INTERNATIONAL MONETARY FUND

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TONGA

August 2022

2022 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TONGA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2022 Article IV consultation with Tonga, 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 July 15, 2022 consideration of the staff report that concluded the Article IV consultation with Tonga.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 15, 2022, following discussions that ended on May 10, 2022, with the officials of Tonga on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 29, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- 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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IMF Executive Board Concludes 2022 Article IV Consultation with Tonga

FOR IMMEDIATE RELEASE

Washington, DC – August 26, 2022: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tonga.

Tonga's economy was severely hit by the double blow from the Hunga Tonga–Hunga Haʻapai volcanic eruption and the local outbreak of COVID-19 in early 2022. The natural disaster derailed the nascent recovery from Tropical Cyclone Harold and border closures in early 2020 and caused substantial damages to properties and public infrastructures. Moreover, strict mobility restrictions involving two national lockdowns to contain the local spreads of COVID-19 brought virtually all activities to a halt in the first quarter of 2022. Although economic activity has been gradually normalizing since April in line with the easing of mobility restrictions and supported by strong policy measures, real GDP is nonetheless expected to decline by 1.9 percent in FY2022, following a significant contraction of 2.7 percent in FY2021.

The outlook is fragile and subject to significant downside risks. Annual GDP growth is projected at 3.2 percent in FY2023, led by reconstruction and policy support. Tourism is also expected to contribute to the growth rebound following the planned gradual reopening of international borders during FY2023, although a meaningful pickup will likely materialize in FY2024 after a further progress in repairs and reconstruction. Downside risks mainly stem from natural disasters, a faster-than-expected rise in international food and energy prices, a new highly contagious and lethal COVID-19 variant or a new virus, and the loss of correspondent banking relationships.

The macroeconomic policy response since the global pandemic has focused on protecting the vulnerable and maintaining stability. The conservation of fiscal space in the run up to the pandemic, including by limiting the increase in the public wage bill and raising additional tax revenues, together with financial support from the international community, allowed the government to deploy significant fiscal support measures to mitigate the socioeconomic impacts of the pandemic and natural disasters, especially in hard-hit sectors such as tourism and agriculture. Meanwhile, foreign exchange reserves have been maintained at comfortable levels (over nine months of import cover) since FY2020.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for taking swift actions to protect the vulnerable following the volcanic eruption and the local outbreak of COVID-19 in early 2022. Directors noted that the outlook remains fragile and subject to downside risks

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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.

[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.

related to the lingering pandemic, rising international food and energy prices, loss of correspondent banking relationships, and vulnerability to natural disasters. They emphasized the need to continue supporting the recovery in the short term and to implement structural reforms aimed at enhancing Tonga's climate resilience and raising its long-term growth potential. Given Tonga's high risk of debt distress and sizable financing needs, Directors underscored the importance of continued financial support from the international community, including through grants and debt relief, as well as capacity development from the Fund.

Directors agreed that fiscal policy should focus on supporting the economic recovery and reconstruction efforts in the short term, while providing targeted financial assistance to low-income households and hard-hit sectors. Once the recovery becomes entrenched, a fiscal adjustment will be necessary to bolster public finances. Directors recommended a combination of revenue and expenditure measures, including to rationalize tax exemptions, strengthen tax administration, improve spending efficiency and contain the public wage bill. They also emphasized the importance of preserving debt sustainability and welcomed the authorities' commitment to avoid non-concessional financing. Directors encouraged the authorities to enhance transparency and accountability of government operations and to follow through on prior emergency financing governance commitments.

Directors concurred that, while the current monetary policy settings are appropriate, the authorities should stand ready to tighten the monetary stance if needed. While banks remain well-capitalized, Directors noted that financial sector risks have risen. They encouraged the authorities to closely monitor credit risks, ensure adequate provisioning for loan losses, and remain vigilant of non-bank financial institutions. Directors supported developing a macroprudential policy framework and welcomed the establishment of the Financial Stability Unit in this regard.

Directors agreed that structural reforms are essential to enhance Tonga's climate resilience and promote private sector development. In this regard, they encouraged the authorities to improve the regulatory framework for foreign direct investment, expand and upgrade public infrastructure, increase social spending, and enhance land leasehold market 2 operations. Directors welcomed the authorities' commitment to continue strengthening the AML/CFT framework, which will help reduce risks to correspondent banking relationships.

