

HALF YEARLY BUDGET REVIEW 2002-2003

1.0 Introduction

The Half Yearly Budget Review presents an overview of the economy for the first six months of the current financial year 2002-03. The Review, the first of its kind, is a precursor to the annual Budget Statement for 2003-04 that is to be presented to the Legislative Assembly in June 2003. The Review evaluates the performance of the economy during this period and provides a projection for the remaining six months of the financial year. Thus, the Review provides a platform for the formulation of budget policies and the strategy for the year 2003-04, the details of which will be provided in the Budget Statement.

The first six months under review is characterized by a headline fiscal deficit of \$0.1 million compared to a budget estimate for 2002-03 of \$8.7 million, increased foreign exchange reserves to 2.7 months of import coverage and an improving balance of payment situation. The agriculture sector, which still accounts for the largest share in the country's gross domestic product showed an increase in production largely contributed to by squash, vanilla and root crops. On the other hand, the decline of pa'anga against New Zealand and Australian dollars added to the inflationary pressure in the highly import-dependent economy. The inflation rate on an annualized basis reached 12.0 percent in December 2002.

On the global economic front, there is some indication that the US economy has begun to recover from the downturn experienced during the 2001-2002 periods. However the recovery has been slower than previously anticipated. The security situation in the Middle East could also have a significant negative effect on global growth both directly and indirectly through its effects on confidence.

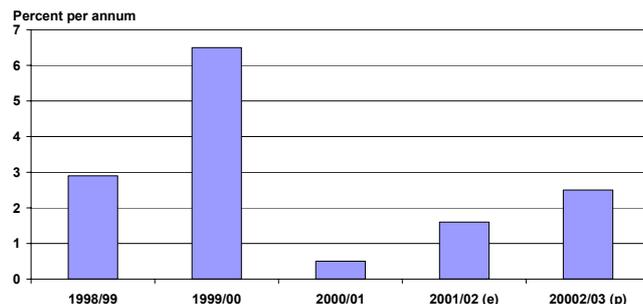
2.0 Performance during first six months of 2002-03- A review

2.1 Real Sector Developments

Indicators suggest that the economy showed only marginal growth during the first six months of the year over the same period the previous year. This was due to a large extent to factors, such as the weather, beyond the control of government policies.



GDP GROWTH RATE

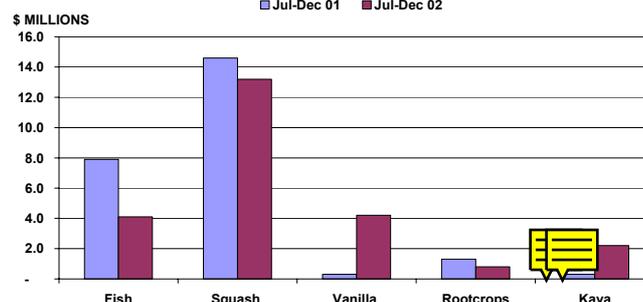


(e): estimate
(p): projection

2.2 Agriculture

Agricultural supplies in the local markets were in abundant supply throughout 2002. Provisional data on the total volumes and value sold for the period July to December 2002 stood at 1,270 metric tonnes and \$1.4 million respectively. This was relatively unchanged from the same period in 2001.

MAJOR EXPORT COMMODITIES



On the export front, provisional data from the Ministry of Labour, Commerce & Industries indicate that the volume of squash exported in 2002 had increased to 18,144 metric tonnes compared to 13,390 metric tonnes in 2001. The average price however was much lower in 2002 than 2001. Vanilla beans exports also increased during the reported period stemming from an increase in prices which reached \$46 per kilogram, the highest ever recorded in Tonga. The export of root crops continued to increase from the high level in 2001. Kava production also increased in Vava'u and 'Eua.

2.3 Fisheries

Activity in the fishing sector was hampered severely during July to December 2002 by the impact of El Niño. However, this is expected to last only until April 2003. The downturn in the industries adversely impacted the operations of some of the main export companies, with the result that one of them went into liquidation during this period.

Largely reflecting this phenomenon, fish exports were \$4.1 million during the period July to December 2002, a decline of \$3.8 million on the

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\$7.9 million earned in the corresponding period in 2001.

2.4 Manufacturing

The performance of the manufacturing sector overall during the first two quarters of 2002-03 has been stagnant compared to the same period of the previous year. At the same time, some growth was recorded in the manufacturing of food and construction materials for domestic consumption, but this was not sufficient to lift the overall performance of the sector.

2.5 Construction

The construction sector continued to perform strongly in the period July to December of 2002 compared to same period in 2001. 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.

