INTERNATIONAL MONETARY FUND

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TONGA

February 2021

2020 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TONGA

In the context of the 2020 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 25, 2021 consideration of the staff report on issues related to the Article IV Consultation.
- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 25, 2021 following discussions that ended on November 20, 2020 with the officials of Tonga on economic developments and policies underpinning the IMF disbursement under the Rapid Credit Facility. Based on information available at the time of these discussions, the staff report was completed on December 18, 2020.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Tonga.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Washington, D.C.

PRESS RELEASE

PR21/30

IMF Executive Board Concludes 2020 Article IV Consultation with Tonga

FOR IMMEDIATE RELEASE

Washington, DC – February 1, 2021: On January 25, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tonga.

Tonga's slow recovery from the devastating 2018 Tropical Cyclone Gita has been derailed by twin shocks from the Covid-19 pandemic and Cyclone Harold. Proactive and timely actions, including the early closure of external borders and prompt economic support, have helped avoid a worse economic outcome and there are no recorded COVID-19 cases in Tonga to date. Nevertheless, FY2020 GDP (ending June 2020) is expected to contract by 2½ percent, followed by a further contraction of 3½ percent in FY2021, as Tonga's peak tourism season gets underway while borders remain closed and reconstruction efforts continue to be delayed. The latter has led to record high international reserves as delayed aid-spending resulted in import compression. Nevertheless, external balances are expected to deteriorate, as declines in tourism and remittance inflows, and higher pandemic- and reconstruction-related imports are expected to worsen the current account deficit, sharply reducing reserves in FY2021. Notwithstanding the pandemic, fiscal consolidation continued through FY2020 as a result of donor support and investment delays. However, a fiscal deficit is unavoidable in FY2021 given the need to support the economy and healthcare through the pandemic. Given limited fiscal buffers and urgent balance of payments needs, Tonga has requested IMF financial assistance under the Rapid Credit Facility. While monetary stability has been maintained and inflation is expected to remain low, financial sector risks are elevated even though banks are still profitable and well capitalized.

The medium-term outlook is modest and fragile. Tonga's growth potential is low due to its heavy reliance on labor exports, and the pandemic has worsened pre-existing vulnerabilities. A weaker global recovery that weighs on exports, aid, and remittances, and further disruptions in correspondent banking relations pose significant downside risks, as does the possibility of a local outbreak. Tonga is highly vulnerable to natural disasters and is at a high risk of external debt distress. Large external debt repayments come due starting in 2024, while current account deficits are also likely to remain large, reflecting persistently weak export competitiveness and heavy import dependence, a pickup in reconstruction and the implementation of delayed climate-resilient infrastructure investments. Together, these forces are likely to reduce international reserves below desirable levels in the medium-term.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors commended the authorities for their swift actions to prevent a local outbreak of the pandemic, and for prudent policy management, which has preserved macro-financial stability. Directors noted that the global pandemic and recent natural disasters have amplified the already weak economic growth, worsened fiscal and external balances, and added pressure on debt sustainability. The medium-term outlook remains fragile, with low growth potential and sizable financing needs. Given Tonga's high risk of debt distress, Directors underscored the importance of post-pandemic fiscal adjustment and continued financial support from the international community, including through grants and debt relief, as well as technical assistance from the Fund.

Directors agreed that fiscal policy should continue to support the economy through the pandemic, while improving the targeting of measures and safeguarding priority spending on an effective vaccine rollout, healthcare, infrastructure maintenance, and investment. They emphasized that, once the recovery is underway, high-quality fiscal adjustment will be needed to stabilize debt dynamics and strengthen climate resilience. They recommended broadening the tax base, enhancing spending efficiency, and expanding the social protection system. Directors also encouraged the authorities to improve public financial management, debt management strategies, and transparency and governance in government operations.

Directors welcomed the continued monetary policy support, given low inflation. They noted that, while banks are still profitable and well-capitalized, financial sector risks are rising, given the prospects for deteriorating credit quality and the withdrawal of correspondent banking relationships. This calls for stronger financial sector supervision, including by strengthening stress testing and the monitoring of household debt. Directors also encouraged establishing a macroprudential framework and enhancing the AML/CFT framework.

Directors stressed the need to promote private sector growth through structural reforms, prioritizing measures to enhance the business environment, climate resilience, and productivity. In this regard, they encouraged improving land market operations, strengthening female labor force participation, enacting an insolvency law, and deregulating protected sectors.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Table 1. Tonga: Selected Economic Indicators, FY2018 -FY2023[1]

Population (2019): 104 thousands
GDP per capita FY2018 (thousands of US$): 4.9
Key export markets: Australia, Japan, New Zealand, and United States
Major exports: root crops, vanilla, squash, fish
Quota: SDR 13.8 million

		Est.	Projections			
	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Output and prices			(Annual percent change)			
Real GDP[2]	0.3	0.7	-2.5	-3.5	4.0	3.0
Consumer prices (period average)[3]	6.8	3.3	0.2	-0.9	2.1	2.0
Consumer prices (end of period)[3]	6.7	-0.1	-1.4	1.8	2.4	1.6
GDP deflator	5.1	7.7	0.4	-0.9	2.1	2.0
Central government finance			(In percent of GDP)			
Total Revenue	42.6	41.7	45.7	45.7	42.0	44.4
Revenue (excluding grants)	24.8	23.4	24.7	22.9	23.9	24.3
Grants	17.8	18.3	21.0	22.9	18.1	20.1
Total Expenditure	39.7	38.5	41.3	50.6	42.3	43.4
Expense	31.4	30.3	35.4	44.4	35.6	34.9
Transactions in Nonfinancial Assets (Net)	8.3	8.3	5.9	6.2	6.7	8.5
Overall balance	2.9	3.2	4.4	-4.8	-0.3	1.0
Net Acquisition of Financial Assets	2.4	2.0	5.1	-1.8	0.5	1.3
External financing (net)	-0.6	-1.2	-0.5	1.6	-1.4	-1.7
Domestic financing (net)	0.1	0.0	1.1	1.4	2.2	2.0
Money and credit			(Annual percent change)			
Total liquidity (M3)	7.6	4.3	1.2	-8.9	10.6	7.7
Of which: Broad money (M2)	9.4	3.5	1.1	-9.4	11.1	8.0
Domestic credit	-6.5	6.0	-15.7	4.0	18.4	12.0
Of which: Private sector credit	6.7	7.6	1.1	0.7	3.4	3.9
Interest rates (end of period)						
Average deposit rate	2.3	2.3	2.3	...	...	...
Average lending rate	8.5	8.2	8.1	...	...	...
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	14.2	15.8	18.3	14.4	17.7	19.0
Imports, f.o.b.	215.3	223.3	213.7	208.2	234.6	246.7
Services balance	-15.0	-9.3	-20.9	-88.2	-29.7	-36.3
Investment income balance	26.4	39.9	42.2	14.7	27.4	34.6
Transfers balance	158.9	172.4	154.4	181.3	168.7	182.6
Of which: Remittances	137.1	141.6	144.9	113.8	122.4	128.0
Of which: Official grants	28.8	45.3	20.3	84.3	64.2	73.4
Current account balance	-30.7	-4.4	-19.6	-85.9	-50.5	-46.9
(In percent of GDP)	-6.3	-0.9	-3.9	-17.5	-9.6	-8.5
Overall balance	22.7	-2.1	29.1	-64.7	-23.2	-21.4
(In percent of GDP)	4.7	-0.4	5.8	-13.2	-4.4	-3.9
Terms of trade (annual percent change)	-2.5	0.2	0.1	-0.5	0.6	0.4
Gross official foreign reserves						
In millions of U.S. dollars	214.9	212.8	241.9	192.3	169.1	147.7
(In months of next year's total imports)	7.8	8.2	9.6	6.7	5.5	4.7
Debt (in percent of GDP)						
Public debt (external and domestic)	45.9	41.3	42.3	46.3	44.6	42.7
Of which: External debt	40.5	36.4	36.2	38.5	35.1	31.6
External debt service ratio	1.2	1.7	1.5	2.0	1.8	2.0
Exchange rates						
Nominal effective exchange rate (2005=100)	93.5	94.6	93.4	...	...	...
Real effective exchange rate (2005=100)	101.8	102.4	99.9	...	...	...
Memorandum items:						
Remittances (in percent of GDP)	28.2	27.4	28.7	23.2	23.3	23.2
Tourism (in percent of GDP)	9.0	9.2	7.4	0.4	7.3	7.5
FDI (in percent of GDP)	4.9	0.1	0.7	0.9	0.9	0.8
Nominal GDP (millions of US$)	485.9	516.8	504.1	491.0	526.1	551.9
GDP Growth 2018 - 2023 (Calendar Year Basis)	0.5	-0.9	-3.0	0.2	3.5	2.8

Sources: Tonga authorities; and IMF staff estimates and projections.
[1]Fiscal year beginning July.
[2]Including preliminary data.
[3]CPI basket and methodology changed in September 2018.

PRESS RELEASE

PR21/22

IMF Executive Board Approves a US$9.95 Million Disbursement to Tonga

FOR IMMEDIATE RELEASE

- *The COVID-19 pandemic and the 2020 Cyclone Harold are taking a heavy toll on Tonga's economy, derailing the slow recovery from the devastating 2018 tropical Cyclone Gita.*
- *The IMF Executive Board approved the disbursement of US$9.95 million in emergency financing to help Tonga meet its urgent balance of payments and fiscal needs arising due to economic and healthcare support necessary to cope with the pandemic.*
- *The authorities are taking strong policy actions to address the pandemic. Continued support from donors, particularly through budget grants and debt relief, will be critical to help Tonga navigate the pandemic and meet its development and climate-resilience needs.*

Washington, DC – January 25, 2020: The Executive Board of the International Monetary Fund (IMF) today approved the disbursement of SDR 6.9 million (about US$9.95 million or 50 percent of quota) under the Rapid Credit Facility (RCF)[1] to Tonga to help meet its urgent balance of payments and fiscal needs arising due to the COVID-19 pandemic and Cyclone Harold.

At the conclusion of the Executive Board's discussion, Mr. Tao Zhang, Chair and Deputy Managing Director issued the following Statement:

"Tonga's slow recovery from the devastating 2018 Tropical Cyclone Gita has been derailed by twin shocks from the Covid-19 pandemic and Cyclone Harold. Early closure of external borders and prompt economic support have helped avoid a worse economic outcome. Nevertheless, an economic contraction is expected in FY2021. A sudden stop of tourist arrivals and higher pandemic- and reconstruction-related imports are expected to generate a large external financing gap. Fund assistance under the Rapid Credit Facility is intended to help Tonga cope with its immediate balance-of-payments and budget financing needs and to catalyze critical donor support for the recovery.

"Macroeconomic and financial stability has been maintained despite the difficult circumstances. A series of budget surpluses, low inflation, adequate bank capital buffers, and ongoing efforts to improve financial supervision have demonstrated the authorities' commitment in this regard. In response to the pandemic, the authorities have put together a strong policy package, with fiscal support for health care and affected businesses and households, and provision of liquidity to the financial sector. The authorities are committed to enhancing the AML/CFT framework and are considering developing macroprudential tools.

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[1] The RCF provides rapid financial support in a single, up-front payout for low-income countries facing urgent financing needs. Financial assistance under the RCF is provided as an outright disbursement to Poverty Reduction and Growth Trust (PRGT)-eligible members that face an urgent balance of payments need, and where a full-fledged economic program is either not necessary or not feasible. Financing under the RCF carries a zero interest rate, a grace period of 5½ years, and a final maturity of 10 years.

"Post-pandemic, high-quality fiscal adjustment will be important to ensure debt sustainability while achieving climate and development goals. Continued efforts are needed to broaden the tax base, improve spending efficiency and the targeting of fiscal support, strengthen transparency and accountability in public financial management, and ensure effective debt management strategies. Financial supervision warrants further improvements in light of rising risks to financial stability.

"Over the medium term, structural reforms to promote private sector-led growth will help Tonga meet fiscal and development challenges. Continued support from the international community, through grant financing and debt relief, would be essential."

INTERNATIONAL MONETARY FUND

TONGA

December 18, 2020

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY

EXECUTIVE SUMMARY

Tonga's recovery following the devastation of the 2018 Cyclone Gita has been derailed by a double blow from the pandemic and Cyclone Harold. FY2020 GDP growth is estimated to fall to -2½ percent due to domestic containment measures, a sudden stop in tourism, and investment delays. The full brunt of the pandemic will be felt in FY2021 (beginning July) during peak tourism season, when a deeper contraction is expected. A worse outcome was avoided by early actions to close external borders—which has kept Tonga COVID-19-free—and prompt economic support. Beyond FY2021, the recovery is expected to resume in line with the global recovery, but the magnitude and trajectory is uncertain.

Given limited fiscal buffers and urgent balance of payments needs, Tonga has requested IMF financial assistance under the Rapid Credit Facility. The drop in tourism and higher imports related to COVID-19, along with post-cyclone reconstruction, are expected to reduce international reserves and generate a large financing gap. At 6.9 million SDR (50 percent of IMF quota and 10 percent of external funding needs), the emergency assistance, along with funding from other international partners, would help Tonga weather the shock while its borders remain closed, while leaving room for further borrowing should Tonga be hit by another natural disaster.

The medium-term outlook is fragile. Tonga's growth potential is low due to its heavy reliance on labor exports, and the pandemic has worsened pre-existing vulnerabilities. A weaker global recovery that tempers exports, aid, and remittances, or a local outbreak, poses downside risks. So does Tonga's high vulnerability to natural disasters and a high risk of external debt distress. Weak competitiveness, high import-dependence, and large impending debt repayments are likely to reduce international reserves below desirable levels in the medium-term.

Post-pandemic, higher-quality budget surpluses will be needed. After five years of budget surpluses helped by donor grants, the FY2021 budget balance will swing into a deficit due to a weak economy, containment costs, and support measures. Supporting the economy through the pandemic and achieving climate and development goals, while ensuring debt sustainability, is a daunting task. Aided by new donor grants, fiscal

adjustment of 2½−3 percent of GDP is needed, and could be achievable, over FY2022−24 once the pandemic is over. This could be achieved through better targeted fiscal support, tax base broadening, stricter current spending controls, strengthened capacity, and continued improvements in revenue collection, governance, and public financial management. Spending related to health (including vaccines), infrastructure and maintenance should be prioritized. More donor grants and debt relief could help the government meet its policy goals faster, provided implementation capacity is improved.

Monetary policy support should continue and financial supervision improvements accelerated. Though banks are still profitable and well-capitalized, financial sector risks are rising. Additional provisioning and a capital boost may be required in some banks. The priorities are to strengthen stress testing, monitor household debt, establish a macroprudential framework, improve supervision of nonbank financial intermediaries, strengthen regulations (insolvency and insurance), and enhance the AML/CFT framework and enforcement.

A more durable solution to addressing Tonga's fiscal, external, and development challenges is to grow the private sector. The main priorities are to: improve land market operations; strengthen female labor force participation; and increase business formation by investing in climate-resilience, enacting an insolvency law, deregulating investments, and strengthening financial literacy while lowering credit costs.

Approved By
Ranil Salgado and Geremia Palomba

Article IV discussions were held in Nuku'alofa, Tonga (February 10–20, 2020), which overlapped with an IMF-World Bank Climate Change Policy Assessment mission, led by James Daniel (FAD). Staff conclusions were published at the end of the mission (https://www.imf.org/en/News/Articles/2020/02/25/mcs022520-tongo-staff-concluding-statement-imf-2020-article-iv-consultation-mission). A remote mission (November 9–20, 2020) held discussions regarding a request for disbursement under the Rapid Credit Facility and concluded the 2020 Article IV consultation. The IMF team that visited Tonga comprised Angana Banerji (Head), Yun He, and Charlotte Sandoz (all APD), and Analisa Ribeiro Bala (SEC). Discussions in November 2020 were conducted by an IMF team comprising Angana Banerji (Head), Yinqiu Lu, Mouhamadou Sy (all APD), Analisa Ribeiro Bala (SEC) and Torsten Wezel (MCM). Piyaporn Sodsriwiboon, Jeanne Verrier (both APD), Aleksandra Zdzienicka (FAD) and Andrew Blackman (World Bank) provided important contributions, and the report draws on the IMF-World Bank CCPA Report (June 2020). Ricardo Davico, Yadian Chen, and Francis Landicho (APD) provided excellent research and editorial assistance respectively for the preparation of this report.

CONTENTS

FIGURES

TABLES

ANNEXES

APPENDIX

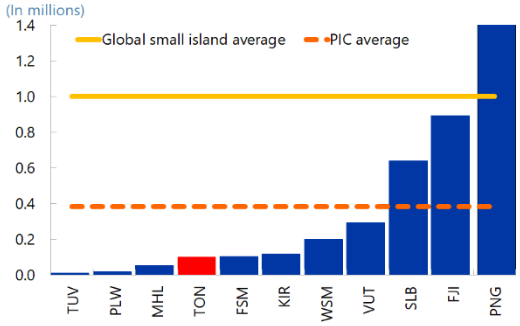
Acronyms

ADB	Asian Development Bank
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
APG	Asia Pacific Group on Money Laundering
CBR	Correspondent Banking Relationships
CCPA	IMF-World Bank Climate Change Policy Assessment
CT	Consumption Tax
CIT	Corporate Income Tax
DSSI	G20 Debt Service Suspension Initiative
GDL	Government Development Loan
HTS	Heilala Tax System
ICT	Information and Communications Technology
KYC	Know Your Customer
LTO	Large Taxpayers Office
MNC	Multinational Corporations
MOF	Ministry of Finance
MORC	Ministry of Revenue and Customs
MSME	Micro, Small and Medium Enterprises
MTO	Money Transfer Operators
NBFI	Nonbank Financial Intermediaries
NCD	Non Communicable Diseases
NIM	Net Interest Margins
NPL	Non-Performing Loans
NRBT	National Reserve Bank of Tonga
PACER Plus	The Pacific Agreement on Closer Economic Relations
PEFFA	Public Expenditure and Financial Accountability Assessment
PFM	Public Financial Management
PIC	Pacific Island Countries
PIT	Personal Income Tax
RCF	IMF's Rapid Credit Facility
SDG	Sustainability Development Goals
SWP	Seasonal Worker Program
TA	Technical Assistance
TC	Tropical Cyclone
TSDFII	Tonga Strategic Development Framework 2015–2025
TVET	Technical and Vocational Education and Training
WB	World Bank

CONTEXT: CAUGHT IN A LOW-GROWTH EQUILIBRIUM

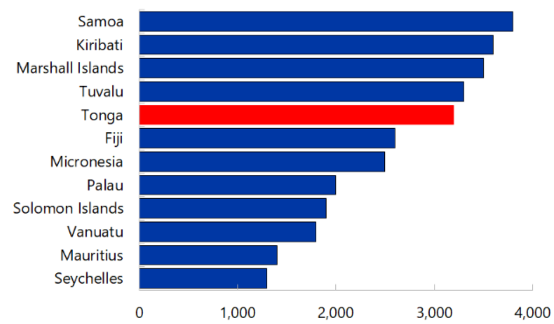
1. **Tonga's growth potential has been constrained by its natural endowments**, prior to the pandemic. A middle-income country, Tonga has been growing well below the regional average for two decades. Economic activity is hampered by remoteness, leading to structurally high production costs, a narrow production base and low economies of scale. Tonga is also highly prone to natural disasters (Figure) which exact large economic costs and sets back growth potential by destroying infrastructure and agricultural land. For instance, the 2018 Cyclone Gita wrought massive devastation (38 percent of GDP), from which Tonga is yet to fully recover.[1]

Tonga is Sparsely Populated.
PICs: Population, 2019
(In millions)



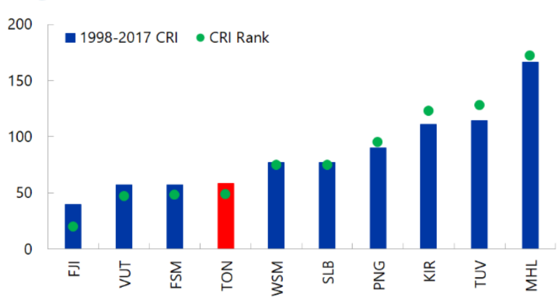
Sources: Tonga authorities and IMF staff estimates.

Tonga is Remote.
PICs: Distance to Closest Continent



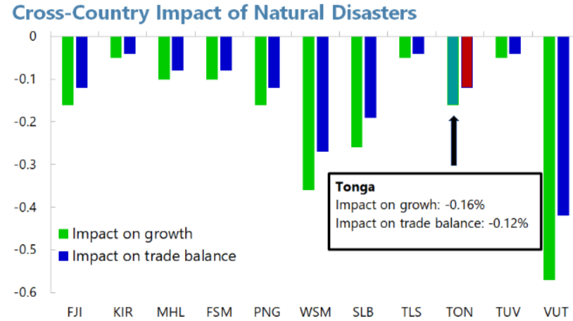
Sources: Google Earth and IMF staff estimates.

Tonga is at High-Risk from Natural Disasters.
Long-Term Climate Risk Index for Pacific Island Countries



Source: Global Climate Risk Index 2019 and IMF Staff estimates.
Note: Countries with lower CRI scores are more impacted, a lower index value indicates higher risk.

Natural Disasters are Costly for Tonga.
Cross-Country Impact of Natural Disasters



Source: D. Lee, H. Zhang, and C. Nguyen, The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness, IMF Working Paper WP/18/108.
Note: Estimates measure average annual impact of natural disasters.

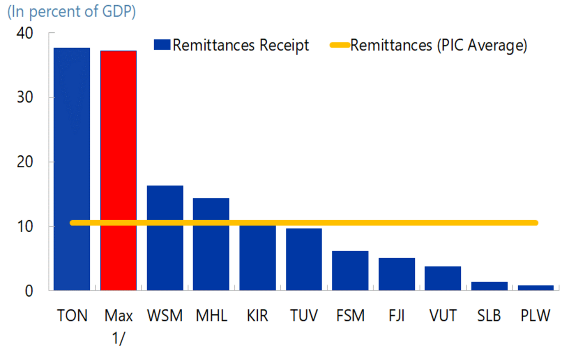
2. **Moreover, Tonga's growth model—heavily reliant on labor exports—is unsustainable**. Tonga is the world's largest recipient of remittances (Figure), reflecting large-scale migration of Tongans to Australia, New Zealand, and the United States (remitting countries) and seasonal worker programs (SWPs) which have expanded over time. However, remittances are a mixed blessing.

[1] Tonga's fiscal year runs from July 1–June 30.

- Remittances have helped reduce poverty, buttress the effects of natural disasters, and finance Tonga's heavy import-dependence. They also provide liquidity to the financial sector and mitigate NPLs in the event of economic shocks. Indeed, the resilience of remittances so far helped support aggregate demand and international reserves during the pandemic.

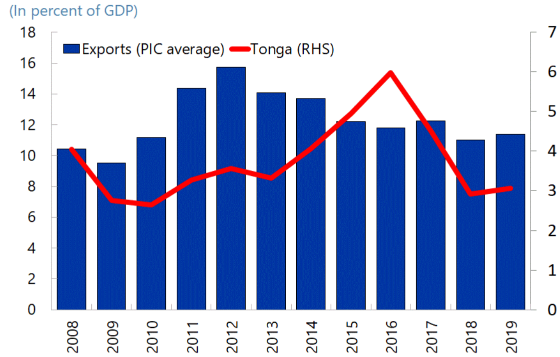
- However, remittances are helping to keep the economy caught in a low-growth equilibrium.[2] Tonga reservation wages are high, reflecting a significant wage differential with remitting countries.[3] High reservation wages reduce incentives to enhance skills and enter the workforce. They increase turnover, limiting public sector capacity and business formation, helping to keep the production base narrow, agrarian, and informal by constraining economic and financial diversification and the relative growth of the tradeable sector vis-à-vis the non-tradeable sector. Relative to peers, Tonga's export shares has been steadily declining recently, reflecting deteriorating competitiveness (Figure). A lack of workers also affects reconstruction and agricultural production, as evident from the boost to agriculture and construction during the pandemic due to a halt in SWPs. Remittances are also cyclical and dependent on the economic strength of remitting countries. They can be disrupted unless the AML/CFT framework is substantially strengthened.

Pacific Island Countries: Remittances, 2019
(In percent of GDP)



Sources: Tonga authorities, Migration and Remittances Database, World Bank and IMF staff estimates.
1/ World maxmium excluding Tonga (Haiti).

Pacific Island Countries: Exports (2019)
(In percent of GDP)



Sources: IMF, World Economic Outlook database and IMF staff estimates.

3. The above constraints are aggravated by the impact of the pandemic and policies. Deterrents to growing the formal private sector limit economic opportunities that could slow the labor exodus. As a result, while an emphasis on climate-resilience has increased Tonga's capital stock, its labor force remains virtually stagnant despite high birth rates. Moreover, social and economic limitations on the ability of women (the more skilled section of the labor force) to contribute effectively to the economy, even as the country loses its male workers to emigration or SWPs, hurts growth.

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[2] Cross-country evidence suggests that economies receiving high levels of remittances tend to get trapped in a lower-growth, high emigration equilibrium (Barajas and others, 2009; Chami and others, 2018 a and b).

[3] The lowest annual salary in Tonga's public sector, the largest share of the formal sector, is US$1½ per hour compared to minimum wages in the three remitting countries (ranging between US$7¼ –13½).

4. Political commitment to economic stability and private sector-led growth remains strong. Following the 2010 constitutional reform, the first elected government came to power in 2014. Their reform agenda—enshrined in the TSDFII—focuses on building an inclusive, sustainable and knowledge-based economy, emphasizing development; gender equality; good-governance; climate-resilience; provision and maintenance of infrastructure and technology; and effective land administration and environment management (Figure). The new government sworn in in late-2019 has reduced political tensions, and its commitment to economic reform is widely perceived to be strong. The government has demonstrated strong commitment to fiscal consolidation by achieving a string of budget surpluses with donor support, albeit with some weaknesses in underlying policies (Annex I). Monetary, exchange rate and financial stability have been maintained (Annex I).

SDGs Mapped to Tonga's Strategic Development Framework (2015-2025)

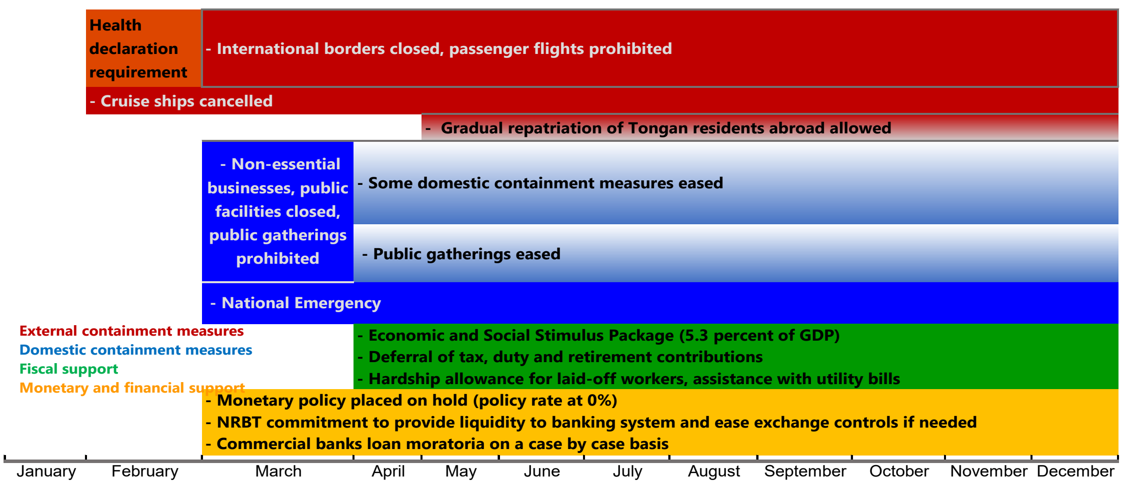
Priority Areas	Select Tongan Outcomes	Corresponding SDGs	
1.Economic Institutions	1. Improved macroeconomic management and stability with deeper financial markets	8. Decent Work & Economic Growth	10. Reduced Inequalities
		16. Peace, Justice, and Strong Institutions	
	2. Closer public/private partnership	17. Partnerships for the Goals	
	3. Improved public enterprise performance	9. Industry, Innovation, and Infrastructure	17. Partnerships for the Goals
	4. Better access to, and use of overseas trade and employment, and foreign investment	8. Decent Work & Economic Growth	
	5. Participation of private sector in development enhanced	9. Industry, Innovation, and Infrastructure	
2. Social Institutions	6. Improved collaboration with, and support to CSOs	11. Sustainable Cities and Communities	
	7. Improved education and training providing lifetime learning	4. Quality Education	5. Gender Equality
	8. Improved health care and delivery systems (universal health coverage)	3. Good Health and Well-being	
	9. Improved collaboration with the Tongan diaspora	17. Partnerships for the Goals	
	10. Better care and support for vulnerable people, in particular the disabled	1. No Poverty	2. Zero Hunger
		3. Good Health and Well-being	
3. Infrastructure and Technology	11. More reliable, safe and affordable energy services	7. Affordable and clean energy	13. Climate Action
	12. 11. More reliable, safe and affordable transport services	9. Industry, Innovation, and Infrastructure	13. Climate Action
	13. 11. More reliable, safe, affordable and innovative ICT	9. Industry, Innovation, and Infrastructure	
	14. 11. More reliable, safe and affordable water supply and sanitation services	6. Clean Water and Sanitation	14. Life Below Water
4. Natural Resources and Environment	15. Improved land use planning, administration and management for private and public spaces	11. Sustainable Cities and Communities	15. Life on Land
	16. Improved use of natural resources and a cleaner environment with improved waste recycling	12. Responsible Consumption and Production	13. Climate Action
	17. Improved resilience to extreme natural events and impact of climate change	13. Climate Action	

Source: Tonga's Voluntary National Review 2019

FY2020: AN INTERRUPTED RECOVERY

5. **A mild recovery from Cyclone Gita was derailed by a double blow from COVID-19 and Cyclone Harold.** The post-Gita recovery was largely based on reconstruction supported by remittances and government consumption. Private consumption and agricultural exports—typically major contributors to GDP—remained weak due to highly leveraged households and a loss of market share following cyclone-related damages. Growth was expected to gather speed in FY2020 due to continued growth in tourism and reconstruction. Instead, Tonga was faced with a global pandemic to which its population is highly vulnerable given a high incidence of noncommunicable diseases (NCDs). Learning from the experience with a measles outbreak in Samoa and Tonga in late-2019, the government acted quickly and proactively to contain the pandemic (Figure). Timely actions staved off a calamitous outcome, and Tonga remains COVID-free to date. While under lockdown, Tonga was hit by a Category 4 Cyclone Harold in April 2020, which destroyed public infrastructure and tourism facilities.

Measures to Address the Pandemic, 2020

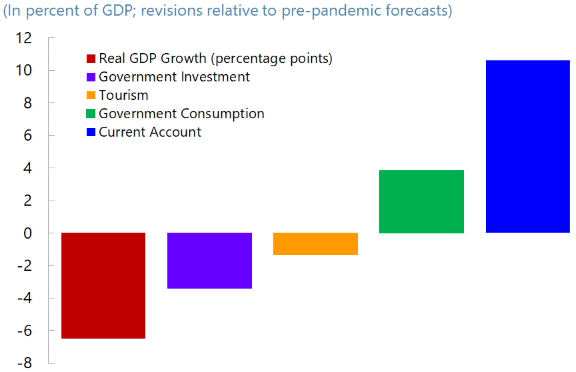


Sources: Tonga authorities.

6. **The economy is now expected to have contracted in FY2020** (Figure)**.** Domestic containment measures, economic uncertainty, a halt in SWPs and tourism, have weighed on consumption, the mainstay of the economy. International travel restrictions and the departure of external experts, the lack of domestic capacity, and lockdown have further delayed donor-funded public infrastructure projects (Tables 1–4, Figures 1-4). A deeper contraction was avoided by prompt government support to hard-hit

Tonga: Growth Forecast Revisions, FY2020

(In percent of GDP; revisions relative to pre-pandemic forecasts)

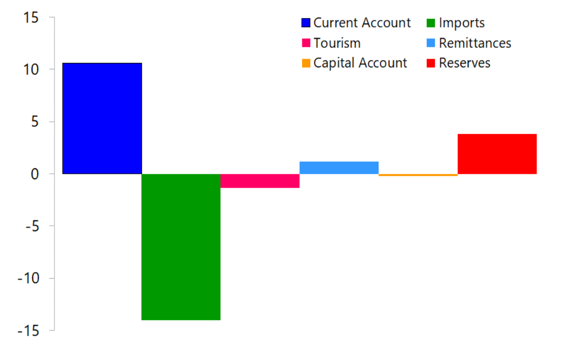


Sources: Tonga authorities and IMF staff estimates.

sectors, fortuitous timing (off-peak tourism season and the tail end of the fiscal year), and targeted fiscal support in remitting countries which supported remittances. The impact on domestic tourism was minimized as the supply-side shock from Cyclone Harold coincided with the demand-shock from lockdown. Post-lockdown, the reallocation of workers from SWP and tourism to construction and agriculture has supported employment and growth. Headline annual inflation declined to 0.2 percent by end-FY2020, well below the National Reserve Bank of Tonga (NRBT) reference rate (5 percent), due to lower global oil and food prices and a recovery of domestic agricultural production from Cyclone Gita.

7. **International reserves hit all-time highs due to import compression and fresh donor support**. Had the recovery stayed on-track, it would have translated into wider current account deficits due to the acceleration of import-intensive investment projects and stronger consumption. However, despite increased imports of medical supplies and testing equipment to fight COVID-19, imports remained constrained due to investment delays, subdued consumption, and economic uncertainty about tourism prospects. Remittances held up. As a result, the current account deficit narrowed in FY2020 relative to earlier forecasts (Figure), aided also by stronger export competitiveness due to an REER depreciation (reflecting larger inflation differentials). New pandemic- and cyclone-related aid, combined with a narrower current account balance, substantially boosted international reserves to US$251 million at end-October 2020 (about 9.7 months of import cover).

Tonga: Revisions to Balance of Payments Forecasts, FY2020
(In percent of GDP; revisions relative to pre-pandemic forecasts)



Sources: Tonga authorities and IMF staff estimates.