It is expected that the next Article IV consultation with Tonga will be held on the standard 12-month cycle.

Table 1. Tonga: Selected Economic Indicators, FY2019–FY2024 1/

Population (2020): 106 thousands
Major exports: root crops, vanilla, squash, fish Quota: SDR 13.2 million
Quota: SDR 13.2 million

Output and prices			(Annual percent change)				
Real GDP[2]		0.7	0.5	-2.7	-1.9	3.2	3.0
Consumer prices (period average)[3]		3.3	0.4	1.4	8.4	4.7	3.4
Consumer prices (end of period)[3]		-0.1	-1.4	6.9	9.7	3.8	2.9
GDP deflator		7.7	-4.2	-1.9	8.4	4.7	3.4
Central government finance				(In percent of GDP)			
Total Revenue		41.7	44.2	48.3	51.5	45.8	39.9
Revenue (excluding grants)		23.4	25.1	25.9	21.2	25.3	25.3
Grants		18.3	19.1	22.4	30.2	20.5	14.6
Total Expenditure		38.6	38.8	49.3	53.6	50.6	45.0
Expense		30.3	33.7	41.8	47.0	38.8	36.3
Transactions in Nonfinancial Assets (Net)		8.3	5.2	7.5	6.6	11.8	8.7
Overall balance		3.2	5.4	-1.0	-2.1	-4.8	-5.2
Net Acquisition of Financial Assets		2.0	6.1	1.7	0.0	-3.3	-3.1
External financing (net)		-1.2	-0.4	2.9	-0.4	0.2	-1.7
Domestic financing (net)		0.0	1.1	-0.2	2.5	1.4	3.8
Money and credit			(Annual percent change)				
Total liquidity (M3)	4.3		1.2	7.0	6.0	7.7	6.2
Of which: Broad money (M2)	3.5		-0.6	-4.6	6.3	8.1	6.4
Domestic credit	6.0		-16.1	-8.2	16.6	4.4	16.5
Of which: Private sector credit	7.6		1.1	1.0	-0.5	0.3	0.8
Interest rates (end of period)							
Average deposit rate	2.3		2.3	2.2	2.3	...	...
Average lending rate	8.2		8.1	8.0	7.9	...	...
Balance of payments			(In millions of U.S. dollars)				
Exports, f.o.b.		15.7	18.2	16.3	4.5	13.3	21.4
Imports, f.o.b.		221.1	211.6	205.4	284.2	313.9	321.0
Services balance		-9.3	-20.6	-88.9	-92.2	-100.4	-82.2
Investment income balance		39.6	41.8	61.9	49.9	51.8	50.3
Transfers balance		170.8	152.9	230.1	291.5	225.4	218.8
Of which: Remittances		140.2	143.4	199.2	187.4	160.9	171.6
Of which: Official grants		44.8	20.1	33.1	110.2	77.1	60.6
Current account balance		-4.4	-19.4	14.0	-30.6	-123.8	-112.6
(In percent of GDP)		-0.9	-4.0	3.0	-6.1	-23.1	-19.8
Overall balance		2.1	24.3	64.7	6.2	-101.8	-99.6
(In percent of GDP)		0.4	5.0	13.7	1.2	-19.0	-17.5
Gross official foreign reserves							
In millions of U.S. dollars		212.8	237.2	317.9	324.1	231.8	132.2
(In months of next year's total imports)		8.3	9.5	10.0	9.2	6.2	3.8
Debt (in percent of GDP)							
Public debt (external and domestic)		41.3	43.6	47.5	47.6	45.5	47.9
Of which: External debt		36.4	37.4	41.2	39.3	35.8	32.0
External debt service ratio		1.7	1.5	0.7	1.4	2.1	4.1
Exchange rates							
Nominal effective exchange rate (2005=100)		91.6	93.0	88.5	...	...	...
Real effective exchange rate (2005=100)		108.1	108.4	104.4	...	...	...
Memorandum items:							
Remittances (in percent of GDP)		27.4	29.3	42.3	37.5	30.1	30.1
Tourism (in percent of GDP)		11.1	8.2	0.8	0.5	1.0	5.2
FDI (in percent of GDP)		-0.1	-0.7	-1.5	-1.2	-1.2	-0.8
Nominal GDP (millions of US$)		511.3	490.2	470.5	499.7	534.9	569.5

[1] Fiscal year beginning July 1.
[2] Including preliminary data.
[3] CPI basket and methodology changed in September 2018.

