Non-performing loans	6.3	5.3	4.7	5.1	10.0	23.7	17.9
Provision expense to gross loans	1.6	0.4	1.1	3.2	10.4	11.0	...
Loan loss reserves to gross loans	4.8	2.5	2.4	3.6	6.4	9.6	14.1
Source: National Reserve Bank of Tonga and IMF IFS database.							
1/ Data are based on the end- fiscal year.							

Table 7 Tonga: Millennium Development Goals

	1990	1995	2000	2005	2008	2009
Goal 1: Eradicate extreme poverty and hunger						
Employment to population ratio, 15+, total (%)	..	..	..	..	..	..
Employment to population ratio, ages 15-24, total (%)	..	..	..	..	..	..
GDP per person employed (constant 1990 PPP \$)	..	..	..	..	..	..
Income share held by lowest 20%	..	..	..	..	..	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	..	..	..	..
Poverty gap at \$1.25 a day (PPP) (%)	..	..	..	..	..	..
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	..	..	..	..	..	..
Prevalence of undernourishment (% of population)	..	..	..	..	..	..
Vulnerable employment, total (% of total employment)	..	57	..	..	..	..
Goal 2: Achieve universal primary education						
Literacy rate, youth female (% of females ages 15-24)	..	99	..	100	100	..
Literacy rate, youth male (% of males ages 15-24)	..	99	..	100	100	..
Persistence to last grade of primary, total (% of cohort)	..	..	95	91	..	..
Primary completion rate, total (% of relevant age group)	133	114	104	137	100	..
Total enrollment, primary (% net)	..	..	96	99	..	..
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliaments (%)	0	0	0	3	3	3
Ratio of female to male enrollments in tertiary education	..	..	164	168	..	..
Ratio of female to male primary enrollment	98	99	97	96	95	..
Ratio of female to male secondary enrollment	104	..	110	104	104	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	35.7	..	38.6	..	..
Goal 4: Reduce child mortality						
Immunization, measles (% of children ages 12-23 months)	86	94	95	99	99	99
Mortality rate, infant (per 1,000 live births)	19	18	18	17	17	17
Mortality rate, under-5 (per 1,000)	23	21	20	20	19	19
Goal 5: Improve maternal health						
Adolescent fertility rate (births per 1,000 women ages 15-19)	..	..	21	22	22	..
Births attended by skilled health staff (% of total)	92	..	95	98	..	..
Contraceptive prevalence (% of women ages 15-49)	..	41	33	..	..	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	..	..	..
Pregnant women receiving prenatal care (%)	..	..	..	..	..	..
Unmet need for contraception (% of married women ages 15-49)	..	..	..	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	34	31	28	25	24	..
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	..	..
Prevalence of HIV, male (% ages 15-24)	..	..	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	..	..	..
Tuberculosis case detection rate (all forms)	72	67	88	71	53	..
Goal 7: Ensure environmental sustainability						
CO2 emissions (kg per PPP \$ of GDP)	0.4	0.4	0.4	0.3	..	..
CO2 emissions (metric tons per capita)	1	1	1	2	..	..
Forest area (% of land area)	5	5	5	5	..	..
Improved sanitation facilities (% of population with access)	96	96	96	96	96	..
Improved water source (% of population with access)	..	100	100	100	100	..
Marine protected areas, (% of surface area)	..	..	..	..	2	..
Goal 8: Develop a global partnership for development						
Debt service (PPG and IMF only, % of exports, excluding workers' remittances)	3	4	8	6	8	..
Internet users (per 100 people)	0.0	0.1	2.4	2.9	8.0	..
Mobile cellular subscriptions (per 100 people)	0	0	0	29	49	..
Telephone lines (per 100 people)	5	7	10	13	25	..
Other						
Fertility rate, total (births per woman)	5.0	4.0	4.0	4.0	4.0	..
GNI per capita, Atlas method (current US\$)	1,230	1,990	2,020	2,470	3,240	3,260
GNI, Atlas method (current US\$) (billions)	0.1	0.2	0.2	0.3	0.3	0.3
Gross capital formation (% of GDP)	18	26	22	22	26	26
Life expectancy at birth, total (years)	70	70	71	71	72	..
Literacy rate, adult total (% of people ages 15 and above)	..	99	..	99	99	..
Population, total (millions)	0.1	0.1	0.1	0.1	0.1	0.1
Trade (% of GDP)	99	73	62	80	70	72

Source: World Development Indicators database.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 11/XX
FOR IMMEDIATE RELEASE
May [], 2011

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

Appendix I. Draft Public Information Notice IMF Executive Board Concludes 2011 Article IV Consultation with Tonga

On May 4, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.¹

Background

Tonga's economy is recovering, on the back of increased construction activity and improvements in the external environment. GDP growth is estimated to rebound to 1¼ percent in FY2010/11 on the back of stronger tourism activity and an expansionary fiscal policy financed by donor aid and previously contracted loans. Remittance inflows have stabilized in recent months and should provide additional impetus to growth during the remainder of the fiscal year. However, this growth momentum will likely be limited by continued tight domestic financial conditions as banks maintain tight lending standards following the large rise in nonperforming loans of the past two years.

CPI inflation rose to 6½ percent y/y in February 2011, reflecting mainly increases in global food and oil prices and one-off effects from higher excises on tobacco and alcohol. Inflation is likely to average around 6 percent in FY2010/11.

