

# Tonga: economic survey 2009

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The Tongan economy was well on its way to recovery from the effects of the riots and the oversized rise in public sector salaries of 2005 when it was hit by three new shocks: an inflation surge in 2007–08 due to price rises for imported food and fuels; the bursting of a bank credit ‘bubble’; and the global financial crisis. Nevertheless, GDP growth has remained positive, as the subsistence sector is sheltered, and foreign financial assistance has supported construction activity and permitted an expansionary stance of fiscal policy. The macroeconomic picture is one of stability, with inflation back to low levels and the budget and the balance of payments showing overall surpluses. The economy remains vulnerable, however, and Tonga still does not appear to be within reach of a sustainable development path. The government will need—with the help of donor countries—to mobilise the private sector in key areas and tackle the main obstacles to development. Regional cooperation should also be strengthened, especially through consolidation and harmonisation. Pursuing these goals while maintaining the momentum for constitutional reform will be a major challenge.

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Throughout its history, the Kingdom of Tonga—like many other island states—has had to cope with the ‘tyranny of distance’, its small size, the dispersion of its population across some 40 islands (Map 1), the threat of natural catastrophes and the lack of essential raw materials and fossil fuels. From an early date, however, it has benefited from favourable developments. The first was the stimulation of emigration, which reduced demographic pressure on resources and became a sizeable source of remittances (equivalent to 28 per cent of GDP in 2007–08). The growth rate of the population is less than 0.5 per cent (Figure 1) and the

number of Tongans living overseas is about the same as the population in Tonga. The second development was the country’s emphasis on education, which eliminated illiteracy. The third has been the continuous inflow of foreign aid. In the past five years, the Tongan economy has been affected by several shocks of external or domestic origin. The latest one—unfortunately associated with considerable loss of life—was the capsizing of the *Princess Ashika* ferry.

As discussed in the previous survey (*Pacific Economic Bulletin*, Volume 22(3), 2007), the reconstruction of the capital city, Nuku’alofa, is proceeding to repair

the damage caused by the civil disorder of November 2006 (Utoikamanu 2007). In addition, the effects on public finances of the oversized civil service wage settlement of September 2005 have been offset by a substantial number of redundancies. This survey focuses on three recent shocks: the global financial crisis, the bursting of the credit bubble and the surge of inflation.

### Three shocks and their effects

#### The global financial crisis, 2007–?

Tonga's informal sector has been sheltered from the global financial crisis, but the commercial sector has been affected indirectly by a decline in the amount of remittances coming from overseas. Tourism has held up somewhat better and a fall in exports does not seem to be related to the global financial crisis.

Remittances are linked to the incomes (and the income prospects) of Tongans living overseas—mainly in Australia, New Zealand and the United States—three countries that have been affected to various degrees by the global financial crisis and, in particular, by rising unemployment. For example, the Los Angeles metropolitan area, where about half of the Tongans living in the United States resides, saw a decline of 221,300 (3.9 per cent) in the numbers employed between March 2008 and March 2009 (US Department of Labor 2009). In Australia, employment growth slowed to 0.7 per cent during the 12 months to February 2009 and is expected to contract by 0.25 per cent during 2008–09 and to remain weak during 2010 (*Australian Labour Market Update*, April 2009). In Tonga in the fiscal year 2008/09, remittances declined by 14 per cent (in pa'anga terms) and receipts from tourism dropped by 5.9 per cent, with a negative impact on the balance of

payments and government revenue. For the current fiscal year—since remittances are sensitive to prospects for employment and incomes—recent signs of improvement in the economic situation of the three main host countries could stabilise the amount of private transfers.

#### The credit bubble

From the first quarter of 2002 to the first quarter of 2008, lending by the commercial banks<sup>1</sup> to the private sector increased by 256 per cent—or 23.6 per cent per annum—notwithstanding a marked slowdown after the events of November 2006 and the imposition of credit ceilings on individual banks between January 2006 and February 2007 (Figure 2). In comparison, the consumption of electricity (in kilowatt hours)—a measure of real economic activity—increased by only 37 per cent during the same period (5.6 per cent per annum). In what seemed to be a coincidence, Tonga was heading along the same path as the largest economy in the world with regard to the build-up of excessive levels of debt by households and businesses. As in the United States, in Tonga, the credit bubble ended with liquidity problems in part of the banking sector in 2008 and a sharp rise in non-performing loans—which reached 20 per cent of loans outstanding by the first quarter of 2009.

After large injections of capital into Tonga's two largest banks, the liquidity and the capital positions of the banking sector are now comfortable. During the 12 months to June 2009, however, bank lending to the private sector contracted by 2.9 per cent. The main reason was the stricter lending standards set by the banks, however, weaker demand for loans was also a factor. The latter factor was probably related to the impact of the decline in remittances on borrowers' eligibility for loans.

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Figure 1a Population growth, 2007 (per cent)

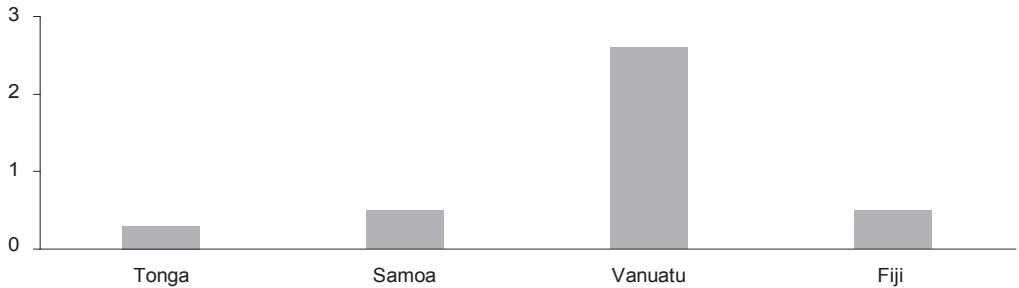


Figure 1b Government revenue<sup>b</sup>, 2007 (percentage of GDP)