INTERNATIONAL MONETARY FUND

TONGA

July 29, 2022

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY

EXECUTIVE SUMMARY

Context. Tonga's nascent economic recovery following Tropical Cyclone Harold and border closures in early 2020 has been severely disrupted by a double blow from the Hunga Tonga–Hunga Ha'apai volcanic eruption and the first local outbreak of COVID-19 at the start of 2022. The authorities are augmenting reconstruction and restoration efforts, with support from the international community. Real GDP is projected to contract by 1.9 percent in FY2022 (July 2021–June 2022), before rebounding by 3.2 percent in FY2023 with a gradual reopening of international borders.

Request for Fund support. Tonga faces an urgent BOP need following the double shock, which has intensified due to the rise in global commodity prices since the war in Ukraine. In this context, the authorities have requested financial assistance under the Rapid Credit Facility (RCF) of 50 percent of quota (US$9.4 million), which, together with external grants from Tonga's other development partners, will be used to meet the urgent BOP and government's budget financing needs for reconstruction and social protection. Staff support this RCF request.

Policy recommendations.

- In the short term, fiscal policy should focus on supporting reconstruction and recovery with a larger budget envelope for FY2023, as envisaged by the authorities. The current monetary policy settings are appropriate under staff's baseline inflation outlook, but the central bank should stay vigilant and stand ready to act given significant risks to inflation. Banks should be required to closely monitor credit risks and actively provision for loan losses.
- In the medium-to-long term, after the recovery becomes entrenched, Tonga should strengthen the public finances through a combination of domestic fiscal measures—including rationalization of tax exemptions and reduction of the public wage bill—and by seeking continued donor support, which is essential to meet Tonga's development spending needs while reducing the risk of debt distress.
- A stronger push for structural reforms is needed to enhance Tonga's climate resilience and promote private sector development, with priority on: (i) further liberalizing FDI; (ii) easing access to credit; (iii) expanding climate-resilient public infrastructure; and (iv) strengthening the AML/CFT and anti-corruption frameworks.

Approved By
Ranil Salgado (APD) and Kevin Fletcher (SPR)

Mission dates: April 25–May 10, 2022 (virtual)
Mission team: Minsuk Kim (Head), Mouhamadou Sy, Rui Xu (all APD). Son Thanh Nghiem (OED) and Ruth Nikijuluw (World Bank) participated in some of the discussions. Rosemary Lim, Executive Director; Firman Mochtar, Alternate Executive Director; and Ranil Salgado (APD senior reviewer) joined the concluding meetings. To-Nhu Dao, Chandra Raagini, and Patricia Tanseco (all APD) provided excellent research and editorial assistance for the preparation of this report.

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CONTEXT

1. **Tonga was hit by a powerful volcanic eruption on January 15, 2022**. The explosion from the underwater Hunga Tonga–Hunga Ha'apai (HTHH) volcano took place just 41 miles north of the country's main island, Tongatapu, and was the largest recorded globally since 1883.[1] The ensuing tsunami and ashfalls caused extensive property, infrastructure, and agriculture damages, estimated at 19.2 percent of FY2021 GDP (excluding potential economic losses due to disruptions in economic activity).[2] As a result, about 2 percent of the total population was displaced from their homes immediately following the disaster. The undersea fiber-optic cable to Tonga was also severed for nearly a month immediately following the tsunami, resulting in disruptions of telecommunication services and remittance inflows.[3] The international community swiftly responded and provided essential humanitarian relief supplies, such as food, water supply systems, and vaccines, as well as emergency transportation and communication services.

Text Table 1. Tonga: Estimated Direct Damages to Capital Stock 1/

	Buildings		Infrastructure	Agriculture	Ash Cleanup	Total
	Residential	Nonresidential				
In millions of US$s	14.9	28.8	20.9	20.9	4.9	90.4
In percent of FY2021 GDP	3.2	6.1	4.4	4.4	1.0	19.2

Sources: World Bank Global Rapid Post-Disaster Damage Estimation (GRADE) Report; and IMF staff estimates.
1/ The estimates do not include economic losses due to the disruption in economic activities resulting from the disaster. Based on the impacts of past natural disasters in Tonga and a damage assessment completed by the authorities following the publication of the World Bank's GRADE report, the World Bank staff preliminarily estimate the total physical damages and economic losses due to disruptions in economic activity amount to about US$182 million (or 38.7 percent of FY2021 GDP), of which economic losses are estimated at about US$80 million.