2.6 Tourism

The performance of the tourism sector improved during the period under review with total air arrivals increasing by 9 percent to 20,234, compared to the same period the previous year. This was due to many factors including the more competitive level of the exchange rate as well as the development of the international service of the national airline.

2.7 Wholesale, Retail and Distribution

Indicators suggest that the wholesale, retail and distribution sector has not performed as well as some of the other sectors. The indicators suggest that activity among the largest operators in the sector declined in the second half of 2002 compared to the same period of the previous year. One of the major reasons for the decline is the continued expansion of the informal markets, which undermine demand for the products of the operators in the formal sector.

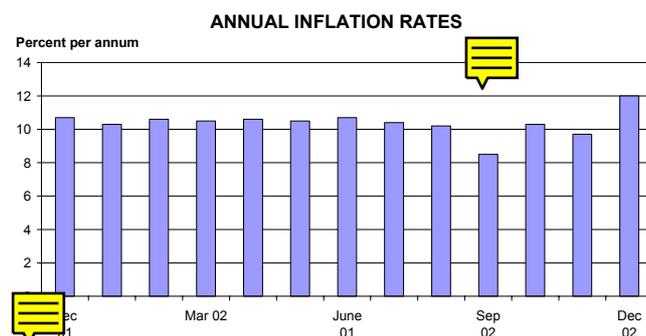
2.8 Transportation & Communication

In August 2002, the Shoreline Group commenced operations in the telecommunications sector, providing competition to the service of the government-owned Tonga Communications Corporation. The most visible impact of competition has been the significant reduction in the costs of telecommunications services. It is anticipated that the reduction in costs will encourage a greater of demand for such services. At the same time, the limited size of the domestic market may impose constraints on the contribution by the sector to overall economic growth.

Some of the other sectors of the economy such as tourism, agriculture and fisheries also benefited from the expansion by Royal Tongan Airlines of its international services through the leasing of a Boeing 757 aircraft from Royal Brunei Airlines. Shipping services have also recorded moderate growth during the reported period.

2.9 Domestic Price Developments

For the six months period of July to December 2002, the average inflation rate was 10.2 percent compared to 9.4 percent during the same period of 2001.



The chart above indicates that the high level of inflation is attributable to the continuous high level of imported inflation and fluctuations in prices in the domestic market. Food products contributed the most to the significant increases in prices by 17.2 percent, followed by clothing & footwear (19.8 percent), household operation (11.1 percent), miscellaneous goods (9.7 percent) and then transportation (5.3 percent).

3.0 Monetary Developments

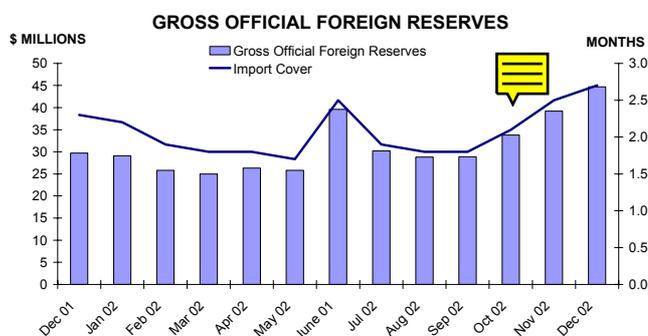
Domestic credit increased by 9.1 percent for the period July to December 2002 compared with the same period in 2001. Credit to the private sector increased by 17.1 percent, while credit to public enterprises increased by 51.3 percent. This was offset by net credit to the government declining significantly as the government became a net creditor to the banking system for the first time in many years.

Nominal annual interest rates paid on savings deposits by the commercial banks remained unchanged during the first quarter of the 2002-03 financial year. Overall in real terms, (after accounting for inflation) lending rates are positive while rates paid on deposits are negative.

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4.0 External Sector Development

At the end of December 2002, the level of official foreign reserves was equivalent to 2.7 months of imports, compared with 2.5 months at the end of June 2002, and 2.3 months at the end of December 2001.



5.0 Public Finance

For the period under review, **total revenue and grants** amounted to \$43.8 million, or 41.9 percent of the \$104.6 million total estimated revenue for 2002-03. This level registered \$1.4 million higher than the \$42.4 million recorded for the same period last financial year. Of the total revenue, 81.8 percent was collected from tax revenue (of which 74 percent was customs duty), 15.1 percent from non-tax revenue and the rest were grants from donor agencies.

