

HALF YEARLY BUDGET REVIEW 2003-2004

1.0 Introduction

This is the second half yearly budget review, outlining the performance of the economy. The review evaluates the performance of the economy during the first six months of the current financial year, 2003-04. It provides a projection for the remaining six months of the financial year and precedes the annual Budget Statement for 2004-05 to be presented to the Legislative Assembly in May. It therefore provides a platform for budget policies and strategy for 2004-05.

The first six months under review are characterized by a headline fiscal surplus of \$2.1 million compared to a budget deficit estimate for 2003-04 of \$6.6 million, increased foreign exchange reserves to 3.50 months of import coverage and an improving balance of payment situation. At the same time, the agriculture sector, which accounts for the largest share in the country's gross domestic product showed a decrease in production largely due to a significant decline in the price of squash despite an increase in the volumes exported. The contribution of rootcrops and kava were also negative with only vanilla making a positive contribution. As in 2002-03, the value of the pa'anga continued to decline against the New Zealand and Australian dollars. This contributed to rising prices in an economy highly dependent on imports. The year on year inflation rate reached 11.7 percent in December 2003 compared to 12.0 percent in December 2002.

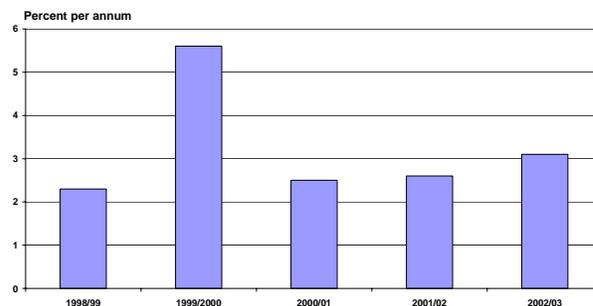
On the global economic front, the recovery has continued to strengthen and broaden. In the second half of 2003 the International Monetary Fund estimates that global GDP growth averaged nearly 6 percent at an annualized rate, the highest since late 1999. At the same time the recovery masks differences in the regional performances. The United States economy, China and Asia show the most rapid growth, while the performance of the euro area is less strong.

2.0 Performance during first six months of 2003-04 A review

2.1 Real Sector Developments

Indicators suggest that the economy performed below expectations during the first six months of the year over the same period the previous year. This was due to a combination of factors. These included unfavourable price conditions for squash exports to Japan; low catch rates by fishing companies; and subdued market conditions for commodity exports with the exception of vanilla.

GDP GROWTH RATE

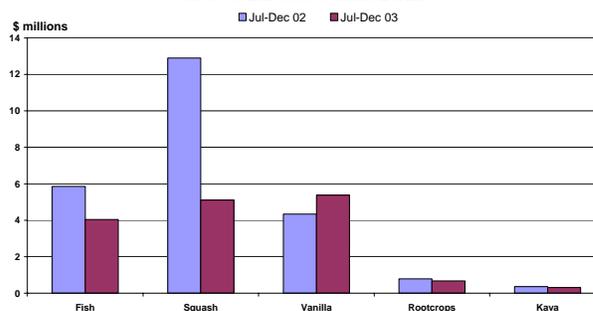


Source: Statistics Department

2.2 Agriculture

Agricultural supplies in the local markets declined in 2003 compared to 2002. It is estimated that agriculture supplies in the domestic markets declined by almost 25 percent in terms of volume and value compared to the corresponding period in 2002. Provisional data on the total volumes and value sold for the period July to December 2003 stood at 953 metric tonnes and \$1.1 million respectively.

MAJOR EXPORT COMMODITIES



The performance of export commodities has not been favourable. Squash exports increased from 18,162 metric tonnes in 2002 to 22,657 metric tonnes in 2003. The average price however declined from 71 seniti per kilo to 23 seniti per kilo in 2003 from 2002. Some growers failed to receive any proceeds from their exports. The total exports of vanilla beans during the reporting period increased to \$5.38 million compared to \$4.34 million for the same period in 2002. Increased prices were a major contributing factor to the increase. The export of root crops declined by 15.35 compared to the same period in 2002. Kava exports also declined due to also dormant prices.

2.3 Fisheries

Total exports of fish during July to December 2003 declined to \$4.04 million compared to \$5.86 million for the same period in 2002. Although the impact of El Nino weather conditions had diminished, fish catches were low due to low fish stocks brought about by over fishing. The downturn in the industry

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resulted in many fishing companies facing serious financial difficulties. An industry conference in November 2003 was initiated by the Ministry of Fisheries to coordinate efforts with the industry to overcome various obstacles affecting the industry.