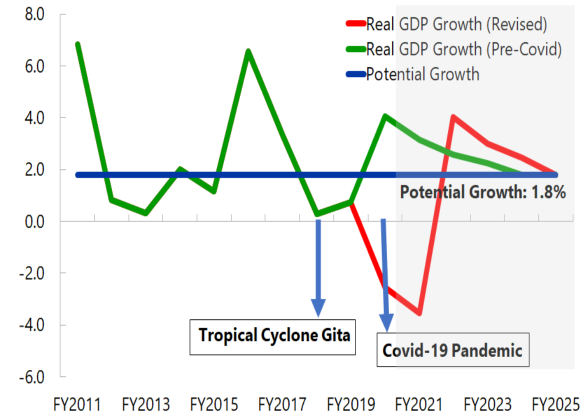
FY2021 AND BEYOND: A DEEPER CONTRACTION AND FRAGILE OUTLOOK

8. **The full brunt of the pandemic will be felt in FY2021.** Output is projected to contract further to -3½ percent in FY2021 even as the global economy begins to mend (Figure). Presuming an effective vaccine is available at the time, the forecast assumes that international borders will open only by end-FY2021, resulting in a sudden stop in tourism during peak season and continued delays in reconstruction and development efforts. The weak global recovery and a tapering off of fiscal support in remitting countries will have knock-on effects on Tonga by moderating remittances (Figure) and, thereby, consumption. Beyond FY2021, the economy is likely to gradually bounce back to 3–4 percent growth in FY2022–23 in line with the global recovery, assuming that travel and remittances normalize. These forecasts are subject to considerable uncertainty regarding the scale and persistence of the epidemic. Over the longer-term, growth is expected to decline to

an estimated potential rate of 1.8 percent as Tonga remains locked in a low-growth remittance-dependent equilibrium. Inflation is forecast to remain low, given current expectations of low global food and fuel prices.

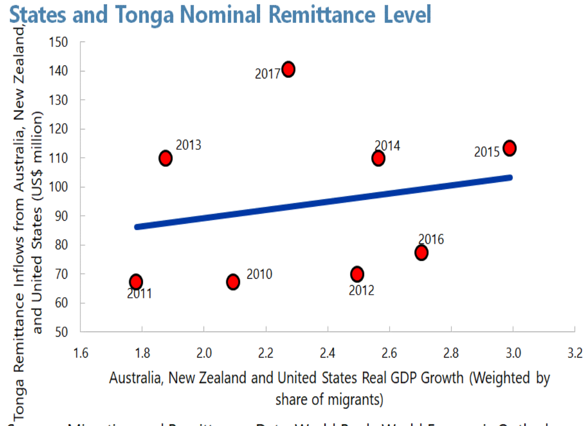
Real GDP Growth Forecast

(In percent, year-on-year)



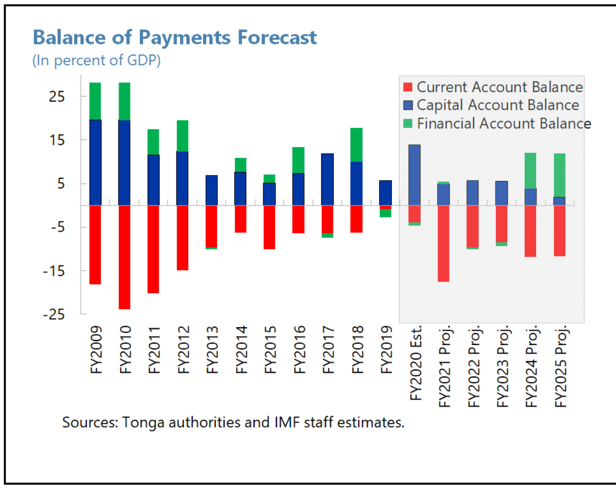
Sources: Tonga authorities and IMF staff estimates and calculations.

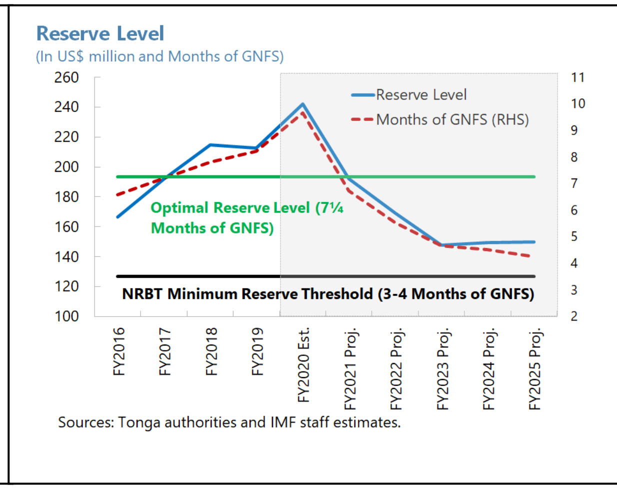
Real GDP Growth in Australia, New Zealand and United States and Tonga Nominal Remittance Level



Sources: Migration and Remittances Data, World Bank; World Economic Outlook Database, IMF and IMF staff estimates.

9. **External balances are expected to deteriorate.** Tonga's external position in FY2020 is assessed to be broadly in line with fundamentals and desirable policy settings (Annex II). The recent reserve accumulation due to unspent aid and import compression is, however, likely to be short-lived. A drop in tourism and remittance inflows and higher imports related to COVID-19 (e.g., medical supplies) and post-Harold private sector reconstruction is expected to generate large external financing gap (Table 8) and sharply reduce reserves in FY2021 to well-below its desirable levels (7¼ months of imports; Annex II). Beyond FY2021, persistently weak export competitiveness, heavy import-dependence, and large infrastructure needs will keep current account deficits high (Figure). As the pace of reconstruction picks up, and large external debt repayments come due starting in 2024, reserve coverage is expected to trend down to around 4 months of imports, well below desirable coverage levels (Figure). Due to capacity constraints, high import-dependence, weak monetary transmission, and the need for continued government support to lean against the pandemic, the policy options to bolster reserves in the short-term are limited, except for, new external financing, and enforcing long-standing repatriation requirements allowed under the 2018 Foreign Exchange Control (FEC) Act. Measures to improve export competitiveness and reduce import-reliance can provide a more lasting solution but will take time to implement.





10. The growth outlook is fragile (Annex III). A weaker global recovery due to a second wave of the pandemic and rising forces of deglobalization may temper exports, aid and remittances, on which the economy relies heavily. A possible domestic spread of COVID-19 is a major downside risk given the economy's heavy reliance on domestic demand. The pandemic has also worsened pre-existing vulnerabilities. Tonga's risk of external debt distress remains high. Moreover, there is a significant risk that another major cyclone could worsen the contraction while placing additional demands on scarce public resources. Tonga also remains vulnerable to disruptions in CBRs. If the shortcomings identified in the upcoming APG assessment are not addressed (see paragraph 29), international banks could withdraw from servicing remitters, and thereby negatively impact GDP and undermine financial stability. Despite efforts to strengthen institutions, the ability to prepare for and manage economic risks is hampered by limited public sector capacity and resources, and data limitations. The balance of risks therefore is tilted to the downside. Upside risks pertain to an earlier-than-anticipated resumption in SWPs or tourism or a faster global recovery due to an early success in developing a vaccine.

Authorities' Views

11. The authorities concurred with the assessment of a fragile and uncertain outlook and significant downside risks. Despite the pick-up in post-Harold reconstruction, real output in FY2020 is expected to contract by 2.5–2.7 percent. A further contraction is expected in FY2021 (-3.7–3.9 percent) due to the impact of the border closure on the services sector and low consumer confidence, despite the reallocation of service sector workers to other activities. The authorities acknowledged the impact of labor mobility schemes on growth potential and capacity constraints, while also noting that the resilience of remittances so far has helped support consumption.

12. A high level of uncertainty regarding the duration and global impact of the pandemic, and the ability to ensure the availability of a vaccine for the entire population remains a prime concern. Preventing a local COVID-19 outbreak is top priority, and, for this reason, external borders are likely to remain closed for the foreseeable future, with a slow and cautious approach to repatriating

Tongans stranded abroad. Tonga's vulnerability to natural disasters is another major concern, given forecasts for three major cyclones in coming months. While foreign reserves are expected to remain above the NRBT's minimum threshold in the near-to-medium-term, the authorities shared staff concerns about external sustainability and the need to maintain higher levels of reserves, given Tonga's vulnerability to external shocks and its large external debt.

COMBATTING COVID-19, CLIMATE CHANGE, CAPACITY CONSTRAINTS

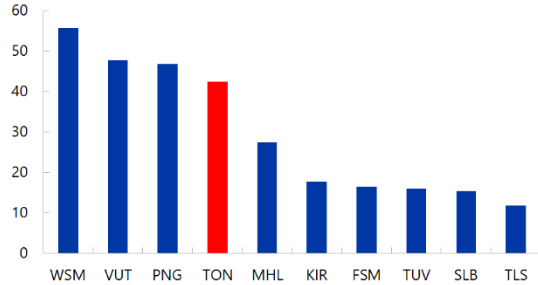
The main challenge is to support those hit by the pandemic, but with an eye toward achieving fiscal sustainability and the longer-term goals of boosting climate-resilience and development. Stronger budget surpluses based on high-quality revenue and spending policies are needed. However, large-scale consolidation is neither desirable nor feasible in FY2021 given the need to build healthcare capacity to address the pandemic and because the underlying reforms can only be implemented over time. Additional donor support is vital. A more durable solution to addressing Tonga's challenges is to grow the private sector. The reforms needed to unlock private sector potential are manifold, but improving the operation of the land market and reducing barriers for female workers are crucial. Greater vigilance on emerging financial sector risks is warranted.

A. Debt Sustainability, Disaster-Resilience, and Development in a Pandemic

13. Despite a string of budget surpluses, Tonga's fiscal challenges are daunting. A much-needed consolidation, which started in FY2016, continued through FY2020 with the help of donor support, notwithstanding the pandemic. The FY2019–20 surpluses reflect continued strength in revenue collection and generally effective controls on current spending, broadly in line with fiscal anchors adopted in FY2018 (Table 4). Additional pandemic- and cyclone-related spending was financed with new donor funds, domestic debt issuance, spending reallocations, and a temporary drawdown of emergency and reserve funds. However, underlying policies reflected some weaknesses, such as investment delays, and pre-pandemic healthcare and wage bill overruns which were compensated with lower maintenance-related spending. Despite ongoing reform to the public-sector remuneration system, contractual and overtime-related wage bill components have risen, potentially crowding out crucial service delivery spending. Looking ahead, in addition to supporting the economy through the pandemic, the main fiscal challenges are as follows:

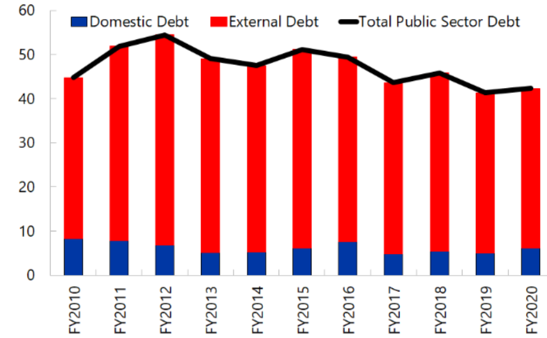
- **The risk of public and external debt-distress remains high** and debt repayments are set to spike starting in FY2024, especially to China EXIM Bank (Figure and DSA). The PV of public debt-to-GDP ratio is expected to rise above the 70 percent debt-distress benchmark in FY2029 under current policies and financing commitments. Without significant fiscal adjustment and new grant financing, the already low fiscal buffers (1-2 months of current spending at end-FY2020) and international reserves will need to be run down and additional debt incurred to service existing obligations and meet primary spending needs, leading to an exploding medium-term debt path.

Tonga: A High Debt Country, 2020
(In percent of GDP)



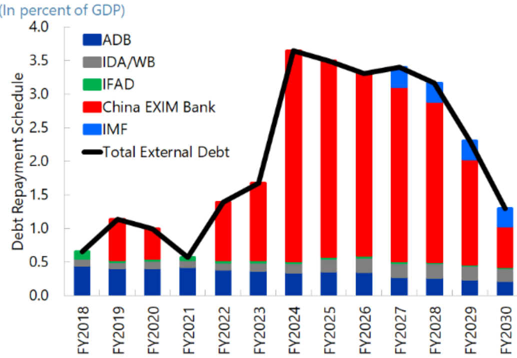
Sources: Tonga authorities; IMF WEO database; and IMF staff estimates.
Note: PIC General Government Gross Debt. For Tonga, the data is for FY2020.

Tonga: Largely External Debt
(In percent of GDP)



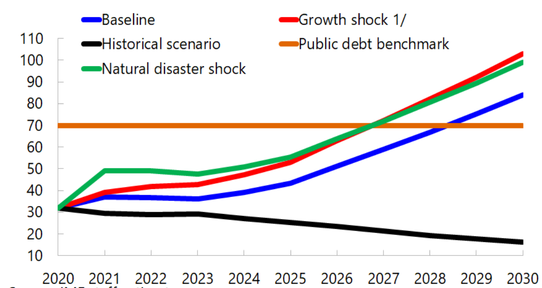
Sources: Tonga authorities; and IMF staff estimates.

Tonga: Sharp Increase In Repayment Starting FY2024
(In percent of GDP)



Sources: Tonga authorities; and IMF staff estimates and calculations.

Tonga: High Risk of Public Debt Distress
Present Value of Debt-to-GDP Ratio
(In percent of GDP)



Source: IMF staff estimates.
1/ The most extreme shock scenario is the growth shock (one standard deviation below the baseline for two years starting from FY2021).

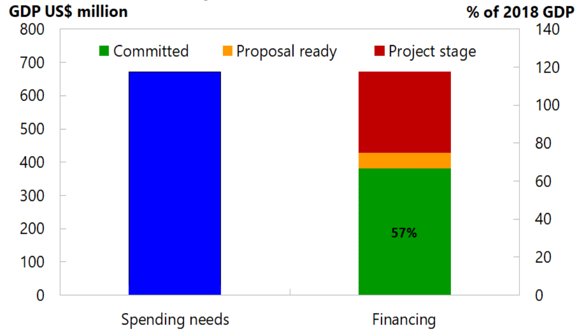
- **The cost of achieving climate-resilience and development goals are formidable.**[4] The CCPA estimated that climate-resilience projects will cost some 140 percent of 2018 GDP cumulatively, of which donor grant funding has been committed for about half. Meeting selected SDG (physical infrastructure, health and education) goals by 2030 will require an additional annual spending of about 5 percent of 2030 GDP by 2030 (Annex IV). The pandemic has exacerbated persistent pre-existing challenges (e.g., in the health sector), adding to the already large spending needs.

- **A small tax base and fledgling institutions are major deterrents to large-scale and front-loaded consolidation.** Beyond the public sector, the size of the formal sector is small. The capacity of the public sector to carry ever-larger tax burdens is limited by the need to control the wage bill and retain high-skilled officials to improve capacity. A more durable solution to overcoming financing and capacity constraints would be to grow the formal private sector to expand the tax base, but this will take time.

[4] See IMF CCPA Report for Tonga, 2020 (Daniel and others (2020), henceforth referenced as CCPA Report. Estimates are based on information available as of February 2020.

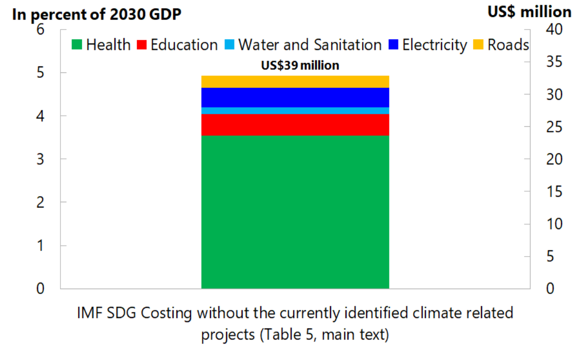
- **Finally, the pandemic will delay plans to build adequate buffers.** Given weak monetary transmission and an exchange rate peg,[5] the only policy tool at the authorities' disposal to support the economy during the pandemic is fiscal policy. The surplus planned in the draft FY2021 budget strategy has been shelved.

Cumulative Cost and Financing of Currently Identified Climate-Related Projects



Sources: IMF CCPA Report, 2020. Based on GCF (2018), World Bank, ADB, Tonga's Budget Strategy 2020, and IMF Staff estimates.

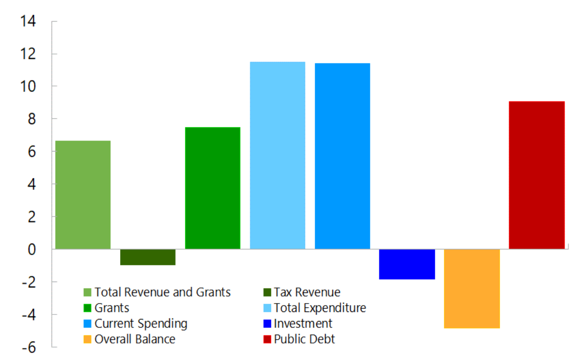
Additional Annual Cost of Meeting 5 SDG Targets Beyond Identified Climate Projects



Sources: IMF CCPA Report 2020.

14. The FY2021 budget balance is likely, and unavoidably, to swing into a deficit (Table 4). The fiscal policy response to the pandemic has been appropriate although beset by implementation delays. Notwithstanding improved collection, tax revenues are expected to be lower-than-budgeted due to tax exemptions/deferrals for post-Harold reconstruction and the pandemic, weaker imports and economic activity. Current spending is likely to rise to accommodate the cost of containment and healthcare, and targeted support to those affected. Spending on the latter will be larger-than-budgeted, given the longer duration of the pandemic than anticipated in the budget. Further delays in public investment can be expected while borders remain closed. The resulting deficit will be financed by additional donor support, resources disbursed under the Rapid Credit Facility (RCF; see below), and a suspension of FY2021 debt repayments to China Exim Bank.[6]

Tonga: Revisions to Fiscal Balances, FY2021
(In percent of GDP; revisions relative to pre-pandemic forecasts)



Sources: Tonga authorities and IMF staff estimates.

[5] The exchange rate is pegged against a basket of currencies (with a ± 5 percent monthly adjustment limit).

[6] Tonga's request for a suspension of 2020 debt repayments to China Exim Bank under the G20 DSSI has been approved. The authorities intend to request the suspension of repayments coming due in the first half of 2021.

15. Post-pandemic, better-quality surpluses are needed to achieve debt sustainability while meeting climate and development goals without having to rely on external budget grants exceeding historical trends. Without new grant commitments, a major fiscal consolidation would be required to achieve a sufficient buildup of fiscal buffers for debt repayments, emergencies and infrastructure upkeep while implementing necessary investments. Such a large fiscal consolidation is infeasible (given significant capacity constraints) and undesirable, as it would compromise climate-resilience and development policy goals. Additional donor support—including approval of the 2019 request for debt relief from China Exim Bank—could therefore be vital to keep investments on track. With the help of new donor grants, fiscal adjustment of 2½–3 percent of GDP relative to baseline forecasts—ideally front-loaded—could be achievable over the period FY2022–24 (Table). With the right policies, the economic impact of such consolidation can be minimized given low fiscal multipliers.[7]

Tonga: Estimated Fiscal Adjustment Relative to Baseline, FY2022-24

(In percent of GDP)

	FY2022	FY2023	FY2024	*FY2022-24 (Average)*
Revenue and grants (+ = increase)	1.9	2.9	3.2	*2.7*
Tax revenue	1.8	2.8	3.1	*2.6*
Taxes on income/profits	0.7	0.4	0.4	*0.5*
Taxes on property	0.2	0.1	0.2	*0.2*
Taxes on goods and services	0.9	2.3	2.5	*1.9*
Total Expenditure (+ = increase)	-0.1	-0.2	-0.2	*-0.2*
Expense	-0.3	-0.4	-0.5	*-0.4*
Transactions in nonfinancial assets1	0.2	0.2	0.3	*0.2*
Primary Balance	2.0	3.1	3.4	*2.8*
Overall balance	2.0	3.1	3.4	*2.8*
Net acquisition of financial assets and liabilities	3.0	5.1	7.4	*5.2*
Unidentified financing gap[1]	1.0	2.0	4.0	*2.3*

Source: IMF staff estimates.

[1] In line with historical trends, the financing gaps are assumed to be filled with new grant commitments and/or debt relief.

Note: Required adjustment relative to the baseline scenario to reduce public debt to 42 percent of GDP—the sustainable debt level under the baseline scenario—by 2024.

16. There is scope to improve the targeting of exemptions and broaden the tax base. Given frequent economic and climate-related shocks, short-term economic support in the form of tax exemptions have become the norm in Tonga in recent years (Figure). Greater transparency and public disclosure of the criteria, time frame, recipients, and amounts of such exemptions would help improve accountability and targeting of such support. Given the urgency of building buffers, tax policy changes need to be introduced post-pandemic (possibly in the FY2022 budget), following consultations with stakeholders.

- The planned review and closure of major CT exemptions; updated excise tax rates, fees and charges, especially on property; and further improvements in revenue administration through training and better risk assessment, are steps in the right direction.[8] An additional 2½ percent of GDP in tax revenues could be collected by removing various other tax exemptions, notably the CT exemption for the electricity company, and by improving processes (Liu and Mullins, 2020). Some exemptions could continue to be granted in line with international practices, but should be less ad hoc (with a sunset clause) and more transparent.

[7] Countries with higher propensity to import tend to have lower fiscal multipliers (Batini and others, 2014).

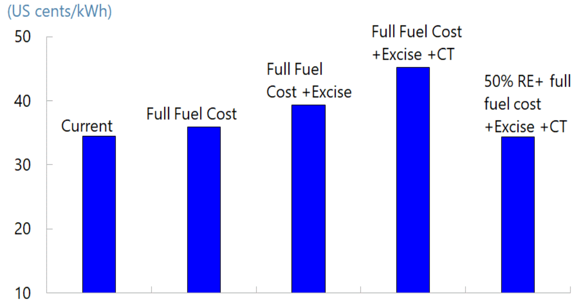
[8] Sutherland, 2019.

- Taking advantage of low global prices, tax breaks for the electricity company should be removed and the full cost of diesel passed on to consumers to help achieve Tonga's emission targets.[9] Any resulting rise in electricity tariffs could be phased in while protecting vulnerable households. Over time, investments in renewable energy sources could help reduce tariffs (Figure).

- Additional measures could also be considered: further reducing excise and CT exemptions; broadening the PIT base to include local employees of donors; closing CIT loopholes for MNCs; collecting tax arrears and reducing tax avoidance; and, improving the collection of land-related fees. Tax policy design should reside in the MOF to ensure consistency with the budget and debt sustainability framework.[10]

Electricity Tariff Under Various Policy Options

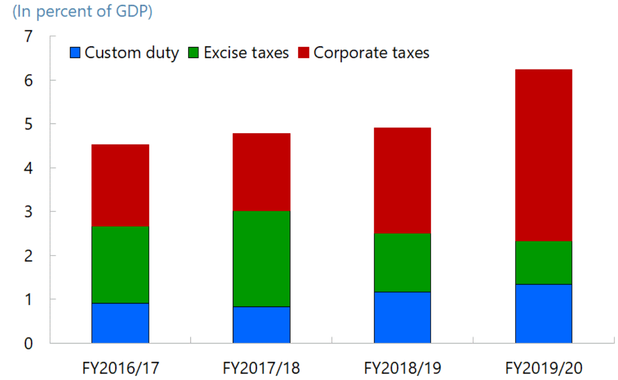
(US cents/kWh)



Sources: IMF CCPA Report, 2020.
Notes: Electricity tariff estimates assume 8.7 million liters of diesel used (under 50 percent Renewable Energy (RE) scenario), diesel price of 70 US cents/liter, excise of 12 US cents/liter, non-fuel cost of 18 US cents/kWh, renewable electricity generation cost of 18 US cents /kWh (i.e. same level as non-fuel costs), Corporate Tax (CT) rate of 15 percent, generation of 71 GWh, and billing of 63 GWh.

Revenue Cost of Tax Exemption by Type

(In percent of GDP)



Sources: Tonga authorities, and IMF staff estimates (Liu and Mullins, 2020).
Note: Partial FY2019/20 data up to January 24, 2020.

17. **Spending policies should be geared toward improving efficiency, capacity and value-for-money.** The FY2022 budget should focus on evaluating and, if necessary, rectifying the drivers behind slippages vis-à-vis fiscal anchors. This could be followed by a deeper review of appropriate fiscal anchors with IMF assistance when economic conditions are less precarious.

- In the near-term, it is critical to ensure that priority spending—such as strengthening the basic healthcare system and infrastructure maintenance—are not crowded out by pandemic-related measures. Building out the social protection system (beyond just the elderly and disabled) could be helpful, as it could be scaled up automatically after natural disasters and during the pandemic, and allow effective targeting of fiscal support. [11] Having such a system in place would also allow the government to provide assistance with electricity and other utility bills to those in need, while reducing CT exemptions for the electricity company. The planned health insurance

[9] CCPA Report, 2020 and Liu and Mullins, 2020.

[10] As a first step, the Revenue Policy Committee comprising representatives of the MOF and MORC could be reinstated to drive tax policy reform.

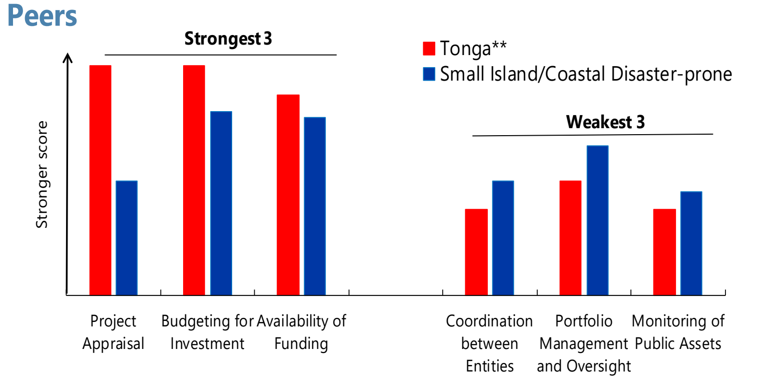
[11] CCPA Report, 2020.

system and voluntary retirement scheme should be properly designed to avoid unintended consequences (such as cost overruns and large staff turnover).

- Efforts to centralize and strengthen hiring and staffing decisions should continue. Within the current fiscal anchor on the wage bill, policies should focus on rationalizing civil service functions and clarifying job descriptions; identifying and staffing critical positions; increasing automation as a step toward a phased elimination of redundant positions; prioritizing service delivery; gradually aligning compensation with market pay levels while eliminating overtime to improve work incentives and reduce turnover. Ideally, this should be accompanied by a systemic review of the appropriate and sustainable size and structure of the civil service required to deliver quality public sector output. Stronger controls on allowances (e.g., overtime) and non-permanent staff costs are also necessary.

18. To improve implementation, effective and consistent prioritization is needed with a longer-term perspective in mind. This requires greater stability in the government's policy priorities, better sequencing, and improvements in cross-governmental coordination to maximize benefits from donor funds.[12] Longer-term and whole-of-economy planning should help the government lead, instead of reacting to, donor priorities. For faster execution of investments, the pipeline of projects should be better prioritized and published to allow private markets time to prepare in advance (Figure). Improving awareness of procurement measures across ministries and strengthening procurement to allow contract bundling, can attract international firms to complement local capacity.[13]

Public Investment Management Assessment: Tonga vs. Peers



Source: IMF PIMA tool and IMF Staff Assessment. See IMF CCPA Report (2020) for more detail.
Note: * PIMA is based on 15 aspects: 1. Fiscal targets and rules; 2. National and sectoral Planning; 3. Coordination Between Entities; 4. Project Appraisal; 5. Alternative Infrastructure Financing; 6. Multi-year Budgeting; 7. Budget Comprehensiveness and Unity; 8. Budgeting for Investment; 9. Maintenance Funding; 10. Project Selection; 11. Procurement; 12. Availability of Funding; 13. Portfolio Management and Oversight; 14. Management of Project Implementation; 15. Monitoring of Public assets. ** For Tonga, the results are only indicative as a full PIMA has not been conducted.

19. Debt management should be improved. The current policy of borrowing only on concessional terms and limiting external debt-to-GDP ratio to below 50 percent remains

[12] CCPA Report, 2020.

[13] The IMF's 2020 PEFAA (Kubasta and others, 2020) notes that central government procurement is monitored, although it does not cover procurements below a certain threshold and donor procurement systems are used for donor financed purchases. All procurement funded by the government of Tonga above a certain threshold are recorded in a database that includes details of contracts procured, value of procurement, and who has been awarded the contract. A procurement reform strategy has begun to be implemented which has led to improved rules, policies and endorsement of compliance efforts, consistent with best practice.

appropriate, although for debt sustainability considerations, financing should ideally be restricted to grants if possible. Adopting a medium-term debt strategy, with proper documentation of policies and procedures that guide borrowing and guaranteeing of loans, can help better align debt-related decisions with broader fiscal objectives.[14] In the medium-term, there may be scope to expand domestic borrowing through financial deepening to limit reliance on external financing and help improve monetary transmission.[15] The management of resources set aside to meet debt repayments should be institutionalized via legislation to ensure adequate governance structures.

20. Donors need to do their part. The international community provides considerable support to Tonga. Such support will continue to be needed, including to mitigate the impact of the pandemic in the near term. But the assistance could be better aligned with the government's priorities, more coordinated to avoid further stretching thin capacity, more inclusive when developing specific solutions, and use (while strengthening) Tonga's own PFM and information systems to allocate funding.

21. Further enhancements in transparency and accountability of government operations could strengthen the case for more donor support and debt relief.[16] The finalization of the public financial action plan, and strengthened cash management and financial management information systems, and internal audit processes would help improve the monitoring of public service delivery. Policies and implementation of pandemic-related spending and economic relief packages should be transparent, closely monitored, audited, and reported in a timely manner to demonstrate accountability (Appendix I). In particular, publication of audited COVID-19 related spending, and pandemic-related public procurement documents (including information of the beneficial owners of the companies awarded the contract) would be desirable.

Authorities' Views

22. The authorities' assessment of fiscal challenges were in sync with those of staff. Noting Tonga's risk of high public and external debt distress, they welcomed the G20 Debt Service Suspension Initiative and hoped that it would be extended to ensure further reductions in debt burdens. Recognizing the challenges associated with building adequate fiscal buffers while supporting the economy during a downturn, and meeting climate-resilience and development goals, the authorities underscored their intention to seek new grant financing from donor partners as a first priority, and bilaterally pursue additional debt relief from China Exim Bank. Concessional loans from the IMF maybe needed, including additional funding under the RCF in the event of a major natural disaster giving rise to urgent balance of payments needs. At the same time, they

[14] Technical issues that have prevented complete recording of new debt instruments since 2018 should be addressed (Kubasta and others, 2020).

[15] Recommendations for expanding the domestic debt market are provided in Griffin and others, 2017.

[16] The IMF will support Tonga's effort to implement the IMF's Enhanced General Data Dissemination Standard (e-GDDS) and launch a National Summary Data Page to enhance data transparency in October 2020.

acknowledged that the implementation of investments should be accelerated to make full use of disbursed financial assistance.

23. Overall, tax base broadening; prioritization of targeted support, health and infrastructure spending; stricter wage bill controls; and improved processes, governance, public financial management and implementation capacity are needed to meet the government's policy goals and debt repayments. While the government's economic and social stimulus package has helped prevent a worse economic contraction, underlying policies need improvement—notably extending the social protection system and ensuring greater transparency and accountability in the provision of tax exemptions—to better target those in need during the pandemic or future economic shocks. In the spirit of transparency, audited pandemic-related spending and all procurement documents will be published, including owners of awarded companies. They will also make every effort to identify and publish the beneficial owners of the companies awarded the contracts for which appropriate disclosure modalities will first need to be established. Recommendations by the ADB, IMF and World Bank reviews of various aspects of fiscal policy—the effectiveness of pandemic support, wage bill overruns, tax exemptions, spending priorities, climate change policy, public financial management, and fiscal statistics—will be implemented starting in FY2022. New climate and medium-term debt strategies are also being developed. Efforts to improve revenue collection and administration by improving tax compliance of high-value taxpayers through audit, debt recovery and stronger risk assessments, are underway.

B. Maintaining Monetary and Financial Stability

24. Monetary policy has remained accommodative, given low inflation and the economic contraction. Pre-COVID, the NRBT set out to mop up excess liquidity by introducing a minimum loan-to-deposit indicative ratio to encourage lending. It also allowed the public sector pension fund to transfer balances abroad as it was facing declining returns on investment and contributions relative to benefit payments, with the understanding that these funds might need to be repatriated in times of external stress. Following the outbreak, the NRBT has stayed on hold, maintaining the monetary policy rate[17] at 0 percent, the inflation reference rate at 5 percent, and shelved its pre-pandemic plans to raise the statutory reserve deposit (SRD) rate. It is closely monitoring liquidity conditions in the banking system and has signaled its willingness to ease liquidity and exchange control requirements if necessary. Exchange rate stability has been maintained with a review of currency basket-weights in 2020. Given the significant build-up in international reserves, the NRBT has not needed to invoke the provisions of the 2018 FEC Act,[18] however, the expected repeal of the

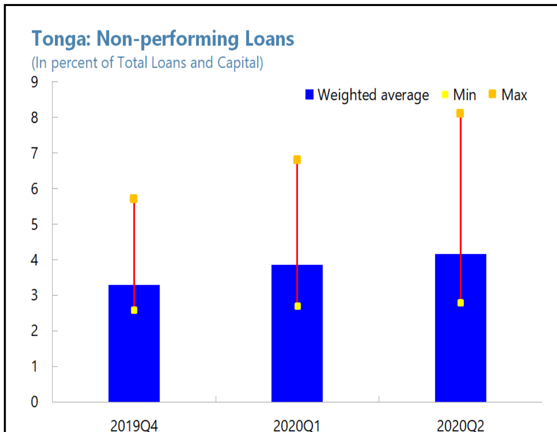
[17] Interest rate on banks' exchange settlement account (excess reserves) at the NRBT.

[18] The 2018 FEC Act clarified long-standing repatriation and surrender requirements. It requires repatriation and surrender of 60 percent of goods export receipts. Residents are also required to repatriate their offshore investments (including housing and equity) if international reserves fell below 2 months of imports. The 2018 FEC Act is being revised.

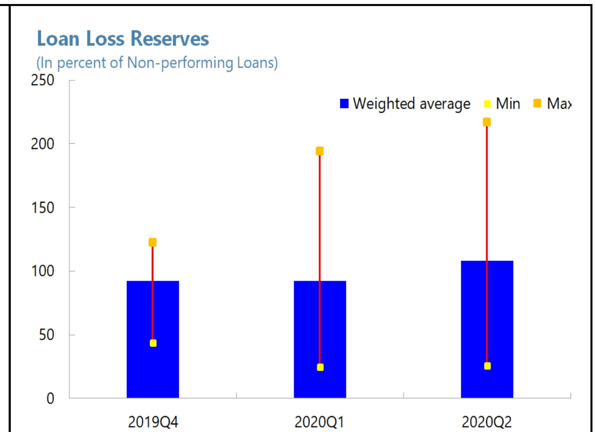
Foreign Exchange Levy in June 2020 is no longer under consideration and the public sector pension fund has opted to halt overseas investments.

25. Bank balance sheets remain resilient, but risks have increased. Banks[19] are still profitable and well-capitalized as they do not yet reflect the possible deterioration in asset quality. However, financial sector risks are elevated, especially if the pandemic were to do more economic damage than anticipated or fiscal support be reduced, worsening credit risk.

