

The Tonga economy 2005

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On 29 November 2005, the Pacific Policy Project of the Asia Pacific School of Economics and Government at the Australian National University held the Tonga Update 2005 at the Janfull International Dateline Hotel, Nuku'alofa. As part of the program, the Hon. Siosiu T.T. 'Utoikamanu as Acting Prime Minister presented the following overview of the Tongan economy.

The Hon. Siosiu T.T. 'Utoikamanu is the Minister of Finance in the Government of the Kingdom of Tonga.

As at June 2005, the indicators for the economy were generally encouraging. Economic growth had improved in 2004/05, largely reflecting a recovery in agricultural production and a strong growth in the construction sector. In my June 2005 Budget, I estimated GDP growth at 2.5 per cent in 2004/05, up from 1.6 per cent in 2003/04 and above the average growth rate of the past 10 years of 1.9 per cent.

The recovery in economic activity largely reflected improved exports of squash and root crops, with other produce such as kava and nonu also making small contributions. Exports of vanilla were disappointing, partly reflecting low world prices. Activity remained hampered by poor fish catches, although an easing in fish exports has been offset by increases in exports of seaweed. Construction activity is estimated to have increased by 4 per cent in 2004/05, underpinned by major non-residential building projects as well as housing construction.

Recent information suggests that initial growth projection of 2.9 per cent for 2005/06 may have to be revised downwards in light of lower than expected prices for squash exports.

Economic indicators

Prices

Inflation returned to single digits in 2004/05 for the first time in four years. Average consumer prices rose by 9.9 per cent, compared with 11.8 per cent in 2003/04. The fall in inflation largely reflected lower contributions from imported food and tobacco, the latter owing to the unwinding effects of a tax increase in late 2003. Changes to the tax system also contributed to the lower price growth. On 1 April 2005, the Port and Service Tax and Fuel Sales Tax were replaced with a consumption tax, while a government subsidy to households for electricity consumption was introduced in June 2005.

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Import prices increased by an annual average of 8.7 per cent in 2004/05, down from 15.4 per cent in 2003/04. In contrast, domestic prices rose by an annual average of 12.4 per cent, compared with a rise of 5.4 per cent in 2003/04. Headline inflation continued to fall in the first three months of 2005/06. Consumer prices rose by 7.8 per cent over the year to the September quarter 2005. This encouraging scenario, however, is likely to be undermined by events in the monetary sector.

Domestic credit

Domestic credit increased by 31 per cent in the year-ended August 2005, the fastest pace in more than 15 years. Much of the growth reflects the expansion in credit to the household sector and, more recently, the business sector. On the other hand, credit to the government sector has been negative; that is, the government is a net lender to the banking sector, which is dampening growth in overall liquidity.

Interest rates

Domestic interest rates have been relatively stable. In 2004/05, average deposit rates offered by commercial banks and non-monetary financial institutions eased slightly across most maturities, with the exception of the 30-day term deposit rate, which was unchanged at 4.9 per cent. Interest rates on deposits of greater than 30 days ranged between 5.6–6.5 per cent at the end of June 2005.

Average published lending rates of the commercial banks relating to business loans eased, with the prime rate averaging 9.4 per cent at end-June 2005, compared with 10 per cent in 2004.

The slight decline in interest rates, together with rapid credit expansion, indicates growing imbalances in terms of aggregate demand and its impact on the balance of payments.

Balance of payments

The balance of payments, as measured by the Reserve Bank's overseas transaction data, points to growing deficits relating to merchandise trade services and investment. The trade deficit has continued to widen to TOP\$173.1 million in 2004/05 compared with TOP\$140.8 million the previous year. The value of exports rose by TOP\$2.8 million to TOP\$31.1 million in 2004/05; higher export receipts from squash and seaweed more than offset a fall in export receipts from fish. The value of imports rose by TOP\$35.1 million to TOP\$204.2 million, consistent with the firm growth in private remittances and household credit over the past year.

The services and investment income balances in aggregate recorded a higher deficit of TOP\$17.7 million from 2004/05 from TOP\$6.7 million in 2003/04. An increase in net private remittances was sufficient to finance the total deficits of the balances of trade, services and investment income, resulting in a current account deficit moving from a surplus of TOP\$15.7 million in 2003/04 to a deficit of TOP\$19.9 million in 2004/05.

The capital account declined from TOP\$75.6 million to TOP\$31.7 million in 2004/05, reflecting a fall in official and private capital inflows.