2. **Furthermore, Tonga is coping with a local outbreak of COVID-19 since February this year**. Tonga reported its first two cases of community transmission on February 1, after managing to stay virtually COVID-free through earlier border closures. The authorities subsequently announced a State of Public Health Emergency involving national lockdowns and stricter quarantine protocols and have augmented other efforts, including by enhancing contact-tracing capability and accelerating the booster shots.[4] Strong containment measures and the relatively high vaccination rate helped limit the initial infection wave in March to manageable levels and without undue burden on the health care system. The number of confirmed daily new

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[1] https://www.science.org/doi/10.1126/science.abo7063

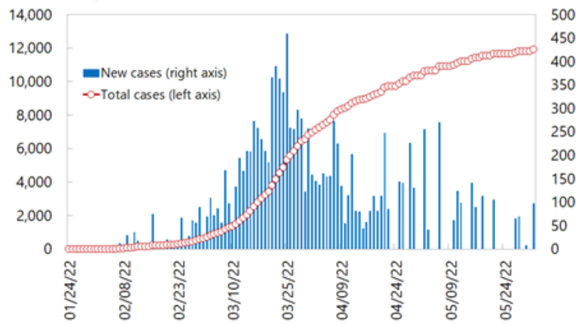
[2] https://www.worldbank.org/en/news/press-release/2022/02/14/tonga-volcanic-eruption-and-tsunami-world-bank-disaster-assessment-report-estimates-damages-at-us-90m

[3] Tonga's economy relies heavily on remittances (including salaries of overseas workers), which stood at about 34 percent of GDP on average over FY2016-FY2020.

[4] As of April 18, 56 percent of the eligible population (aged 18 or above or 34 percent of the total population) have received booster shots. The authorities aim to administer booster shots to 70 percent of the eligible population by end-June 2022.

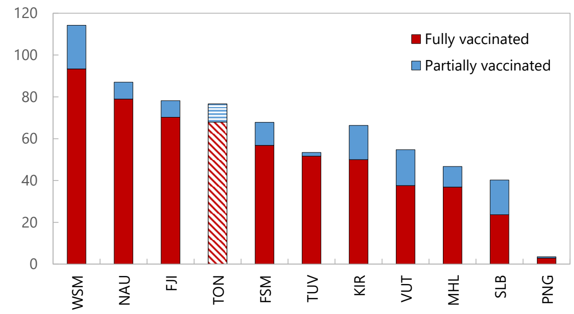
cases has steadily declined since late March, accompanied by a gradual easing of social distancing measures—including reopening of primary schools starting on June 6.

New COVID-19 Cases
(Number of persons)



Sources: John Hopkins University; and Our World in Data. Data as of 06/01/2022.

Pacific Islands: Vaccines Administered
(Percent of population)

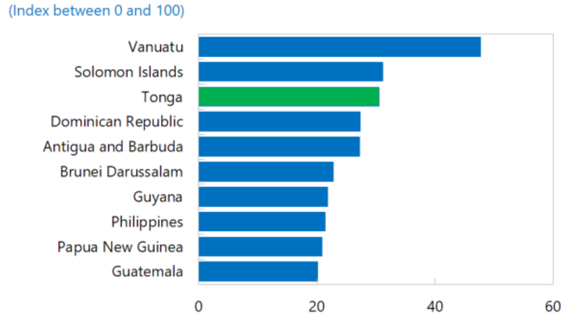


Sources: Our World in Data. Marshall Islands & Micronesia as of 6/01/2022; Fiji as of 5/30/2022; Samoa, Kiribati, Solomon Islands, and PNG as of 5/23/2022; Tonga as of 5/02/2022; Vanuatu as of 4/25/2022; Nauru as of 4/11/2022; Tuvalu as of 4/05/2022

3. **Against this backdrop, the authorities are seeking emergency assistance under the Rapid Credit Facility (RCF-2)**. They have requested a disbursement of SDR 6.9 million (equivalent to US$9.4 million or 50 percent of quota) to address the urgent BOP need following the disaster. Tonga already has an outstanding RCF balance of 50 percent of quota (RCF-1), which was approved by the Board on January 25, 2021.