The government's stepped up capital expenditure in FY2010/11 helped to offset weaknesses in private demand. At the same time, generous grant inflows from donors during FY2010/11 contributed to narrowing the fiscal deficit to an estimated 4¼ percent of GDP (from about

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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

5¾ percent of GDP in FY2009/10). Nevertheless, Tonga remains at a “high risk of debt distress” according to this year’s World Bank-IMF debt sustainability analysis.

Monetary policy was geared toward jumpstarting bank lending. In FY2010/11, the National Reserve Bank of Tonga (NRBT) remunerated banks’ exchange settlement account balances over TOP 1 million and maintained adequate liquidity in the system to encourage banks to step up lending. However, credit to the private sector continued to fall, albeit at a slower pace.

The slower decline in bank lending reflects some improvements in banks’ balance sheets. Banks are now well capitalized; and profitability has improved somewhat in recent months, but remains well below levels of the past years, owing to high provisioning. Nevertheless, banks are likely to maintain a cautious lending stance in FY2010/11 amid uncertainties on the outlook.

Executive Board Assessment

< >

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.

Table 1 Tonga: Selected Economic Indicators, 2006/07–2011/12 1/

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			Prel.		Proj.	
	(Annual percent change)					
Output and prices						
Real GDP 2/	-1.0	2.7	-0.1	-0.5	1.2	1.7
Consumer prices (period average)	5.1	9.8	5.0	2.0	6.0	5.8
Consumer prices (end of period)	5.6	12.2	1.2	2.6	10.4	1.7
	(In percent of GDP)					
Central government finance						
Total revenue and grants	28.0	25.9	29.8	26.3	28.8	21.8
Total revenue	24.3	24.6	22.9	21.0	17.6	17.6
Grants	3.7	1.3	6.9	5.2	11.2	4.2
Total expenditure and net lending	26.9	24.3	29.6	31.9	33.0	27.0
<i>Of which:</i> Current expenditure	25.9	23.9	25.3	26.2	20.0	19.8
Capital expenditure	0.9	0.4	3.0	3.4	10.5	5.2
Overall balance	1.0	1.6	0.1	-5.7	-4.2	-5.2
Overall balance (excl. China's EXIM bank loans)	...	...	0.4	-3.3	0.8	-2.3
External financing (net)	0.1	0.2	-0.1	4.0	9.2	5.9
Domestic financing (net)	-1.2	-1.7	4.7	1.6	-5.0	-0.7
Privatization receipts	0.0	0.0	-4.7	0.0	0.0	0.0
	(Annual percent change)					
Money and credit						
Total liquidity 3/	13.3	6.7	-1.1	5.8	5.2	-0.9
<i>Of which:</i> Broad money (M2)	11.9	8.2	-1.8	5.1	5.7	-1.1
Domestic credit	12.2	13.9	-5.2	-11.5	-18.5	9.0
<i>Of which:</i> Private sector credit	9.5	17.1	-3.7	-15.6	-4.5	9.4
Interest rates (end of period)						
Average deposit rate	5.7	5.7	4.9	3.4	...	...
Base lending rate	9.5	10.0	10.0	9.6	...	...
	(In millions of U.S. dollars)					
Balance of payments						
Exports, f.o.b.	13.3	12.4	5.5	5.9	7.1	7.8
Imports, f.o.b.	-108.6	-138.1	-130.1	-108.2	-146.1	-140.0
Services (net)	-17.9	-3.3	-2.6	-4.1	-4.3	-5.6
Investment income (net)	3.5	3.4	4.6	2.7	2.7	2.6
Services and investment income (net)	-14.4	0.1	2.0	-1.3	-1.6	-3.0
Current transfers (net)	84.2	94.7	75.8	76.2	99.7	90.4
<i>Of which:</i> Private transfer receipts	93.3	106.7	84.0	81.7	79.2	87.1
Current account balance	-25.5	-30.9	-46.9	-27.4	-40.9	-44.8
(In percent of GDP)	-8.3	-8.9	-14.7	-7.8	-11.0	-11.7
Current account balance (excl. China's EXIM bank loans)	-25.5	-30.9	-45.4	-14.2	-11.1	-26.0
Overall balance	4.2	-1.4	22.6	17.7	15.3	-13.9
Terms of trade (annual percent change)	21.4	-0.6	0.1	...	...	...
Gross official foreign reserves						
In millions of U.S. dollars	47.1	48.2	67.7	88.7	104.0	90.1
In months of goods and services imports	3.9	3.2	4.7	7.1	6.5	5.8
External debt (in percent of GDP)						
External debt	26.8	24.9	32.5	36.6	43.3	44.3
Debt service ratio	1.1	1.4	1.2	1.8	1.6	1.4
Exchange rates						
Pa'anga per U.S. dollar (period average)	2.0	1.9	2.1	1.9	...	...
Pa'anga per U.S. dollar (end of period)	1.9	1.8	2.0	1.9	...	...
Nominal effective exchange rate (1990=100)	99.1	101.1	107.5	106.5	...	...
Real effective exchange rate (1990=100)	99.1	101.1	107.5	107.5	...	...
Memorandum item:						
Nominal GDP (millions of T\$)	611.0	661.4	663.2	681.4	752.9	810.2
Gross Disposable Income (millions of T\$)	809.1	868.9	840.3	843.3	970.8	1018.4
Population (thousands)	102.0	102.4	102.9	103.3	103.7	104.1

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.