The current account deficit, together with lower net capital inflows, contributed to a balance of payments deficit of TOP\$7.7 million and a fall in gross official foreign reserves. The fall in reserves would have been larger if not for a fall in unrecorded outflows.

Foreign reserves

The level of foreign reserves has fallen from its December 2004 peak of TOP\$93.4 million or 5.4 months of import cover to TOP\$81.5 million or 4.3 months worth of imports. A reserve level of 3–4 months of imports is considered by the Reserve Bank to be adequate. Yet again, this is another indicator of the growing imbalances in the economy.

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Exchange rates

With regards to exchange rates, the value of the pa'anga has been relatively stable over the past year or so. In 2004/05, the external value of the pa'anga fluctuated between US\$0.50–0.53, but moved towards the lower end of this range in the first four months of 2005/06. At the end of October 2005, the pa'anga had depreciated against the US dollar by 2.1 per cent since the end of June 2005, by 0.6 per cent against the Australian dollar and 2.7 per cent against the New Zealand dollar.

Fiscal position

In June 2005, the fiscal balance for 2004/05 was estimated at TOP\$0.7 million or 0.1 per cent of GDP. In other words, a fiscal surplus had been reported. This compares to a deficit of TOP\$10.6 million or 2 per cent of GDP in the original 2004/05 Budget. The difference stems from higher tax revenue and significantly lower expenditure than originally budgeted.

In the June 2005/06 Budget, the fiscal deficit was projected to increase to TOP\$9.2 million or 1.9 per cent of GDP, due mainly to the loan financing of capital works in the health sector.

Since September, as the Asian Development Bank report makes clear, the fiscal position has become a serious challenge for the country. Although the fiscal position has been on a sound footing in recent years, a sharp deterioration can be expected over coming years unless significant savings can be made to fund the recent civil service salary increase of about 70 per cent on average. This followed the industrial action taken by public servants in July–September 2005.

This deficit will increase markedly, depending on the financing of the salary increase. Without any offsetting cuts and/or

unbudgeted revenue increase, the deficit could increase to 5.4 per cent of GDP in 2005/06 and 9.6 per cent of GDP in 2006/07

Facing the new challenges

The projected large fiscal deficit for 2006/07, if left unmanaged in light of strong credit growth, may have adverse flow-on effects throughout the economy, triggering a balance of payments crisis, placing downward pressure on the level of foreign reserves and the exchange rate, while placing upward pressure on inflation. Without sufficient revenue sources to meet its commitments, the government may have to scale back the level of public services, exacerbating the economic and financial downturn.

Obviously the challenges to economic management outlined here were unexpected. In a number of ways, however, they did not find us completely unprepared. So my first message is that the government has already agreed on some of the next steps. To explain, I refer to the summary of our economic strategy, recently endorsed by the government as the basic framework or our response. The strategy can be represented by the policy matrix presented in Box 1.

In recent years, Tonga has made substantial progress with restoring sound and consistent macroeconomic policies, with the intention of providing the foundations for private sector-led growth. We recognised that the more predictable government policies are, the easier it is for the private sector to plan and deliver the growth in jobs and incomes that Tonga depends on for a successful future. Those foundations are threatened by recent events.

Government effectiveness is a central plank of public sector governance—government must be effective in creating a macroeconomic environment in which

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Box 1

Summary of Tonga's economic strategy

1. Review and reform public sector governance to increase transparency and accountability.
2. Stabilise the projected fiscal imbalance in 2006/07 through
 - a. amalgamation and rationalisation of the number of ministries
 - b. accelerated corporatisation
 - c. accelerated privatisation
 - d. selected asset sales
 - e. appropriate recalibration of monetary policy targets.
3. Enhance private sector-led growth through
 - a. enhanced public–private partnership ventures in education and health
 - b. reducing the cost of doing business
 - c. outsourcing selected government activities.
4. Implement 'pro-poor' policy initiatives to target selected groups of vulnerable members of the population who are seriously affected by the impact of the new pay structure on services, including unemployed youth, elderly, single-parent families, and so on.

individuals and businesses can plan their activities with a high degree of certainty. Obviously we don't control everything—we don't want to go down the path that even communist countries are abandoning, and we simply can't make the rest of the world do what we want. So we cannot provide complete certainty, but we must provide predictable and sound policies that reliably deliver results.

We also must provide the micro foundations for successful businesses—the rule of law, and fairness in its application to all.