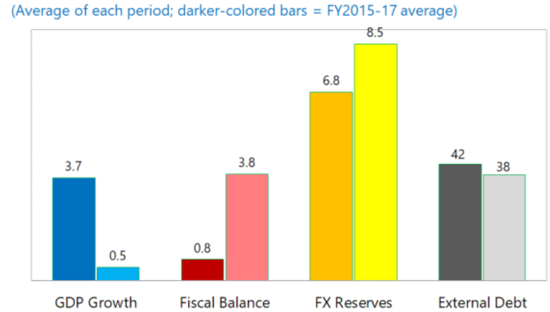
4. **The series of natural disasters underscore the urgency to implement reforms to enhance climate resilience and nurture the private sector**. Tonga is among the most vulnerable to natural disasters globally. While battered by two major tropical cyclones in early 2018 and 2020, Tonga nonetheless managed to build macroeconomic policy buffers, including by mobilizing additional tax revenue and limiting public wage bill increases. These buffers helped Tonga to counter the adverse spillover effects from the global pandemic in FY2021 through a bold policy support package focused on health care and social protection. Looking forward, implementing reforms to enhance climate resilience and promote private sector development, accompanied by efforts to strengthen the public finances, will be essential to meet the long-term development goals outlined in Tonga's Strategic Development Framework 2015–2025 (Table 9).

Exposure to Extreme Natural Disaster Risk 1/
(Index between 0 and 100)



Sources: World Risk Report 2021; and IMF staff estimates.
1/ Top 10 countries out of 181 countries. The index takes into account disaster exposure, vulnerability, susceptibility, lack of coping capacities, and lack of adaptive capacities.

Economic Performance: FY2015-17 vs. FY2018-20
(Average of each period; darker-colored bars = FY2015-17 average)

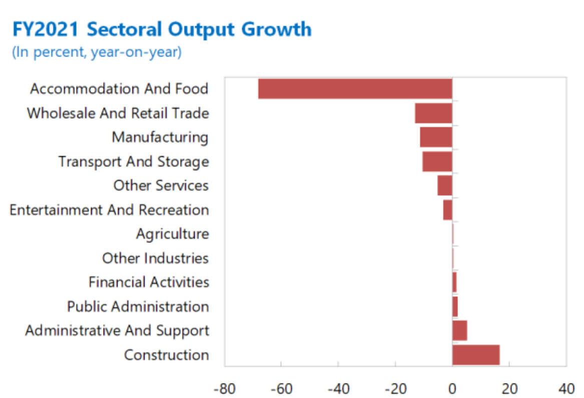


Sources: Tongan authorities; and IMF staff estimates.
Note: All variables expressed in percent (GDP Growth) or in percent of GDP (Fiscal balance, External Debt), except FX Reserves (in months of import cover).

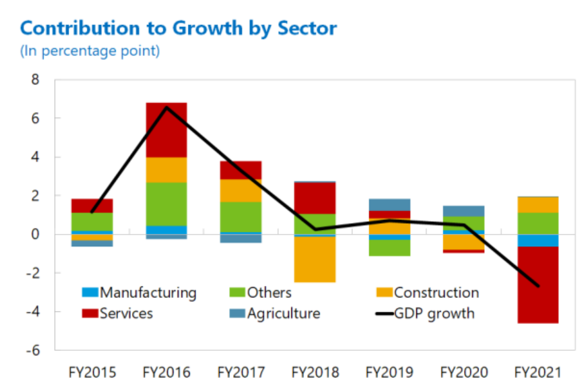
5. Tonga received considerable capacity development (CD) assistance from the Fund (Annex III). It is one of the largest recipients of Fund CD resources in the region, and the authorities have shown strong ownership and the capacity to absorb Fund CD. Recent technical assistance on climate change, public financial management (PFM), tax policy, revenue administration, macroeconomic frameworks, AML/CFT, and financial stability frameworks have informed staff's policy recommendations in these areas.