- **NPLs.** After declining through 2019 due to loan write-offs and settlements (Table 6, Figure 6), NPLs have ticked up recently due to agricultural losses and non-performing housing loans. Reported NPL ratios range between 3−8 percent across banks (Figure). Similar to their post-Gita response, with the NRBT's tacit approval, banks have deferred loan repayments on a case-by-case basis, ranging between 1-30 percent of their gross loan book. NPLs could therefore rise sharply in 2021 for some banks after debt relief measures expire, and if loan reclassification is needed at that point. Only one bank has raised provisions significantly with a forward-looking approach to NPL recognition, signaling that the underlying NPL ratio could be above 10 percent. Other banks appear to be under-provisioned relative to their current NPL levels, let alone for forthcoming NPLs (Figure).



Sources: National Reserve Bank of Tonga and IMF staff calculations.



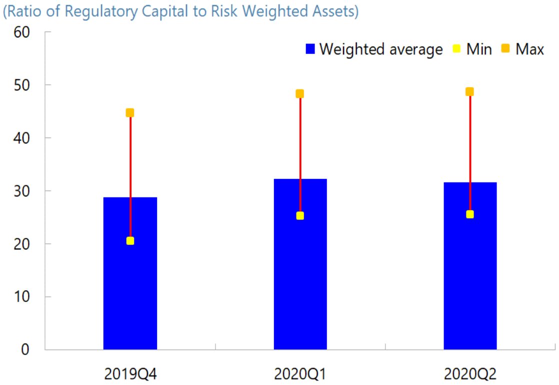
Sources: National Reserve Bank of Tonga and IMF staff calculations.

- **Profitability and capital adequacy.** Bank capital is likely to be lower—though still adequate—when considering the higher underlying NPL ratios (Figure). Capital buffers could come under pressure as profits decline due to emerging loan defaults of financially stretched borrowers and lower operating income in line with weaker lending, after several years of double-digit growth. Sensitivity analysis suggests that a deterioration in NPLs to 25 percent could drive capital ratios below the regulatory threshold (Figure). Under this stress scenario, options for raising bank capital are two-fold: retaining earnings (if still positive) and capital injections from shareholders. However, bank profits were declining even before the pandemic as credit slowed due to delays

[19] Tonga's financial landscape is dominated by four banks (three foreign-owned bank subsidiaries and a government development bank, with total assets of 78 percent of GDP at end-June 2020) and NBFIs (2 pension funds, 4 insurance companies, 12 foreign exchange dealers, 1 microfinance institutions, and several money lenders).

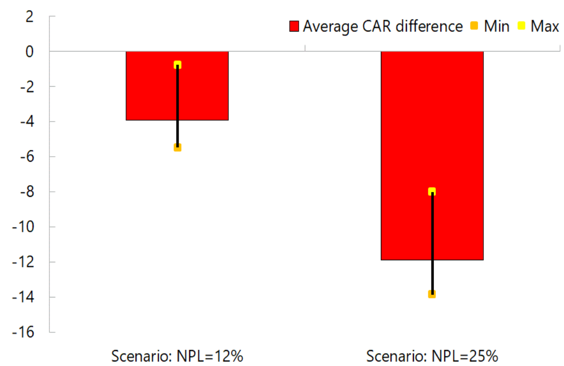
and cancellation of projects, market saturation, and stretched household debt-servicing capacity. Credit demand declined further during the pandemic due to rising uncertainty, and lending came almost to a halt by end-FY2020. Competition from the pension fund (now into mortgage lending) and moneylenders (with better regulated rates following the enactment of the Moneylenders' Act) is also pressuring bank profitability. Besides squeezing expenses and suspending dividend payments, options to boost retained earnings is also limited by lower remittance fees (in response to competition from money transfer operators (MTOs), and, structural impediments to broadening credit. Therefore, capital injections from parent banks would be warranted should capital buffers come under stress.

Capital Adequacy Ratio
(Ratio of Regulatory Capital to Risk Weighted Assets)



Sources: National Reserve Bank of Tonga and IMF staff calculations.

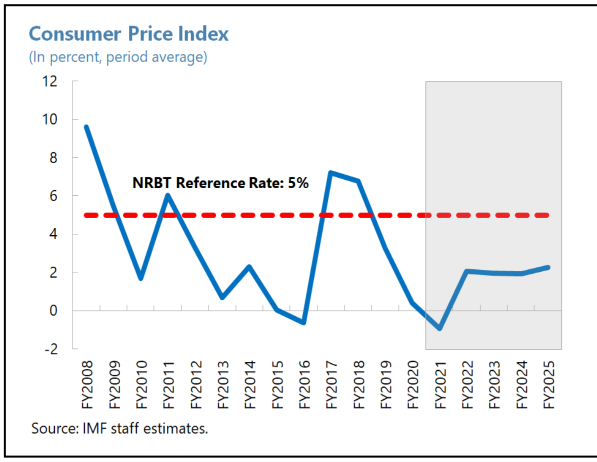
Decline in Capital Adequacy under NPL Scenarios, 2020Q2
(Ratio of Regulatory Capital to Risk Weighted Assets ; Percentage point changes)

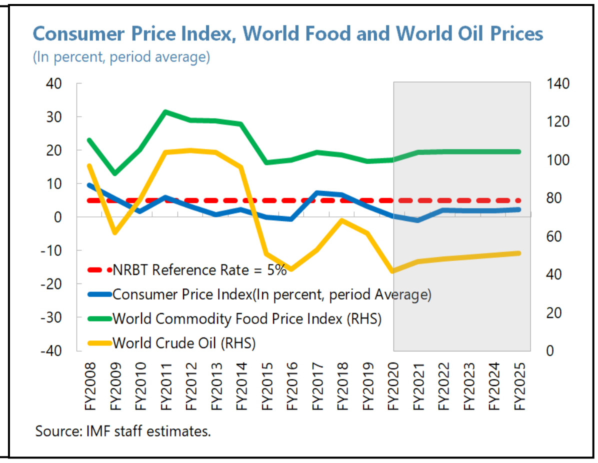


Sources: National Reserve Bank of Tonga and IMF staff calculations.

- **Liquidity.** Given rising deposits in the banking system, onshore profits retention, and continued remittance inflows, the banking system is not facing liquidity constraints at the moment. Liquidity ratios, though adequate, have been on a declining trend recently as the pension fund moved part of its assets out of the banking system. A sharp decline in remittances or drawdown in deposits in the event of a sharp escalation of the global pandemic, could conceivably generate liquidity pressures, including in foreign currency. However, liquidity stress tests indicate that for individual banks and for the system as a whole, liquidity holdings are sufficient to meet assumed outflows of deposits and other liabilities across different maturity buckets.

26. Monetary policy should continue to stay supportive and ensure adequate liquidity, since inflation is likely to remain low (Figure). Should liquidity pressures arise, the NRBT should, in the first instance, lower the SRD rate (dividend payments have already been suspended). In the event of extreme economic stress, the NRBT could consider restricting resident investments abroad, while weighing the implications on bank profits. Finally, it could seek repatriation of pension fund investments abroad provided it does not incur large losses in the process as that may have budgetary implications. The NRBT should continue to look through temporary inflation spikes emanating from domestic supply-side and global commodity price shocks, as they are beyond its control and are typically transitory.





27. Ongoing improvements in financial supervision should be accelerated. The NRBT is strengthening risk-based offsite supervision (Annex VI and Figure 6). New regulations were enacted in 2019; others are being drafted or awaiting Cabinet decisions. The NRBT's capacity to supervise NBFIs (which are a known unknown) is lagging the expansion of their financial activities. The near-term priorities are to:

- Continue to enhance the NRBT's risk assessment capacity and take preemptive steps to ensure that banks are adequately provisioned and capitalized to withstand adverse developments. The NRBT needs to anticipate challenges on the funding side (arising from sharp declines in aid, remittances, government and pension fund deposits), and credit risk (due to the weak economy, natural disasters and household leverage).

- Establish a solvency stress testing framework with IMF TA; and, enhance household debt monitoring by broadening credit information systems to cover NBFI lending. These measures could help reduce credit risk, given the concentration of mortgage lending and signs of stretched household balance sheets, which have further deteriorated during the pandemic.

- Develop macroprudential instruments to limit systemic risk, e.g., the Basel III countercyclical capital buffers providing an additional cushion in a country as shock-prone as Tonga, and prudential limits on debt service-to-income.

28. Deeper reforms are needed to improve monetary transmission, financial risk management, and financial inclusion. Large remittance inflows shut down a major transmission channel by providing a stable flow of interest-insensitive funding, reducing the need for an interbank market (absent in Tonga) and severing the link between the policy rate and banks' marginal costs of funds.[20] This increases bank holdings of liquid assets, as evident in Tonga, which can lead to credit misallocation in the absence of strong prudential norms and financial supervision.

[20] Barajas and others, 2016.

- The effectiveness of monetary transmission can be improved through improved communication and by addressing structural barriers, including measures to improve supervision and debt management, develop a domestic debt market, and improve MSME creditworthiness (see paragraphs 33 and 35).[21]

- Improved financial sector risk management and financial deepening require enhancing insolvency regimes, improving credit bureau operations to reduce credit costs and removing operational risks posed by the land leasehold market (see paragraph 33). Insurance penetration could be increased from its very low levels by improving financial literacy and awareness of the benefits and availability of insurance.[22]

- In addition to current initiatives—such as the Pacific Financial Inclusion Program (PFIP) which helps expand services through the Ave Pa-anga Pau (a money transfer service)—new initiatives to increase access to, and use of, financial services, and improve financial literacy should continue, in line with the NRBT's Maya Declaration targets.

29. A stronger AML/CFT framework is imperative. Tongan money operators have recently seen their bank accounts closed due to "de-risking" policies implemented by international banks. The pandemic is further increasing pressure on multinational financial institutions' AML/CFT systems. Given the importance of remittances to the economy, a loss of CBRs—which could magnify the cost of, and a drop in, remittance inflows—could have a significant macrofinancial impact. To minimize the potential impact on financial institutions, weaknesses in Tonga's legal and regulatory framework and enforcement, as currently being discussed by the APG in its ongoing assessment, will need to be addressed. Tonga's vulnerability to the partial withdrawal of CBRs would be reduced by amending the AML/CFT framework to mandate a risk-based approach, by strengthening regulations, and improving enforcement through increased awareness, adequate resources, and better information sharing, particularly in relation to beneficial ownership and politically exposed persons.

Authorities' Views

30. The NRBT plans to maintain an accommodative monetary policy stance until the recovery gains traction and to continue improving the effectiveness of monetary policy transmission, including through improved liquidity management and communication. Although liquidity levels remain adequate at the moment, the NRBT will consider lowering the SRD rate in case additional liquidity needs arise.

31. The NRBT assessed the banking system to be sound, but agreed that risks have increased and there was need for enhanced vigilance. The NRBT has been meeting weekly with banks to ensure there is clear communication, enhanced preparedness and best prudential practices in place to withstand the pandemic. Both banks and the NRBT are committed to taking preemptive steps to ensure that banks are adequately provisioned and capitalized. Improvements to the NRBT's stress

[21] Griffin and others, 2017.

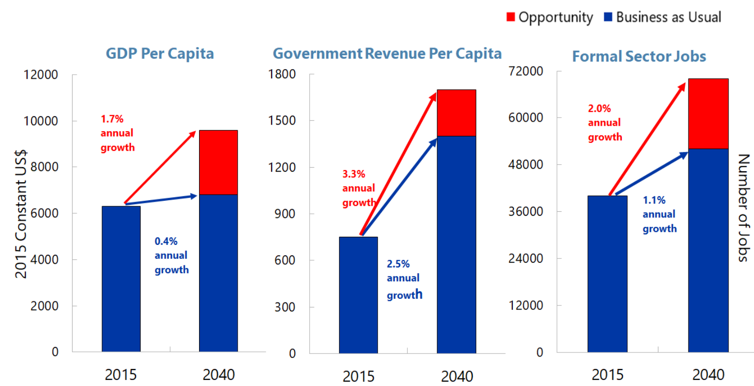
[22] CCPA Report, 2020.

testing framework with IMF technical assistance would be desirable. Efforts are underway to improve credit bureau reporting requirements but necessary improvements in credit information systems would need to await the passage of legislation—being drafted—for the licensing and supervision of insurance companies, pension funds, and capital markets. As the insurance regulator, the NRBT also plans to improve financial literacy and awareness once regulations are finalized. Tonga is looking to develop a national Know Your Customer (KYC) system, drawing on experiences from the regional KYC utility, which it supports. Finally, given the importance of remittances for the economy and the financial system, the NRBT is undertaking a gap analysis and working to strengthen legislation and frameworks, in consultation with the Attorney General, for managing AML/CFT risks and to address possible concerns that may be raised by the ongoing draft mutual evaluation by the APG.

C. Unlocking Private Sector Potential to Escape A Low-Growth Trap

32. A concerted effort is needed to remove bottlenecks for the small private sector to grow. A stronger business climate and private sector would help broaden the tax base and increase fiscal resilience, help expand the financial sector and its capacity to hold government debt, and enable Tonga to gain from Pacer Plus by attracting investments that could increase its export share and improve climate resilience.[23] Tonga performs well relative to country comparators across many aspects of the business environment, but lags in terms of registering property, protecting minority investors, and the legal framework and processes for resolving insolvency. There also remains scope to improve governance, particularly regarding regulatory quality and enforcement, government effectiveness, and control of corruption (Figures next page). Relative to a baseline "business-as-usual" scenario, there is potential to realize substantial additional economic growth, revenues, and job creation via reforms that maximize the gains from tourism, labor market opportunities and skilling, and ICT (Figure above).

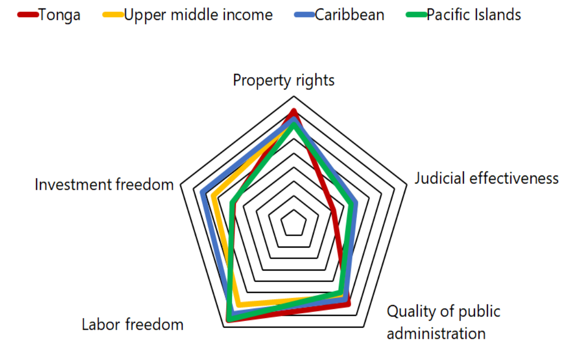
Greater Prosperity is Possible



Source: World Bank, 2017, Pacific Possible: Long-term Economic Opportunities and Challenges for Pacific Island Countries. Washington, DC: World Bank.

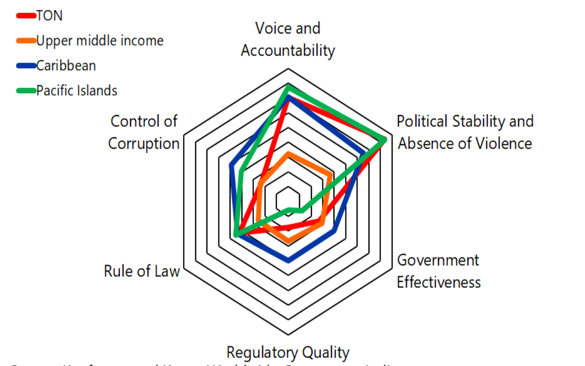
[23] Pacer (The Pacific Agreement on Closer Economic Relations) Plus—a regional agreement emphasizing trade liberalization and regional cooperation—came into effect in December 2020. For Tonga, this is likely to increase labor exports and, in time, cost some 1-1⅓ percent of GDP in lost revenues from lower tariffs (Liu and others 2019), which can partly be recouped by reducing tax exemptions. To gain from increased agricultural exports on which tariffs are already close to zero, Tonga would need to meet high quality and phytosanitary requirements of principal export markets (Australia and New Zealand).

Economic Freedom: Tonga vs. Comparators (2019)



Source: Index of Economic Freedom (2020), Country Policy and Institutional Assessment (CPIA), 2019.
Note: The index of econmic freedom ranges from 0 (low) to 100 (high). CPIA scores ranges fom 1 (low) to 6 (high). The scores were normalized to make them comparable.

Average Governance Performance: Tonga vs. Comparators (2013-2017)

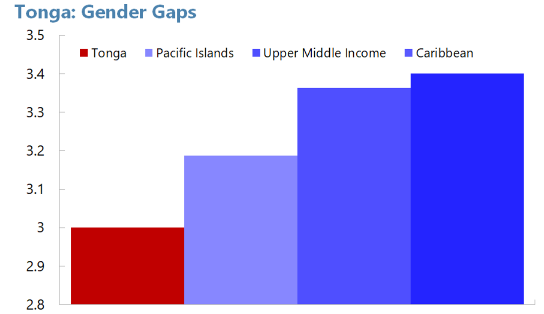


Source: Kaufmann and Kraay. Worldwide Governance Indicators.

33. Improving land market operations is a priority. Complexity and delays in leasehold operations pose major hurdles for investors (e.g., all leases above 5 years require Cabinet approval).[24] Short lease tenures and uncertainties regarding renewal and property rights make it difficult to attract major investments, even from non-resident Tongans. They constrain banks' ability to support worthy long-term projects (e.g., private solar farms) since the collateral value of property loans, and the creditor's rights vis-à-vis the land is unclear, leaving banks' potentially subject to significant operational risks. Land-related concerns have also stalled high-priority investor-friendly regulations, such as the insolvency law. Despite revisions to the Land Act, low liquidity in the property market makes it difficult for MSMEs to use real estate as collateral. Modernizing and clarifying the land lease process by improving transparency and predictability on lease tenures, renewal, and ownership rights could help maximize the use of vacant or underutilized land, improve investment, and strengthen incentives to ensure that structures built on leasehold land are climate-resilient.

34. Stronger female labor force participation will lift productivity. The female workforce—with more years of schooling and lower likelihood of emigration—should be empowered to achieve their full potential (Figures). While Tongan women fare better than regional counterparts in terms of labor participation and access to schooling, they are constrained by land ownership limits, a legal framework that does not adequately protect their interests (especially regarding property

Tonga: Gender Gaps

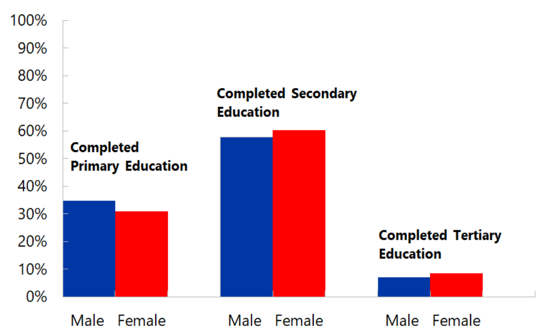


Source: World Bank - Country Policy and Institutional Assessment (CPIA).
Note: Index of gender equality (from 1 (low) - 6 (high)), comprises scores for gender gaps in primary schooling completion rates, accesss to secondary education, labor force disparities, inheritance practices, political participation at the national level, etc.

[24] Under the constitution, all land is property of the Crown. Every estate and allotment is hereditary according to prescribed rules of succession. No foreigner can own land, although anyone can lease property for up to 50 years subject to Cabinet approval or 99 years subject to Privy Council approval. Selling land is illegal; however, there is a leasehold market which operates in a complex manner with delays. There is an active market in informal land transactions that functions through the transferring or leasing of land in exchange for a “gift” of the equivalent value.

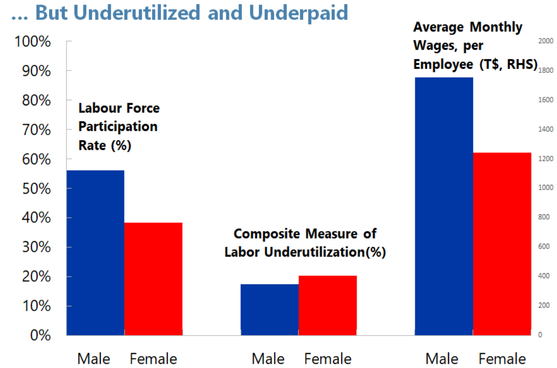
rights), and poor representation in Government. Plans to improve female participation are ill-defined and under-resourced. A landmark Employment Relations Bill, approved by Cabinet in 2019, could potentially improve employment conditions for women once enacted.

Tongan Women Are More Skilled...



Sources: Tonga Labour Force Survey (TLFS 2018) Analytical Report; and IMF Staff estimates.

... But Underutilized and Underpaid



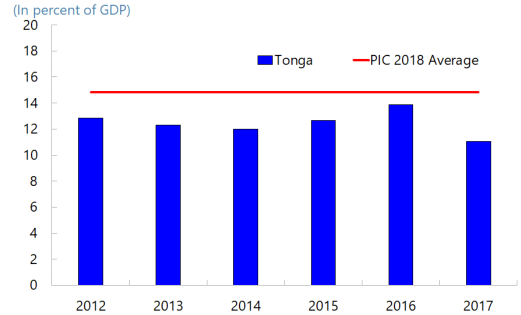
Sources: Tonga Labour Force Survey (TLFS 2018) Analytical Report; and IMF Staff estimates.

35. Improving climate resilience is of utmost importance.[25] In addition to the fiscal measures discussed earlier, the main priorities are to consistently implement high-quality strategic plans, gearing up for "transformational" responses for long-term extreme events (such as sea level rises), improving risk management by building a proper public sector asset registry, continuing to enhance emergency management, and improving human and financial capacity across the board.

36. Improving the supply of skilled labor is vital. Building and maintaining safe schools and improving the quality, relevance, and access to TVET programs and secondary and tertiary education are ongoing. Donors could support these efforts by ensuring that SWPs help boost skills that are more relevant to Tonga's circumstances, and are complemented with mechanisms to facilitate the return and reintegration of workers into higher value-added economic activities.

37. More could be done to increase business formation. The insolvency regime should be improved to provide banks and private companies with a predictable and transparent resolution framework. This would help boost credit to MSMEs (Figure). Additional measures could include: greater competition in corporate lending by further developing NBFIs; land leasehold reforms to facilitate the use of real estate as collateral; and, enhanced financial training and literacy for MSMEs (accounting,

Outstanding Bank Loans to Small and Medium Enterprises
(In percent of GDP)



Source: IMF Financial Access Survey.
Note: Pacific Island average comprises Fiji, Micronesia, and Samoa.

[25] CCPA Report, 2020.

budgeting) to reduce screening and lending costs. Deregulating restricted lists of protected sectors will allow greater foreign investment.[26]

38. Amendments to the 2018 FEC Act, under consideration, are necessary. While repatriation requirements are common in countries with capital controls, the Act should be sufficiently robust to ensure its objective of protecting the country's international reserves, particularly in times of economic stress, are met in a manner that provides certainty and a conducive environment for investors and the public at large.

Authorities' Views

39. Developing the private sector is an important strategic priority for the government. To encourage MSME lending, the NRBT is considering managing a credit guarantee scheme (similar to that of Fiji) with donor funding, to help incubate small businesses with funding and training. Amendments to the 2018 FEC Act repealing provisions related to immovable property in or outside Tonga are under consideration. Reforms to land administration, including enabling female property rights, are needed, but likely to be complicated given the political, cultural and social significance of land in Tonga. A draft land reform bill introduced in Parliament awaits consideration. The Land Ministry actively facilitates leasing, which, in their view, does not deter investment. However, they agreed that land-lease processes could be modernized by improving transparency and administration and are working to digitalize their records to create an online portal. An insolvency law would be politically untenable as it is closely tied to the land tenure system. The authorities agreed female labor force participation should be strengthened and highlighted improvements in the representation of women in government, including in Parliament. They also supported the seasonal worker programs as they help boost remittances in the short term, while acknowledging the dampening effect of labor exports on growth potential. Mechanisms to facilitate the return and reintegration of workers into higher value-added economic activities would be welcome.

FINANCING NEEDS AND ROLE OF IMF SUPPORT

40. IMF assistance through the RCF is needed to meet Tonga's urgent balance of payment needs due to the pandemic and Cyclone Harold. Tonga is expected to feel the full brunt of the pandemic in FY2021 during its peak tourism season. The sharper drop in tourism, weaker remittances as recovering remitting countries scale back fiscal support, and higher imports related to COVID-19 and post-cyclone reconstruction are expected to generate a large financing gap and sharply reduce reserves below desirable levels. This would result in a severe economic fallout if unaddressed. The terms of the RCF make it the most suitable of IMF concessional financing facilities for Tonga. Although Tonga's policy reform efforts would benefit from a longer-term upper-credit-tranche (UCT) IMF arrangement, agreement on the parameters of such an arrangement

[26] Foreign investors are restricted from participating in several areas under the "Reserved and Restricted List." Ongoing revisions to the Foreign Investment Act are being resisted by the business community as they restrict decision-making authority to only two officials without input from the broader business community.

would take additional time given the election calendar (November 2021). Moreover, in the short-term such an arrangement would be subject to high uncertainty given large downside risks, no prior experience with IMF UCT arrangements, and thinly stretched capacity which can be overcome with the help of external experts but only when borders are allowed to be opened.

41. Access of 50 percent of quota under the exogenous shock window of the RCF would be appropriate (Table 8). At 6.9 million SDR, around US$9.7 million, the amount to be provided under the RCF would be equivalent to 10 percent of the balance of payments funding need brought on by the pandemic as the brunt of the crisis is felt in FY2021, and would leave room for further borrowing in the event Tonga is hit by another natural disaster. The disbursement would help catalyze other external financing and the authorities to weather the shock while Tonga's borders remain closed, while also safeguarding macroeconomic stability.

42. The RCF disbursement will be made available as budget support to finance the authorities' response to the Covid-19 pandemic. The authorities have expressed their intent to use this budget support to safeguard public health, and support the economic recovery (Appendix I). Consistent with standard practice, it is anticipated that the RCF allocation would take the form of a credit to the NRBT, subsequently on-lent to the government. The Ministry of Finance and NRBT are finalizing a Memorandum of Understanding on their respective roles and responsibilities for servicing financial obligations to the IMF. The funds will be maintained in the Treasury accounts at the NRBT pending their use.

43. Budget support through the proposed RCF is expected to catalyze additional support from IFIs. Emergency assistance under the RCF will be critical in securing additional financing to cover Tonga's urgent and large external financing gap. Other major donors have already provided about US$17 million in grants as new budget support since the outbreak of the pandemic. Additional World Bank grants of some US$30 million is being considered for FY2021.

44. Tonga's capacity to repay the IMF is adequate (Table 9). The proposed disbursement under the RCF would, if approved, increase the IMF's exposure to Tonga to some 2 percent of GDP and 4 percent of gross international reserves in FY2021. This level of access would be manageable, given the level of reserves. While Tonga remains at high risk of debt distress, debt is assessed to be sustainable under current macroeconomic forecasts given the authorities' policy commitments to undertake fiscal adjustment, and seek new donor support including debt relief (Appendix I). Major delays in honoring these commitments could pose risks to debt sustainability.

45. The authorities have committed to measures to improve macroeconomic stability and debt sustainability (Appendix I). This commitment is needed to ensure an orderly adjustment, without pressuring domestic credit conditions and the exchange rate regime. The authorities commit to evaluating fiscal priorities, redirecting the available funds to combat the pandemic and provide temporary support to the most vulnerable and to ensuring that the financial assistance received will be subject to the application of budgetary procedures and controls, including audits. They also commit to pursue monetary and financial policies to support liquidity and economic activity, maintain financial stability, and avoid undermining banking system soundness.

46. The NRBT has committed to undertake a safeguards assessment in connection with the RCF. To this end, they have agreed to authorize the NRBT's external auditors to hold discussions with IMF staff and to provide access to the NRBT's most recent external audit reports.

STAFF APPRAISAL

47. Tonga's economic contraction is likely to deepen in 2021 due to twin shocks from the pandemic and Cyclone Harold. Proactive and timely actions, including the early closure of external borders and prompt economic support, have helped avoid a worse economic outcome. Nevertheless, FY2020 GDP is expected to have dropped by -2½ percent due to domestic containment measures, economic uncertainty, a halt in SWPs and tourism, and, investment delays. Output is expected to contract further by -3½ percent in FY2021 as Tonga's peak tourism season gets underway while borders remain closed, and reconstruction delays continue. Assuming borders reopen by end-FY2021, a gradual recovery could be expected in FY2022−23, but this remains uncertain.

48. External balances are set to worsen. The FY2020 external balance is broadly in line with fundamentals. Nevertheless, declines in tourism and remittance inflows, and higher pandemic- and reconstruction-related imports, are expected to generate a large external financing gap, sharply reducing reserves in FY2021 from its current record highs. Beyond FY2021, as large external debt repayments come due starting in 2024, current account deficits are also likely to remain large, reflecting persistently weak export competitiveness and heavy import dependence, a pickup in reconstruction and the implementation of delayed infrastructure projects reflecting Tonga's large investment needs. Reserve coverage is expected to decline to around 4 months of imports by 2025, well below desirable levels (7¼ months of imports).

49. The medium-term outlook is modest and fragile. With the pandemic having worsened Tonga's pre-existing debt and external vulnerabilities, the medium-term outlook remains fragile and Tonga's growth potential, low. A weaker global recovery that weighs on exports, aid, and remittances, a local outbreak, and further disruptions in correspondent banking relations pose significant downside risks. Financial sector risks are elevated, and the risk of public and external debt distress is high.

50. Prudent economic management has helped maintain macroeconomic and financial stability despite the circumstances. A series of budget surpluses (albeit with some weaknesses in underlying policies), low inflation, still adequate bank capital buffers, and improving financial supervision bear testament to a strong commitment to reforms. Nevertheless, economic challenges remain large because of modest economic prospects and elevated risks.

51. Post-pandemic, higher-quality budget surpluses will be needed to stabilize debt dynamics and strengthen climate-resilience. A fiscal deficit is unavoidable in FY2021 to support the economy through the pandemic, but priority spending on healthcare (including vaccines), maintenance, and investment should be protected. Aided by donor support in the form of new grant commitments and/or debt relief, fiscal adjustment of 2½–3 percent of GDP could be achievable on average over FY2022–24. The targeting of fiscal support could be improved through better processes and greater transparency about the approval and monitoring of tax exemptions, publication of audited pandemic-related expenditures and procurement contracts including beneficiary owners of the companies awarded the contracts, and by expanding the social protection system to effectively target those most affected by economic shocks. The tax base should be broadened by gradually closing major CT exemptions, updating excise tax rates, fees and charges, closing tax loopholes, collecting tax arrears and reducing tax avoidance, and improving the collection of land-related fees. Stricter current spending controls are warranted within the current fiscal anchors to improving efficiency, capacity and value for money.

52. Continued support from the international community would be warranted. Given the limited time to build adequate buffers, continued donor support in the form of new grant financing commitments and debt relief is needed to help the government meet its policy goals faster. At the same time, implementation capacity should be improved through more consistent prioritization and cross-governmental coordination, improved public financial management practices and governance.

53. Monetary policy support should continue, given low inflation. The NRBT should continue to ensure adequate liquidity levels and lower the SRD rate should liquidity pressures arise.

54. Improvements in financial sector supervision and the AML/CFT framework should be accelerated. Though banks are still profitable and well capitalized, financial sector risks are elevated. The NRBT's risk assessment capacity should continue to be enhanced and preemptive steps taken to ensure that banks are adequately provisioned and capitalized to withstand adverse developments. A solvency stress testing framework needs to be established, household debt monitoring enhanced by broadening credit information systems to cover lending by NBFIs, and macroprudential instruments developed to limit systemic risk. Given the importance of remittances for the economy and the financial system, the AML/CFT framework should be strengthened as a matter of priority.

55. A lasting solution to Tonga's fiscal and development challenges would be to grow the small private sector. A stronger business climate and private sector would help increase fiscal and financial resilience, by broadening the tax base and boosting financial sector growth, and enable Tonga to gain from Pacer Plus by attracting investments that could increase its export share and improve climate resilience. Modernizing and clarifying the land lease process by improving transparency and predictability on lease tenures, renewal and ownership rights can boost investment and expand access to credit. Increasing female labor force participation and improving the supply of skilled labor, including through improved TVET programs and mechanisms to facilitate the return and reintegration of SWPs into higher value-added economic activities, and enhanced financial training and literacy for MSMEs can help to lift productivity and encourage business formation. Strengthening climate-resilience, improving regulations (such as the 2018 FEC Act and insolvency laws), deregulating protected sectors, boosting official capacity can all help raise productivity by attracting investors. The quality, timeliness and dissemination of statistics could be further improved.

56. Staff supports the authorities' request for financial assistance under the RCF equivalent to 50 percent of quota (SDR 6.9 million). IMF assistance through the RCF will help meet Tonga's urgent balance of payments and budget financing needs and could catalyze additional external financing. Access of 50 percent of quota would be equal to 10 percent of Tonga's balance of payments funding needs brought on by the pandemic, and would leave room for further borrowing in the event Tonga is hit by another natural disaster. If approved, the proposed RCF would increase the IMF's exposure to Tonga to 2 percent of GDP or about 4 percent of gross international reserves in FY2021. This level of access would be manageable, given Tonga's level of reserves. The disbursement will be made available as budget support to finance Tonga's response to the Covid-19 pandemic. The authorities have committed to measures to improve macroeconomic stability and debt sustainability to ensure an orderly adjustment, without pressuring domestic credit conditions and the exchange rate regime.

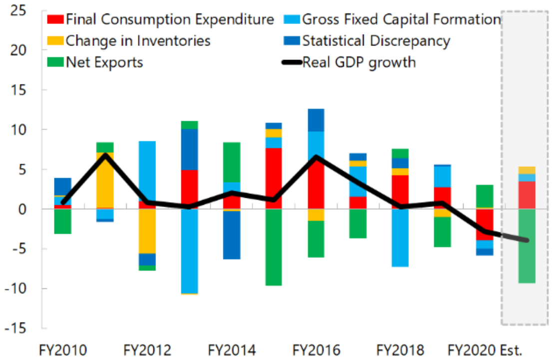
57. It is recommended that, instead of the current biannual cycle, the next Article IV Consultation for Tonga take place on a standard 12-month cycle.

Figure 1. Tonga: A Recovery Interrupted by the Pandemic

Net exports contracted due to the pandemic…

Contribution to Growth by Expenditure Category

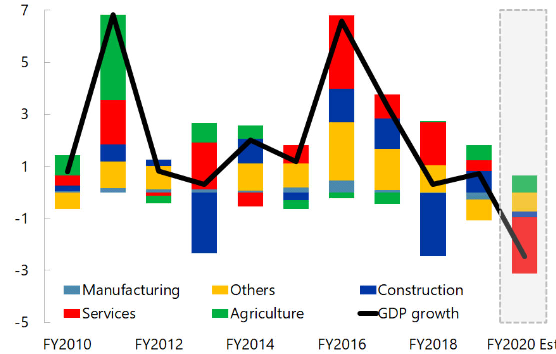
(In percent)



… with the services sector hit particularly hard.