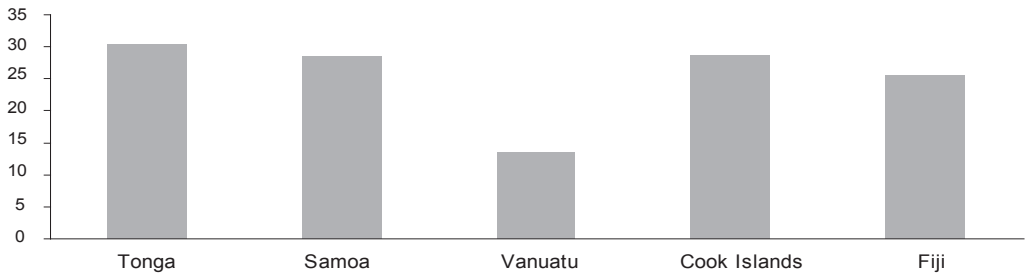


Figure 1c Capital formation, 2007 (percentage of GDP)

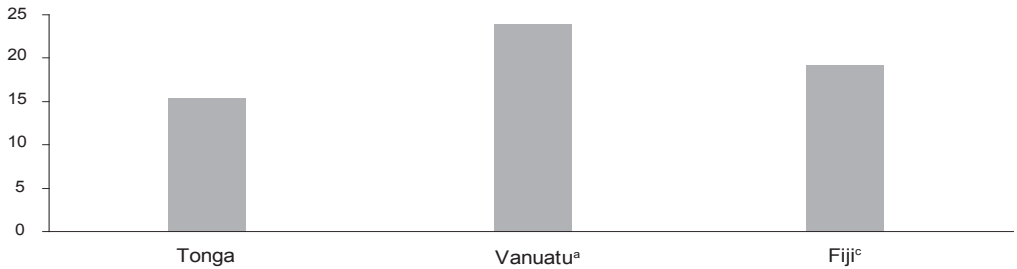
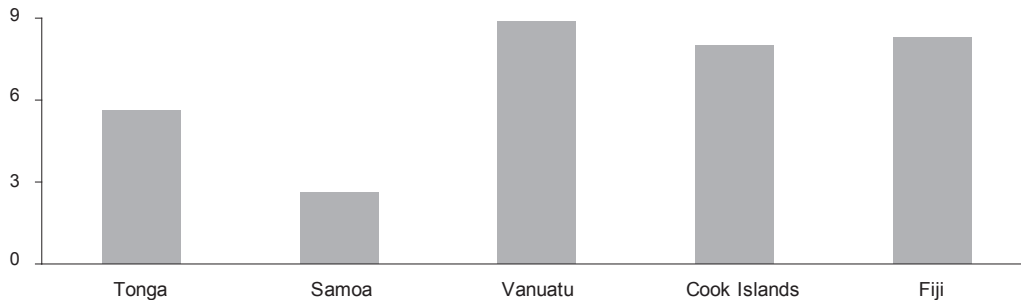


Figure 1d Exports, 2007 (percentage of GDP)



<sup>a</sup> 2006 <sup>b</sup> excluding grants <sup>c</sup> 2005

Source: Asian Development Bank (ADB), 2008. *Key Indicators for Asia and the Pacific*, Asian Development Bank, Manila.

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### The surge in inflation

Price levels in Tonga are determined largely by the prices of imports, as imports make up two-thirds of the consumer price index (CPI). Although the effective exchange rate of the pa'anga has remained unchanged, import prices can be affected by changes in the exchange rate of the pa'anga against the currency of the main countries of import origin—notably New Zealand.

The year-on-year rate of inflation began to accelerate in the third quarter of 2007 and peaked at 12.2 per cent in the second quarter of 2008 (Figure 3). Increases in food and petroleum prices were largely responsible for this development and they were rapidly reflected in the local component of the CPI through electricity and transportation costs. The subsequent decline in import prices led to a sharp fall in the rate of inflation—to 1.2

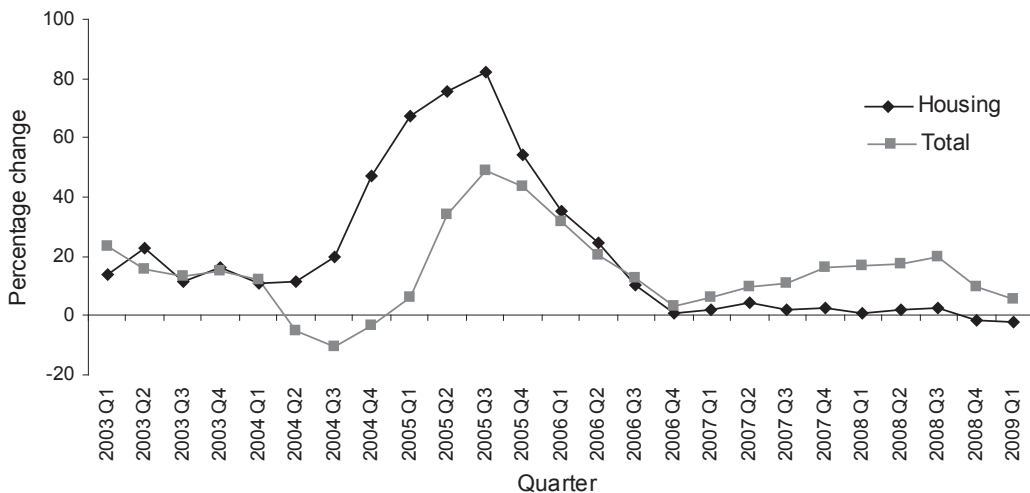
per cent year-on-year by June 2009. It was helped by the government's decision to remove import duties on some food items and on fuel for domestic shipping and air transport.