The efficiency of revenue collections had been mixed with the collections of tax revenue being on target. Better collections of tax revenue reflect the efforts of the Ministry of Finance to strengthen its administrative capacity by improving compliance especially for income taxes and customs duties. The Inland Revenue Department had recovered \$2 million to \$3 million of arrears during this period. On the other hand, collections from non-tax revenue such as entrepreneurial and property income (13.8 percent of budgeted target), fees and charges (32.9 percent), revolving funds (26.1 percent), grants (16.9 percent), and capital revenue (4.8 percent) were very low. The low collections from non-tax revenue may be due to some of the receipts such as dividends from government investments and license being received in the second half of the financial year. Grants and revolving funds have always average around \$3 million to \$5 million a year hence the actual received to date is around the 50 percent mark.

On the expenditure front, the government's **total expenditure** for the period under review amounted to \$43.9 million, or 39.0 percent of the \$112.5 million total estimated expenditure. In nominal

terms, total expenditure decreased by \$0.5 million from the \$44.4 million recorded in the same period in 2001-02. The total expenditure included an additional \$2.0 million to finance the acquisition of unsubscribed shares of Royal Tongan Airlines. This amount was financed by a short-term commercial loan, while longer term financing was being explored.

Of the total expenditure, 91.3 percent were spent on current expenditure particularly wages and salary (47.4 percent), capital expenditure (2.3 percent) and lending and transfers to public enterprises (6.4 percent). It is evident from the table below that there's an improvement in the management of public expenditure, with expenditure to-date remaining within target.

The **fiscal position** as at the end of December 2002 registered an estimated headline deficit of \$0.1 million (in the GFS presentation). This is represented by an estimated outturn for total revenue and grants of \$43.8 million exceeded by the total expenditure and lending minus repayment of \$43.9 million. The small fiscal deficit highlighted the efforts by the government to tighten and improve its administration of revenue collection. However, there is concern at this stage that the overall projection of a headline deficit of the order of \$8.7 million for 2002-03 as a whole will be revised upwards due to the financing through borrowing of the additional share acquisition by the government in Royal Tongan Airlines.

6.0 Economic Outlook

The economic outlook for the rest of 2002-03 and for the next financial year 2003-04 to a large extent depends on stability in the external markets. The International Monetary Fund has predicted a more stabilized global economy through 2002-03 as major advanced economies recover from the economic downturn in 2001-02. The security situation with Iraq however, is a major threat to the global growth in particular its impact on business confidence and international oil prices.

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 mixed with agriculture and tourism activities performing in line with expectations whereas fisheries activity was dampened by the El Nino phenomenon.

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HALF YEARLY BUDGET OUT TURN

(In millions of pa'anga)	Estimate 2002-03	Provisional Jul-Dec 02/03	Actual as a % of Budgeted Target
Total revenue and grants	103,807,175	43,802,809	42.2%
Total revenue	96,356,922	42,472,487	44.1%
Current revenue	95,949,920	42,452,432	44.2%
Tax revenue	72,603,537	35,842,035	49.4%
Trade taxes	50,356,137	26,459,630	52.5%
Other taxes	22,247,400	9,382,405	42.2%
Nontax revenue	23,346,383	6,610,397	28.3%
of which: revolving funds	5,425,073	1,418,420	26.1%
Capital revenue	407,002	20,055	4.9%
Grants (in cash)	7,450,253	1,330,322	17.9%

(In millions of pa'anga)	Estimate 2002-03	Provisional Jul-Dec 02/03	Actual as a % of Budgeted Target
Total expenditure and lending minus repayments	112,544,850	43,924,600	39.0%
Total expenditure	113,181,707	41,127,428	36.3%
Current expenditure	101,933,463	40,124,151	39.3%
Wages and salaries	52,145,677	20,833,088	39.9%
Other expenditures	48,187,786	18,712,300	38.8%
Additional expenditures	1,600,000	578,763	36.1%
Capital expenditure	11,248,244	1,003,277	8.9%
Total lending minus repayments	(636,857)	2,797,172	539.21%

It is projected that the second half of 2002-03 will provide positive improvement as the fisheries sector recovers and a pick up in the commerce, restaurants, and hotels activities as the tourism sector shows additional strength. The real GDP growth rate is still expected in the order of 2.5 percent.

The government's fiscal policy is under significant pressure from the need to support some of its public enterprises. This in turn has serious implications for actions needed to ameliorate continued upward inflationary pressures and further downward pressure on the international reserves. 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 reduce upward pressures on inflation.

The ability of the Tongan economy to rebound from natural and economic shocks is crucial if the economy is to rise from the downturn it currently experienced in the short and medium term. The success in meeting this recovery objective will depend in a large part on the success of the government's effort through the Economic and Public Sector Reform Program that targets efficient public services, minimizing administrative regulations, strengthen fiscal and financial mechanisms and freeing up of sufficient resources for private sector development.