Obviously, this way of looking at the strategic policy framework links all of the first three strategies, but the fourth strategy, namely pro-poor initiatives, is an even stronger element binding us together in our Tongan culture. The Tongan traditions of

fairness and compassion must bind us together as we cope with the tough choices and unavoidable hardships ahead. And before we can begin tackling those tasks—making adjustments and protecting the vulnerable—we must first create a shared understanding of what is the true economic situation and what implications this has for our society.

So that is my second message: good governance in these circumstances is based around a process of consensus building, so that all members of Tongan society—especially those whose voices are not often heard—share an understanding of the economic situation and its implications for the most vulnerable members of Tongan society, and an acceptance of how we must respond. Leadership in these circumstances, when there is such a large gap between

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popular beliefs and harsh realities, means bringing the people with us, not imposing something on them. And people must see that Tongan traditions of fairness and compassion are reflected in our policies.

One big challenge is achieving well-informed decision-making. This week I have arranged for the people of Tonga to be involved in addressing our economic issues in a way that has never been seen before. I will release, in the form of the Asian Development Bank report, information that the government uses to plan its budget strategy and roll forward its longer-term reforms of the economy. I personally briefed the public service heads of department last week, and yesterday morning they received a briefing from the Asian Development Bank team. Yesterday afternoon I spoke to the media. Today I am talking to you. On Thursday morning the Asian Development Bank team will be briefing representatives of our private sector, and on Thursday afternoon I will join them in briefing representatives of civil society, and discussing with them the implications for our social goals. I will then spend most of Friday with our development partners—representatives of those countries and international organisations who have worked with us over the years.

We start from some existing points of consensus. Grassroots consultation throughout Tonga as part of the Strategic Development Planning 8 process has reaffirmed that the policy matrix I outlined earlier aligns very closely with community wants and needs. Our communities see economic development, not handouts, as the way ahead. The high-level goals of the government are the high-level goals of the people.

In addition to having a clear policy framework endorsed by the Government, we start from a position in which many of the possible policy responses, including those that are outlined in the Asian Development

Bank report, are already part of our declared reform agenda.

In particular, as the Prime Minister (who is also chairman of the Public Service Commission) has announced more than once in recent years, the long-term strategy for the public sector includes substantial downsizing of public sector employee numbers. The plan was for this to be accomplished in two ways

- outsourcing or privatisation of activities better performed by the private sector
- fundamental restructuring of the public service to reduce over 30 ministries and departments to a set of around 12–15 government agencies performing core functions.

Another reason why we do not have to look around for the basic answers to the problems we have is that many other countries have faced similar problems. We can learn from both their successes and failures. This seminar is well-timed.

For example, our near neighbours and good friends in Samoa were in a similar position some years ago. The comparative perspective from the speaker from Samoa—Tuu'u Amaramo Sialoa Pagimalie (see Sialoa 2005)—will give us some insights from Samoa's past about what does and does not work in a small Pacific nation.

Perhaps the presenters from the Australian National University will also look at the different starting points and different approaches to budget adjustment and reform of public services by Australian state governments, and of course we will be particularly interested in lining up that information with the different results obtained.

I say this because it is one thing to have the basic answers, as we do, but it is quite another thing to know how best to sequence and integrate the different elements in the

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reforms, and how best to reprioritise and reconcile conflicts between different policy objectives. Already it is clear that, although some adjustments are accelerations of planned reforms, other parts require us to modify or postpone elements of our reform.

My third message is that there is still much detail to be developed. Perhaps this is highlighted by the fact that, although the Asian Development Bank team took its work as far as it reasonably could, it concluded that we still face a considerable number of unresolved questions about how to achieve fiscal savings of around TOP\$50 million next year. In fact, because some of this year's savings were temporary and cannot simply be locked in, and thus must be replaced by a genuine long-term savings next year, there are still unanswered questions even within the TOP\$30 million fiscal savings that the Asian Development Bank team suggested, as well as within the TOP\$29 million remaining required savings for which they had no specific answers.

My first three messages define the big challenges ahead: the government knows in broad terms what has to happen; the people must understand and support those actions; and, the detail is yet to be decided.

What this means is that we are going through a genuine process of engagement with the various groups within Tonga.

Therefore, my fourth and final message is that the current process of consultation with the people is real. The detail will depend on the responses.

Reference

Sialaoa, Amaramo, 2005. 'The Samoa economy 2005', *Pacific Economic Bulletin*, 20(3):1-17.