### The state of the economy and its prospects

#### Production, employment and prices

After recovering in 2007/08 from the contraction experienced in the previous year, the Tongan economy is estimated to have grown by 0.4 per cent in real terms in 2008/09 (Figure 4). No doubt, the decline in the amount of remittances played a role, as already mentioned, but most sectors showed slow growth or outright declines—notably agriculture and manufacturing.<sup>2</sup> Commercial agriculture

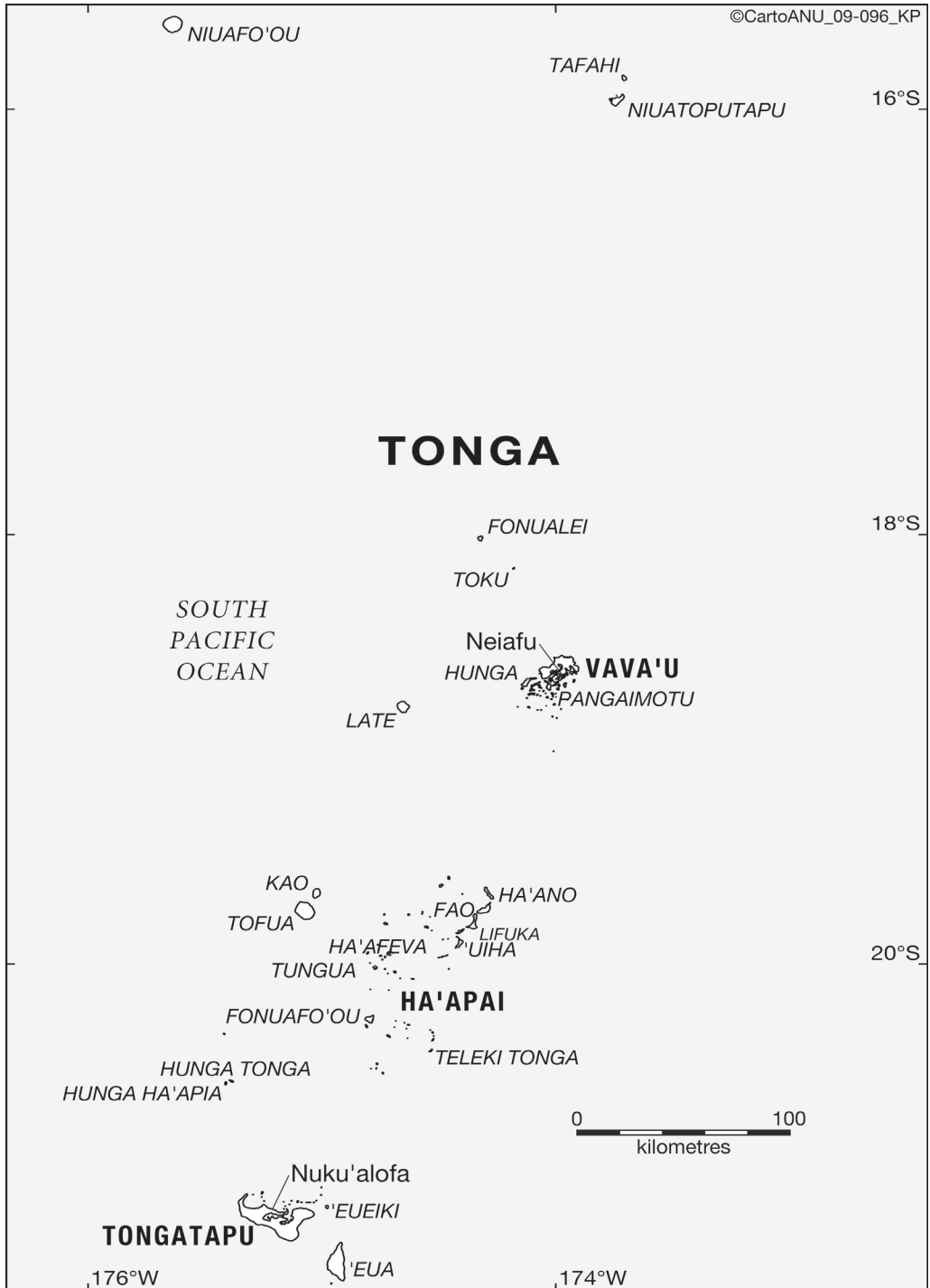
Figure 2 Commercial bank lending to the private sector (annual percentage change, quarterly)



Source: National Reserve Bank of Tonga (NRBT), 2009. *Quarterly Bulletin*, National Reserve Bank of Tonga, Nuku'alofa.

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Map 1 Kingdom of Tonga



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suffered from the difficulties experienced by exports due to increased competition and transportation costs. Fishing has been affected for some time by the depletion of stocks, difficulties in accessing some markets and, more recently, by the recession in the United States. Agriculture and fishing output remain well below their levels at the beginning of the decade

Tonga's Ministry of Finance projects that growth will pick up in 2009/10—to 1.7 per cent—but this seems on the high side given the slowdown in bank lending and the weakness of the agricultural and fishing sectors, which accounted for 25.6 per cent of 2008/09 GDP. The most favourable development is the build-up of the work on the reconstruction of Nuku'alofa. Loans (from China, Australia and New Zealand) for the reconstruction work are sizeable—about T\$120 million—and although they will be spread over four years and some will be spent on the importation of goods and services directly related to the project, they will provide a significant stimulus to the economy.<sup>3</sup> The Ministry of Finance estimated that the construction sector grew by 2.4 per cent in 2008/09 and it forecast a 3.3 per cent growth rate for 2009/10. The prime minister recently announced a new concessionary loan of US\$45 million from China for infrastructure investment (Sevele 2009). It is not known when disbursements will begin, but the loan is unlikely to have much impact in the current year.

As usual, the rate of inflation will be determined largely by import prices. In this respect, the recent increase in oil and raw materials prices, together with the appreciation of Australia's and New Zealand's currencies, can be expected to be reflected in higher import prices and in the CPI. Should the recovery of the world economy strengthen, the pressure on commodity and fuel prices is likely to increase and the impact on the Tongan economy could be quite adverse.