Contribution to Growth by Sector

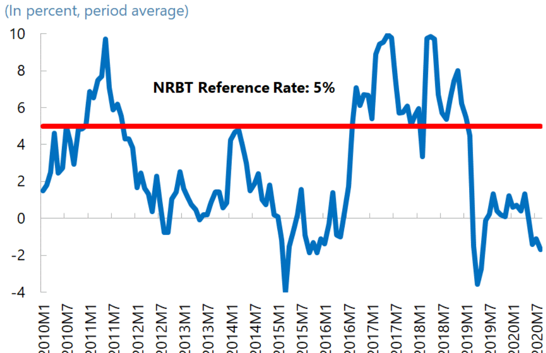
(In percent)



Inflation remains well below the NRBT's reference rate, falling into negative territory since June 2020…

Consumer Price Index

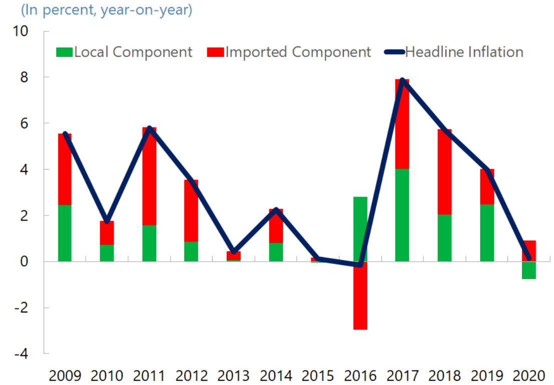
(In percent, period average)



…helped by low global commodity and food prices and lower domestic food prices.

Contribution to Headline Inflation

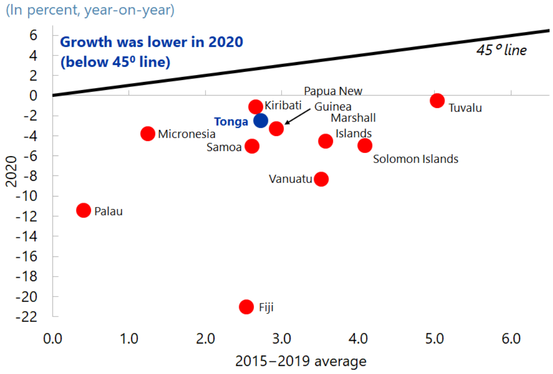
(In percent, year-on-year)



Growth is expected to be higher than regional peers…

PICs: Real GDP Growth

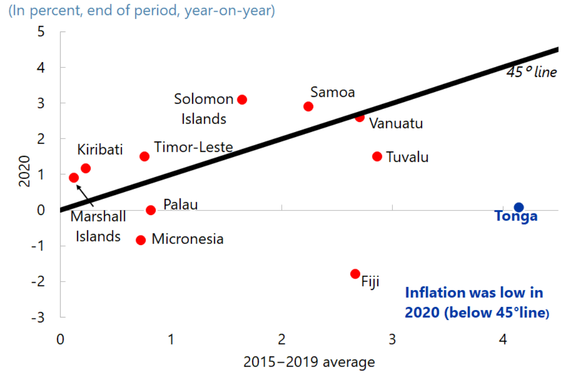
(In percent, year-on-year)



…but inflation has been much lower.

PICs: Inflation

(In percent, end of period, year-on-year)



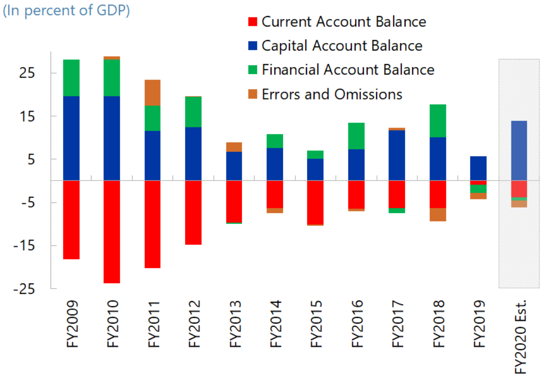
Sources: Tonga authorities; and IMF staff estimates.

Figure 2. Tonga: External Shock Mitigated by Import Compression and Aid

The current account deficit widened…

Balance of Payments

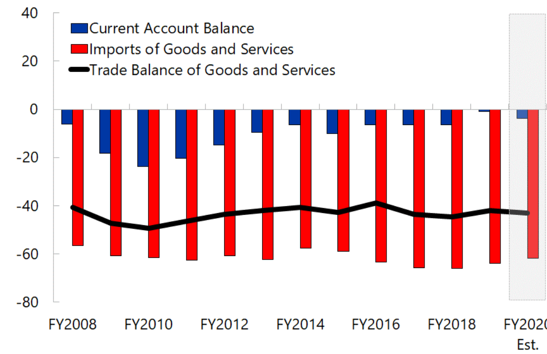
(In percent of GDP)



…despite imports being constrained by investment delays.

Trade Balance

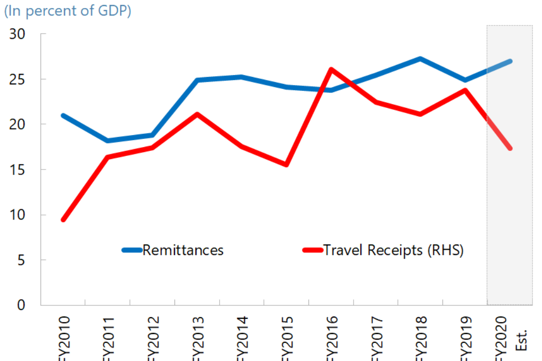
(In percent of GDP)



A modest pickup in remittances offset a sharp decline in travel receipts…

Remittances and Travel Receipts

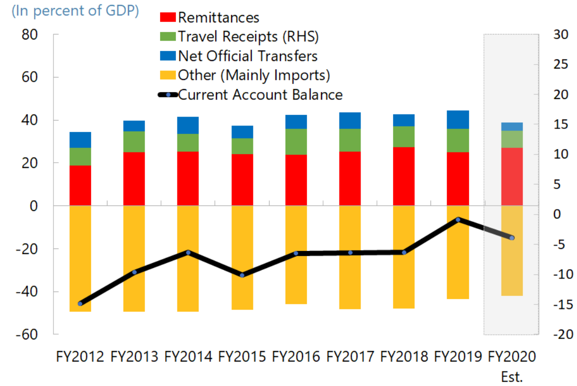
(In percent of GDP)



…thereby also supporting the current account balance.

Contributions to Current Account Balance

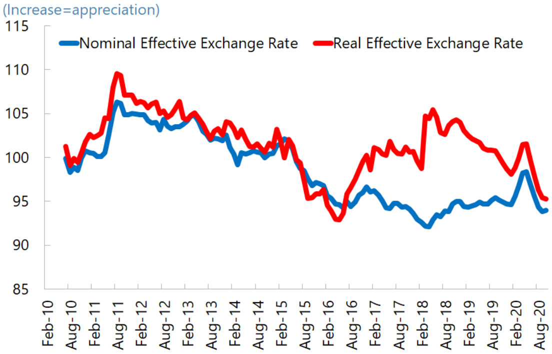
(In percent of GDP)



Low inflation contributed to a small REER depreciation which boosted competitiveness.

Nominal Effective Exchange Rate and Real Effective Exchange Rate

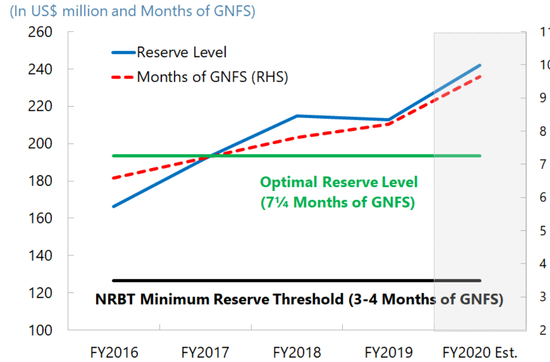
(Increase=appreciation)



Reserves are at all-time highs due to higher capital transfers (grants) and import compression.

Reserve Level

(In US$ million and Months of GNFS)

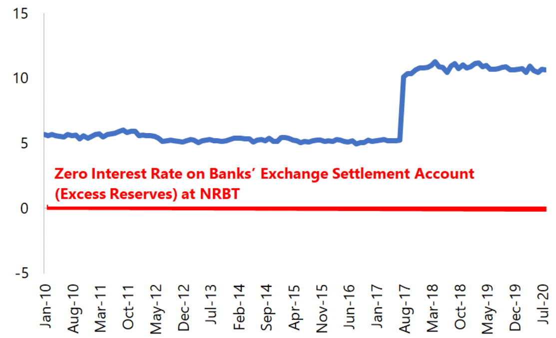


Sources: Tonga authorities; and IMF staff estimates.

Figure 3. Tonga: Monetary Stability was Maintained

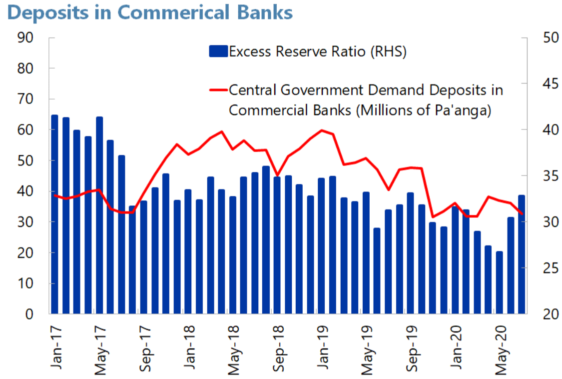
Monetary policy remains on hold…

Required Reserves Ratio
(In percent of Total Bank Deposits)



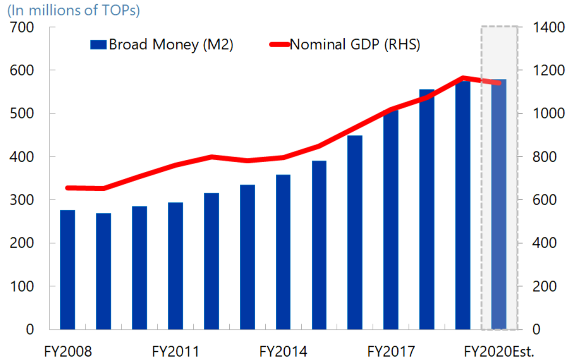
…and liquidity levels remain adequate.

Excess Reserve Ratio and Central Government Demand Deposits in Commerical Banks



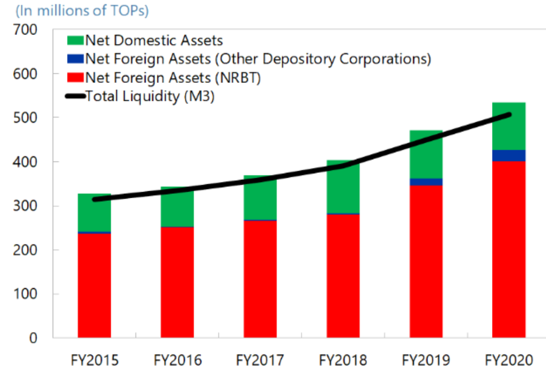
Domestic liquidity has grown in tandem with nominal GDP…

Domestic Liquidity
(In millions of TOPs)



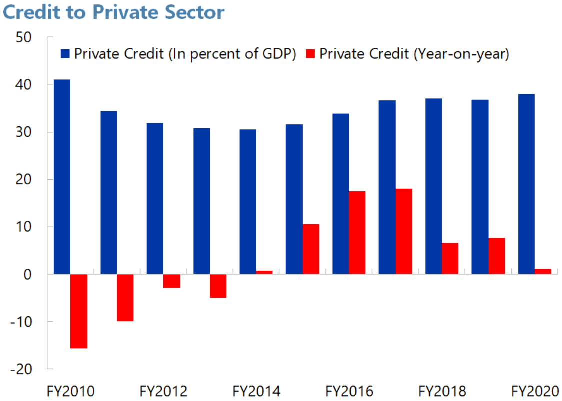
…driven mostly by unsterilized net foreign assets accumulation.

Contribution to Total Liquidity: M3
(In millions of TOPs)



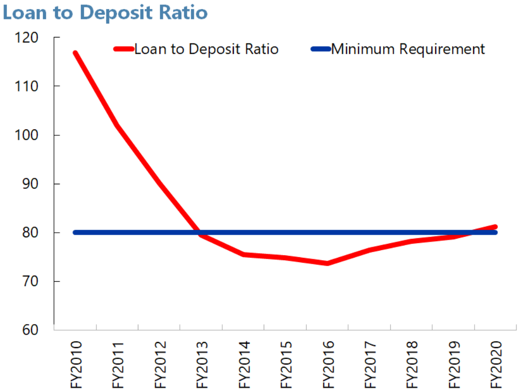
Private sector credit slowed due to weak demand from already highly leveraged households…

Credit to Private Sector



… while loan to deposit ratios remain close to the 80 percent minimum indicative requirement.

Loan to Deposit Ratio

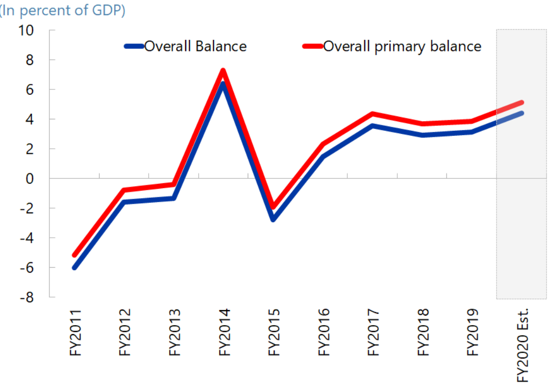


Sources: Tonga authorities; and IMF staff estimates.

Figure 4. Tonga: A Fifth Consecutive Budget Surplus was Recorded

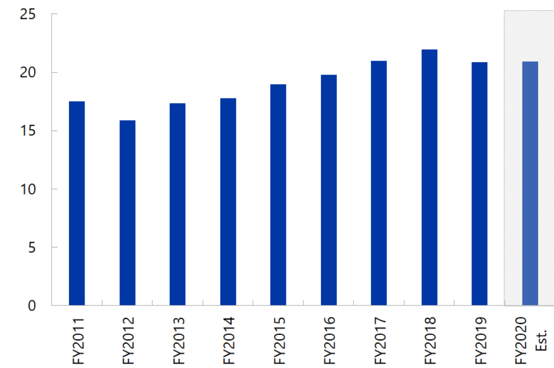
Fiscal balances have been in surplus since FY2016.

Overall and Primary Balance
(In percent of GDP)



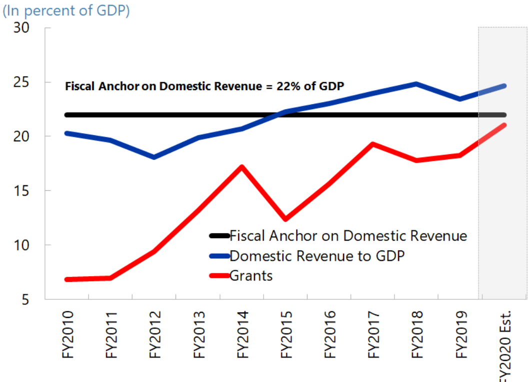
Due to improved collection, tax revenues remained stable despite exemptions and a weak economy.

Tax Revenue
(In percent of GDP)



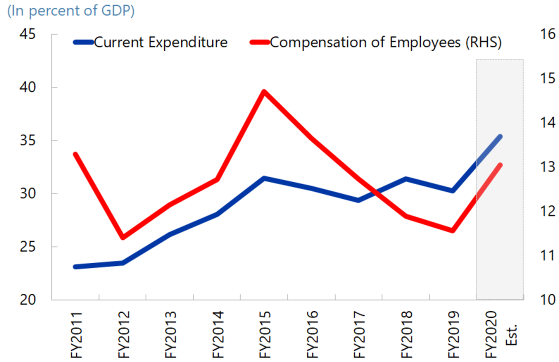
Donors stepped up aid in the form of grants.

Domestic Revenue
(In percent of GDP)



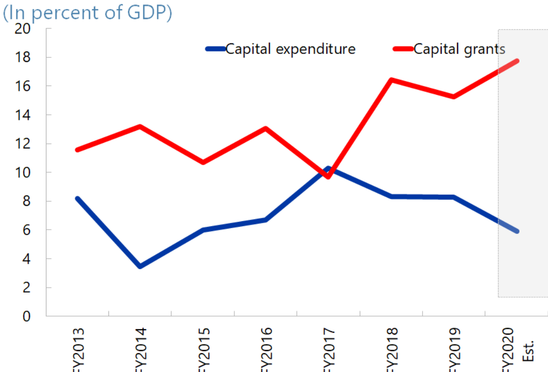
Rising pandemic-related spending and the wage bill…

Current Expenditure and Compensation of Employees
(In percent of GDP)



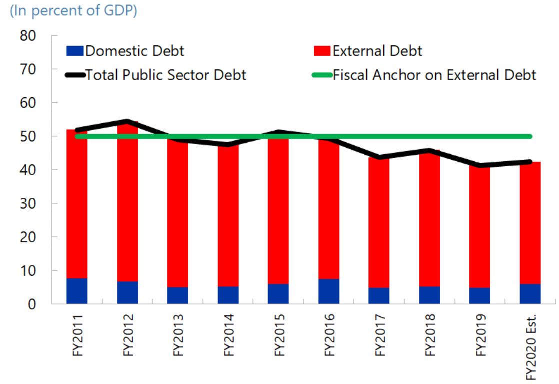
…was offset by delayed investments, resulting in large unspent reconstruction-related grants.

Capital Expenditure and Capital Grants
(In percent of GDP)



Public legacy debt levels, while declining, remain high.

Total Debt and Fiscal Anchor
(In percent of GDP)

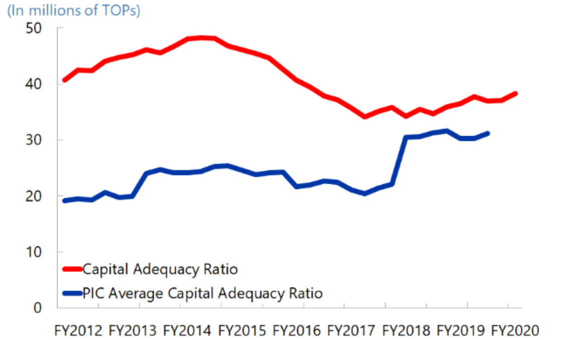


Sources: Tonga authorities; and IMF staff estimates.

Figure 5. Tonga: Bank Balances are Still Strong, but with Rising Risks

Capital buffers remain above the PIC average.

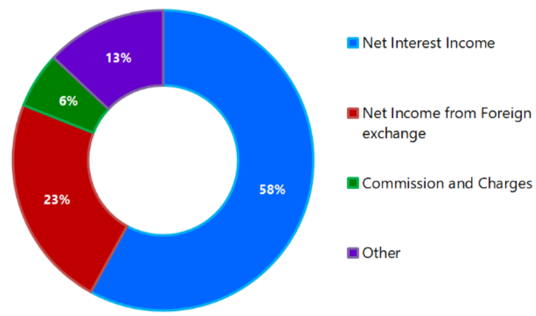
Capital Buildup
(In millions of TOPs)



Note: PIC Countries includes Fiji, Micronesia, Papua New Guinea, Samoa, Solomon Islands and Vanuatu.

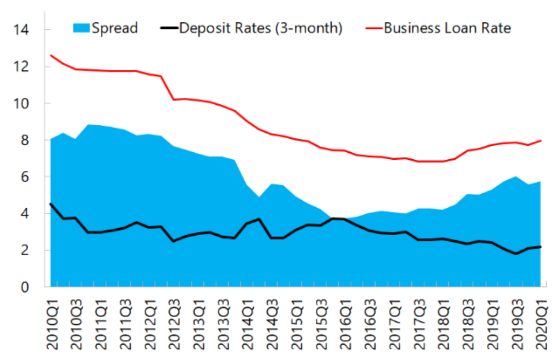
Bank profitability continues to rely on large NIMs...

Financial Sector Operating Income Components in 2020



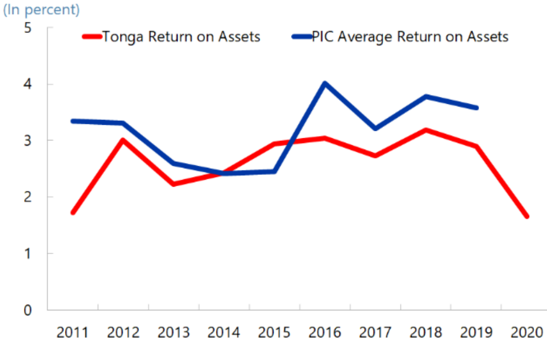
...as interest rate spreads remain wide.

Interest Rates
(In percent)



However, profitability has been declining due to slower credit growth...

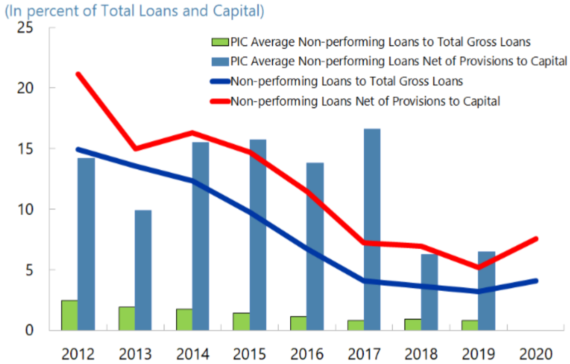
Return on Assets
(In percent)



Note: PIC Countries includes Fiji, Micronesia, Papua New Guines, Samoa, Solomon Islands, and Vanuatu.

...while NPLs have started to tick up.

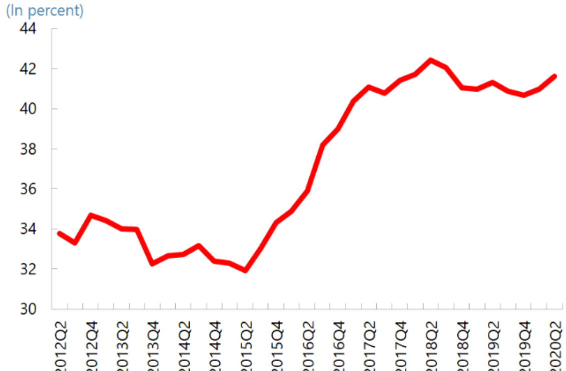
Non-Performing Loans
(In percent of Total Loans and Capital)



Note: PIC Countries includes Fiji, Micronesia, Papua New Guinea, Samoa, Solomon Islands, and Vanuatu.

Bank lending remains concentrated in residential loans.

Residential Real Estate Loans to Total Loans
(In percent)

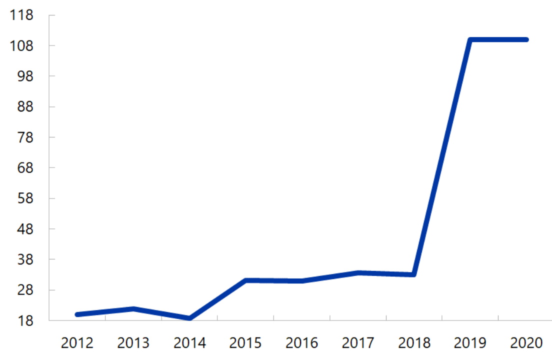


Sources: Tonga authorities; and IMF staff estimates.

Figure 6. Tonga: Improving Financial Inclusion Stalled During the Pandemic

Lower bank profits has delayed new bank branches…

Commercial Bank Branches per 100,000 Adults

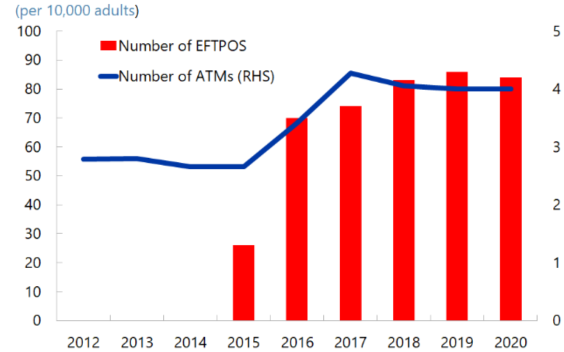


Note: Non-bank data are included starting in 2019.

….and new ATMs, EFTPOS…

Number of ATMs and EFTPOS

(per 10,000 adults)

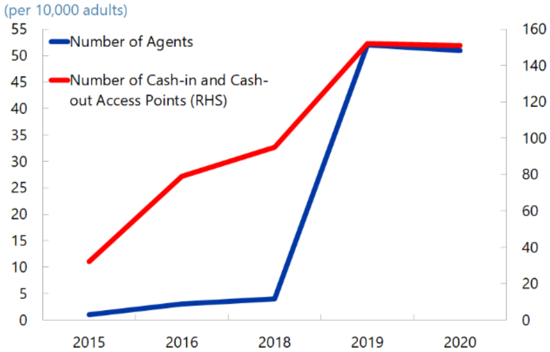


Note: Non-bank data are included starting in 2019.

and cash points.

Number of Agents and Access Points

(per 10,000 adults)

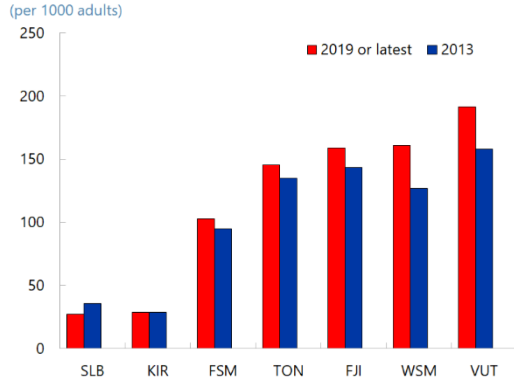


Note: Non-bank data are included starting in 2019.

Tongans are taking out more loans…

Commercial Bank Loan Accounts

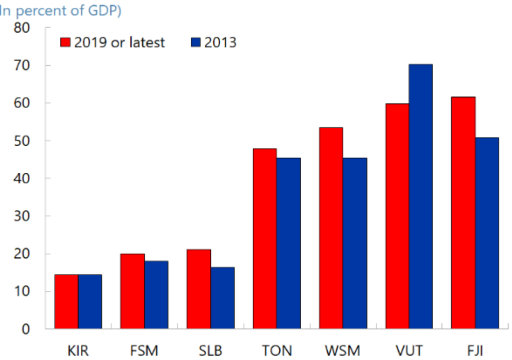
(per 1000 adults)



…though financial development remains lower than peers.

Commercial Bank Loans

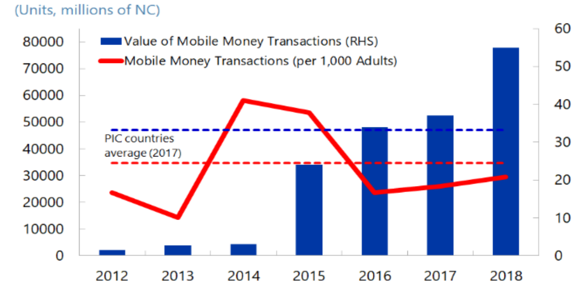
(In percent of GDP)



Mobile money transactions have been rising.

Mobile Money Transactions

(Units, millions of NC)



Note: Pacific Island countries include Fiji, Samoa and Solomon Islands (mobile money transaction value) and Fiji, Papua New Guinea, Samoa and Solomon Islands (mobile money transaction per 1000 adults).

Sources: Tonga authorities; and IMF staff estimates.

Table 1. Tonga: Selected Economic Indicators, FY2018–FY2023 1/

Population (2019): 104 thousands
GDP per capita FY2018 (thousands of US$): 4.9
Key export markets: Australia, Japan, New Zealand, and United States
Major exports: root crops, vanilla, squash, fish
Quota: SDR 13.8 million

		Est.	Projections			
	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Output and prices			(Annual percent change)			
Real GDP[2]	0.3	0.7	-2.5	-3.5	4.0	3.0
Consumer prices (period average)[3]	6.8	3.3	0.2	-0.9	2.1	2.0
Consumer prices (end of period)[3]	6.7	-0.1	-1.4	1.8	2.4	1.6
GDP deflator	5.1	7.7	0.4	-0.9	2.1	2.0
Central government finance			(In percent of GDP)			
Total Revenue	42.6	41.7	45.7	45.7	42.0	44.4
Revenue (excluding grants)	24.8	23.4	24.7	22.9	23.9	24.3
Grants	17.8	18.3	21.0	22.9	18.1	20.1
Total Expenditure	39.7	38.5	41.3	50.6	42.3	43.4
Expense	31.4	30.3	35.4	44.4	35.6	34.9
Transactions in Nonfinancial Assets (Net)	8.3	8.3	5.9	6.2	6.7	8.5
Overall balance	2.9	3.2	4.4	-4.8	-0.3	1.0
Net Acquisition of Financial Assets	2.4	2.0	5.1	-1.8	0.5	1.3
External financing (net)	-0.6	-1.2	-0.5	1.6	-1.4	-1.7
Domestic financing (net)	0.1	0.0	1.1	1.4	2.2	2.0
Money and credit			(Annual percent change)			
Total liquidity (M3)	7.6	4.3	1.2	-8.9	10.6	7.7
Of which: Broad money (M2)	9.4	3.5	1.1	-9.4	11.1	8.0
Domestic credit	-6.5	6.0	-15.7	4.0	18.4	12.0
Of which: Private sector credit	6.7	7.6	1.1	0.7	3.4	3.9
Interest rates (end of period)						
Average deposit rate	2.3	2.3	2.3	…	…	…
Average lending rate	8.5	8.2	8.1	…	…	…
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	14.2	15.8	18.3	14.4	17.7	19.0
Imports, f.o.b.	215.3	223.3	213.7	208.2	234.6	246.7
Services balance	-15.0	-9.3	-20.9	-88.2	-29.7	-36.3
Investment income balance	26.4	39.9	42.2	14.7	27.4	34.6
Transfers balance	158.9	172.4	154.4	181.3	168.7	182.6
Of which: Remittances	137.1	141.6	144.9	113.8	122.4	128.0
Of which: Official grants	28.8	45.3	20.3	84.3	64.2	73.4
Current account balance	-30.7	-4.4	-19.6	-85.9	-50.5	-46.9
(In percent of GDP)	-6.3	-0.9	-3.9	-17.5	-9.6	-8.5
Overall balance	22.7	-2.1	29.1	-64.7	-23.2	-21.4
(In percent of GDP)	4.7	-0.4	5.8	-13.2	-4.4	-3.9
Terms of trade (annual percent change)	-2.5	0.2	0.1	-0.5	0.6	0.4
Gross official foreign reserves						
In millions of U.S. dollars	214.9	212.8	241.9	192.3	169.1	147.7
(In months of next year's total imports)	7.8	8.2	9.6	6.7	5.5	4.7
Debt (in percent of GDP)						
Public debt (external and domestic)	45.9	41.3	42.3	46.3	44.6	42.7
Of which: External debt	40.5	36.4	36.2	38.5	35.1	31.6
External debt service ratio	1.2	1.7	1.5	2.0	1.8	2.0
Exchange rates						
Nominal effective exchange rate (2005=100)	93.5	94.6	93.4	…	…	…
Real effective exchange rate (2005=100)	101.8	102.4	99.9	…	…	…
Memorandum items:						
Remittances (in percent of GDP)	28.2	27.4	28.7	23.2	23.3	23.2
Tourism (in percent of GDP)	9.0	9.2	7.4	0.4	7.3	7.5
FDI (in percent of GDP)	4.9	0.1	0.7	0.9	0.9	0.8
Nominal GDP (millions of US$)	485.9	516.8	504.1	491.0	526.1	551.9
GDP Growth 2018 - 2023 (Calendar Year Basis)	0.5	-0.9	-3.0	0.2	3.5	2.8

Sources: Tonga authorities; and IMF staff estimates and projections.
[1]Fiscal year beginning July.
[2]Including preliminary data.
[3]CPI basket and methodology changed in September 2018.

Table 2. Tonga: Balance of Payments Summary, FY2018–FY2023

	FY2018	FY2019	Est. FY2020	Projections FY2021	FY2022	FY2023
			(In millions of U.S. Dollars)			
Current account balance	**-30.7**	**-4.4**	**-19.6**	**-85.9**	**-50.5**	**-46.9**
Trade balance	-201.1	-207.4	-195.4	-193.7	-216.9	-227.8
Exports, f.o.b.	14.2	15.8	18.3	14.4	17.7	19.0
Imports, f.o.b.	-215.3	-223.3	-213.7	-208.2	-234.6	-246.7
Services balance	-15.0	-9.3	-20.9	-88.2	-29.7	-36.3
Receipts	89.8	97.6	76.3	4.5	79.2	84.6
Payments	-104.7	-107.0	-97.2	-92.8	-108.9	-120.9
Investment income balance	26.4	39.9	42.2	14.7	27.4	34.6
Receipts	50.5	55.8	58.1	33.6	45.9	51.4
Payments	-24.1	-15.8	-15.8	-18.9	-18.5	-16.8
Transfers balance	158.9	172.4	154.4	181.3	168.7	182.6
Official transfers (net)[1]	26.5	44.0	18.5	82.6	62.4	71.5
Private transfers (net)	132.5	128.5	135.9	98.7	106.3	111.1
Capital account balance	**48.8**	**29.3**	**70.2**	**23.9**	**30.1**	**30.2**
Financial account balance	**37.7**	**-10.0**	**-3.6**	**2.7**	**-2.8**	**-4.8**
FDI (net)	23.8	0.3	3.7	4.5	4.5	4.5
Other investment (net)	14.5	-5.4	-2.3	-1.8	-7.3	-9.2
Of which: Loan disbursements	0.0	0.0	2.5	5.4	0.0	0.0
Errors and omissions	-33.0	-16.9	-18.0	0.0	0.0	0.0
Overall balance	**22.7**	**-2.1**	**29.1**	**-64.7**	**-23.2**	**-21.4**
Financing	**-22.7**	**2.1**	**-29.1**	**64.7**	**23.2**	**21.4**
Change in reserve assets (- decrease)	22.7	-2.1	29.1	-49.6	-23.2	-21.4
Use of IMF credit (net)	0.0	0.0	0.0	9.7	0.0	0.0
Disbursement (RCF)[2]	0.0	0.0	0.0	9.7	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0
Suspended debt service under G20 DSSI[3]	0.0	0.0	0.0	5.4	0.0	0.0
			(In percent of GDP)			
Current account balance	-6.3	-0.9	-3.9	-17.5	-9.6	-8.5
Trade balance	-41.4	-40.1	-38.8	-39.5	-41.2	-41.3
Exports, f.o.b.	2.9	3.1	3.6	2.9	3.4	3.4
Imports, f.o.b.	-44.3	-43.2	-42.4	-42.4	-44.6	-44.7
Services balance	-3.1	-1.8	-4.1	-18.0	-5.7	-6.6
Receipts	18.5	18.9	15.1	0.9	15.0	15.3
Payments	-21.6	-20.7	-19.3	-18.9	-20.7	-21.9
Investment income balance	5.4	7.7	8.4	3.0	5.2	6.3
Receipts	10.4	10.8	11.5	6.8	8.7	9.3
Payments	-5.0	-3.1	-3.1	-3.8	-3.5	-3.1
Transfers balance	32.7	33.4	30.6	36.9	32.1	33.1
Official transfers (net)[1]	5.4	8.5	3.7	16.8	11.9	13.0
Private transfers (net)	27.3	24.9	27.0	20.1	20.2	20.1
Capital account balance	10.0	5.7	13.9	4.9	5.7	5.5
Financial account balance	7.8	-1.9	-0.7	0.5	-0.5	-0.9
FDI (net)	4.9	0.1	0.7	0.9	0.9	0.8
Other investment (net)	3.0	-1.0	-0.5	-0.4	-1.4	-1.7
of which : Loan disbursements	0.0	0.0	0.5	1.1	0.0	0.0
Overall balance	4.7	-0.4	5.8	-13.2	-4.4	-3.9
Financing	-4.7	0.4	-5.8	13.2	4.4	3.9
Change in reserve assets (- decrease)	4.7	-0.4	5.8	-10.1	-4.4	-3.9
Use of IMF credit (net)	0.0	0.0	0.0	2.0	0.0	0.0
Disbursement (RCF)[2]	0.0	0.0	0.0	2.0	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0
Suspended debt service under G20 DSSI[3]	0.0	0.0	0.0	1.1	0.0	0.0
Memorandum items:						
Gross official foreign reserves	214.9	212.8	241.9	192.3	169.1	147.7
In months of next year's total imports	7.8	8.2	9.6	6.7	5.5	4.7
Exchange rate						
T$ per U.S. dollar (period average)	2.2	2.3	2.3	...	...	...
T$ per U.S. dollar (end of period)	2.2	2.3	2.2	...	...	...
Nominal GDP (in millions of US$)	485.9	516.8	504.1	491.0	526.1	551.9
Commodity price indexes (2005 = 100)						
Food	103.2	100.9	99.5	101.9	104.1	104.3
Fuel	140.8	144.1	110.5	98.0	107.1	110.1

Sources: Tonga authorities; and IMF staff estimates and projections.