2.4 Manufacturing

The performance of the manufacturing sector overall during the period July to December 2003 has been unfavourable. The sector is highly import-intensive. The high level of imported inflation and the strengthening of the currencies on Tonga's main trading partners have exacerbated the difficulties faced by the sector. The total value of intermediate imports declined by 0.3 percent during the reporting period compared to the same period in 2002.

2.5 Construction

The construction sector performed strongly in the period July to December of 2003 compared to same period in 2002. The sector is still largely dominated by and dependent upon the projects financed by external aid, although private sector activity continues to be quite strong. Lending by commercial banks for housing increased to \$47.1 million in December 2003 compared to \$38.2 million in December 2002.

2.6 Tourism

The performance of the tourism sector improved during the period under review with total air arrivals increasing by 10.2 percent to 22,300, compared to the same period in 2002. This was due to many factors including the more competitive level of the exchange rate as well as more intense competition in the industry. Tourism earnings are also estimated to have increased by 32.7 percent to \$16.5 million for the period July to December 2003 compared to the same period in 2002.

2.7 Wholesale, Retail and Distribution

The wholesale, retail and distribution sector has continued to demonstrate slow growth. The highly import intensive nature of the sector and the consequent impact of imported inflation and of the strengthening of the exchange rates of the main trading partners have been major factors. The level of activity of the largest operators in the sector appears continue to be under downward pressure. One of the major reasons for the downward pressure is the continued expansion of the informal markets, which undermine demand for the products of the operators in the formal sector.

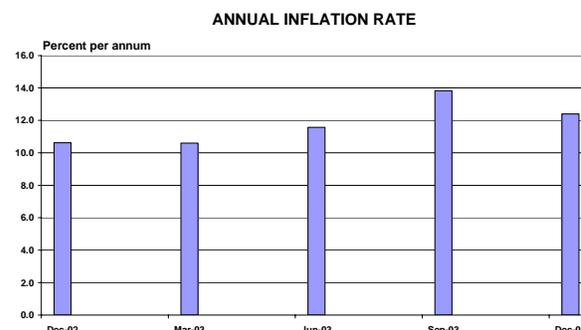
2.8 Transportation & Communication

During the period July to December 2003, intense competition in the telecommunications sector has led to the significant reduction in the costs of telecommunication services. It is anticipated that the reduction in costs will encourage a greater demand for such services. On the other hand, the possible reductions in the profit margins of telecommunications service providers are expected to lead to the need for consolidation. The limited size of the domestic market imposes constraints on the contribution by the sector to overall economic growth.

Some of the other sectors of the economy, such as tourism, also benefited from the expansion by Royal Tongan Airlines of its international services, although this benefit must be offset by the costs of servicing lease payments. Like the telecommunications sector, the limited size of the market imposes constraints on the contribution by the air transport sector to overall economic growth.

2.9 Domestic Price Developments

For the six months period of July to December 2003, the average inflation rate was 12.1 percent compared to 10.2 percent during the same period of 2002.



The high level of inflation is attributable mainly to the continuous high level of imported inflation, which reached 17.9 percent in December 2003, compared to 12.0 percent in December 2002. Domestic inflation was 0.7 percent in December 2003 compared with 13.5 percent for the same month the previous year. It is apparent that exchange rate movements have been a significant factor in the increase of the annual rate of inflation, although closer examination suggests that other factors such as increased taxes, adjustments of margins by retailers and overseas inflation are also be important factors.

3.0 Monetary Developments

Domestic credit increased by 5.6 percent from \$185.9 million at the end of December 2002 to

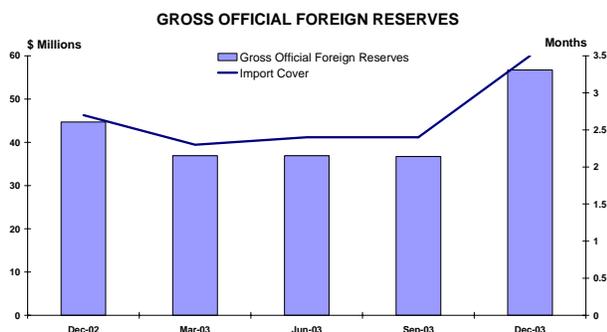
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\$196.4 million at the end of December 2003. Credit to the private sector increased by 11.4 percent, while credit to public enterprises increased by 61.1 percent. This was offset by net claims by the banking system on the government becoming negative \$16.1 million at the end of December 2003.

Nominal annual interest rates paid on savings deposits by the commercial banks remained unchanged during the first quarter of the 2003-04 financial year. Overall in real terms, (after accounting for inflation) lending rates are positive while rates paid on deposits are negative.

4.0 External Sector Development

At the end of December 2003, the level of official foreign reserves was equivalent to 3.5 months of imports, compared with 2.4 months at the end of June 2003, and 2.7 months at the end of December 2002. The improvement of the external position was due mainly to the drawdown by the government on external loans.