Data on employment are available only from the 2006 census, which reported a rate of unemployment of 1.1 per cent—or 4.9 per cent after adjustment to include discouraged jobseekers. As in other developing countries, in Tonga, unemployment is hidden by 'underemployment'. If 'subsistence work' is classified as unemployment, the unemployment rate jumps to 35.9 per cent. The census did confirm, however, Tonga's remarkable achievements in the area of education. School enrolment rates for ages 6–14 reached 98 per cent and the proportion of the population aged 15 years and older with a secondary education was 63 per cent.

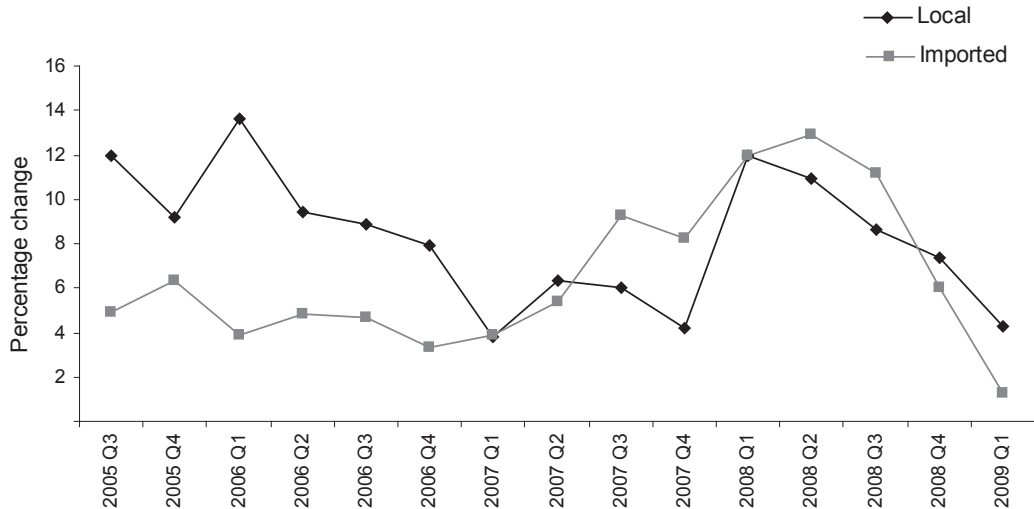
#### The external sector

The volume of imports declined in 2008, but this was more than made up for by the sharp rise in import prices. Exports—notably of squash—continued to fall and the trade deficit widened by T\$9 million (Table 1). In 2009, import prices and volumes were lower and the trade balance deficit was likely to be slightly lower for 2008/09 than in 2007/08. The National Reserve Bank of Tonga (NRBT) estimated that remittances fell by 14 per cent and tourist receipts by 5.9 per cent in the year to June 2009, but this decline was more than offset by the receipt of investment income by a private company, which should bring the current account deficit back to its 2005/06 level.

The capital account benefited from injections of capital into the commercial banks and from foreign loans. By the end of June 2009, official reserves had reached T\$136.3 million, compared with T\$89.1 million a year ago. The present level is equivalent to 5.1 months' of imports, above the three to four-month target that the NRBT has so far regarded as adequate. The bank might need to reassess its target, however, given the vulnerability of foreign exchange receipts and the expected

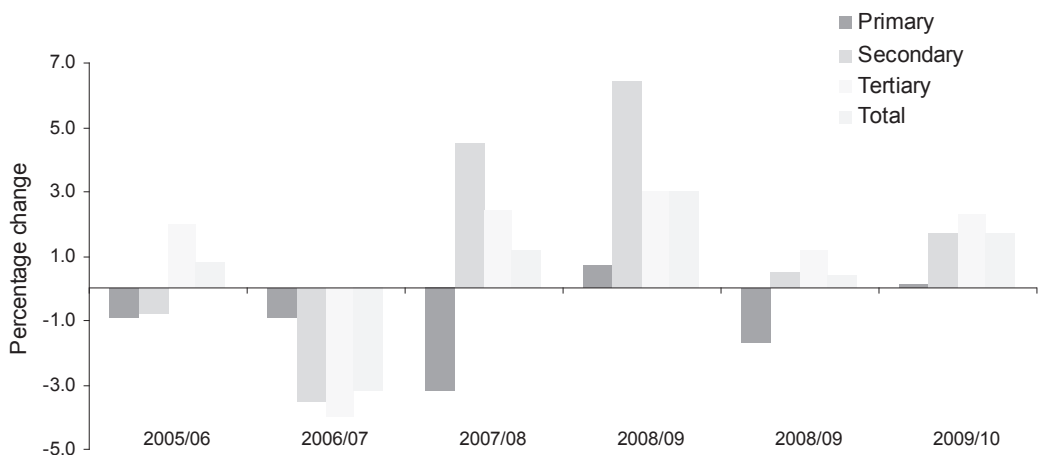
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Figure 3 Consumer price index (annual percentage change, quarterly)



Source: National Reserve Bank of Tonga (NRBT), 2009. *Quarterly Bulletin*, National Reserve Bank of Tonga, Nuku'alofa.

Figure 4 Real GDP, by sector (annual percentage change, yearly)



Sources: Ministry of Finance, 2007. *Budget Statements*, Ministry of Finance, Nuku'alofa; Ministry of Finance, 2008. *Budget Statements*, Ministry of Finance, Nuku'alofa; Ministry of Finance, 2009. *Budget Statements*, Ministry of Finance, Nuku'alofa.

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increase in imports linked to the Nuku'alofa reconstruction project.

For 2009/10, much will depend on import prices and on whether remittances and tourism recover. The new Australian seasonal worker program will help, but its net impact on remittances might be modest once transport and accommodation costs are taken into account.<sup>4</sup> The current account deficit is likely to widen because imports will increase as the Nuku'alofa reconstruction project reaches cruising speed. The large investment income receipts in 2008/09 were of a one-off nature, but the grants and loans in the pipeline will cover it easily. As long as the debt service is low and the money is used for productive purposes, Tonga's external debt position is sustainable—but the exchange rate risk is a matter of concern.