[1]Includes all official grants excluding project-related funds related to capital formation.

[2]SDR 6.9 million, equivalent to 50 percent of Tonga's quota.

[3]Debt service suspended for 1 year, with a 1 year grace period and 3 years maturity.

Table 3. Tonga: Depository Corporations Survey, FY2018–FY2023 1/

	FY2018	FY2019	FY2020	Projections FY2021	FY2022	FY2023
	(In millions of T$, end of period)					
Net foreign assets	485.1	492.3	570.6	532.8	389.6	539.2
Claims on nonresidents	520.9	531.3	601.9	570.4	426.2	571.6
NRBT	479.1	484.3	555.9	527.6	378.9	526.9
Other depository corporations	41.8	47.0	46.0	42.8	47.3	44.7
Liabilities to nonresidents	-35.8	-39.0	-31.2	-37.6	-36.6	-32.5
NRBT	-20.7	-20.9	-20.8	-20.7	-20.9	-20.8
Other depository corporations	-15.1	-18.0	-10.4	-16.9	-15.7	-11.7
Net domestic assets	90.3	86.1	37.5	20.6	222.5	120.1
Net domestic credit	283.1	300.1	252.9	263.0	311.3	348.7
Net claims on government	-169.1	-190.9	-244.8	-229.6	-204.5	-181.7
Claims on public nonfin. corps.	52.3	60.2	61.6	53.3	61.8	58.8
Claims on private sector	397.5	427.9	432.7	436.0	450.7	468.1
Other items, net	-192.7	-214.0	-215.4	-242.5	-88.8	-228.5
Total liquidity (M3)	575.5	600.1	607.2	553.4	612.1	659.3
Broad money (M2)	555.1	574.5	579.2	524.9	583.2	629.8
Narrow money	240.5	262.2	247.3	251.7	256.2	260.8
Quasi money	314.5	312.2	331.9	273.2	326.9	369.0
FX deposits	20.4	25.6	28.0	28.5	29.0	29.5
	(Annual percentage change)					
Net foreign assets	13.5	1.5	15.9	-6.6	-26.9	38.4
Net domestic assets	-16.0	-4.7	-56.4	-45.2	982.0	-46.0
Net domestic credit	-6.5	6.0	-15.7	4.0	18.4	12.0
Claims on private sector	6.7	7.6	1.1	0.7	3.4	3.9
Total liquidity	7.6	4.3	1.2	-8.9	10.6	7.7
Broad money (M2)	9.4	3.5	0.8	-9.4	11.1	8.0
Memorandum items:						
Nominal GDP (in millions T$)	1073.2	1164.0	1140.2	1090.3	1156.8	1214.6
Velocity (GDP/M2)	1.9	2.0	2.0	2.1	2.0	1.9
T$ per U.S. dollar (end of period)	2.2	2.3	2.2	…	…	…

Sources: Tonga authorities; and IMF staff estimates and projections.
[1]Comprises the balance sheets of the National Reserve Bank of Tonga (NRBT) and other depository corporations (ODCs).

Table 4. Tonga: Summary of Central Government Operations, FY2018–FY2023

	FY2018	FY2019	*Budget FY2020*	Est. FY2020	*Budget FY2021*	Projections FY2021	Projections FY2022	Projections FY2023
				(In percent of GDP)				
Total Revenue	42.6	41.7	*50.7*	45.7	*49.7*	45.7	42.0	44.4
Memo: Revenue (excluding grants)	24.8	23.4	*26.8*	24.7	*25.7*	22.9	23.9	24.3
Tax revenue	21.9	20.9	*22.5*	20.9	*23.0*	20.3	20.9	21.2
Taxes on income/profits	4.6	4.7	*5.0*	4.6	*5.3*	4.6	4.6	4.7
Taxes on property	0.0	0.0	*0.0*	0.0	*0.0*	0.0	0.0	0.0
Taxes on goods and services	14.7	13.3	*15.0*	14.1	*15.3*	13.8	14.0	14.2
Taxes on international trade and transactions	2.7	2.8	*2.5*	2.2	*2.3*	1.8	2.2	2.3
Other taxes	0.0	0.0	*0.0*	0.0	*0.0*	0.0	0.0	0.0
Grants	17.8	18.3	*23.9*	21.0	*24.0*	22.9	18.1	20.1
Current grants (cash)	1.3	3.0	*3.4*	3.3	*3.7*	8.6	3.3	3.2
Capital grants (cash)	4.4	4.7	*20.5*	8.6	*20.3*	5.7	5.9	6.8
Grants in-kind	12.0	10.5	…	9.1	…	8.6	8.9	10.1
Other Revenue	2.9	2.5	*4.3*	3.7	*2.7*	2.6	3.1	3.1
Property income	1.0	0.9	*1.8*	1.3	*0.9*	0.9	1.2	1.2
Sales of goods and services	1.3	1.3	*1.5*	1.3	*1.4*	1.4	1.4	1.4
Total Expenditure	39.7	38.5	*49.8*	41.3	*53.2*	50.6	42.3	43.4
Memo: Expenditure (excluding grants in-kind)	27.7	28.0	…	32.2	…	42.0	33.5	33.3
Expense	31.4	30.3	*40.0*	35.4	*48.1*	44.4	35.6	34.9
Salaries and wages	10.9	10.6	*13.1*	12.1	*14.9*	13.1	12.8	12.4
Employers' social contribution	1.0	1.0	*1.1*	1.0	*1.2*	1.2	1.1	1.1
Interest	0.8	0.7	*0.7*	0.7	*0.9*	0.8	0.6	0.6
Of which: External	0.6	0.5	*0.5*	0.6	*0.6*	0.6	0.4	0.4
Use of goods and services[1]	14.2	13.0	*20.0*	17.2	*25.4*	24.0	16.4	16.2
Subsidies	0.1	0.1	*0.1*	0.1	*0.1*	0.1	0.1	0.1
Grants	0.5	0.3	*0.4*	0.3	*0.4*	0.4	0.4	0.4
Social benefits	2.1	2.2	*2.4*	1.9	*2.7*	2.6	2.4	2.4
Other expense	1.8	2.5	*2.3*	2.1	*2.5*	2.4	1.8	1.8
Net investment in nonfinancial assets	8.3	8.3	*9.8*	5.9	*5.2*	6.2	6.7	8.5
Buildings and structures	5.2	2.3	*5.8*	3.6	*2.9*	4.0	3.6	4.5
Machinery and equipment	1.8	5.5	*2.4*	2.0	*1.2*	1.1	1.4	1.4
Other fixed assets and non-produced assets	1.3	0.5	*1.6*	0.4	*1.1*	1.0	1.6	2.5
Gross Operating Balance	11.2	11.4	*10.7*	10.3	*1.7*	1.3	6.4	9.4
Overall balance	2.9	3.2	*0.9*	4.4	*-3.6*	-4.8	-0.3	1.0
Primary balance	3.7	3.9	*1.6*	5.2	*-2.8*	-4.0	0.4	1.5
Net acquisition of financial assets	2.4	2.0	*1.8*	5.1	*-3.6*	-1.8	0.5	1.3
External financing (loans)	-0.6	-1.2	*-1.0*	-0.5	*-0.4*	1.6	-1.4	-1.7
New disbursement	0.0	0.0	…	0.5	*1.8*	3.0	0.0	0.0
Of which : IMF RCF[2]	0.0	0.0	…	0.0	…	2.0	0.0	0.0
Of which : G20 DSSI	0.0	0.0	…	0.0	…	1.1	0.0	0.0
Repayment	0.6	1.2	…	1.0	*2.2*	1.5	1.4	1.7
Domestic financing (debt securities)	0.1	0.0	*0.1*	1.1	*2.0*	1.4	2.2	2.0
Memorandum items:								
Effective import duties rate	6%	6%	*6%*	5%	*5%*	4%	5%	5%
Nominal GDP (in millions of T$)[3]	1073.2	1164.0	*1140.2*	1140.2	*1031.0*	1090.3	1156.8	1214.6
Fiscal anchors[4]								
Compensation of employees								
(in percent of domestic revenue) **< 53**	47.9	49.3	*53.1*	52.9	*62.9*	62.3	58.1	55.6
(in percent of current expense) **< 45**	37.9	38.2	*35.6*	36.9	*33.6*	32.0	39.0	38.7
Domestic revenue (in percent of GDP) **> 22**	24.8	23.4	*26.8*	24.7	*25.7*	22.9	23.9	24.3
External debt (in percent of GDP) **< 50**	40.5	36.4	*36.2*	36.2	*39.3*	38.5	35.1	31.6

Sources: Tonga authorities; and IMF staff estimates and projections.

[1]For FY2020, an estimated 25 million (2.2 percent of GDP) of spending is related to the COVID-19. For FY2021, an estimated 70 million (6.4 percent of GDP) of spending is related to the pandemic. The amounts are added to the spending on goods and services, as disaggregated information is not available.

[2]SDR 6.9 million, equivalent to 50 percent of Tonga's quota.

[3]Projections assume a decline in grants over the medium-term once current commitments are fully disbursed; decline in revenue during 2021 due to tax exemptions, deferrals, or arrears as a result of the pandemic; improvements in revenue collection (CT, CIT and PIT) due to ongoing improvements in revenue administration and the expiration of tax exemptions; and improved collection of property-related revenues. On spending, the projections assume an increase in pandemic related spending in 2021 due to containment, healthcare and social assistance. Over the medium term, the projections assume ongoing efforts to control spending especially on wages, and better accounting of the wage bill which, starting in FY2021, no longer includes wage estimates for persistently unfilled vacancies. Investment forecasts include current plans for donor-funded projects for development and climate-resilience goals, but some are likely to be delayed to subsequent years due to the pandemic. The 2020 IMF-World Bank Climate Change Policy Assessment spending estimates to achieve climate- and sustainable development goals are included in the forecasts based on staff assessments of implementation capacity.

[4]Numbers in bold indicate the thresholds in Tonga’s fiscal anchors.

Table 5. Tonga: Medium-Term Baseline Scenario, FY2018–FY2025 1/

		Est.	Projections					
	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025[2]
Output and prices			(Annual percentage change)					
Real GDP	0.3	0.7	-2.5	-3.5	4.0	3.0	2.5	1.8
Consumer prices (end of period)	6.7	-0.1	-1.4	1.8	2.4	1.6	2.3	2.3
Consumer prices (period average)	6.8	3.3	0.2	-0.9	2.1	2.0	1.9	2.3
GDP deflator	5.1	7.7	0.4	-0.9	2.1	2.0	1.9	2.3
Central government finance[3]			(In percent of GDP)					
Total Revenue	42.6	41.7	45.7	45.7	42.0	44.4	34.6	32.3
Memo: Total Revenue (excluding grants)	24.8	23.4	24.7	22.9	23.9	24.3	24.2	24.2
Tax revenue	21.9	20.9	20.9	20.3	20.9	21.2	21.6	21.6
Grants	17.8	18.3	21.0	22.9	18.1	20.1	10.5	8.1
Other Revenue	2.9	2.5	3.7	2.6	3.1	3.1	2.6	2.6
Total Expenditure	39.7	38.5	41.3	50.6	42.3	43.4	42.7	42.3
Memo: Total Expenditure (excluding grants in-kind)	27.7	28.0	32.2	42.0	33.5	33.3	38.9	38.4
Expense	31.4	30.3	35.4	44.4	35.6	34.9	33.9	32.9
Salaries and wages	10.9	10.6	12.1	13.1	12.8	12.4	12.4	12.4
Employers' social contribution	1.0	1.0	1.0	1.2	1.1	1.1	1.1	1.1
Use of goods and services	14.2	13.0	17.2	24.0	16.4	16.2	15.2	14.2
Interest expense	0.8	0.7	0.7	0.8	0.6	0.6	0.7	0.8
Other expense	4.5	5.0	4.4	5.4	4.7	4.6	4.6	4.6
Transactions in Nonfinancial Assets	8.3	8.3	5.9	6.2	6.7	8.5	8.8	9.4
Gross Operating Balance	11.2	11.4	10.3	1.3	6.4	9.4	0.7	-0.7
Overall Balance	2.9	3.2	4.4	-4.8	-0.3	1.0	-8.1	-10.0
Primary Balance	3.7	3.9	5.2	-4.0	0.4	1.5	-7.4	-9.3
Net Acquisition of Financial Assets	2.4	2.0	5.1	-1.8	0.5	1.3	0.0	0.0
External financing (net)	-0.6	-1.2	-0.5	1.6	-1.4	-1.7	7.4	9.2
Domestic financing (net)	0.1	0.0	1.1	1.4	2.2	2.0	0.6	0.8
Balance of payments			(In percent of GDP)					
Trade balance	-41.4	-40.1	-38.8	-39.5	-41.2	-41.3	-41.2	-41.6
Exports, f.o.b.	2.9	3.1	3.6	2.9	3.4	3.4	3.7	3.8
Imports, f.o.b.	-44.3	-43.2	-42.4	-42.4	-44.6	-44.7	-44.9	-45.4
Services balance	-3.1	-1.8	-4.1	-18.0	-5.7	-6.6	-3.2	-2.6
Investment income balance	5.4	7.7	8.4	3.0	5.2	6.3	6.3	6.1
Transfers balance	32.7	33.4	30.6	36.9	32.1	33.1	26.3	26.4
Of which: Remittances	28.2	27.4	28.7	23.2	23.3	23.2	24.8	24.8
Of which: Official grants	5.9	8.8	4.0	17.2	12.2	13.3	4.7	4.8
Current account balance	-6.3	-0.9	-3.9	-17.5	-9.6	-8.5	-11.8	-11.7
Capital account balance	10.0	5.7	13.9	4.9	5.7	5.5	3.9	1.9
Financial account balance	7.8	-1.9	-0.7	0.5	-0.5	-0.9	8.1	9.9
Gross international reserves (end of period)								
In millions of U.S. dollars	214.9	212.8	241.9	192.3	169.1	147.7	149.2	149.9
In months of next year's goods and services imports	7.8	8.2	9.6	6.7	5.5	4.7	4.5	4.3
External debt (in percent of GDP)								
Public sector external debt	40.5	36.4	36.2	38.5	35.1	31.6	37.8	45.7
Debt service ratio	1.2	1.7	1.5	2.0	1.8	2.0	4.0	3.9
Public sector total debt (in percent of GDP)	45.9	41.3	42.3	46.3	44.6	42.7	49.1	57.3
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	132.5	128.5	135.9	98.7	106.3	111.1	126.7	131.4
(In percent of imports of goods and services)	41.4	38.9	43.7	32.8	31.0	30.2	33.4	33.0
Commodity price indexes (2005 = 100)								
Food	103.2	100.9	99.5	101.9	104.1	104.3	104.4	104.4
Fuel	140.8	144.1	110.5	98.0	107.1	110.1	112.3	112.3
Nominal GDP (millions of T$)	1073.2	1164.0	1140.2	1090.3	1156.8	1214.6	1269.3	1321.8

Sources: Tonga authorities; and IMF staff estimates and projections.

[1]Fiscal year beginning July.

[2]FY2025 incorporate the average effect of natural disasters.

[3]See Table 4 footnote regarding underlying assumptions for fiscal projections.

Table 6. Tonga: Financial Soundness Indicators, FY2013–FY2020

	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	PIC Average[1] FY2016-18
Banks									
Net domestic credit				(Year-on-year percent change)					
Public non-financial corporations	22.2	148.4	14.0	-3.0	-5.9	20.5	15.2	2.4	…
Private sector	-5.0	0.8	10.6	17.5	18.0	6.7	7.6	1.1	…
				(In percent of GDP)					
Credit/GDP	33.0	35.7	37.3	38.8	40.9	41.9	41.9	43.4	…
Private Sector Credit/GDP	30.9	30.5	31.7	33.9	36.6	37.0	36.8	38.0	…
Public Nonfinancial Corporations/GDP	2.1	5.2	5.6	4.9	4.3	4.9	5.2	5.4	…
				(In percent)					
Regulatory Capital to Risk-Weighted Assets	35.2	39.8	39.4	34.0	29.4	28.3	30.5	31.6	26.1
Return on Assets	2.2	2.4	2.9	3.6	2.7	3.2	2.9	1.7	2.7
Return on Equity	9.7	10.0	11.8	15.5	12.9	16.0	13.6	7.1	18
Non-performing Loans to Total Gross Loans	13.6	12.4	9.8	6.7	4.1	3.6	3.2	4.1	4.6
Non-performing Loans Net of Provisions to Capital	19.3	19.7	17.3	13.5	7.3	7.0	5.2	7.6	11.6
Liquid Assets to Total Assets	34.4	31.9	31.4	33.5	32.4	27.1	25.6	27.9	35.4
Liquid Assets to Short-term Liabilities	68.3	68.0	66.5	65.0	63.3	51.0	49.8	60.2	48.9
Large Exposures to Capital	68.4	75.6	80.9	90.5	90.9	101.5	96.9	93.1	118.4
Personnel Expenses to Non-interest Expenses	32.1	31.8	31.1	32.3	28.0	29.8	29.5	29.1	37.4
Foreign-Currency-Denominated Loans to Total Loans	0.0	0.0	0.0	0.3	1.0	1.4	2.3	0.7	7.4
Foreign-Currency-Denominated Liabilities to Total Liabilities	2.8	3.2	3.2	4.7	6.9	5.7	7.1	6.2	11.9
Residential Real Estate loans to Total Loans	34.0	32.7	31.9	35.9	41.1	42.4	41.3	41.6	26.4
Commercial Real Estate Loans to Total Loans	2.7	2.2	2.3	2.3	2.4	2.5	2.2	2.4	11.3
Household Debt to Income	18.3	18.8	20.3	23.6	27.4	28.7	…	…	…
Debt Service to Banks	5.7	5.6	6.2	6.7	6.9	6.9	…	…	…
Memorandum Items:									
Nominal GDP (millions T$)	781.3	797.2	849.1	932.6	1,017.7	1,073.2	1,164.0	1,140.2	

Sources: National Reserve Bank of Tonga; and IMF, Financial Soundness Indicators.

[1] Kiribati, Marshall Islands, Nauru, Palau, Timo-Leste and Tuvalu.

Table 7. Tonga: Baseline and Alternative Scenario, FY2019–FY2024

		Est.	Projections			
	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024
	(In percent of GDP)					
	Baseline					
Central Government						
Revenue and grants	41.7	45.7	45.7	42.0	44.4	34.6
Memo: Total Revenue (excluding gran	23.4	24.7	22.9	23.9	24.3	24.2
Total Expenditure	38.5	41.3	50.6	42.3	43.4	42.7
Expense	30.3	35.4	44.4	35.6	34.9	33.9
Transactions in nonfinancial assets[1]	8.3	5.9	6.2	6.7	8.5	8.8
Primary balance	3.9	5.2	-4.0	0.4	1.5	-7.4
Fiscal balance	3.2	4.4	-4.8	-0.3	1.0	-8.1
Net acquisition of financial assets	2.0	5.1	-1.8	0.5	1.3	0.0
External financing (loans)	-1.2	-0.5	1.6	-1.4	-1.7	7.4
Domestic financing (debt securities)	0.0	1.1	1.4	2.2	2.0	0.6
Memorandum items:						
Real GDP growth	0.7	-2.5	-3.5	4.0	3.0	2.5
Inflation (CPI average)	3.3	0.2	-0.9	2.1	2.0	1.9
Public debt	41.3	42.3	46.3	44.6	42.7	49.1
	Alternative fiscal scenario: Sustainable Debt Levels by 2024					
Central Government						
Revenue and grants	41.7	45.7	45.7	44.0	47.3	37.8
Memo: Total Revenue (excluding gran	23.4	24.7	22.9	25.8	27.1	27.2
Total Expenditure	38.5	41.3	50.6	42.2	43.2	42.5
Expense	30.3	35.4	44.4	35.3	34.6	33.4
Transactions in nonfinancial assets[1]	8.3	5.9	6.2	6.9	8.7	9.1
Primary balance	3.9	5.2	-4.0	2.4	4.6	-4.0
Fiscal balance	**3.2**	**4.4**	**-4.8**	**1.8**	**4.0**	**-4.7**
Net acquisition of financial assets	2.0	5.1	-1.8	2.4	5.9	0.0
External financing (loans)	-1.2	-0.5	1.6	-1.4	-1.3	0.6
Domestic financing (debt securities)	0.0	1.1	1.4	1.0	1.1	0.1
Unidentified financing gap[2]	0.0	0.0	0.0	1.0	2.0	4.0
Memorandum items:						
Real GDP growth	0.7	-2.5	-3.5	3.5	2.7	1.5
Inflation (CPI average)	3.3	0.2	-0.9	2.1	2.0	1.9
Public debt	41.3	43.1	48.1	45.1	42.8	41.9

Sources: Tonga authorities; and IMF staff estimates and projections.

[1] Spending estimates from IMF-WB CCPA, 2020, are included in both the baseline and the alternative scenarios. In the latter, investment is marginally frontloaded assuming improvement in execution capacity.

[2] In line with historical trends, the financing gap in 2022-24 are assumed to be filled with new grant

Note: Required adjustment relative to the baseline scenario to reduce public debt to sustainable levels by 2024, assuming fiscal adjustment will be supported by new current grant commitments in line with historical trends. The alternative fiscal scenario illustrates the fiscal effort required to achieve debt sustainability: fiscal adjustment of 2.5-3 percent of GDP per year on average over FY2022-24, including stronger revenue collection starting in FY2022 (through tax base broadening, expiration of cyclone- and pandemic-related tax exemptions, improved collection of land-use fees and tax arrears, updated excise rates, and non-tax revenue fees and charges, and the impact of improved revenue administration) and the rebalancing of spending toward higher investment, maintenance, health, and SDG related spending, tighter non-priority current spending and wage bill containment in line with fiscal anchor. Due to capacity constraints, improvements are assumed to be

Table 8. Tonga: External Financing Requirements and Sources, FY2019–FY2025
(In millions of U.S. dollars, unless otherwise indicated)

		Estimate	Projections				
	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
	(In millions of U.S. dollars, unless otherwise indicated)						
Total requirement	**10.3**	**24.4**	**123.1**	**57.8**	**56.1**	**89.0**	**91.1**
Current account deficit (excluding the budget support from the World Bank for FY2021)	4.4	19.6	115.9	50.5	46.9	68.0	70.2
Amortization	5.9	4.8	7.2	7.3	9.2	21.0	20.9
Total sources	**8.1**	**53.5**	**28.4**	**34.6**	**34.7**	**90.5**	**91.8**
Capital account	29.3	70.2	23.9	30.1	30.2	22.5	11.5
Official medium- and long-term loans	0.0	2.5	0.0	0.0	0.0	63.7	76.0
Multilateral	0.0	2.5	0.0	0.0	0.0	63.7	76.0
Bilateral	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others (including errors and omissions)	-21.1	-19.2	4.5	4.5	4.5	4.3	4.3
Financing gap (- = excess of financing)	**2.1**	**-29.1**	**94.7**	**23.2**	**21.4**	**-1.5**	**-0.7**
Additional financing sources	**2.1**	**-29.1**	**94.7**	**23.2**	**21.4**	**-1.5**	**-0.7**
Use of IMF credit (net)	0.0	0.0	9.7	0.0	0.0	0.0	0.0
Disbursement (RCF)[1]	0.0	0.0	9.7	0.0	0.0	0.0	0.0
Repayments	0.0	0.0	0.0	0.0	0.0	0.0	0.0
World Bank	0.0	0.0	30.0	0.0	0.0	0.0	0.0
Suspended debt service under G20 DSSI[2]	...	...	5.4	0.0	0.0	0.0	0.0
Change in reserves (increase = +)	-2.1	29.1	-49.6	-23.2	-21.4	1.5	0.7
Remaining gap	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Sources: Tonga authorities; and IMF staff estimates and projections.

[1]SDR 6.9 million, equivalent to 50 percent of Tonga's quota.

[2]Debt service for September 2020 and March 2021 suspended. Repayments due over 3 and 5 years respectively, with 1 year grace period.

Table 9. Tonga: Indicators of Capacity to Repay the IMF, FY2020–FY2033
(In millions of SDRs, unless otherwise indicated; Reporting Year: July to June)

	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033
							(In millions of SDRs, unless otherwise indicated)							
IMF obligations based on existing														
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF Obligations based on prospective														
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.4	1.4	1.4	1.4	0.0	0.0
Charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding IMF credit														
Millions of SDRs	0.0	6.9	6.9	6.9	6.9	6.9	6.9	5.5	4.1	2.8	1.4	0.0	0.0	0.0
Millions of Tonga	0.0	21.6	21.8	21.9	22.0	22.1	22.2	17.9	13.5	9.0	4.5	0.0	0.0	0.0
Percent of revenue	0.0	5.3	5.7	5.3	5.6	5.9	6.4	5.0	3.6	2.3	1.1	0.0	0.0	0.0
Percent of total exports	0.0	51.3	10.2	9.6	8.1	7.5	7.0	5.4	3.8	2.5	1.2	0.0	0.0	0.0
Percent of external debt service	0.0	97.0	103.1	88.6	43.7	43.0	42.1	29.7	21.7	16.8	9.1	0.0	0.0	0.0
Percent of net foreign assets	0.0	4.3	6.1	4.3	5.4	5.5	4.5	4.4	3.0	1.8	1.1	0.0	0.0	0.0
Percent of GDP	0.0	2.0	1.9	1.8	1.7	1.7	1.6	1.2	0.9	0.6	0.3	0.0	0.0	0.0
Percent of quota	0.0	50.0	50.0	50.0	50.0	50.0	50.0	40.0	30.0	20.0	10.0	0.0	0.0	0.0
Net use of IMF credit[1]	0.0	6.9	0.0	0.0	0.0	0.0	0.0	-1.4	-1.4	-1.4	-1.4	-1.4	0.0	0.0
Disbursments	0.0	6.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.4	1.4	1.4	1.4	0.0	0.0
Memorandum items:														
Nominal GDP (millions of T$)	1,140.2	1,090.3	1,156.8	1,214.6	1,269.3	1,321.8	1,378.0	1,440.5	1,504.7	1,565.3	1,624.3	1,685.8	1,753.5	1,826.4
Exports of goods and services	214.2	42.1	213.1	227.9	272.3	294.4	315.9	333.4	351.4	365.7	385.8	406.4	426.0	444.4
Government revenue (millions of T$)	417.4	405.1	383.8	415.8	390.7	374.5	345.6	360.9	376.7	391.4	405.7	454.2	507.0	564.1
External debt service (millions of T$)	17.2	22.3	21.1	24.7	50.4	51.5	52.7	60.1	61.9	53.6	49.3	51.1	60.3	74.9
Net Foreign Assets Central Bank	535.0	506.8	357.9	506.2	409.1	403.5	493.6	402.8	445.5	491.8	426.1	487.6	480.3	434.3
Quota (millions of SDRs)	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8

Source: IMF staff estimates and projections.

[1]SDR 6.9 million, equivalent to 50 percent of Tonga's quota.

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Annex I. Progress On IMF 2017 Article IV Recommendations

Policies	Recommendations	Actions Since 2017 Article IV Consultation
Fiscal Policies	A more prudent fiscal stance, better prioritization of self-financed capital expenditures and containment of the large wage bill. Targeting a gradual adjustment of the primary balance to approximately 1 percent of GDP by FY2022, through revenue and expenditure measures, would help ensure debt sustainability.	Fiscal consolidation which started in FY2016, continued through FY2020 with the help of donor grants. The FY2019-20 surplus reflected continued strength in revenue collection and generally effective controls on current spending broadly in line with fiscal anchors adopted in FY2018. But underlying policies reflected some weaknesses, such as healthcare and overtime-related cost overruns, compensated by delayed investments and maintenance spending.
	PFM should be further strengthened to ensure appropriate medium-term planning, accountability, and budget control and the efficient use of public funds.	Ongoing. The 2019 PEFA identified relatively sound PFM processes. Budget planning and preparation are generally sound but budget reliability has been weak because of significant variation in aggregate spending and revenue and expenditure composition, largely due to overestimations and/or underspending of budget support and development funds.
Monetary Policy	Maintain a supportive monetary policy stance; stand ready to adjust if risks emerge.	Given low inflation and the slow and interrupted recovery, the monetary policy rate was maintained at 0 percent, the statutory reserve deposit rate at 10 percent and the inflation reference rate at 5 percent.
	Consider more flexible liquidity management tools in addition to reserve requirements, e.g., short-term NRBT securities.	Ongoing. Measures taken to manage excess liquidity while ensuring adequate liquidity. The NRBT introduced a minimum loan-to-deposit ratio to encourage lending and allowed pension funds to transfer balances abroad.
Financial Sector Policies	Strengthen the monitoring of financial institutions and NRBT's supervisory capacity.	Microfinance Institutions Act came into effect June 2019, and Moneylenders Act in September 2020. Financial Institutions Act was amended and renamed the Banking Act. Onsite examinations and spot checks of banks continued. Annual financial reports from NBFIs were made mandatory. Improvements in insurance regulations are underway.
	Ensure AML/CFT regulations continue to satisfy relevant international standards.	Cabinet Committee endorsed Tonga's National AML/CFT Risk Assessment Report as well as Tonga's first National AML/CFT Strategy in October 2019. APG assessment underway.
Structural Policies	Improve the business environment and develop the private sector; formalize MSMEs.	The Employment Relations Bill approved by Cabinet includes provisions for maternity leave and protections for both workers and employers. Draft amendments to the 2018 FEC Act intended to clarify repatriation requirements have been submitted to the Cabinet for consideration. The government is investing in improving the quality of, and access to, Technical and Vocational Education and Training (TVET) programs. Tonga Development Bank continued lending to MSMEs.
	Invest in climate-resilient infrastructure.	In line with the Tonga Energy Road Map, investments in renewable energy projects have ramped up, funded by donors. Implementation of other investments have been delayed, including by the pandemic.
Statistics	Although data are broadly adequate for surveillance, efforts are needed to improve the main macroeconomic datasets including BOP, fiscal and national account statistics.	More resources made available to Tonga Statistics Department, staff numbers have increased, and a new strategy adopted to turnover. Staff training processes being revamped (online training and more staff being trained at once and initiatives adopted to foster the transfer of skills and handover processes) to avoid delays in statistical releases due to staff turnover.

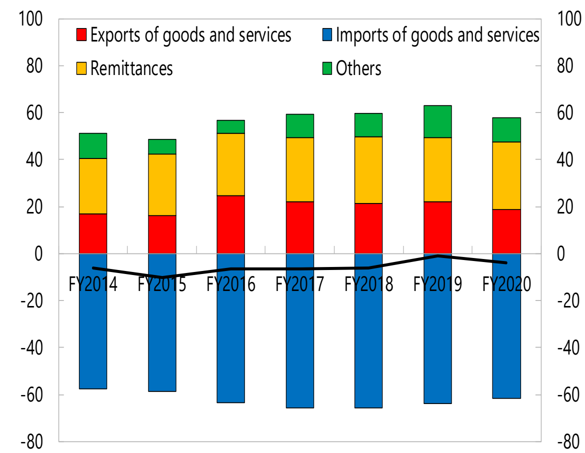
Annex II. External Sector Assessment[1]

The external sector position for FY2020 is broadly in line with the level implied by fundamentals and desirable policy settings. The current account deficit is expected to widen in FY2021 due to a sharp drop in tourism, lower remittance inflows and strong imports, including of health equipment to mitigate the impact of the Covid-19 pandemic. International reserves have increased in FY2020 as a result of donor support and unspent aid but are expected to decline in the medium-term to about 4 months of prospective imports. Given Tonga's high vulnerability to natural disasters and large imminent debt repayments, a higher reserve buffer is critical to ensure external stability in the coming years.

1. Current account balance. Tonga's current account (CA) deficit widened to 3.9 percent in FY2020 from 0.9 percent in FY2019, mainly due to the drop in tourism in the last quarter of FY2020 and despite higher aid and import compression due to delays in the implementation of public infrastructure projects. Historically, Tonga has had high CA deficits, averaging some 6 percent of GDP over FY2015−19, reflecting its high dependence on imports (chart). The EBA-Lite CA model indicates a gap of 0.9 percent of GDP in FY2020 (table).[2] Thus, the CA in FY2020 is assessed to be broadly in line with the level implied by fundamentals and policies. A sharp drop in tourism, lower remittance inflows, and strong imports of goods for health infrastructure/preparedness to aid vulnerable sectors and groups impacted by the Covid-19 pandemic are expected to widen the current account deficit substantially in FY2021. In subsequent years, the current account deficit is projected to remain large and above the norm, reflecting weakness in export competitiveness, continued heavy import-reliance, and lower official transfer inflows after current commitments are met.

Current Account Developments

(in percent of GDP)



Sources: Tonga authorities; and IMF staff estimates.