5.0 Public Finance

For the period under review, **total revenue and grants** amounted to \$49.8 million, or 39.8 percent of the \$124.9 million total estimated revenue for 2003-04. This level registered \$5.8 million higher than the \$44.0 million recorded for the same period last financial year. Of the total revenue, 79.1 percent was collected from tax revenue (of which 72.6 percent was customs duty), 18.3 percent from non-tax revenue and the rest were grants from donor agencies.

The efficiency of revenue collections has continued to be mixed with the collections of tax revenue being on target. On the other hand, collections from non-tax revenue (35.9 percent of budget target) such as entrepreneurial and property income, fees and charges, revolving funds, grants, and capital revenue were very low. The low collections reflect timing factors as well as apparently optimistic projections.

On the expenditure front, the government's **total expenditure** for the period under review amounted to \$47.7 million, or 36.27 percent of the \$131.5 million total estimated expenditure. In nominal terms, total expenditure increased by \$3.78 million from the \$43.92 million recorded in the same period in 2002-03. The total expenditure included additional statutory expenditure to meet payments on loans guaranteed by the government as well as emergency loans to public enterprises. The public enterprises had been unable to meet their debt service commitments. The unanticipated expenditure placed the government's cash flow position under serious strain. At the same time the government also increased its loan guarantees during the July to December period, including a loan guarantee for \$2 million for the squash export council to finance price support to growers following the 2003 season when prices fell to very low levels.

Of the total expenditure, 93.1 percent were spent on current expenditure particularly wages and salary (50.9 percent), and capital expenditure (7.1 percent).

The **fiscal position** as at the end of December 2003 registered an estimated headline surplus of \$2.1 million (in the GFS presentation). This is represented by an estimated outturn for total revenue and grants of \$49.8 million exceeding total expenditure and lending minus repayments of \$47.7 million. However, there is concern at this stage that the overall projection of a headline deficit of the order of \$6.6 million for 2003-04 as a whole will be revised upwards due to downward projections in revenue and possible higher expenditure. This is due to the steady deterioration in the condition of some public enterprises, such as Royal Tongan Airlines.

6.0 Economic Outlook

The economic outlook for 2003-04 depends very much on stability in the external markets.

Agriculture, fisheries and tourism are still considered to be the key sectors to stimulate economic growth. Their performance in the first six months had been below expectations with only tourism activities performing in line with expectations.

Poor market conditions have affected the squash industry while low catch rates have reduced the contribution by the fishing industry to overall economic growth.

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HALF YEARLY BUDGET OUT TURN

(In millions of pa'anga)	Estimate 2003-04	Provisional Jul-Dec 03/04	Actual as a % of Budgeted Target
Total revenue and grants	124.90	49.80	39.87
Total revenue	109.80	48.50	44.17
Current revenue	108.40	48.50	44.74
Tax revenue	83.10	39.40	47.41
Trade taxes	56.90	28.60	50.26
Other taxes	26.20	10.80	41.22
Nontax revenue	25.30	9.10	35.97
<i>of which: revolving funds</i>	7.20	1.50	20.83
Capital revenue	1.40	0.00	0.00
Grants (in cash)	15.10	1.30	8.61

(In millions of pa'anga)	Estimate 2003-04	Provisional Jul-Dec 03/04	Actual as a % of Budgeted Target
Total expenditure and lending minus repayments	131.50	47.70	36.27
Total expenditure	131.90	47.80	36.24
Current expenditure	113.70	44.40	39.05
Wages and salaries	52.90	22.60	42.72
Other expenditures	59.20	21.80	36.82
Additional expenditures	1.60	0.00	0.00
Capital expenditure	18.20	3.40	18.61
Total lending minus repayments	-0.40	-0.10	25.00

It is projected that the second half of 2003-04 will provide positive improvement as the tourism sector continues to show growth supported by higher remittances driven by the global recovery. The pick up in remittances should support commerce, restaurant, and hotel activities. There are signs that the fishing industry may be starting to recover.

The government's fiscal policy continues to be under significant pressure from the need to support some of its public enterprises as well as provide relief to sectors such as the squash and fishing industries, which have been hard hit by events beyond their control. The unanticipated pressure exerted by loan guarantees has placed significant pressure on the government's cash position. Both fiscal and monetary policy will need to be maintained at appropriate levels to conserve the level of foreign reserves at an acceptable level, and to curb inflation.

There is increasing concern that the government's external public debt position may be reaching unsustainable levels. Although this is not yet

apparent with debt servicing ratios remaining fairly modest, recent exchange rate movements have increased allocations for debt servicing in the budget.

Furthermore there is a need for the government to exercise greater caution in assessing new capital projects to ensure that such investments do provide a positive yield to the economy. Failure to do so may increase the pressure on the fiscal balance.