## The policy stance

### Macroeconomic policies of 2008/09

Budgetary policy has been constrained by the availability of external financing, as the capacity of the domestic market to absorb government debt is limited. The government has aimed to cover recurrent expenditure with current revenue, although this has not always been possible—notably since the wage settlement of 2005.

Total revenue (excluding grants) has trended upwards as a percentage of GDP from 2003/04, but dipped in 2008/09 (based on estimated results for that year) due to the slowdown in economic activity and higher subsidies to compensate households and some businesses for the impact of the rise in energy prices (Table 2). As for current expenditure, after the spurt in 2005/06, it has diminished as a share of GDP through 2008/09. In part, this reflects the success of the public sector redundancy program,

which aimed to offset the impact on the budget of the 2005 wage settlement. The overall balance has showed a surplus in every year except 2005/06. The surplus reached a record amount of more than T\$20 million in 2008/09 due to a large increase in grants.

Since 2002, the Ministry of Finance has undertaken important reforms in the areas of taxation and public enterprises. The aims of the taxation reform were to reduce the dependency of budget revenue on import duties,<sup>5</sup> to shift instead to a consumption tax and to excise duty adjustments, and to implement a new system of income taxation (the Income Tax Act 2007). The new act broadened the tax base, while reducing the business tax rate, and simplified the administration of income tax for government and taxpayers. Public enterprise reform has taken place through corporatisation, privatisation and improved management. Competition has also been enhanced in the communications sector by allowing a second company to operate alongside the national enterprise. The Asian Development Bank recently praised Tonga's achievements in reforming its public enterprises. The public sector Retirement Fund Board also deserves praise for combining good governance with a prudent investment policy—and for achieving satisfactory results without taking excessive risk and having relatively low administrative costs.

The NRBT's mandate is to 'maintain internal and external monetary stability [and] promote a sound and efficient financial system' (NRBT 2008). These goals appeared to be achieved at the end of 2008/09, as official reserves reached their highest level since 2004, the exchange rate was stable in effective terms, inflation was down to a very low rate and the liquidity and capital position of the banking sector were strong. This was a turbulent year, however, when inflation shot up above 12 per cent, the



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credit bubble burst, liquidity problems developed in part of the banking sector, pushing up interest rates on term deposits above 16 per cent, and non-performing loans forced banks to write off a sizeable part of their assets. Without the willingness and ability of two of the commercial banks' parents to refinance their Tongan affiliates, Tonga might have found it difficult to avoid a financial crisis. As the liquidity of the banking sector improved in the last quarter of 2008 and the beginning of 2009, the NRBT resumed the sale of its notes to mop up some of the liquidity. Throughout 2008/09, total

private sector credit growth declined by 3 per cent and lending to households showed an even greater contraction. The increase in official foreign reserves offset the decline in net domestic credit, allowing the money supply (M1) to increase by 9.5 per cent between March 2008 and March 2009.

Tonga has given up on an attempt to establish an offshore financial centre and for the financial sector is complying with the anti-money laundering and counterterrorist financing benchmarks established by the OECD-related group.

Table 1 **Balance of payments (transaction basis) (T\$ million)**

	2004/05	2005/06	2006/07	2007/08	2008/09 (9 months)
A. Merchandise trade balance	-173.1	-205.9	-190.8	-238.9	-211.4
Exports f.o.b	31.1	30.4	26.7	23.5	8.4
Imports f.o.b.	204.2	236.3	217.5	262.4	219.8
B. Service balance	-19.3	-15.6	-35.8	-6.2	-17.3
C. Investment income balance	3.1	5.7	7.1	6.4	54.5
D. Transfer balance	178.1	178.7	168.6	180.2	121.6
Receipts	208.7	205.8	187.3	203.6	137.4
Payments	30.6	27.1	18.7	23.4	15.8
E. Current account balance (A+B+C+D)	-11.1	-37.1	-50.9	-58.6	-52.6
F. Capital account balance	24.2	43.6	53.8	69.0	32.5
Official capital	9.4	16.8	19.7	22.7	-13.1
Private capital	14.9	26.7	34.2	46.2	45.7
G. Other items, net	-20.7	-5.3	5.5	-12.9	61.6
H. Overall balance (E+F+G)	-7.6	1.1	8.4	-2.5	41.5

Source: National Reserve Bank of Tonga (NRBT), 2009. *Quarterly Bulletin*, National Reserve Bank of Tonga, Nuku'alofa.

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**Policies for 2009/10**

The government's budget for 2009/10 has been prepared within the context of the *National Strategic Planning Framework* (Prime Minister's Office 2009) and with a view to alleviating the impact of the global financial crisis on the economy. It therefore provides a fiscal stimulus package consisting mainly of infrastructure investments with a high local labour content. More controversial is the inclusion in the package of a 10 per cent increase in civil service remuneration—when public sector salaries as a share of GDP are already higher in Tonga than in other Pacific island countries.<sup>6</sup> Moreover, civil servants are not the most vulnerable group in society. The raise is, however, to be accompanied by adjustments to leave arrangements and improvements in performance assessments.

Total government revenue, including grants, is projected to increase by 10.9 per cent from the expected results for 2008/09 (Table 2). Most of the change is due to a 33 per cent increase in domestic taxes on goods and services and to customs duties, while the collections from taxes on income and profits will decline by 24.5 per cent—due mainly to the reduction in the rate of corporate tax. Grants are expected to show an increase of 11.4 per cent from the estimated outcome for 2008/09—which included a large grant from China—thanks in part to the bringing forward of a grant from the ADB of US\$10 million.<sup>7</sup> Current expenditure is projected to be 20.3 per cent above the expected results for 2008/09 and capital expenditure to be 22.5 per cent lower—due to a reduction in the purchase of fixed capital assets. Overall, the budget is projected to achieve a surplus of T\$17.4 million, of which T\$12.3 million will be allocated to the repayment of debt.