Tonga: Results from EBA-lite Models, FY2020

(In percent of GDP, unless otherwise indicated)

	CA model
CA-Actual	**-3.9**
Cyclical contributions (from model)	-0.2
Additional temporary/statistical factors	0.0
Natural disasters and conflicts	1.0
Adjusted CA	**-4.7**
CA Norm (from model) 1/	**-7.5**
Adjustments to the norm 2/	1.9
Adjusted CA Norm	**-5.6**
CA Gap	**0.9**
o/w Policy gap	4.7
Elasticity	-0.25
REER Gap (in percent)	**-3.8**

Source: IMF staff estimates.

1/ Cyclically adjusted, including multilateral consistency adjustments.
2/ CA norm is adjusted to be the same as that for 2019 to reflect the historical trend and limited external financing capacity.

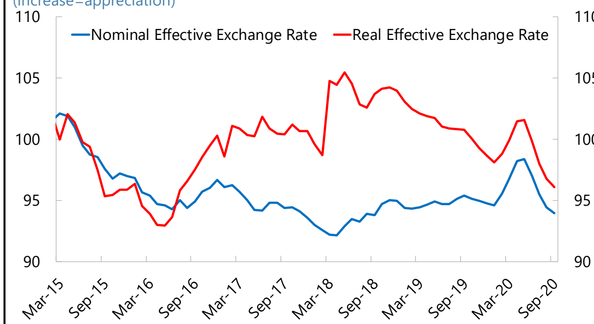
[1] Prepared by Analisa Ribeiro Bala and Yinqiu Lu.

[2] See the Revised EBA-Lite Methodology. The EBA-Lite REER model for Tonga cannot be calculated due to data limitations.

2. Exchange rate and competitiveness. The real effective exchange rate (REER) depreciated by 2.7 percent on average in FY2020, reflecting the depreciation of Tonga's nominal effective exchange rate (NEER). Despite a small increase in March and April, the REER is likely to continue to depreciate due to Tonga's lower headline inflation relative to its trading partners (text figure), which will help support the competitiveness of Tonga's exports in the near-term. However, export competitiveness is expected to remain weak over the medium-term due to structural barriers to moving toward high-value added production. While marine exports have improved, the capacity for strong growth is limited by concerns about overfishing. Agricultural exports have lost market share in recent years due to significant cyclone-related damage.[3] Despite recent efforts to move toward higher value-added production, the sector is still largely based on traditional and subsistence farming. Moreover, Tongan products face difficulty in meeting quality and phytosanitary requirements of principal export markets (Australia and New Zealand). There remains significant potential for the tourism sector to drive higher economic growth, incomes and job creation. Competitiveness remains weak, however, due to limited capacity (e.g., hotels) and gaps in tourism-related infrastructure which could help boost value added, delays in rebuilding after Cyclones Gita and Harold, and Tonga's remoteness relative to similar tourist destinations. Moreover, with tourists unwilling or unable to travel due to travel restrictions, expansion of the sector seems unlikely in the short-to-medium term.

Nominal Effective Exchange Rate and Real Effective Exchange Rate

(Increase=appreciation)



Sources: Tonga authorities; and IMF staff estimates.

3. Capital and financial accounts. Tonga's current account deficit has been largely financed by capital and financial account flows in recent years, driven by donor project-related grants. To protect international reserves, the NRBT implemented a new law in 2018—Foreign Exchange Control (FEC) Act—which clarified repatriation and surrender requirements for exports receipts and capital transactions in the event international reserves fell below 2 months of imports. Amendments to the FEC Act are currently under consideration.

4. International reserves and adequacy. Tonga's international reserves increased to US$241 million at end-FY2020 (about 9.6 months of imports coverage) and further to US$251 million by end-October 2020, due to additional emergency grants from donor partners related to Covid-19, which have not yet been fully spent. Over time, reserve coverage is projected to sharply decline to just around 4 months of prospective imports by FY2025, reflecting the need to finance increasing imports for reconstruction and rising debt repayments.

[3] Agriculture sustained the highest share of economic losses from Cyclone Gita (82 percent of total losses, according to Disaster Recovery Framework for Tropical Cyclone Gita, October 2018). Cyclone Harold hit Tonga in April 2020, again causing damage to the agriculture and tourism sectors.

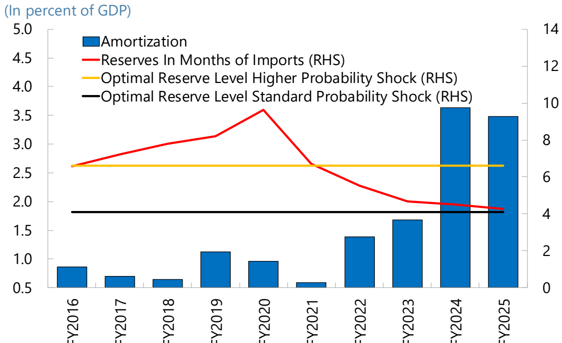
The reserve adequacy methodology estimates an optimal level of reserves, comparing the costs and benefits of holding reserves. If the probability of a large shock is set at the sample average of 50 percent, the estimated optimal level of reserves would be 4.1 months of imports—broadly in line with the NRBT's minimum threshold of 3–4 months of prospective imports. However, given Tonga's large negative CA norm and relatively high vulnerability to natural disasters and external shocks, the model is calibrated using a higher-than-average risk of an adverse external shock of 80 percent. The estimated adequate level of reserves would then rise to 6.6 months of prospective imports (table).

5. An additional buffer may be needed to finance rising debt repayments. Amortization between FY2020 and FY2023 averages around US$6.1 million per year and then jumps in FY2024 to US$21.0 million with the Export-Import Bank of China (China Eximbank) loan coming due, resulting in a decline in reserves over the medium-term. To finance the rise in debt repayments between FY2024−29, accumulating an additional US$91 million in reserves is recommended. This amounts to US$21 million per year during FY2021−23 (after accounting for the already accumulated reserves of US$29 million in FY2020), an additional 0.7 months of imports. Therefore, the optimal level of reserves for Tonga, taking into account both its higher-than-average levels of risks and large upcoming debt repayments, is estimated at around 7.3 months of imports.

International Reserve Adequacy Metric	FY2020
Actual Reserves (months of prospective imports)	9.6
Optimal level with standard shock probability	4.1
Optimal level with higher shock probability	6.6
Optimal level taking into account debt repayment	7.3
Broad Money coverage	309%

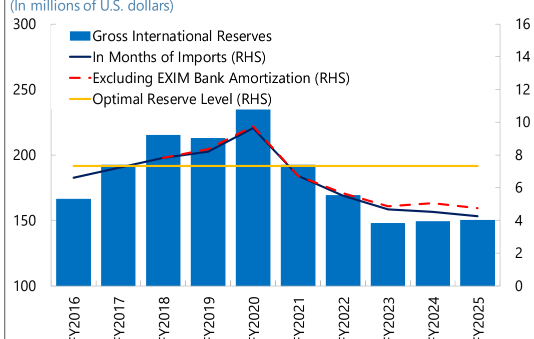
Source: IMF Staff estimates.

Amortization and Reserves
(In percent of GDP)



Sources: Tonga authorities; and IMF staff calculations and projections.

International Reserves
(In millions of U.S. dollars)



Sources: Tonga authorities; and IMF Staff calculations and projections.

Annex III. Risk Assessment Matrix

Source and Likelihood of Risk	Impact on Tonga	Policies to Minimize Impact
External Risks		
Unexpected shift in the Covid-19 pandemic *H* **Accelerating deglobalization** *H* **Widespread social discontent and political instability** *H* **Intensified geopolitical tensions and security risks** *H*	*H*: Weaker global growth could have an adverse impact on Tonga via reduced remittances, donor funds from development partners such as China, and delays in the resumption of tourism. This could lead to pressures on the exchange rate, international reserves, consumption and growth, and a deterioration in public sector and financial sector balance sheets.	To mitigate the impact of the pandemic, targeted fiscal support, continued monetary and liquidity support, clear communication, and enhanced vigilance regarding financial sector stability is needed. Build external and fiscal buffers to cope with adverse shocks. Ensure financial sector balance sheets are resilient to shocks. Undertake fiscal rebalancing to support the vulnerable and improve healthcare systems, testing/tracing abilities, public investment and climate resilience while ensuring debt sustainability. Accelerate financial sector reforms, improve private sector business climate and diversify the economy, and build capacity to improve the utilization of donor funds, in order to boost productivity, and reduce dependence on remittances and aid.
Domestic Risks		
Higher frequency and severity of natural disasters related to climate change *H*	***H:*** Tonga is highly vulnerable to natural disasters, which have caused large damage to infrastructure and businesses in the past, and the threat of rising sea levels.	Lower the intensity of fossil fuels by raising the contribution of renewable energy. Invest in climate resilient infrastructure. Improve government capacity to coordinate and implement reconstruction efforts. Maintain adequate fiscal buffers.
Worsening debt dynamics due to the pandemic *H*	***H:*** Difficult debt dynamics worsened by economic contraction, policy weaknesses, and capacity constraints. Crowding out of critical spending leads to weaker productivity and output growth.	Continue to strengthen tax revenues by gradually eliminating tax exemptions and to improve tax administration. Curtail non-essential spending, reduce wage bill through remuneration reforms, improve prioritization and pace of investment spending on climate resilient projects by improving capacity.
Financial stability risks due to pandemic *M*	*M:* Weak economy, rising non-performing loans and elevated credit risk can exacerbate credit crunch, exacerbating financial sector weaknesses.	Enhance financial stability framework and proactively manage risks in bank and nonbank financial sectors. Develop a macroprudential framework and improve financial deepening.
Partial withdrawal of CBRs due to gaps in AML/CFT framework *M*	***M:*** Given the importance of remittance inflows and aid, a loss of CBRs would have knock on effects on the economy, financial sector and debt sustainability.	Strengthen the legal and regulatory framework and the effective implementation of the AML/CFT framework, including by improving risk-based supervision and enforcement in line with the ongoing APG assessment.

"L" =Low; "M" =Medium; "H" =High. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

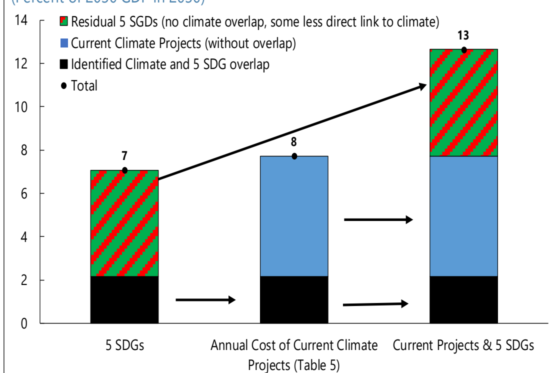
Annex IV. Spending Needs to Achieve Sustainable Development Goals and Improve Climate Resilience[1]

Tonga is highly committed to achieving its SDG goals and reducing climate vulnerabilities. Progress has been mixed and significant challenges persist (including additional spending needs)—which are likely to be exacerbated by the pandemic. Well-designed sectoral strategies and national plans, stronger capacity, and further external technical and financial support are essential to cushion the impact of the pandemic and ensure progress towards sustainable and climate-resilient development.

1. Progress toward meeting SDG and climate goals has been mixed, with substantial challenges (including spending needs), which are likely to be further exacerbated by the pandemic. Public spending on SDG and climate goals, mainly supported by development partners, increased over the past years, improving access to, and the quality of, physical infrastructure, health, and education. But more is needed. In early 2020, IMF staff estimated that additional annual spending to achieve the five SDGs amounted to about 7 percent of GDP in 2030 (left bar). The authorities' climate projects (middle bar)[2] significantly overlapped with IMF staff estimates, but did not include additional spending needs mainly in health and education. Accounting for IMF staff estimates of spending needs to meet SDG targets and the authorities' plans to increase resilience amounts to a total additional annual spending need of about 13 percent of 2030 GDP in 2030 (right bar). The pandemic has exacerbated persistent existing challenges (e.g., related to the health system), adding to the already large spending needs in the health sector.

Annual Additional Spending Needs to Meet SDGs and Improve Climate Resilience

(Percent of 2030 GDP in 2030)



Sources: Gaspar and others (2019), Daniel and others, (2020).

2. Tonga needs better-designed sectoral strategies, national plans, fiscal policies, and additional external support. It needs to develop new national health, education, and strategic investment plans which clearly define and prioritize development objectives, and channel financial and technical resources toward these ends. Implementation of these sectoral strategies should go hand-in-hand with improving spending efficiency, public financial management practices, and domestic revenue mobilization. Maintaining progress towards sustainable and climate-resilient development—which will also help cushion the impact of the pandemic—requires further external assistance on technology, technical skills upgrade, capacity building, and statistics. Additional grant support is the sine qua non to avoid exacerbating already-high debt levels.

[1] Prepared by Aleksandra Zdzienicka (FAD) based on information available as of February 2020 (CCPA Report for Tonga, 2020).

[2] Identified authorities' projects are already included in staff baseline projections.

Annex V. Integration Matrix of Surveillance Issues and Capacity Building

Surveillance Issues	IMF			World Bank		Asian Development Bank	
	Past	2019 1/	Planned/ ongoing	Past	Planned/ ongoing	Past	Planned/ ongoing
Fiscal Sector							
Public Financial Management	✓	✓	✓	✓	✓	✓	✓
Expenditure framework		✓	✓	✓	✓	✓	✓
Revenue framework	✓	✓	✓	✓	✓		
Macro-Financial Issues							
Financial supervision and regulation	✓	✓	✓	✓	✓		
Financial market development	✓	✓	✓	✓	✓		✓
Correspondent Banking							✓
Macro-structural issues							
Infrastructure			✓	✓	✓		✓
Private Sector Development				✓	✓	✓	✓
Governance issues				✓	✓	✓	✓
Poverty/Gender/ Inequality				✓	✓	✓	
Climate Change			✓	✓	✓	✓	✓
Natural Disaster Management			✓	✓	✓	✓	✓
Financial Inclusion						✓	
Gender				✓	✓	✓	✓
Labor markets				✓	✓		
Land						✓	
Business climate				✓	✓		
Statistics							
Data Enhancement	✓	✓	✓				✓

Sources: IMF; World Bank; Asian Development Bank (ADB). Prepared by Yun He.

1/ IMF fiscal year

Key Recommendations	Rationale	Progress
Strengthen Supervision and Regulation of the Nonbank Sector		
Enhance NBFI oversight.	The NRBT's capacity to supervise NBFIs remains weak.	Ongoing. The NRBT collects financial reports from most NBFIs. Spot checks are conducted, and regular meetings held with the NRBT to improve compliance.
Introduce a correspondent bank risk monitoring tool to capture the interconnections between domestic and foreign financial intermediaries.	Correspondent banks have stepped up scrutiny of respondent banks' interaction with the remittances sector. This led banks to close MTO bank accounts in sender and receiver countries. Given the importance of remittances for the economy, a risk monitoring tool would be helpful.	No progress to report. Transactions are monitored in real-time with an automated AML/CFT reporting system. Options are still being explored for a regional solution.
Finalize legislation to regulate and supervise NBFI activities.	To strengthen NRBT's supervisory capacity and set the legal basis for financial stability and macroprudential policy.	The Microfinance Institutions Act was approved in 2018 and took effect from June 2019 to restrict excessively high interest rate loans. The Moneylenders Act became effective September 30, 2020. Legislation for licensing and supervision of insurance companies, pension funds and capital markets are being drafted.
Strengthen Financial Stability Governance		
Develop a definition of financial stability for NRBT Act.	The NRBT Act was amended in 2014 to include the financial stability as one of the principal objectives of the NRBT. However, financial stability is not defined. A definition could help inform the powers and functions related to the NRBT's financial stability mandate.	The definition is to be included in amendments to the NRBT Act.
Assign macroprudential authority to NRBT.	While the NRBT Act contains a broad mandate for financial stability, responsibilities and powers for macroprudential policy formulation and implementation are not clearly assigned.	To be included as part of the amendments to the NRBT Act.
Develop systemic risk indicators to enhance systemic risk monitoring.	The NRBT does not have a systematic approach for evaluating macrofinancial risks to financial stability.	No progress to report. Technical assistance would be required.

Key Recommendations	Rationale	Progress
Strengthen Financial Stability Governance (contd.)		
Establish a Financial Stability Unit (FSU) within the NRBT that is appropriately staffed.	The NRBT intends to establish an FSU to conduct stress tests, help prepare a financial stability report, and aid macroprudential policy.	In progress. The NRBT is working on increasing positions, but training and technical assistance will be needed.
Prepare strategy to guide macroprudential policy. Develop macroprudential toolkit and conduct research on macroprudential policy measures.	A strategy with clear intermediate targets could help to guide the FSU to monitor macroprudential objectives. The indicators available to NRBT could be consolidated and mapped to a subset of tools (e.g. reserve requirements).	No progress to report. Training and technical assistance would be required for progress on this issue.
Improve Capability for Early Detection of Financial Sector Risks and Vulnerabilities		
Introduce stress-testing framework for the banking system and strengthen capacity through enhanced training.	Supervision continues to rely on risk-based onsite supervision, spot checks and improvements in reporting requirements for offsite monitoring.	Future IMF TA mission will help establish a stress testing framework. NRBT continues to invest in building staff capacity.
Enhanced Financial Statistics for Financial Stability Monitoring and Analysis		
Accelerate collection of financial statistics for the nonbank sector.	Limited information is currently available on the financial strength and prospects of NBFIs.	In progress. Reporting templates for NBFIs were issued in 2018 and amended in 2019.

Source: IMF MCM TA Report, July 2019. A follow-up mission on stress testing framework was delayed due to the pandemic and will need to be rescheduled.

Prepared by Analisa Ribeiro Bala.

Appendix I. Letter of Intent

Nuku'alofa, Tonga
December 16, 2020

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Georgieva,

1. Tonga's economy suffered a double blow in early 2020 as it was barely recovering from the 2018 Tropical Cyclone Gita—first, by the COVID-19 pandemic and, subsequently by Tropical Cyclone Harold. In response to the pandemic, the Government of Tonga introduced restrictive containment measures early, starting with health checks at the border and the cancellation of cruise ships in January–February 2020. It declared a state of emergency (extended until December 21 2020) and several domestic containment measures in March 2020 (which have since been eased) and closed external borders in March 2020. In the midst of the lockdown, Tonga was hit by Tropical Cyclone Harold on April 9, 2020, causing major destruction in infrastructure and tourism-related structures, further damaging the already faltering economy.

2. Although Tonga has recorded no cases of COVID-19 so far, its economic activity has been adversely affected by measures to mitigate risks of a local outbreak, as well as by negative spillovers from the impact of the pandemic abroad. While there is a high degree of uncertainty regarding the evolution and impact of the pandemic, we currently anticipate that, following a contraction in real output in FY2020 by 2.5 percent, FY2021 will contract by about 3.5 percent, compared to the pre-crisis projection of an expansion of 3.5 percent. Due to a precipitous drop in tourist arrivals, our high dependence on remittances, and high imports to fight COVID-19 and post-Harold private sector reconstruction, our current account deficit is projected to widen significantly in FY2021. The deterioration in the balance of payments is estimated to give rise to an external financing gap in the order of US$97million (about 20 percent of GDP). In such a situation, we would expect international reserve coverage to decline significantly.

3. To provide short-term assistance to all affected sectors as a result of the declaration of a state of emergency and build our capacity to address the pandemic, the Government of Tonga announced an Economic and Social Stimulus Package of 60 million Tongan pa'anga (5.3 percent of GDP) on April 2, 2020. Over a third of the funds was to be directed to stepping-up our health care capacity, while the rest was aimed at supporting other affected sectors, such as tourism, transport, agriculture, education, and security. In addition, we announced tax and duty relief on imported goods during the pandemic, income tax deferrals for businesses, which were considered on a case by case basis upon request by the affected businesses, and hardship allowances for laid-off employees. The support has helped to avoid a deeper contraction, but with a shortfall in tax revenues, it would lead to an estimated deficit of 4.8 percent of GDP in FY2021 in our budget, the first deficit after five consecutive years of budget surplus.

4. Against this background, the Government of Tonga requests emerging financing from the IMF under the Rapid Credit Facility (RCF) in the equivalent of SDR 6.9 million (50 percent of our quota). The IMF assistance will help meet our urgent balance of payments financing needs. As the resources provided under the RCF will be on-lent to the Treasury by the National Reserve Bank of Tonga (NRBT), the Ministry of Finance and NRBT are finalizing a Memorandum of Understanding on their respective roles and responsibilities for servicing financial obligations to the IMF. The funds will be maintained in the Treasury accounts at the NRBT pending their use. The disbursement of these funds will help to fill our expected budget financing gap and build up our international reserves. We expect that IMF assistance would also help catalyze additional financing assistance from external resources. We will continue to reach out to our other multilateral and bilateral development partners for support.

5. We have requested and received debt service relief for FY2021 from our main official bilateral creditor under the G20 Debt Service Suspension Initiative, which would help free up budgetary resources to address our urgent pandemic-related spending needs. We are committed to using the fiscal space released by that debt relief on Covid-19 related health or economic relief measures, which we will monitor and report. We will ensure maximum effectiveness of our policy response to COVID-19 with targeted assistance programs, and strong governance and transparency in their implementation.

6. We recognize that our fiscal challenges are daunting. Our overall risk of public and external debt distress remains high. Our debt repayments, especially those to EXIM Bank of China, are expected to rise sharply from FY2024 onwards. Our ability to service our public debt portfolio continues to be constrained by our weak growth potential due to Tonga's natural endowments and structural constraints and its high vulnerability to external and climate-related shocks. At the same time, the cost of achieving climate-resilience and meeting our Sustainable Development Goals (SDG) is formidable: the IMF-World Bank 2020 Climate Change Policy Assessment estimates that climate-resilience projects will cost some 140 percent of 2018 GDP cumulatively.

7. We therefore recognize that, in addition to addressing the economic challenges posed by the pandemic, we need to prepare to resume building adequate buffers to meet our debt repayments and our climate-resilience and development goals as soon as the pandemic is over. To this end, during the post-pandemic economic recovery, we aim to work with the IMF and our development partners to put policies in place—starting already with the FY2022 budget—that could help us adhere to our fiscal anchors on wages, domestic revenues, and external debt, meet our financial obligations, and achieve our policy goals. With the help of IMF technical assistance, we realize that the total revenue gains from removing the key exemptions in consumption tax and excise tax are expected to amount to 2½ percent of GDP. To this end, we remain committed to broadening the tax base by reviewing and rationalizing tax exemptions and improving the process for approving and monitoring tax exemptions. We plan to introduce updated excise tax rates and implement the review of the fees and charges. We will consider measures to broaden the personal income base, close corporate income tax loopholes for multinational companies, improve compliance in the large taxpayer segment, and strengthen measures of collecting tax arrears.

8. We remain committed to curbing and reorienting current spending toward improving our capacity by rationalizing civil service functions; identifying and staffing critical positions; and prioritizing service delivery; while gradually aligning compensation with market pay levels to reduce turnover. To meet the fiscal anchor on wages which is on the brink of being breached (i.e., the compensation of employees below 53 percent of domestic revenues), we are also strengthening controls on overtime and non-permanent staff costs. We plan to build out the social protection system to allow us to better target assistance to those in need during the pandemic and in the event of future economic shocks. We recognize that faster implementation of climate- and development-related investments requires consistent prioritization, better sequencing, improved cross-governmental coordination, and effective use of procurement.

9. We are committed to ensuring that our public and external debt levels are sustainable. Our public debt declined from 51 percent of GDP at end-June 2015 to 42 percent of GDP at end-June 2020, and the external debt, at 36 percent of GDP, is below the fiscal anchor of 50 percent of GDP. As donor grant financing will be essential to fill the budget deficit, build buffers and ensure debt sustainability, we will continue to seek grants from bilateral donors and international financial institutions to keep public and external borrowing at prudent levels. We will continue to pursue debt relief from China Exim Bank which we requested in December 2019, and we will adopt a medium-term debt strategy to continue to improve debt management and better align borrowing decisions with our broader fiscal objectives.

10. We understand that it is important to ensure a high level of transparency and accountability of public financial management. To this end, based on the findings from the Public Expenditure and Financial Accountability Assessment finalized in January 2020, we are finalizing the public financial action plan, and strengthening procurement, cash management and internal audit processes to improve the monitoring of public service delivery. Given the increased spending on health, we are committed to producing financial reports on health spending and outcome, and to improving the recording, monitoring, and reporting of grants as a step to finalizing the central government FY2018 and FY2019 budgetary data to be submitted to the IMF Government Finance Statistics database. We will work closely with the IMF and the World Bank to improve fiscal reporting and transparency in line with international standards and best practices.

11. We intend to maintain an accommodative monetary policy stance to support economic activity. With Tonga's heavy import-reliance and current expectations of low global prices of food and fuel, inflation is likely to remain low. The NRBT plans to maintain an accommodative monetary policy until the recovery gains traction, maintaining the monetary policy rate at zero percent and the statutory reserve deposit (SRD) rate at 10 percent, and to ease the SRD rate should liquidity pressures arise in the financial sector. We will continue to improve the effectiveness of monetary policy transmission through improved liquidity management, communication, and addressing structural barriers which include improving debt management.

12. We assess our financial sector to be resilient to the impact of the pandemic while acknowledging that risks have increased. Banks are still profitable and well-capitalized, while non-performing loans have ticked up recently after declining through 2019. As the pandemic has unfolded, the NRBT approved the provision of liquidity support to the banking system and committed to easing exchange control requirements if needed. The NRBT has been meeting weekly with banks to ensure there is clear communication, enhanced preparedness and best banking practices in place to withstand the pandemic. The NRBT also continued to work with banks in their effort to restructure loans to businesses that have reduced business hours and to individuals who have been laid off. At the same time, the NRBT remains vigilant to the impact of the announced and potential restructuring of loans on banks' capital, profitability, and liquidity buffers and recognizes the importance of better understanding financial sector vulnerabilities. The NRBT is committed to taking preemptive steps to ensure that banks are adequately provisioned and capitalized to withstand the adverse economic shocks.

13. We therefore remain committed to strengthening financial sector supervision and inclusion. To this end, we are in the process of establishing a solvency stress testing framework with the help of IMF technical assistance. We are also gearing up to establish an appropriately resourced Financial Stability Unit to conduct stress tests, help prepare a financial stability report, and aid macroprudential policy. To improve the regulatory frameworks for nonbank financial institutions, we are in the process drafting legislation for licensing and supervision of insurance companies, pension funds, and capital markets. Given the importance of remittances for the economy and the financial system, we are strengthening the legal compliance and effectiveness of our AML/CFT framework as a matter of priority to address possible concerns raised by the ongoing draft mutual evaluation by the Asia Pacific Group, in particular, to amend the legal framework to establish risk-based supervision, and strengthen regulations and enforcement through increased awareness of AML/CFT risks by reporting entities, provision of adequate financial and human resources to the AML/CFT supervisor, and implementation of appropriate measures in relation to beneficial ownership and politically exposed persons, if possible prior to the final adoption of the report.

14. We recognize the importance of good governance, transparency and accountability. We are committed to ensuring that the funds provided by the IMF will be effectively used to safeguard public health, reduce poverty, and support the economic recovery. Toward that end, we will publish on the government's website (i) an audit of COVID-19 related expenditures by the Audit Department within 9-12 months and (ii) pandemic-related public procurement contracts and related documents, including owners of awarded companies. We will make every effort to identify beneficial owners of awarded companies. In line with the IMF's safeguards policy, we commit to undertaking a safeguards assessment of the NRBT, in collaboration with IMF staff, providing IMF staff with NRBT's most recently completed external audit reports, coordinating meetings of IMF staff with the staff in charge of these issues in the NRBT and authorizing IMF staff to hold discussions with NRBT's external auditors.

15. We reaffirm our willingness to remain engaged with the IMF and to benefit from its policy advice and its capacity development support, and financial support as needed. We are committed to ensuring continued macroeconomic stability, and we will avoid any measures or policies that may compound these difficulties. We do not intend to introduce measures or policies that would exacerbate balance of payments difficulties. Tonga will continue to comply with the provision of the IMF's Articles of Agreement, including those related to not imposing new or intensifying existing restrictions on the making of payments and transfers for current international transactions and also bilateral payments under Article VIII, and will implement public policies under that framework and avoid additional trade restrictions.

16. We authorize the IMF to publish this letter, along with the Staff Report of Article IV consultation and request for purchase under the RCF.

Sincerely yours,

/s/	/s/
Hon. Tevita Lavemaau Minister of Finance	Dr. Sione Ngongo Kioa Governor, National Reserve Bank of Tonga

INTERNATIONAL MONETARY FUND

TONGA

December 18, 2020

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY — INFORMATIONAL ANNEX

Prepared By

The Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of November 19, 2020)

Membership Status: Joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	13.80	100.00
Fund holdings of currency	10.36	75.1
Reserves tranche position	3.44	24.9

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	6.58	100.00
Holdings	5.42	82.41

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to the Fund [1]
(SDR million; based on existing use of resources and presenting holdings of SDRs);

	Forthcoming											
	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032
Principal	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.4	1.4	1.4	1.4	0.0
Charges/Interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.4	1.4	1.4	1.4	0.0

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Catastrophe Containment and Relief: Not applicable

Exchange Arrangement

The de jure exchange rate arrangement is a pegged exchange rate within horizontal bands. The external value of the pa'anga is determined on the basis of a weighted currency basket comprising the U.S. dollar, Australian dollar, New Zealand dollar, and Fijian dollar. The basket weights are determined based on the proportions of trade with trading partners. The exchange rate of the pa'anga in terms of the U.S. dollar, the intervention currency, is fixed daily by the National Reserve Bank of Tonga within a band of ±5% a month. Because the composite weights cannot be confirmed, the de facto exchange rate arrangement was reclassified to "other managed" from "pegged exchange rate with horizontal bands", effective January 1, 2019. Tonga has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 and maintains an exchange control system that is free of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation

It is proposed that Tonga move to a 12–month consultation cycle from 2020 onward. The previous Article IV consultation was concluded on a lapse-of-time basis on January 17, 2018 (Country Report No. 18/12) reflecting discussions that took place during September 25-October 3, 2017.

Technical Assistance: APD, FAD, MCM, PFTAC, and STA have provided technical assistance on Climate Change Policy Assessments, Financial Stability, Monetary Policy Framework, Internal Audit, Tax Policy, Revenue Administration, Public Financial Management, Insurance Regulations, Enhanced General Data Dissemination System (e-GDDS) and Statistics.

Resident Representative: The IMF Regional Resident Representative Office based in Suva, Fiji covers 12 IMF member countries in the Pacific, including Tonga. Ms. Leni Hunter is the current Resident Representative.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS AND PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER

Relations with other International Financial Institutions:

- Asian Development Bank:

https://www.adb.org/countries/tonga/main

- World Bank Group:

https://projects.worldbank.org/en/projects-operations/projects-summary?countrycode_exact=TO

Relations with Pacific Financial Technical Assistance Center:

- Pacific Financial Technical Assistance Center:

https://www.pftac.org/content/PFTAC/en1/reports11.html#tab_5

STATISTICAL ISSUES

(As of November 19, 2020)

I. Assessment of Data Adequacy for Surveillance
General: While economic statistics are broadly adequate for surveillance, the lack of officially reported data continues to complicate the monitoring of economic conditions and policy formulation. The IMF's Statistics Department (STA), in collaboration with the Pacific Financial Technical Assistance Centre (PFTAC) and Capacity Development Office (CDOT), has provided regular technical assistance to Tonga Statistics Department (TSD), the Ministry of Finance and National Planning (MOFNP) and the National Reserve Bank of Tonga (NRBT). Recent topics covered by technical assistance included national accounts, government finance, and balance of payments statistics.
National Accounts: While improving, GDP compilation capacity remains limited, leading to delays. The coverage of the national accounts data has widened in the past few years with technical assistance, but there is room for improvement. Annual national accounts are compiled using both the production and expenditure approaches, in both current and constant prices. Recent PFTAC technical assistance in November 2020 assisted the authorities with compiling new experimental estimates of quarterly national accounts.
Price Statistics: The Consumer Price Index (CPI) was updated in 2018 to reflect a basket of goods and services from the 2015–16 Household Income and Expenditure Survey (HIES). CPI is estimated monthly with lags in dissemination. Coverage was expanded to include the Vava'u Division in addition to the Tongatapu Division.
Government Finance Statistics (GFS): GFS compilation has been migrated to GFS2014 with technical assistance provided by PFTAC in June 2017. A PFTAC mission in 2019 helped the authorities with the compilation and dissemination of GFS and public sector debt statistics. The compilation and dissemination of GFS data is progressing but the timeliness, ease and efficiency in reporting remain an issue. Source data are often available with a significant time lag and in-year sub-annual reporting requires considerable manual intervention. The financial accounting system (IFMS) has not been upgraded and thus is not capable of capturing all transactions with much of the government's financial business processes and data collection completed manually. Debt management is conducted outside of the financial accounts, and aid revenue data is not included in the financial accounts. Reconciliation with monetary and balance of payments data requires enhancement and published data are often subject to significant revisions. Reconciliation between IFMS data and public account data is also not systematically done.
Monetary and Financial Statistics: The NRBT reports data for the central bank, other depository corporations, and monetary aggregates using standardized report forms (SRFs) in line with the methodology set out in the Monetary and Financial Statistics Manual and Compilation Guide.
Financial Sector Surveillance: Tonga compiles financial soundness indicators for deposit takers and reports them to STA on a quarterly basis. Tonga reports data on some key series and indicators of the Financial Access Survey (FAS), including mobile money and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the United Nations to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

I. Assessment of Data Adequacy for Surveillance (concluded)	
External Sector Statistics: Source data have shortcomings in accuracy, completeness, timeliness, and classification, reflecting resource limitations which affects the timeliness of quarterly balance of payments compilation. An October 2020 CDOT mission assisted TSD and the NRBT in improving the timeliness of external sector statistics (ESS) compilation and helped improve the data on goods and services, current and capital transfers to the government, direct investment, and international reserves, resulting in a reduction in net errors and omissions which remain large. The mission also helped the authorities start compilation of the international investment position.	
II. Data Standards and Quality	
Tonga has been participating in the GDDS since May 30, 2006. An e-GDDS mission took place in October 2020 to assist the authorities launch the National Summary Data Page (NSDP) on the website of the NRBT, tentatively scheduled for end-2020, to disseminate 13 of the 15 e-GDDS data categories according to a regular schedule.	No data ROSC is available.

Tonga. Table of Common Indicators Required for Surveillance
(As of November 19, 2020)

	Date of Latest Observation	Date Received	Data Frequency[1]	Reporting Frequency[1]	Frequency of Publication[1]
Exchange Rates	8/2020	11/2020	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	8/2020	11/2020	M	M	M
Reserve/Base Money	8/2020	11/2020	M	M	M
Broad Money	8/2020	11/2020	M	M	M
Central Bank Balance Sheet	8/2020	11/2020	M	M	M
Consolidated Balance Sheet of the Banking System	8/2020	11/2020	M	M	M
Interest Rates[3]	8/2020	11/2020	M	M	M
Consumer Price Index	1/2020	2/2020	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government	2018/19	9/2019	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[4,5]—Central Government	2018/19	9/2019	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2018/19	9/2019	A	A	A
External Current Account Balance	Q4/2019	7/2020	Q	Q	Q
Export and Import of Goods and Services	Q4/2019	7/2020	Q	Q	Q
GDP/GNP	2017/18	9/2019	A	A	A
Gross External Debt	2018/19	9/2019	A	A	A
International Investment Position	Q2/2015	3/2016	Q	Q	Q

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), and Not Available (N/A).