The projections for revenue from the taxes on goods and services appear optimistic, however, and corporate tax collections

could fall further if bank profits suffer from continued weakness in new lending. If this proves to be the case, it could put pressure on the recurrent budget balance. An ensuing slowdown in payments for purchases of goods and services would adversely affect the private sector.

At the end of April 2009, public debt amounted to T\$208 million. The external debt component was T\$185.6 million—or 30.6 per cent of GDP—and the domestic debt component was T\$22.5 million, which was 3.7 per cent of GDP. Foreign debt is highly concessionary so that debt service payments are less than 2 per cent of GDP. Various projects—such as the Business Recovery Facility and the Private Sector Reconstruction Facility—are financed off-budget with donor funds.

With Tonga's foreign exchange reserves at a healthy level and the banking sector showing strong liquidity and capital positions, the slow growth of lending and the predicament of some debtors have received attention from the NRBT. In August, the Bank announced a halving of its reserve deposit (SRD) from 10 per cent to 5 per cent, allowing banks to reduce their lending rates. Banks have also agreed to reduce their spread on foreign exchange transactions by telegraphic transfers with a view to reducing business costs. At the same time, the NRBT noted that the reconstruction loan from China was equivalent to an increase in lending of more than 30 per cent—although spread over a couple of years and limited to the construction sector in Nuku'alofa. The second loan will raise lending even further.

The general picture is one of economic and financial stability and resilience to severe shocks, but this picture masks Tonga's vulnerability to a worsening of the international economic situation, a resurgence of inflation or donor fatigue. The political environment is another source

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of uncertainty, although it should not be viewed negatively. The debate about major constitutional changes, which, with the support of the king, could steer Tonga towards a more democratic regime, has been widely welcomed.<sup>8</sup>

The *Constitutional and Electoral Commission Act* of 2008 established a commission that delivered an interim report on 5 June 2009. The report presented the issues examined by the commission after consultation with various groups in the population and the main options available. Recommendations have been deferred until the final

report, which is due on 5 November 2009. Nationwide elections are to take place in 2010 and their procedure and significance could be affected by the adoption of the commission's recommendations.

So far, the Tongan economy does not appear to have been affected by the political debate, but it is not unreasonable to expect that the fundamental changes in the structure of government that are envisaged could have wide repercussions.

Table 2 Government revenue and expenditure (T\$ million)

	2003/04	2004/05	2005/06	2006/07	2007/08 (estimate)	2008/09 (estimate)	2009/10 (projected)
Total revenue and grants	111.0	122.1	154.5	171.1	172.2	198.5	220.1
Revenue	105.9	116.6	144.6	148.5	163.5	155.5	172.2
Grants	5.2	5.5	9.9	22.6	8.7	43.0	47.9
Total expenditure and net Lending	109.8	111.6	170.7	164.7	161.4	178.2	202.7
Current	101.7	107.9	167.0	158.5	158.8	159.2	192.6
Capital	3.9	4.3	4.6	5.6	2.6	15.2	11.8
Overall balance	1.3	10.5	-16.1	6.4	10.8	20.3	17.4
Memorandum items					Percentage of GDP		
Total revenue	22.5	23.2	25.1	24.8	25.2	22.6	-
Current expenditure	21.6	21.4	28.9	26.5	24.5	23.1	-
Overall balance	0.3	2.1	-2.8	1.1	1.7	2.9	-
GDP (in T\$ million)	470.9	503.37	577.29	597.98	649.15	688.71	-

**Sources:** International Monetary Fund (IMF), 2008. *Staff report for the 2008 Article IV consultation with Tonga*, International Monetary Fund, Washington, DC; Ministry of Finance, 2007. *Budget Statements*, Ministry of Finance, Nuku'alofa; Ministry of Finance, 2008. *Budget Statements*, Ministry of Finance, Nuku'alofa; Ministry of Finance, 2009. *Budget Statements*, Ministry of Finance, Nuku'alofa.

## Beyond resilience

### Development strategy

Notwithstanding a level of aid per capita that is among the highest in the world, and its excellent education standards, Tonga's performance in terms of economic growth, poverty reduction and exports has been disappointing. If it had not been for remittances and foreign aid, GDP per capita would have declined. There are many causes for this, including the relatively low level of investment expressed as a share of GDP, actions (or inaction) favouring the public sector and various obstacles that have been identified as standing in the way of achieving the goal pursued by the government and the major donors of sustainable, private sector-led development. Some of these obstacles have been identified in the annual surveys by the Tonga Chamber of Commerce and Industry (TCCI), although the survey questions have a short-term horizon (Box 1).

The 2009 survey results are as interesting for the issues that they raise as for those not mentioned. In the latter category are, *inter alia*, the land tenure system, the exchange rate, communications and trade barriers. It is surprising that the land tenure system, which is burdensome and discriminatory towards women, does not receive mention as a major obstacle, as it is often seen as an impediment to development.<sup>9</sup> Access to finance is mentioned by nearly half of the respondents to the TCCI survey as an impediment to business growth. This might reflect the current credit tightening as well as the longstanding difficulty for small businesses—especially in agriculture—to obtain financing. The Tonga Development Bank, which is active in this area, is run on a commercial basis and has managed to limit non-performing loans to 7 per cent of its assets. Loans to agriculture represent

30 per cent of its lending, but this share is declining and micro-financing has been launched only recently. New Zealand has sponsored a program with a NZ\$12 million grant for loans to small businesses with a two-year interest subsidy made through the commercial banks. The Civil Society Forum also provides support to small businesses, such as handicraft enterprises. There still, however, seems to be room for new specialised financial institutions, such as credit unions, especially in the outlying islands.

From a longer-term perspective, there is general agreement on the four sectors that should receive priority. The first is agriculture, because productivity gains in this sector would have the greatest beneficial impact on reducing poverty. Unfortunately, it is also the sector that has fared the worst in recent times. The second sector is tourism, in which Tonga has a comparative advantage, but has failed so far to make full use of this. Cook Islands and Vanuatu are examples of what can be achieved in this area. The third sector is fishing, because of the high elasticity of demand for seafood in the main markets and Tonga's extensive sea territory. The fourth sector, on which the success of the other three depends, is transport—by road, sea and air.

There has for some time been recognition that the costs of remoteness make it difficult for Pacific island products—especially manufactured products—to compete globally. This disadvantage led Australia and New Zealand to grant preferential access on a non-reciprocal basis to almost all manufactured products from the Pacific islands under the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA). As foreign trade became almost fully liberalised in both countries, however, the benefits from SPARTECA eroded. Instead, another promising approach, which promotes labour

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mobility, is being tried. First New Zealand, and now Australia, has adopted a program of temporary migration for seasonal workers from the Pacific islands. These programs are not, however, full substitutes for the development of the four sectors mentioned above. Moreover, they face opposition in some quarters of the host countries.

### The role of government

The Tongan government recently issued a *National Strategic Planning Framework* (Prime Minister's Office 2009), which follows the

Strategic Development Plan 8 for 2006–07 to 2008–09 and takes a five to 10-year time horizon. The framework focuses on seven priorities for which progress can be effectively monitored

- facilitate community development through the strengthening of local government
- support private-sector growth through better engagement with government, appropriate incentives and streamlining of rules and regulations

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### Box 1 Tonga Chamber of Commerce and Industry 2009 Annual Business Survey

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#### Excerpts

Question: What do you think are the biggest issues facing the Tongan economy in the next year?

Inflation and the cost of living in Tonga	61%
Infrastructure development	52%
Improvement in government services	45%
Political stability	38%
Fuel prices	25%
Meeting international export standards	22%
Maintaining law and order	17%
Other	20%

Question: What do you think are the biggest barriers to your own business growth in the next year?

Adapting to the global economic downturn	50%
Finding appropriately skilled workers	47%
Access to finance	42%
Too many taxes	38%
Finding new customers	30%
Too much time spent complying with government regulations	30%
Cost of freight	24%
Other	23%

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**Source:** Tonga Chamber of Commerce and Industry (TCCI), 2009. *Annual Business Survey*, Tonga Chamber of Commerce and Industry, Nuku'alofa.

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- facilitate continuation of constitutional reform
- maintain and develop infrastructure to improve the everyday lives of the people
- increase the performance of technical vocational education and training to meet the challenges of maintaining and developing services and infrastructure
- improve the health of the people by minimising the incidence of non-communicable diseases
- integrate environmental sustainability and climate change adaptation measures into all planning and action programs.

The framework also lists four ‘enabling themes’ on which the achievement of the above outcomes depend

- continue to progress to smaller and more efficient government to transfer resources to improved service delivery and maintenance of resources
- ensure state-owned enterprises are accountable to the government as owner
- improve the effectiveness of revenue collection to ensure a level playing field and that services to the people can be funded effectively
- ensure a more coordinated government approach to donor funding.

The objectives and the enabling themes have been well chosen. They provide an appropriate framework against which government decisions can be assessed. One might, however, wish to add the maintenance of macroeconomic and financial stability, and the government taking responsibility for ensuring that all public and private activity is respectful of Tonga’s environment and culture. The government has also announced its intention to develop renewable energy—as a contribution to

carbon emissions reduction and a way of keeping down the cost of imported fuels.

A number of the framework’s objectives provide a response to some of the concerns reflected in the TCCI survey—notably those touching on infrastructure building, vocational education and training, and the streamlining of rules and regulations. In recent discussions with representatives from the private sector, business accepted that it had the main responsibility for the development of agriculture, fishing and tourism, but stressed the need for the government to provide leadership and facilitation. The government’s role was seen to include infrastructure investment, especially for transport, and coordination and/or monitoring of various private or public initiatives—some initiated by donor countries.

Local governments were also seen as having a role to play—for example, in supporting farmers’ councils, which could promote cooperative farming. If, however, the required technical skills and funding are not available within Tonga, donors could help in mobilising and monitoring direct foreign investment—especially for large-scale projects. Tourism is an area where this approach has promise.

### The role of donors

In general, financial assistance to Tonga has aimed at helping the country progress towards achievement of the Millennium Development Goals. It has been well targeted and is reaching the grassroots level. For example, China is running demonstration farms, based on a model popular in China; Japan is training airconditioning technicians; Australia and New Zealand are meeting the expenses of the Constitutional Reform Commission and jointly fund support of the Tonga police force; and the European Union, through its Stabex program, has financed fumigation equipment for agricultural

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exports. Technical assistance is an important component of the aid programs.

Although China overwhelms other donors with the size of the grants and concessionary loans it announced recently, Australia and New Zealand have been long-time economic partners of Tonga. Australia's aid flows to Tonga will be about A\$21 million in 2009/10, of which A\$15 million is bilateral and the rest will be channelled through regional programs. The main objectives of this are economic and governance reform, private-sector development and resource management, human resource development (education, training and health), environment and infrastructure (urban waste management), and community development. New Zealand's official development assistance program with Tonga amounted to NZ\$12 million in 2008/09 and is expected to be higher this year. Its priority areas are improving governance and strengthening civil society; increasing economic opportunities in Tonga, including boosting the tourism sector and reducing youth unemployment; and improving equitable access to education. Japan has recently opened an embassy in Nuku'alofa. Its contribution could reach T\$8 million in grants for infrastructure (hospitals and schools), training and solar energy development, and it will supply a new inter-island ferry.