[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[3] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[4] Foreign and domestic financing.

[5] The central government is only the budgetary central government.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY—DEBT SUSTAINABILITY ANALYSIS

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Prepared by the staffs of the International Monetary Fund and the International Development Association

Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	High
Overall risk of debt distress	High
Granularity in the risk rating	Sustainable
Application of judgment	No

The risk of debt distress rating for Tonga has been maintained at high.[1]*Tonga's indebtedness has gradually declined since end-FY2015*[2] *as a much-needed fiscal consolidation started in FY2016 and continued through FY2020 notwithstanding the Covid-19 pandemic. The present value (PV) of the external debt-to-exports ratio is expected to temporarily breach the indicative threshold under the baseline scenario in FY2021 mainly due to the decline of exports triggered by the pandemic. Moreover, without new grant commitments, both external solvency indicators (i.e., the PV of the external debt-to-GDP ratio and of the external debt-to-exports ratio) are expected to breach their respective thresholds under the baseline scenario starting in FY2029, reflecting the deteriorating fiscal position due to the pandemic, large spending needs, lower grant inflows as existing commitments are fully disbursed, and rising debt repayments to multilateral development banks and China Eximbank over the medium- and long-term. The PV of the public debt-to-GDP ratio is expected to breach the benchmark starting from FY2029 under the baseline scenario. A tailored one-time natural disaster shock would imply a significant deterioration in debt sustainability. Long-term debt sustainability hinges on fiscal adjustment and continued donor grant inflows and debt relief to finance the substantial fiscal and external gaps. Under such policies, continued grant financing consistent with historical levels would help stabilize external debt dynamics. To rebuild fiscal buffers and enhance resilience against shocks, stronger revenue mobilization measures, expenditure rationalization, and effective debt management strategies are needed.*

[1] The Tonga Composite Indicator (CI) index, calculated on the basis of the October 2020 World Economic Outlook (WEO) and the 2019 Country Policy and Institutional Assessment (CPIA) released in July 2020, is at 3.12, indicating that Tonga's debt-carrying capacity is strong. The classification of debt-carrying capacity has shifted from moderate to strong compared to the 2017 debt sustainability analysis (DSA) after confirmation of the change based on both the October 2018 and April 2019 WEO vintages (two consecutive signals are required for a shift in capacity classification ("Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf)).

[2] All the figures are computed using fiscal year beginning in July, e.g., FY2020 runs from July 1, 2019 to June 30, 2020.

PUBLIC DEBT COVERAGE

1. **Tonga's public debt includes obligations of the central government and central bank.** The central bank's debt is borrowed on behalf of the government. Local governments do not incur debt, nor do other entities in the general government. As of end-June 2020, government-guaranteed debt was small, about 1 percent of GDP. Since the DSA coverage does not include debt of guaranteed and non-guaranteed state-owned enterprises, an additional 2 percent of GDP is added to the contingent liability test. Contingent liabilities also include a standard 5 percent of GDP cost to the government of a financial crisis, which is above the existing stock of financial sector NPLs.[3]

Tonga. Public Debt Coverage

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	X
3	Other elements in the general government	X
4	o/w: Social security fund	X
5	o/w: Extra budgetary funds (EBFs)	X
6	Guarantees (to other entities in the public and private sector, including to SOEs)	
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

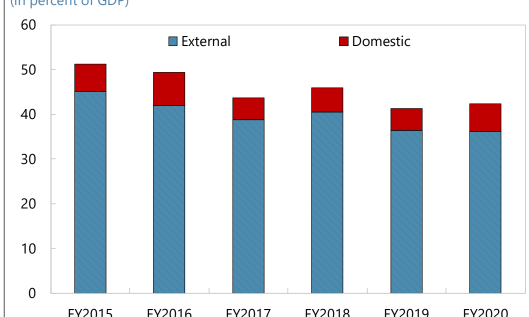
1	The country's coverage of public debt	The general government, central bank			
		Default		Used for the analysis	Reasons for deviations from the default settings
2	Other elements of the general government not captured in 1.	0	percent of GDP	0.0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2	percent of GDP	2.0	
4	PPP	35	percent of PPP stock	0.0	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5	percent of GDP	5.0	
	Total (2+3+4+5) (in percent of GDP)			7.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

BACKGROUND ON DEBT

2. **Public debt remained elevated at 42 percent of GDP at end-June 2020 despite several years of fiscal consolidation.** The risk of external debt distress was downgraded from moderate to high in the 2017 DSA, underscoring the need to rely only on grants for budget financing to contain debt vulnerabilities. To contain unfavorable debt dynamics, the government's fiscal anchors (introduced in FY2018) limit total public external debt-to-GDP to a maximum of 50 percent. Tonga has not contracted any new external loans since 2018, although it is still receiving disbursements from prior loan commitments.[4] The government plans to finance all new

Total Public and Publically Guaranteed Debt
(in percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

[3] Tonga does not have arrears to external creditors.

[4] The remaining loan commitment is about 0.4 percent of GDP.

projects with domestic revenues and multilateral and bilateral donor grants until all debt indicators fall to more sustainable levels. As a result of the fiscal consolidation since FY2016, public debt declined from 51 percent at end-June 2015 to 42 percent at end-June 2020 (chart).

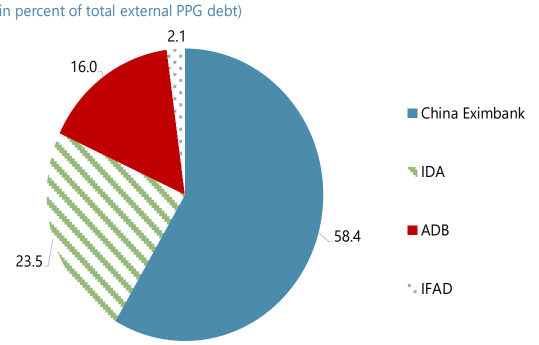
3. Tonga's debt obligations are largely external, and half of its total public debt is to China, with a sharp spike in debt repayments due from FY2024 onwards. Total public and publicly guaranteed (PPG) external debt stood at USD184 million (about 36 percent of GDP) as of end-June 2020, accounting for 85 percent of total public debt. Outstanding debt to all multilateral creditors stood at USD75 million (about 15 percent of GDP), some 41 percent of the total external debt stock. The single largest creditor remains the Export-Import Bank of China (China Eximbank) accounting for 58 percent of total external debt stock (chart).[5] Tonga started repayments to China Eximbank in FY2019 with larger repayments coming due starting in FY2024. Tonga's request for a temporary suspension of its calendar year 2020 debt service to the China Eximbank under the G20 Debt Service Suspension Initiative (DSSI) has been accepted and the rescheduled debt repayments are included in the baseline scenario (table). Reflecting the extension of the DSSI to the first half of the calendar year 2021, the baseline scenario also incorporates rescheduled debt service repayments to China Eximbank coming due during that period.

Tonga. Repayment Schedule for Existing External Debt, FY2020–30

	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030
					(In percent of GDP)						
Total external debt	1.0	0.6	1.4	1.7	3.6	3.5	3.3	3.1	2.9	2.0	1.0
Multilateral	0.6	0.6	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.5	0.4
ADB	0.4	0.4	0.4	0.4	0.3	0.4	0.4	0.3	0.3	0.2	0.2
IDA/WB	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
IFAD 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral	0.4	0.0	0.9	1.1	3.1	2.9	2.7	2.6	2.4	1.6	0.6
EXIM Bank of China (post DSSI)	0.4	0.0	0.9	1.1	3.1	2.9	2.7	2.6	2.4	1.6	0.6
Memorandum item:											
EXIM Bank of China (pre-DSSI)	0.4	0.9	0.9	0.8	2.8	2.7	2.6	2.5	2.4	1.6	0.6

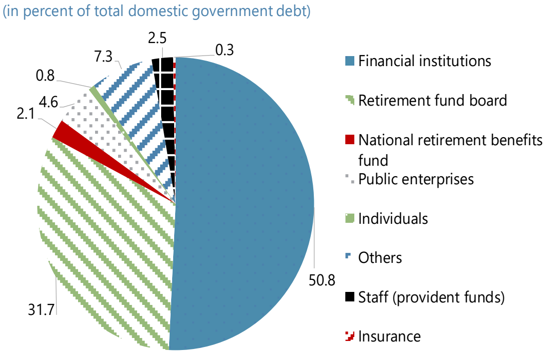
1/ Repayments are around 0.03 percent of GDP per year.
Sources: Ministry of Finance; and IMF staff estimates.

Outstanding External PPG Debt by Creditor, June 2020
(in percent of total external PPG debt)



Source: Ministry of Finance.

Outstanding Domestic Debt by Creditor, June 2020
(in percent of total domestic government debt)



Source: Ministry of Finance.

4. Tonga's domestic debt obligations are relatively small. Public domestic debt stood at USD31 million (about 6 percent of GDP) at end-June 2020, accounting for 15 percent of total public debt.

[5] The loans from China Eximbank are denominated in Chinese renminbi.

Domestic financial institutions hold about half of the total domestic debt with the rest held mainly by domestic pension funds (chart). The authorities plan to issue domestic debt in FY2021 and beyond, if necessary.

BACKGROUND ON MACROECONOMIC FORECASTS

5. The assumptions in the baseline scenario are consistent with the macroeconomic framework presented in the Staff Report for the 2020 Article IV consultation and request for disbursement under the Rapid Credit Facility:

- **Real GDP growth** is projected at 1.3 percent on average during FY2020–30 (Table). The FY2019 recovery from the devastation of Cyclone Gita in 2018 is expected to be interrupted by the impact of the Covid-19 pandemic in FY2020 and, to a lesser extent, Cyclone Harold. Economic activity is expected to contract by 2.5 percent and 3.5 percent respectively in FY2020 and FY2021. In line with the current assumptions of a weak and protracted global recovery, GDP growth is expected to pick up pace in FY2022–23, but trend down thereafter to a potential growth rate of 1.8 percent over the medium- to longer-term. The risks to the projections are mainly on the downside. They stem from a weaker global recovery due to a second wave of the Covid-19 pandemic and rising forces of deglobalization, that could have an adverse impact on Tonga via reduced remittances and donor funds from development partners, and delays in the resumption of tourism. Tonga is also highly vulnerable to natural disasters and the threat of rising sea levels. Moreover, policy weaknesses and capacity constraints could worsen difficult debt dynamics, while crowding out critical productivity-boosting spending. Given the importance of remittance inflows and aid to Tonga's economy, disruptions in correspondent banking relationships especially if the shortcomings identified in the upcoming Asia Pacific Group assessment are not addressed, would have knock on effects on the economy, the financial sector, and debt sustainability. On the upside, an earlier-than-anticipated resumption in tourism or seasonal worker programs can help support consumption, a stronger and faster global recovery can help boost remittances, and higher capital spending on climate-resilient infrastructure projects could increase resilience to natural disasters at a faster pace.

Tonga. Baseline Macroeconomic Assumption
(In percent of GDP, unless otherwise stated)

	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2009-19 Historical average	FY2020-30 average
Real GDP growth (in percent)	-2.5	-3.5	4.0	3.0	2.5	1.8	1.8	1.8	1.8	1.8	1.8	2.3	1.3
GDP deflator in US dollars (change in percent)	0.0	0.9	3.1	1.9	1.9	1.9	2.0	2.1	2.1	2.1	2.1	3.1	1.8
Non-interest current account deficit	3.3	18.3	9.1	8.1	11.5	11.3	13.6	13.2	13.2	13.0	13.1	9.8	11.6
Net FDI (negative = inflow)	-0.7	-0.9	-0.9	-0.8	-0.7	-0.7	0.0	-0.7	-0.7	-1.0	-1.0	-1.3	-0.8
Primary deficit	-5.2	4.0	-0.4	-1.5	7.4	9.3	16.0	16.4	16.7	16.7	16.7	-1.3	8.7
Grants	21.0	22.9	18.1	20.1	10.5	8.1	0.8	0.8	0.7	0.7	0.7	13.7	9.5

Sources: Country authorities; and staff estimates and projections.

- **Inflation** (measured by GDP deflator in USD terms) is projected to average 1.8 percent during FY2020–30 given current projections of low global food and fuel prices (Table).

- The **non-interest current account deficit** is projected to widen to 11.6 percent of GDP on average over FY2020–30 reflecting persistent weakness in export competitiveness, continued heavy import-reliance to support domestic demand, and lower official transfer inflows after current commitments are met (Table).

- **Net FDI inflows** are expected to stand at 0.8 percent of GDP over FY2020–30.

- With the exception of IMF RCF-supported financing and rescheduled China Eximbank repayments under the DSSI, **new external borrowing** is expected to commence in FY2024 after existing grant commitments are disbursed, and to increase gradually over the medium-term to refinance debt repayments coming due and the primary deficit which is expected to reach double digits over FY2026–2030. Even if the authorities were to rely only on grants for their budget spending needs because of the high risk of debt distress, under the baseline scenario, they would still need to borrow in order to meet their existing loan repayments.[6,7] The level of international reserves is expected to be sufficient to cover external debt repayments coming due until FY2023. However, when the large repayments to China Eximbank start coming due beginning in FY2024 (annual payments of about 2.5 percent of GDP in FY2024–29 on average), the authorities would not have enough cash buffers for debt repayments unless they borrow, or risk compromising the central bank's minimum reserve adequacy benchmark of at least 3–4 months of imports of goods and services.

- **Fiscal outlook:** The average primary balance is expected to be at -8.7 percent of GDP per year during FY2020–30 (Table). It is expected to decline from a surplus in FY2019–20 to a deficit of 16.7 percent of GDP by FY2030 due to lower grant inflows after existing commitments are met, and large spending needs to cover infrastructure gaps and meet climate resilience and Sustainability Development Goals. The deterioration in the fiscal position in FY2021 reflects a sharp economic contraction due to the Covid-19 pandemic and increased health and social spending needs.

- **Natural disaster:** The baseline scenario incorporates the effect of natural disasters and climate change over the longer-term. The years FY2021–24 are assumed to be disaster-free to simplify the policy discussion of the near-term outlook. From FY2025 onwards, the baseline incorporates the average long-term effects of natural disasters and climate change by lowering annual GDP

[6] For the World Bank (IDA) and other multilateral development banks, regular credit terms on all lending are assumed for all years in the projection period for which grant finance has not already been committed, consistent with "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf).

[7] From 2024 onwards, new commitments from multilateral donors are assumed to be on full credit terms. The credit terms are 40-year maturity, 10-year grace period, 0.75% service charge. The discount rate used to calculate the net PV of external debt is the default value set at 5 percent.

growth by 0.16 percentage points. These estimates are based on the findings of IMF staff analysis on the impact of natural disasters in Pacific Island countries.[8]

6. **The realism tools indicate that the primary balance projections are reasonable** (Figure 4). The fiscal forecasts between FY2020 and FY2023 are based on reasonable assumptions as the projected three-year adjustment lies in the left section of the distribution of past adjustments of the primary fiscal deficit (Figure 4). Real growth forecasts for FY2020–21 is lower than the projected growth path calculated by the model due to the sharp contraction as a result of the pandemic and a weak recovery in economic activity due to various capacity and structural constraints. As a result, Tonga's output levels are likely to remain below pre-pandemic trends. The realism of projections for public and private investment rates and their contribution to real GDP could not be calculated due to the unavailability of data.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

7. **Tonga's debt-carrying capacity applied in the 2020 DSA is strong**. Tonga's Composite Indicator (CI) index, which has been calculated based on the October 2020 WEO and the 2019 CPIA released in July 2020, is 3.12, indicating that the county's debt-carrying capacity is strong according to the revised low-income country (LIC)-DSA framework. The debt carrying capacity classification was upgraded from moderate to strong after two consecutive signals calculated on the basis of the October 2018 and April 2019 WEO vintages.

Tonga. Composite Indicator and Threshold Tables

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	3.478	1.34	43%
Real growth rate (in percent)	2.719	1.549	0.04	1%
Import coverage of reserves (in percent)	4.052	53.467	2.17	70%
Import coverage of reserves^2 (in percent)	-3.990	28.588	-1.14	-37%
Remittances (in percent)	2.022	15.494	0.31	10%
World economic growth (in percent)	13.520	2.928	0.40	13%
CI Score			3.12	100%
CI rating			Strong	

Applicable thresholds

APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	240
GDP	55
Debt service in % of	
Exports	21
Revenue	23

APPLICABLE	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	70

[8] Lee, D., H. Zhang and C. Nguyen, 2018, "The Economic Impact of Natural Disaster in Pacific Island Countries: Adaptation and Preparedness", the IMF Working Paper No. 18/108.

8. Given the severity and frequency of natural disasters in Tonga, a tailored one-time stress test for natural disaster shocks was conducted. [9] Tonga, a small developing natural disaster-prone state (Lee et al., 2018), is automatically subject to the standard natural disaster shock in the DSA.[10] The Emergency Events Database (EM-DAT) shows that the country's largest damage from natural disasters during 1980–2016 was 28.2 percent of GDP. Thus, the DSA assumes a one-off shock of 14 percentage points (ppts) to the debt to-GDP ratio in FY2021, which is lower than the historical average as infrastructure resilience is continuously improving in Tonga and the average effect on natural disaster is already reflected in the growth forecast after FY2025 under the baseline forecasts. Real GDP growth and exports are lowered by 3 and 7 ppts, respectively, in the year of the shock (Lee et al., 2018).

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

9. Under the baseline scenario, both external solvency indicators are likely to breach their respective thresholds from FY2029 (Figure 1 and Table 3). The external debt-to-GDP ratio is expected to increase from 36 percent in FY2020 to 38 percent in FY2021 (mainly as a result of lower GDP, new external borrowing in the form of disbursements from the IMF RCF, and rescheduled debt service payments under the DSSI). External debt-to-GDP ratios are projected to slowly decline to 32 percent in FY2023, as the authorities save part of the projected fiscal surplus in FY2022–23 for future amortization payments. From FY2024 onwards, under the current baseline forecasts, in the absence of new grant commitments, most of the external debt service payments coming due will need to be refinanced with new borrowings. In addition, given a limited appetite for domestic debt, Tonga will need to incur new external debt to help finance its large spending needs to cover infrastructure gaps and meet its climate resilience and Sustainability Development Goals. As a result, external debt will breach the authorities' fiscal anchor of 50 percent in FY2026. The PV of the external debt-to-GDP ratio is expected to breach the threshold of 55 percent starting from FY2029. Along with the increase of the PV of the external debt-to-GDP ratio, the PV of the external debt-to-exports ratio is expected to increase and breach the threshold starting from FY2029. Debt service indicators are also expected to sharply increase in FY2024 to reach 18 percent of exports and 16 percent of revenue as the larger debt payments to China Eximbank start coming due in FY2024. As Figure 3 shows, the main driver of external debt dynamics is a deterioration of fiscal and current account balances driven by the large import content of public infrastructure projects, which will need to be financed with external borrowing unless there are new commitments for official transfers.[11]

[9] All the standardized stress tests (i.e., growth shock, export shock, combination shock, historical scenario) are described in Table 8 of the new "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf).

[10] The estimated cost of FY2018 Tropical Cyclone Gita is 38 percent of GDP.

[11] The residual is mainly explained by the capital account inflows that are large in Tonga and not included in the model (about 10 percent of GDP on average over FY2016–2020).

10. The stress tests show that a combination of diverse shocks and an export shock have the largest negative impact on the external debt trajectory (Figure 1 and Table 3).[12] While an export shock alone has the largest impact on the PV of the external debt-to-GDP ratio, a combination of diverse shocks has the largest impact on the PV of external debt-to-exports, external debt service-to-exports, and external debt service-to-revenue ratios over the long term.

11. The tailored natural disaster shock causes the PV of external debt- and exports-to-GDP ratios to rise after the shock. The DSA includes a one-off shock that takes place in FY2021, but there is a strong possibility that multiple severe natural disasters could occur within a ten-year timeframe. Multiple natural disasters could have a larger cumulative negative effect on external debt sustainability due to larger reconstruction needs (which may require additional debt financing) and also by lowering long-term growth.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

12. Under the baseline scenario, the PV of the public debt-to-GDP ratio would cross the 70 percent benchmark from FY2029 onwards (Figure 2). The total public debt-to-GDP ratio would rise from 42 percent of GDP in FY2020 and reach 72 percent of GDP in FY2026, at the time the fiscal anchor of external debt is breached (Table 2). As Figure 3 indicates, the public debt dynamic is mainly driven by the primary deficit.

13. The standardized sensitivity analysis indicates an earlier breach in FY2027 (Figure 2, Table 4).[13] The PV of the public debt-to-GDP ratio would be above 70 percent of GDP by FY2027 under a multi-year shock to real GDP growth, a shock to exports, and a natural disaster shock.

14. The tailored one-time natural disaster shock results in a sharper deterioration in public debt sustainability. The PV of public debt relative to both GDP and exports is expected to sharply increase compared to the baseline during the years after the shock.

15. A tailored stress test for the combined contingent liability shock also causes a deterioration in public debt sustainability. The trajectory of the PV of the public debt-to-GDP ratio shifts upwards by 4 ppts from the baseline.

[12] Nominal export growth (in USD) is set to its historical average minus one standard deviation or the baseline projection minus one standard deviation, whichever is lower in the second and third years of the projection period. For the combination of diverse shocks, each individual shock (on real GPD growth, primary balance, exports, current transfers, FDI, and depreciation) is set at half of their magnitude in the second and third years of the projection periods.

[13] Real GDP growth (in USD) is set to its historical average minus one standard deviation or the baseline projection minus one standard deviation, whichever is lower in the second and third years of the projection period.

RISK RATING AND VULNERABILITIES

16. **The 2020 debt sustainability analysis under the new LIC debt sustainability framework suggests that Tonga's risk of external debt distress remains high.** Under the baseline scenario, the indicative thresholds for the PV of the external debt-to-GDP and external debt-to-exports ratios are expected to be breached starting from FY2029, in addition to the temporary breach of the external debt-to-exports ratio in FY2021. The external debt service-to-export ratio is expected to breach the threshold under the adverse scenario.

17. **The DSA suggests that overall risk of debt distress is also high.** The PV of the public debt-to-GDP ratio remains above the indicative benchmark from FY2029 onwards, reflecting a deteriorating fiscal position due to large spending needs, in the absence of new grant commitments over the medium- to- long term.[14] Tonga is highly vulnerable to natural disaster, growth, and exports shocks. These results indicate the urgent need for fiscal adjustments and measures to boost potential growth in the long run. Post-pandemic, the authorities need to embark on fiscal consolidation measures to rebuild fiscal buffers and prioritize investment projects that improve resilience to natural disasters and raise potential growth. New donor grant commitments and debt relief would be helpful.

AUTHORITIES' VIEWS

18. **The authorities agreed with the debt sustainability assessment**, in particular the implications of large debt repayments and potential negative shocks to growth, including from natural disasters. They recognized the need to build adequate fiscal buffers once the pandemic is over. In this regard, they reiterated their commitment to improve the targeting of economic support, further improve revenue administration, implement spending controls, and broaden the tax base in line with recommendations made by the previous and ongoing IMF and World Bank technical assistance. The authorities will continue to seek new grant financing commitments from bilateral donors and international financial institutions, and additional debt relief from China Eximbank, to maintain public and external debt at prudent levels, and to refrain from non-concessional borrowing. To improve debt coverage, the authorities plan to report contingent debt. A medium-term debt strategy is under preparation and will reflect these priorities.

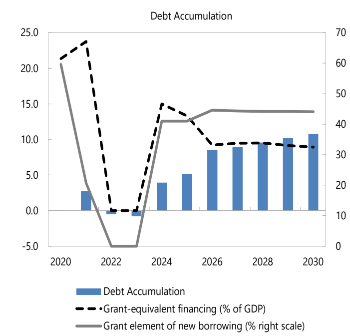
[14] Cash and in-kind grants averaged 16.7 percent of GDP annually over FY2015–2019.

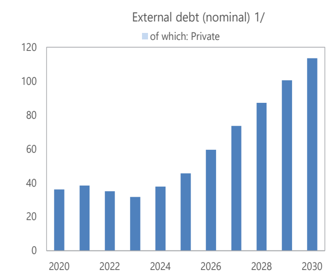
Table 1. Tonga. External Debt Sustainability Framework, Baseline Scenario, FY2017–2040

(In percent of GDP, unless otherwise indicated)

	Actual			Projections												Average 8/	
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2040	Historical	Projections
External debt (nominal) 1/	38.7	40.5	36.4	36.2	38.5	35.1	31.6	37.8	45.7	59.6	73.6	87.3	100.5	113.5	143.1	41.7	59.9
of which: public and publicly guaranteed (PPG)	38.7	40.5	36.4	36.2	38.5	35.1	31.6	37.8	45.7	59.6	73.6	87.3	100.5	113.5	143.1	41.7	59.9
Change in external debt	-3.2	1.8	-4.2	-0.2	2.3	-3.4	-3.4	6.2	7.9	13.9	14.0	13.7	13.2	13.0	-0.3		
Identified net debt-creating flows	4.1	-0.6	-1.6	4.1	17.9	7.3	6.7	10.3	10.4	12.6	12.2	11.9	11.5	11.6	4.3	7.5	10.6
Non-interest current account deficit	5.7	5.7	0.0	3.3	18.3	9.1	8.1	11.5	11.3	13.6	13.2	13.2	13.0	13.1	6.4	9.8	11.6
Deficit in balance of goods and services	43.7	44.5	41.9	42.9	57.4	46.9	47.8	44.4	44.2	45.1	45.1	45.1	45.4	45.4	41.6	43.3	46.3
Exports	22.2	21.4	22.0	18.8	3.9	18.4	18.8	21.4	22.3	22.9	23.1	23.4	23.4	23.8	27.0		
Imports	65.8	65.9	63.9	61.7	61.3	65.3	66.6	65.9	66.5	68.0	68.2	68.5	68.8	69.2	68.5		
Net current transfers (negative = inflow)	-33.3	-32.7	-33.4	-30.6	-36.9	-32.1	-33.1	-26.3	-26.4	-22.9	-23.3	-23.5	-24.1	-24.1	-28.4	-29.8	-27.6
of which: official	-8.1	-5.9	-8.8	-4.0	-17.2	-12.2	-13.3	-4.7	-4.8	-0.8	-0.8	-0.7	-0.7	-0.7	-0.5		
Other current account flows (negative = net inflow)	-4.6	-6.0	-8.6	-8.9	-2.2	-5.7	-6.7	-6.6	-6.5	-8.6	-8.5	-8.4	-8.3	-8.2	-6.7		
Net FDI (negative = inflow)	1.3	-4.9	-0.1	-0.7	-0.9	-0.9	-0.8	-0.7	-0.7	-0.7	-0.7	-1.0	-1.0	-1.0	-1.3	-1.3	-0.8
Endogenous debt dynamics 2/	-3.0	-1.5	-1.5	1.5	0.5	-1.0	-0.6	-0.4	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5	-0.8		
Contribution from nominal interest rate	0.6	0.6	0.9	0.6	-0.8	0.5	0.4	0.3	0.4	0.5	0.7	0.9	1.0	1.2	1.7		
Contribution from real GDP growth	-1.3	-0.1	-0.3	0.9	1.3	-1.4	-1.0	-0.8	-0.7	-0.8	-1.0	-1.3	-1.5	-1.8	-2.5		
Contribution from price and exchange rate changes	-2.4	-1.9	-2.1	...	...	...	...	...	...	...	...	...	...	...	...		
Residual 3/	-7.3	2.4	-2.5	-4.2	-15.6	-10.7	-10.1	-4.1	-2.5	1.3	1.8	1.8	1.7	1.5	-4.7	-7.1	-3.6
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators																	
PV of PPG external debt-to-GDP ratio	...	...	25.4	26.0	29.5	27.1	25.0	27.7	31.7	38.6	45.8	53.2	61.0	69.1	88.8		
PV of PPG external debt-to-exports ratio	...	...	115.5	138.3	764.1	146.9	133.3	129.2	142.2	168.6	197.7	227.8	261.1	290.7	329.5		
PPG debt service-to-exports ratio	6.0	5.8	9.1	8.1	17.9	10.1	11.0	18.5	17.5	16.7	18.0	17.6	14.7	12.8	28.3		
PPG debt service-to-revenue ratio	5.6	5.0	8.6	6.2	3.0	7.7	8.5	16.4	16.1	15.8	17.2	16.9	14.1	12.5	21.1		
Gross external financing need (Million of U.S. dollars)	38.7	10.0	10.0	20.7	88.6	53.3	51.6	84.7	86.8	103.7	107.9	110.1	107.8	109.8	138.0		
Key macroeconomic assumptions																	
Real GDP growth (in percent)	3.3	0.3	0.7	-2.5	-3.5	4.0	3.0	2.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8	2.3	1.3
GDP deflator in US dollar terms (change in percent)	5.9	5.2	5.6	0.0	0.9	3.1	1.9	1.9	1.9	2.0	2.1	2.1	2.1	2.1	2.3	3.1	1.8
Effective interest rate (percent) 4/	1.7	1.6	2.3	1.5	-2.1	1.3	1.2	1.1	1.1	1.2	1.2	1.2	1.2	1.3	1.2	1.7	0.9
Growth of exports of G&S (US dollar terms, in percent)	-1.1	1.9	9.1	-16.6	-80.0	411.2	6.9	19.4	7.7	6.9	5.0	4.9	4.0	5.7	5.8	12.1	34.1
Growth of imports of G&S (US dollar terms, in percent)	13.8	5.6	3.2	-5.9	-3.2	14.1	7.0	3.3	4.8	6.2	4.3	4.3	4.4	4.5	3.7	6.0	4.0
Grant element of new public sector borrowing (in percent)	...	...	...	59.6	20.7	...	...	41.0	41.0	44.6	44.3	44.1	44.1	44.1	44.4	...	42.6
Government revenues (excluding grants, in percent of GDP)	23.9	24.8	23.4	24.7	22.9	23.9	24.3	24.2	24.2	24.3	24.3	24.3	24.3	24.3	36.2	21.6	24.1
Aid flows (in Million of US dollars) 5/	483.2	473.7	517.5	108.5	112.4	95.3	110.7	92.1	86.5	74.1	78.8	82.2	82.2	83.3	76.4	...	
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	21.3	23.7	...	...	15.0	13.3	9.2	9.5	9.5	9.1	8.9	5.5	...	13.3
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	99.1	87.9	...	...	69.6	63.9	46.8	46.4	46.1	46.1	46.1	46.6	...	61.3
Nominal GDP (Million of US dollars)	460	486	517	504	491	526	552	576	598	621	646	671	698	725	1,082		
Nominal dollar GDP growth	9.5	5.5	6.4	-2.5	-2.6	7.2	4.9	4.5	3.8	3.9	4.0	3.9	3.9	3.9	4.1	5.4	3.2
Memorandum items:																	
PV of external debt 7/	...	...	25.4	26.0	29.5	27.1	25.0	27.7	31.7	38.6	45.8	53.2	61.0	69.1	88.8		
In percent of exports	...	...	115.5	138.3	764.1	146.9	133.3	129.2	142.2	168.6	197.7	227.8	261.1	290.7	329.5		
Total external debt service-to-exports ratio	6.0	5.8	9.1	8.1	17.9	10.1	11.0	18.5	17.5	16.7	18.0	17.6	14.7	12.8	28.3		
PV of PPG external debt (in Million of US dollars)			131.1	130.9	144.8	142.3	138.1	159.8	189.4	240.1	295.7	357.3	425.7	500.9	960.7		
(PVt-PVt-1)/GDPt-1 (in percent)				0.0	2.8	-0.5	-0.8	3.9	5.1	8.5	8.9	9.5	10.2	10.8	3.0		
Non-interest current account deficit that stabilizes debt ratio	8.9	4.0	4.1	3.5	16.0	12.6	11.5	5.3	3.5	-0.3	-0.8	-0.5	-0.2	0.0	6.8		

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	Yes





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g) + Ɛα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the local currency, and α= share of local currency-denominated external

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Current-year interest payments divided by previous period debt stock.

5/ Defined as grants, concessional loans, and debt relief.