The ADB has played a major role in helping Tonga—financially and through technical assistance—with urban development, private-sector development, state enterprise reform and public financial management (which includes the development of a medium-term budget framework.). Together with the World Bank, Japan is undertaking a cost-benefit analysis of a renewable energy project. The World Bank is also contributing in the areas of health (hospital extension, with Japan), education (with New Zealand), agriculture and

transport. Although coordination among donors and with the government could be improved, donors have close relationships and cooperate on several projects.

The large increase in development assistance recently obtained by Tonga should not make it complacent, or too dependent, on its continuation. In particular, should progress towards a democratic political regime be aborted, there is a danger that some donors will reassess their aid programs.

### Regional cooperation

As in other regions, such as the Caribbean, where small island countries have attempted to overcome the handicaps of their size by organising common institutions and services, the islands of the South Pacific have come together for several joint ventures—the main one of which is the Pacific Islands Forum. The forum also includes Australia, New Zealand and Papua New Guinea, and it has become the main channel for cooperation among its members.

In the area of economics, the Pacific Islands Forum has sponsored various initiatives, including a free-trade area among Pacific island countries. As this was not likely to have a large impact, the emphasis shifted to trade facilitation. At the latest meeting of Pacific Islands Forum leaders on 4–5 August 2009, progress was made on an initiative for the bulk procurement of petroleum in which the Government of Tonga agreed to participate in the expectation that it would reduce fuel costs. The meeting also called for renewed efforts to manage fishing stocks and protect fisheries, and it encouraged the elaboration of projects aimed at developing renewable energy sources.

The Pacific Islands Forum leaders also agreed on a Compact for Strengthening Development Coordination in the Pacific that would require 'regular peer review of Forum island countries' national development plans to promote international best

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practice in key sectors (Pacific Islands Forum Secretariat 2009). There would, however, also seem to be scope for consolidation and harmonisation in a number of areas with a view to achieving economies of scale or to avoiding each country having to 'reinvent the wheel'. Consolidation implies the establishment of common regional services in areas such as transport, communications, tourism promotion and diplomatic representation. This requires strong political will on the part of the countries involved, since the fear of losing national sovereignty has until now been the main obstacle to the implementation of such initiatives. Harmonisation—for example, in the area of taxation—does not mean the use of the same rates for taxes in all countries, but the adoption of similar legislation and administrative procedures based on best practice. This could also apply in other areas, such as government procurement, recognition of standards and qualifications, and banking regulation and supervision.

## Conclusions

The previous survey detailed Tonga's recovery from the civil unrest of November 2006 and the oversized increase in public sector salaries of September 2005. Since then the Tongan economy has had to face three more shocks: a marked decline in remittances—equivalent to 4 per cent of GDP in 2008/09—related to the global financial crisis; the bursting of the bank credit bubble of previous years; and the surge in food, commodity and fuel prices in 2007–08. Due partly to the size of the sheltered subsistence sector in the economy, and to foreign financial assistance that supported construction activity and permitted an expansionary budget, Tonga has weathered these shocks reasonably well. Economic activity has slowed, but remained positive

in 2008/09 and will probably continue to be so in the current fiscal year, in spite of the marked slowdown in bank credit. The government's budget and the balance of payments show overall surpluses and the year-on-year rate of inflation is below 2 per cent. The effective exchange rate of the pa'anga has been stable.

Tonga's economy, however, remains vulnerable. In 2008/09 and 2009/10, it is expected that government revenue, excluding grants, will not cover current expenditure, while the balance of payments benefited last year from one-off receipts. Inflation could reappear if fuel prices continue to rise and the currencies of the main import supplier countries appreciate further. The continuing constitutional reform process—while widely welcome—could also cause delays in economic recovery. On the positive side, the large concessionary loans obtained from China and earmarked for urban construction and infrastructure will benefit the economy and the balance of payments—and they do not raise concern about the external debt situation.

Notwithstanding the relatively large flows of financial assistance it receives from donor countries and the quality of its education system, Tonga has not succeeded in attaining a sustainable rate of growth for per capita income compatible with its cultural heritage. In order for Tonga to emerge from stagnation, the government, with the help of donors, needs to mobilise the private sector in the key sectors of agriculture, fishing and tourism, and to tackle the main obstacles to development—notably, in infrastructure and transport. Renewable energy could also bring long-term benefits to the country.

Regional cooperation—within the framework of the Pacific Islands Forum—should be strengthened in terms of consolidation and harmonisation. Consolidation applies to common institutions



or services—such as the bulk purchase of fuel for which agreement in principle was reached at the recent Pacific Islands Forum meeting. Harmonisation can achieve substantial savings through the adoption of similar legislation and administrative procedures in the largest possible number of countries. No doubt Tonga can benefit from these initiatives, but the main results, in terms of poverty reduction, will come from its own efforts.

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## Notes

- <sup>1</sup> The two largest commercial banks are Westpac and ANZ. There are two smaller commercial banks—MBf Bank and the Tonga Development Bank.
- <sup>2</sup> Remittances amounted to about T\$200 million in 2007/08. A decline of 14 per cent would be equivalent to 4 per cent of GDP.
- <sup>3</sup> Assuming that T\$30 million is disbursed annually, that one-third is set aside for payments outside Tonga and that the fiscal multiplier for the remaining T\$20 million is 0.6 (ADB 2009:Annex 1), GDP would be raised by 1.7 per cent.
- <sup>4</sup> The program involved only 50 Tongan workers in 2008–09, but the number could grow to 800 over three years.

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- <sup>5</sup> This was also made necessary by Tonga's accession to the World Trade Organization in 2007.
- <sup>6</sup> In addition, the government's contribution to the retirement fund is to increase from 7.5 per cent to 10 per cent.
- <sup>7</sup> The reconstruction loan from China is treated as an off-budget item—a treatment that is unorthodox.
- <sup>8</sup> In his speech opening the Legislative Assembly on 28 May 2009, King Siaosi Tupou V stated: 'I believe that we should continue with the political reform that we have initiated.'
- <sup>9</sup> A potentially important step is the proposed Personal Property Security Bill, which would allow the use of personal property, including land, as collateral for borrowing.