6/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

7/ Assumes that PV of private sector debt is equivalent to its face value.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

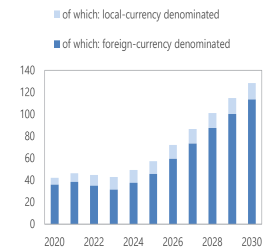
Table 2. Tonga. Public Sector Debt Sustainability Framework, Baseline Scenario, FY2017–2040

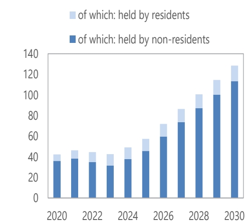
(In percent of GDP, unless otherwise indicated)

	Actual			Projections											Average 6/	
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2040	Historical	Projections
Public sector debt 1/	**43.6**	**45.9**	**41.3**	**42.3**	**46.3**	**44.6**	**42.7**	**49.1**	**57.3**	**72.0**	**86.5**	**100.8**	**114.7**	**128.4**	**156.0**	**47.9**	**71.3**
of which: external debt	**38.7**	**40.5**	**36.4**	**36.2**	**38.5**	**35.1**	**31.6**	**37.8**	**45.7**	**59.6**	**73.6**	**87.3**	**100.5**	**113.5**	**143.1**	**41.7**	**59.9**
Change in public sector debt	-5.8	2.2	-4.6	1.0	3.9	-1.7	-1.9	6.4	8.2	14.7	14.5	14.3	13.9	13.7	-1.4		
Identified debt-creating flows	**-8.0**	**-4.5**	**-5.6**	**-4.0**	**4.5**	**-2.2**	**-2.8**	**6.3**	**8.3**	**15.0**	**15.0**	**15.1**	**14.8**	**14.5**	**-0.4**	**-2.4**	**7.7**
Primary deficit	**-4.4**	**-3.7**	**-3.9**	**-5.2**	**4.0**	**-0.4**	**-1.5**	**7.4**	**9.3**	**16.0**	**16.4**	**16.7**	**16.7**	**16.7**	**2.7**	**-1.3**	**8.7**
Revenue and grants	43.2	42.6	41.7	45.7	45.7	42.0	44.4	34.6	32.3	25.1	25.1	25.0	25.0	25.0	36.7	**35.3**	**33.6**
of which: grants	19.3	17.8	18.3	21.0	22.9	18.1	20.1	10.5	8.1	0.8	0.8	0.7	0.7	0.7	0.5		
Primary (noninterest) expenditure	38.8	38.9	37.8	40.6	49.8	41.7	42.8	42.0	41.5	41.1	41.5	41.8	41.7	41.6	39.4	**34.0**	**42.4**
Automatic debt dynamics	**-3.6**	**-0.8**	**-1.8**	**1.2**	**0.4**	**-1.8**	**-1.3**	**-1.0**	**-0.9**	**-1.1**	**-1.4**	**-1.7**	**-1.9**	**-2.1**	**-3.1**		
Contribution from interest rate/growth differential	-1.8	-0.2	-0.3	1.2	0.4	-1.8	-1.3	-1.0	-0.9	-1.1	-1.4	-1.7	-1.9	-2.1	-3.1		
of which: contribution from average real interest rate	-0.2	-0.1	0.1	0.1	-1.1	-0.1	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.3		
of which: contribution from real GDP growth	-1.6	-0.1	-0.3	1.0	1.5	-1.8	-1.3	-1.1	-0.9	-1.0	-1.3	-1.5	-1.8	-2.0	-2.8		
Contribution from real exchange rate depreciation	-1.7	-0.6	-1.5	...	...	...	...	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	**2.2**	**6.7**	**1.0**	**5.0**	**-0.5**	**0.5**	**1.0**	**0.0**	**-0.1**	**-0.2**	**-0.5**	**-0.8**	**-0.9**	**-0.8**	**-1.0**	**2.5**	**0.2**
Sustainability indicators																	
PV of public debt-to-GDP ratio 2/	**...**	**...**	**30.6**	**32.0**	**36.9**	**36.6**	**36.1**	**39.0**	**43.3**	**51.2**	**58.9**	**66.8**	**75.2**	**83.9**	**101.8**		
PV of public debt-to-revenue and grants ratio	**...**	**...**	**73.3**	**69.9**	**80.7**	**87.1**	**81.3**	**112.8**	**134.3**	**204.1**	**235.0**	**266.9**	**300.6**	**335.8**	**277.2**		
Debt service-to-revenue and grants ratio 3/	**6.3**	**6.0**	**8.7**	**7.4**	**5.9**	**8.2**	**13.3**	**21.5**	**23.6**	**35.8**	**33.1**	**33.4**	**36.6**	**32.1**	**35.3**		
Gross financing need 4/	-1.7	-1.1	-0.2	-1.8	6.7	3.1	4.4	14.8	16.9	25.0	24.7	25.1	25.8	24.7	15.6		
Key macroeconomic and fiscal assumptions																	
Real GDP growth (in percent)	3.3	0.3	0.7	-2.5	-3.5	4.0	3.0	2.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8	**2.3**	**1.3**
Average nominal interest rate on external debt (in percent)	1.7	1.6	2.3	1.5	-2.1	1.3	1.2	1.1	1.1	1.2	1.2	1.2	1.2	1.3	1.2	**1.7**	**0.9**
Average real interest rate on domestic debt (in percent)	-2.9	-1.5	-4.3	3.0	4.1	0.6	1.1	1.4	1.1	1.1	0.8	0.9	1.3	1.5	1.1	**-1.8**	**1.5**
Real exchange rate depreciation (in percent, + indicates depreciation)	-4.3	-1.6	-3.7	...	...	...	...	...	...	...	...	...	...	...	...	**-0.7**	**...**
Inflation rate (GDP deflator, in percent)	5.6	5.1	7.7	0.4	-0.9	2.1	2.0	1.9	2.3	2.4	2.7	2.6	2.2	1.9	2.3	**3.7**	**1.8**
Growth of real primary spending (deflated by GDP deflator, in percent)	10.4	0.5	-2.1	4.6	18.5	-12.9	5.8	0.5	0.7	0.7	2.7	2.6	1.6	1.7	1.7	**8.1**	**2.4**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	1.4	-5.9	0.7	-6.2	0.1	1.4	0.4	1.0	1.0	1.3	1.9	2.5	2.8	2.9	4.1	**-1.3**	**0.8**
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**Yes**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The general government, central bank . Definition of external debt is Residency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

"Other debt creating or reducing flow" is the net acquisition of financial assets.

Table 3. Tonga. Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, FY2020–2030

(In percent)

					Projections 1/						
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
PV of debt-to GDP ratio											
Baseline	26	30	27	25	28	32	39	46	53	**61**	**69**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	26	23	21	19	21	23	28	33	38	43	49
B. Bound Tests											
B1. Real GDP growth	26	31	29	27	30	34	42	50	**58**	**66**	**75**
B2. Primary balance	26	31	29	28	31	35	42	49	**57**	**65**	**73**
B3. Exports	26	38	48	45	48	53	**61**	**70**	**79**	**88**	**97**
B4. Other flows 3/	26	36	38	36	38	42	49	**57**	**64**	**72**	**80**
B5. Depreciation	26	37	26	23	27	32	40	49	**59**	**69**	**79**
B6. Combination of B1-B5	26	47	44	42	45	50	**59**	**67**	**77**	**86**	**96**
C. Tailored Tests											
C1. Combined contingent liabilities	26	32	29	28	31	35	42	49	**57**	**65**	**73**
C2. Natural disaster	26	34.9	32.5	32.4	36	41	48	**56**	**65**	**73**	**82**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	55	55	55	55	55	55	55	55	55	55	55
PV of debt-to-exports ratio											
Baseline	138	**764**	147	133	129	142	169	198	228	**261**	**291**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	138	**584**	113	104	98	105	122	141	161	185	205
B. Bound Tests											
B1. Real GDP growth	138	**764**	147	133	129	142	169	198	228	**261**	**291**
B2. Primary balance	138	**793**	159	147	144	157	184	213	**244**	**277**	**307**
B3. Exports	138	-9421	-2605	-2420	-2264	-2393	-2690	-3032	-3386	-3785	-4129
B4. Other flows 3/	138	**943**	206	191	179	191	216	**244**	**274**	**308**	**336**
B5. Depreciation	138	**764**	110	98	98	112	139	169	199	232	**263**
B6. Combination of B1-B5	138	**2202**	193	**399**	**377**	**403**	**460**	**524**	**591**	**666**	**731**
C. Tailored Tests											
C1. Combined contingent liabilities	138	**819**	158	149	143	157	183	213	**243**	**276**	**306**
C2. Natural disaster	138	**1346**	**263**	**257**	**247**	**272**	**314**	**363**	**412**	**466**	**513**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	240	240	240	240	240	240	240	240	240	240	240
Debt service-to-exports ratio											
Baseline	8	18	10	11	18	17	17	18	18	15	13
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	8	17	9	10	17	15	14	15	15	12	10
B. Bound Tests											
B1. Real GDP growth	8	18	10	11	18	17	17	18	18	15	13
B2. Primary balance	8	18	10	11	19	18	17	18	18	15	13
B3. Exports	8	-205	-124	-150	-237	-224	-214	-229	-224	-188	-165
B4. Other flows 3/	8	18	11	12	20	19	18	19	19	16	14
B5. Depreciation	8	18	10	10	18	17	16	17	17	14	12
B6. Combination of B1-B5	8	**39**	**25**	**27**	**43**	**41**	**39**	**42**	**41**	**34**	**30**
C. Tailored Tests											
C1. Combined contingent liabilities	8	18	10	11	19	18	17	18	18	15	13
C2. Natural disaster	8	**28**	16.3	17.7	**29.5**	**28**	**27**	**29**	**28**	**24**	21
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	21	21	21	21	21	21	21	21	21	21	21
Debt service-to-revenue ratio											
Baseline	6	3	8	8	16	16	16	17	17	14	13
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	6	3	7	7	15	14	14	15	14	11	10
B. Bound Tests											
B1. Real GDP growth	6	3	8	9	18	17	17	19	18	15	14
B2. Primary balance	6	3	8	9	17	16	16	17	17	14	13
B3. Exports	6	4	9	12	21	21	20	22	21	18	16
B4. Other flows 3/	6	3	8	9	17	17	17	18	18	15	13
B5. Depreciation	6	4	10	10	20	20	19	21	21	17	15
B6. Combination of B1-B5	6	4	11	12	21	21	21	22	22	18	16
C. Tailored Tests											
C1. Combined contingent liabilities	6	3	8	9	17	16	16	17	17	14	13
C2. Natural disaster	6	3	8	9	17	17	16	18	18	15	13
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	23	23	23	23	23	23	23	23	23	23	23
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	45.5	45.5	45.5	45.5	45.5	45.5	45.5	45.5	45.5	45.5	**45.5**

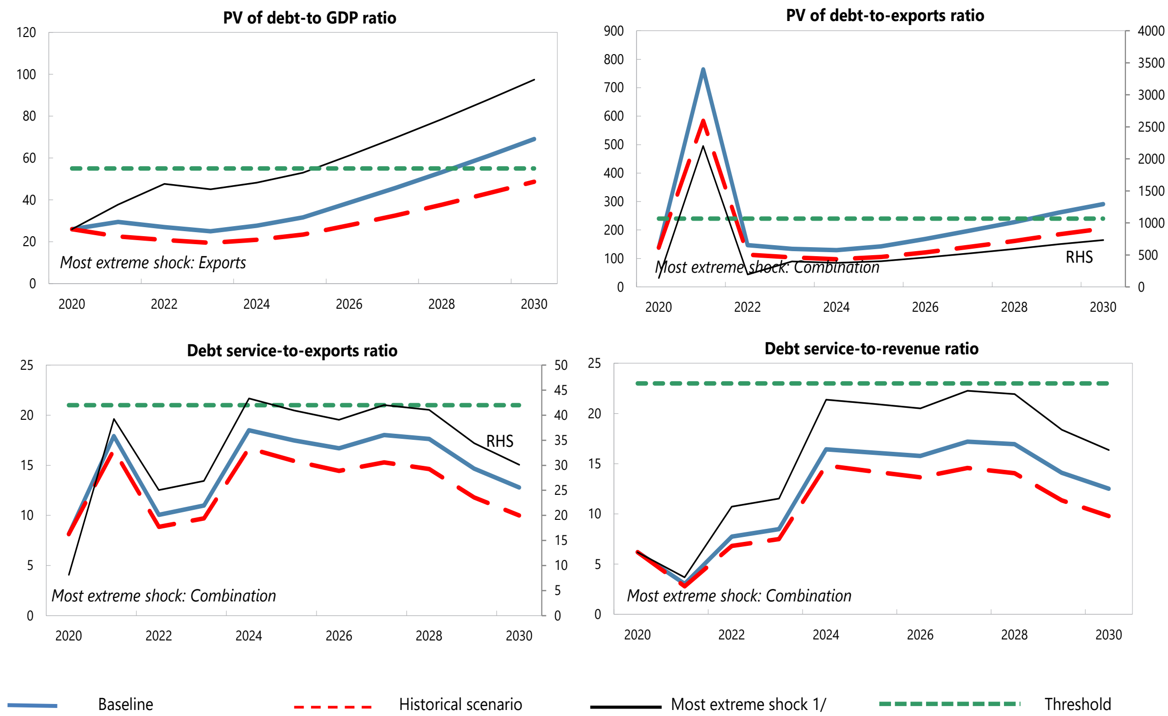
Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Tonga. Sensitivity Analysis for Key Indicators of Public Debt, FY2020–2030
(In percent)

	Projections 1/										
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
PV of Debt-to-GDP Ratio											
Baseline	32	37	37	36	39	43	51	59	67	**75**	**84**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	32	30	29	29	27	25	23	21	19	18	16
B. Bound Tests											
B1. Real GDP growth	32	39	42	43	47	53	63	**72**	**82**	**92**	**103**
B2. Primary balance	32	40	42	41	44	48	55	63	**71**	**79**	**88**
B3. Exports	32	39	50	49	52	56	64	**72**	**80**	**88**	**97**
B4. Other flows 3/	32	44	48	47	50	54	62	70	**78**	**86**	**95**
B5. Depreciation	32	44	42	41	40	40	43	45	48	52	57
B6. Combination of B1-B5	32	38	38	36	39	42	50	57	65	**73**	**82**
C. Tailored Tests											
C1. Combined contingent liabilities	32	42	42	40	43	47	55	63	**71**	**79**	**88**
C2. Natural disaster	32	49	49	48	51	55	64	**72**	**81**	**89**	**99**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	70	70	70	70	70	70	70	70	70	70	70
PV of Debt-to-Revenue Ratio											
Baseline	70	81	87	81	113	134	204	235	267	301	336
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	70	68	72	69	81	81	94	85	78	71	66
B. Bound Tests											
B1. Real GDP growth	70	84	96	93	133	161	250	288	327	368	411
B2. Primary balance	70	87	100	93	126	148	221	252	283	317	352
B3. Exports	70	86	118	110	150	174	256	287	319	352	388
B4. Other flows 3/	70	96	113	106	144	168	247	278	310	344	379
B5. Depreciation	70	101	105	95	119	128	171	181	193	208	227
B6. Combination of B1-B5	70	84	91	81	112	131	199	229	260	293	328
C. Tailored Tests											
C1. Combined contingent liabilities	70	92	99	91	125	147	220	250	282	316	351
C2. Natural disaster	70	106	115	106	146	170	254	287	322	358	396
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio											
Baseline	7	6	8	13	22	24	36	33	33	37	32
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	7	6	7	8	19	21	30	26	25	27	22
B. Bound Tests											
B1. Real GDP growth	7	6	9	15	25	29	44	42	43	46	42
B2. Primary balance	7	6	8	17	26	26	39	35	35	38	33
B3. Exports	7	6	8	14	22	25	37	34	34	38	33
B4. Other flows 3/	7	6	9	14	22	24	37	34	34	37	33
B5. Depreciation	7	6	10	15	24	27	39	37	37	39	34
B6. Combination of B1-B5	7	6	8	13	24	23	36	33	33	36	32
C. Tailored Tests											
C1. Combined contingent liabilities	7	6	9	20	22	28	37	36	34	38	33
C2. Natural disaster	7	6	9	27	24	34	40	42	38	43	37
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the benchmark.
2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.
3/ Includes official and private transfers and FDI.

Figure 1. Tonga. Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, FY2020–2030



Customization of Default Settings		
	Size	Interactions
Tailored Stress		
Combined CL	No	
Natural disaster	Yes	Yes
Commodity price 2/	n.a.	n.a.
Market financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.3%	1.3%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	30	30
Avg. grace period	10	10

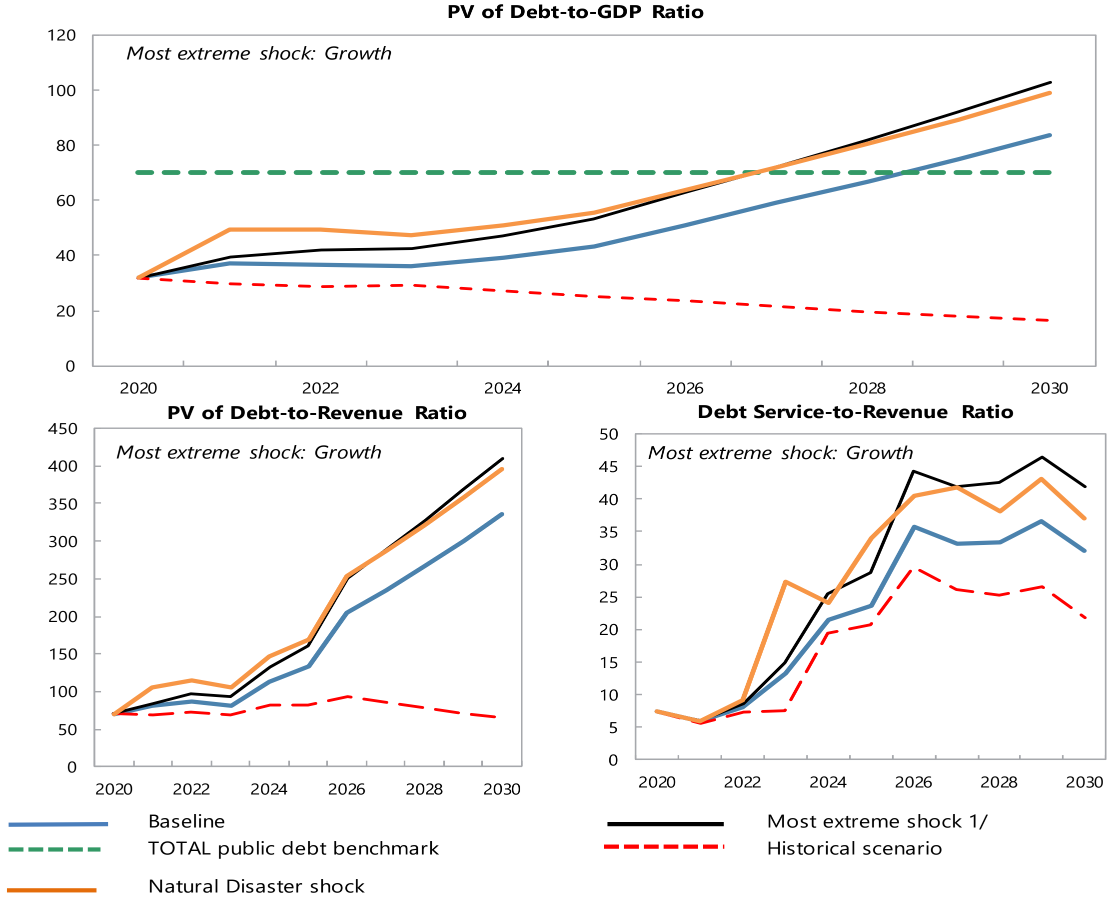
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2030. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Tonga. Indicators of Public Debt Under Alternative Scenarios, FY2020–2030



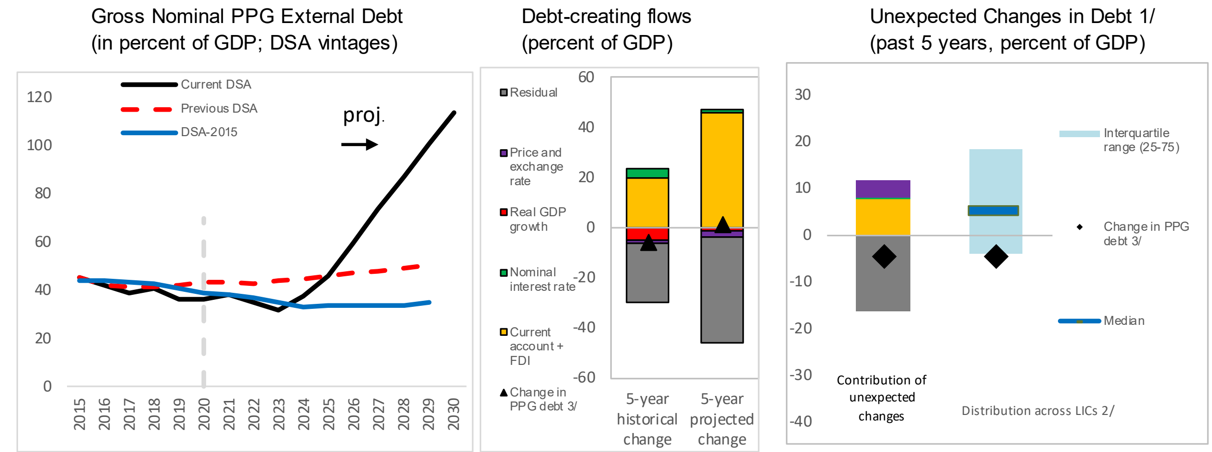
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	55%	55%
Domestic medium and long-term	45%	45%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.3%	1.3%
Avg. maturity (incl. grace period)	30	30
Avg. grace period	10	10
Domestic MLT debt		
Avg. real interest rate on new borrowing	1.7%	1.7%
Avg. maturity (incl. grace period)	2	2
Avg. grace period	1	1
Domestic short-term debt		
Avg. real interest rate	0.0%	0.0%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

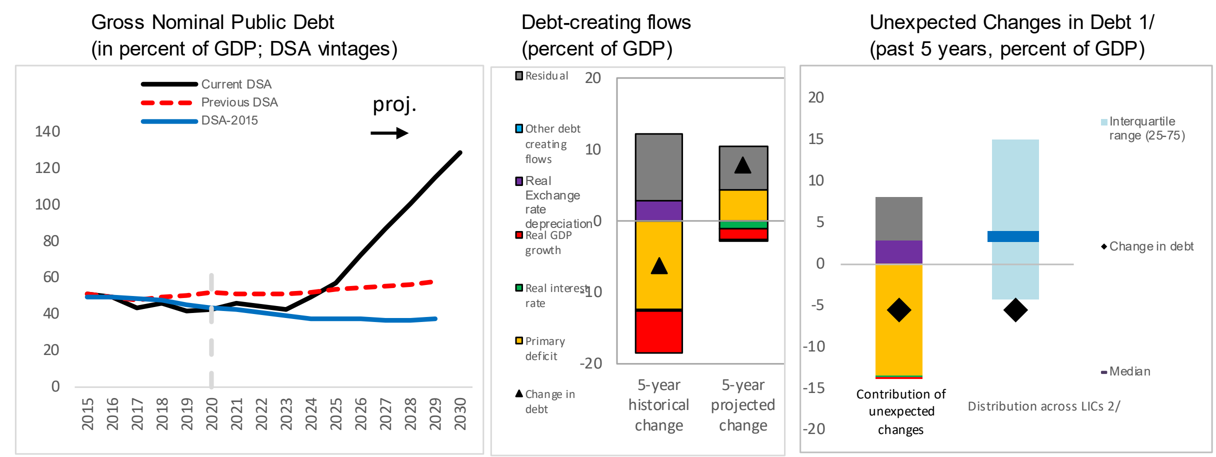
Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2030. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 3. Tonga. Drivers of Debt Dynamics–Baseline Scenario External Debt



Public debt



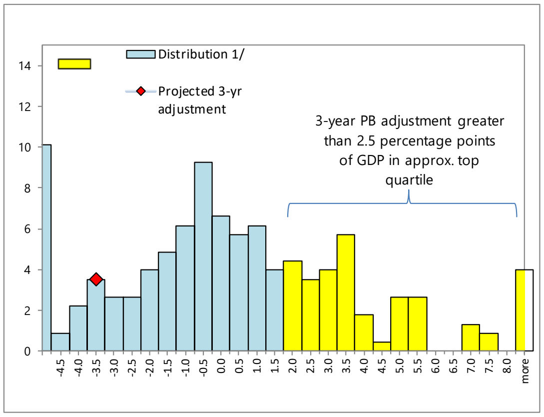
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

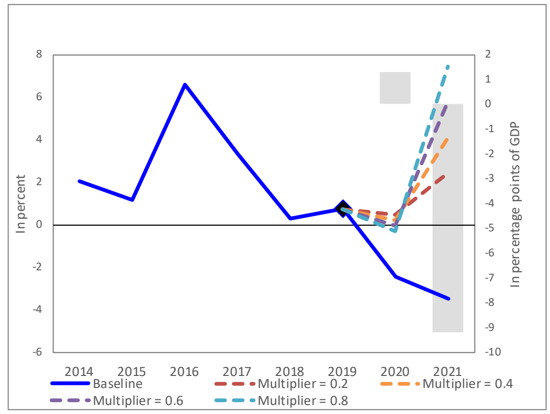
Figure 4. Tonga. Realism Tools

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Statement by Ms. Mahasandana, Executive Director, and Mr. Mochtar, Alternate Executive Director, on Tonga
January 25, 2021

On behalf of the Tongan authorities, we wish to convey our gratitude to staff, management and the Executive Board for their continued support to Tonga, particularly during these challenging times.

Amidst its recovery from the 2018 Tropical Cyclone (TC) Gita, Tonga's economy was further buffeted by the COVID-19 pandemic and TC Harold in early 2020. Given Tonga's limited healthcare capacity and a relatively close-knit small population, a local COVID-19 outbreak would be catastrophic. The prompt adoption of preventive measures was therefore necessary to avert the entry of COVID-19 as early as January-February 2020. These included health screening at the border, cancellation of cruise ships, declaration of a state of emergency, and closure of the external borders. While such early actions have been successful in keeping Tonga COVID-19-free thus far, they have nonetheless amplified the already weak growth dynamics. The major destructions caused by TC Harold, particularly in public infrastructure and tourism-related facilities, also added to the economic setbacks.

The weak near- and medium-term outlook for Tonga's economy while being subject to considerable downside risks, has given rise to sizable government spending and financing needs. Tonga is extremely grateful to its development partners' ongoing support which has been instrumental in helping it meet its wide-varying priorities, including the large climate resilience and developmental needs, within its limited fiscal space while ensuring debt sustainability. This task has become more challenging as Tonga is confronted by concurrent shocks, including the pandemic. The authorities are therefore requesting access to the IMF's Rapid Credit Facility (RCF) for the first time to help close some of its large financing gap in the near term and preserve macroeconomic stability. The RCF disbursement, equivalent to 50 percent of quota (SDR 6.9 million), would also help mobilize additional financial support from other development partners.

Economic Impact and Outlook

Economic activity has been substantially impacted by the containment measures to avoid a local outbreak, negative spillovers from the impact of the pandemic abroad, and damages arising from TC Harold. The authorities expect real GDP to contract by 2.5 percent in FY2020 and decline further by 3.5 percent in FY2021, in contrast to the pre-crisis growth projection of 3.5 percent. The services sector, including tourism and related segments, are severely affected by the border closures and damages of tourist facilities by TC Harold. A more severe economic contraction is anticipated in FY2021 with the peak tourism season starting in July and the continued delays in reconstruction and development efforts. Lower remittance flows are also expected as economic weakness in the source remitting countries persists. The Government's timely support to hard-hit sectors, and the relative resilience in remittances so far, have helped to cushion the impact of the pandemic and cyclone. Reallocation of workers from the seasonal worker program (SWP) and tourism sector to other activities such as construction and agriculture, together with the promotion of local tourism, have also helped to support employment and growth somewhat.

The worsening economic outcomes and outlook are weighing considerably on the fiscal position, putting further pressure on debt sustainability. The higher COVID-19 and cyclone related spending in FY2020 were largely financed by the reallocation of fiscal resources, donor support and drawdown of emergency and reserve funds. In FY2021, spending on healthcare and support to severely affected businesses and individuals will increase further. Meanwhile, the weaker economic environment, together with the ongoing cyclone and pandemic related tax relief, have impacted tax collections. A fiscal deficit equivalent to 4.8 percent of GDP is therefore projected for FY2021, after successive fiscal surpluses since FY2016. The looming significant costs of achieving climate resilience and the SDGs add to the sizable spending needs, even as debt service obligations are expected to increase significantly in FY2024. With debt already at high risk of distress, strong fiscal adjustments and discipline, and effective debt management strategies are warranted to safeguard debt sustainability.

While inflation remains low, risks to external stability are escalating both over the near and medium term. Annual headline inflation declined to -0.8 percent in November 2020 largely reflecting lower global oil and local food prices and weak domestic demand and is expected to remain low. Tonga's international reserves have increased significantly to 9.9 months of import cover as of end-November 2020 due to government receipts from development partners and higher remittances. Nonetheless, the anticipated external financing gap in the near term is significant stemming from projected lower tourism and remittance inflows, even as import demand rises to combat COVID-19 and facilitate post-cyclone reconstruction. A more challenging medium-term outlook is also envisaged with large external debt payments commencing in FY2024 and Tonga's ongoing high vulnerability to external shocks amid high dependence on imports and weak exports. The Fund and other development partners' financing support to help the Tongan authorities maintain adequate international reserves is therefore imperative for safeguarding external sustainability and supporting the exchange rate peg.

The outlook is subject to substantial downside risks. In sharing staff's assessment of risks, the authorities highlight the uncertainty about the extent and global impact of the pandemic, including effectively securing vaccine for the entire population, as their main concern, in conjunction with Tonga's ongoing high vulnerability to natural disasters.

Policy Response

The authorities' response has prioritized the population's safety and their livelihood. The economic and social stimulus package approved in April 2020 focused on upgrading healthcare capacity to deal with the pandemic including when the borders reopen, as well as supporting hard-hit businesses and households. This was complemented by income tax deferrals and duty relief on a case by case basis, voluntary access to retirement benefits, and loan moratoriums and restructuring offered by banks to affected customers. To ensure access to COVID-19 vaccines, Tonga has signed the COVAX Advanced Market Commitment on 8th January 2021 and is in discussions with bilateral donors and development partners, including New Zealand, Australia and the Asia Development Bank (ADB), to seek financing support for the purchase and distribution of vaccines. The Ministry of Health is currently finalizing the vaccine distribution plan.

The authorities remain committed to broadening the tax base and improving spending efficiency. This would support the fiscal adjustment efforts over the medium term while meeting climate and developmental goals. With technical assistance from the Fund and others, the authorities have embarked on a series of reviews of existing tax exemptions, including the electricity tariff to incorporate the contribution of renewal energy, with the aim of phasing out redundant and inadequately targeted exemptions. Improving the process for granting of tax exemptions is also in progress. The authorities will consider staff's suggested further tax policy changes taking into account their absorptive capacity and request any technical assistance if needed. Authorities will also continue efforts to improve tax compliance and administration and reduce tax arrears to enhance revenue collection. The review of property fees is also underway. To improve spending efficiency and controls, efforts to better prioritize health and infrastructure spending and address the wage bill overruns will continue. The authorities also plan to conduct a review of the fiscal anchors on wages, domestic revenues and external debt with technical assistance from the Fund.

Multiple initiatives are underway to help preserve fiscal and debt sustainability. Tonga's request for debt relief in 2020 under the G20 DSSI was approved by its major creditor and a further request for debt relief in 2021 is being sought. The authorities are also actively seeking new grant financing from development partners as a priority and accessing the RCF can help to catalyze further donor support and concessional financing. They appreciate and look forward to the Fund and World Bank's continued joint effort to support calls for further debt relief for low income countries such as Tonga. While a new medium-term debt strategy is being developed, we look forward to the continued support from the Fund and World Bank on enhancing debt management and transparency. A new climate resilient strategy is being developed which can help implement the Climate Change Policy Assessment (CCPA) recommendations particularly in integrating climate spending needs to the medium-term fiscal framework. Strengthening public finance management (PFM) is ongoing, including the completion of a new PFM roadmap to support budget control and fiscal management. Meanwhile, enhancements to the cash management system will ensure sufficient buffers are accumulated for future emergencies including the replenishment of the emergency funds that were drawn on for the pandemic and cyclone related spending.

To better utilize limited fiscal resources, the authorities continue to review the progress and impact of the utilization of the Economics and Social Stimulus package. A national rapid assessment of the economic and social impact of COVID-19 was conducted with technical assistance from the ADB. This has assisted the Government to determine the effectiveness of the support measures, how they can be enhanced to meet the desired objectives, as well as when and how to phase out these measures with minimal impact particularly on the vulnerable. Lessons learned from the rollout of the stimulus package are useful inputs to the design and implementation of future support measures to ensure they are better targeted, timely and have more inclusive coverage. The authorities also agree with extending the social protection system, building on the recommendations of the rapid assessment, which may require technical assistance from relevant development partners.

The authorities are committed to strengthen governance, accountability and transparency in government operations including the rollout of pandemic and cyclone related support. A number of measures imposed within the PFM Roadmap based on the findings of the Public Expenditure and Financial Accountability (PEFA) Assessment, together with the auditing and publication of pandemic related spending and procurement documents, are on track. The authorities will continue to work closely with the Fund and the World Bank to improve fiscal reporting and transparency in line with international standards and best practices.

The accommodative monetary policy will be maintained. Despite the low inflation and comfortable liquidity, the NRBT will continue to closely monitor developments and stand ready to provide liquidity support if necessary, including reducing the statutory reserve deposit (SRD) requirement. The authorities also agree on continued efforts to enhance monetary policy transmission through improved communication and liquidity management. Further assistance from the Fund and other relevant development partners on developing the domestic debt market would be required.

The authorities broadly agree with staff's assessment of rising financial stability risks and the need to enhance financial supervision. The banking system remains sound with profitable and well capitalized banks and adequately provisioned NPLs. Nonetheless, the NRBT continues to be vigilant against the fallout from the worsening economic backdrop on banks' credit risks and the associated implications on profitability and capital adequacy. To maintain public confidence, they are actively engaging with financial institutions, and closely monitoring developments in both the banking and non-banking sectors for early identification and addressing of potential vulnerabilities while also ensuring unimpeded access to essential financial services. The continued efforts to extend the NRBT's supervision and regulation of non-bank financial institutions would also help support its financial inclusion initiatives and improving financial literacy. The efforts to safeguard financial stability would be further strengthened with the forthcoming IMF technical assistance on enhancing the solvency stress testing framework and developing of macroprudential tools. Efforts are also underway to improve the credit environment including the strengthening of the credit bureau operations and enhancing the efficiency of the land lease administration. The NRBT is also strengthening the financial regulatory laws through new legislations for the supervision of insurance and pension funds to enhance its supervisory role drawing from the experience during the pandemic.

Strengthening the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime in line with the ongoing mutual evaluation by the Asia Pacific Group on Money Laundering (APG) is **an important priority to mitigate the ongoing risk of correspondent banking relationship (CBR) withdrawal**. The IMF Legal Department had reviewed the AML/CFT law which could be considered together with any further recommendations from the APG mutual evaluation. Improving enforcement is a key priority to ensure effective compliance with the FATF requirements. In this context, developing a national KYC system is being considered to improve the identification and monitoring of customers and transactions.

The authorities acknowledge staff's assessment of Tonga's low growth potential in light of its natural endowments and heavy reliance on remittances. Growing the formal private sector remains a priority while noting the challenges that slow the progress in this area, some of which are politically and culturally difficult to address and therefore warrant practical and well-tailored solutions. To this end, the authorities agree with the recommended modernization of the land lease administration while any further substantial reforms such as changes to female land rights would take time to implement. They view the SWP as a key initiative to address unemployment including youth and women unemployment which can be complemented with mechanisms to facilitate the return and reintegration of workers into higher value-added economic activities. They also concur with the importance of building domestic capacity to support initiatives to meet the SDGs and climate goals and enhance growth prospects. Efforts to improve skilled labor supply will continue including the Technical and Vocational Education and Training (TVET) programs, while advancing legal and structural reforms to promote business formation. The review of the National Infrastructure Investment Plan (NIIP) that is underway would also contribute to effective investments and minimize public infrastructure project delays. Development partners' technical and financial support for developing new national plans and sectoral strategies for meeting the SDGs would be welcome, building on the Tonga Strategic Development Framework 2015-2025 (TSDF II). While the authorities expect the strong Tongan family ties and culture to support remittances, they agree that structural reforms to diversify the economy and create economies of scale are necessary for more sustainable growth over the long term. Fund's policy advice and technical assistance in this context is welcome.

Conclusion

The Tongan authorities remain committed to continued prudent economic policies to address the pandemic, support a strong recovery and safeguard macroeconomic stability while promoting sustainable and inclusive growth. They are thankful to staff for their policy advice and ongoing technical assistance, including from the PFTAC, and look forward to continuing constructive engagement to help Tonga address its multiple policy and reform challenges. Sustained support from the international community, including the Fund, is crucial in enhancing Tonga's economic and financial resiliency in the medium- and longer-term.