RECENT ECONOMIC DEVELOPMENTS

6. For FY2021 as a whole, Tonga's economy experienced the first contraction since FY2009, although some signs of recovery began to emerge during the second half of the year. Tonga sustained a double shock from Tropical Cyclone (TC) Harold (April 2020) and border closures in response to the pandemic overseas in late FY2020. A full year of border closures resulted in annual real GDP growth of -2.7 percent in FY2021, led by tourism-related sectors such as accommodation and food service activities, wholesale and retail trade, and transport. The economy had been slowly regaining momentum since the second half of FY2021 (January 2021–June 2021), underpinned by strong remittances and policy support. Construction activity held up even with closed international borders, reflecting reconstruction demand, while the tourism sector, which took the brunt of the hit from the pandemic, managed to diversify into other related businesses, such as local catering services, partially offsetting the losses due to border closures.



Sources: Tongan authorities; and IMF staff estimates

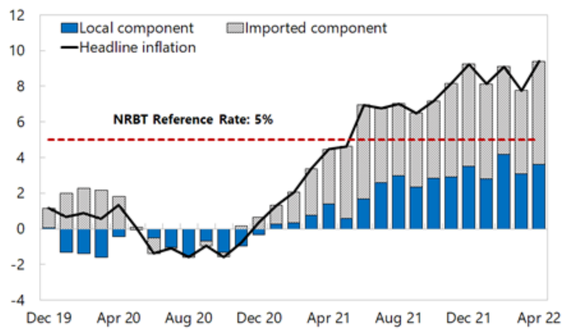


Sources: Tongan authorities; and IMF staff estimates.

7. But Tonga's nascent economic recovery has been severely disrupted by another double blow from the volcanic eruption and the first local outbreak of COVID-19 at the start of 2022. The disaster and COVID-19 put all activities to a virtual halt in the third quarter of FY2022. Tourism facilities, most of which are located alongside the coastal areas, were particularly hit hard by the tsunami, and agriculture suffered from volcanic ashfalls. The economy has gradually reopened since April, as mobility restrictions eased in line with declining COVID-19 cases. Reconstruction of homes and ash clean-up activities are well underway, with support from the international community through provisions of humanitarian aid and financial assistance.

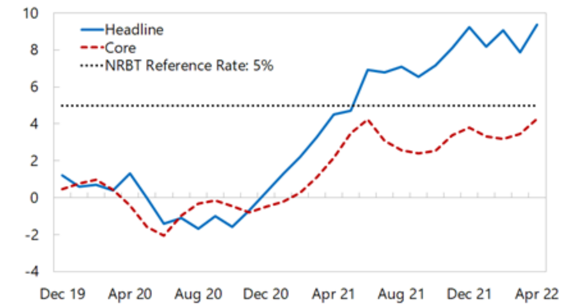
8. Inflation rose markedly since July 2021, largely reflecting higher import prices. Headline inflation averaged 7.9 percent (y/y) from July 2021 to April 2022, above the National Reserve Bank of Tonga's (NRBT's) reference rate of 5 percent. The rise in inflation was mostly driven by higher import prices for food and energy including in the context of the war in Ukraine and, after the double blow in early 2022, also by disruptions in domestic supply conditions—notably in agriculture. Despite high headline inflation, a measure of core inflation (excluding food and energy) estimated by IMF staff at end-April 2022 stood at a relatively moderate 4.3 percent, continuing to stay below the NRBT's reference rate.

Contribution to Headline Inflation
(Year-on-year percent change)



Sources: Tonga Statistics Department; and IMF staff calculations.

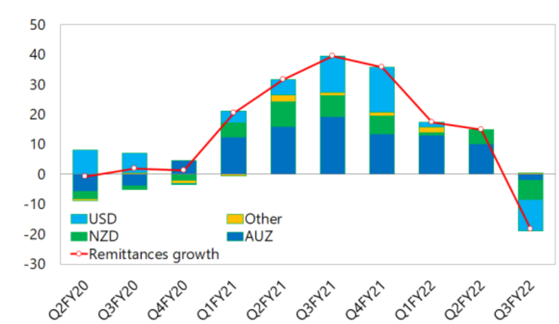
Headline and Core Inflation1/
(Year-on-year percent change)



Sources: Tonga Statistics Department; and IMF staff calculations.
1/ IMF staff estimates excluding energy and food.

9. On a preliminary basis, the external position in FY2021 is assessed as broadly in line with medium-term fundamentals and desirable policies (Annex I). The current account balance (CAB) is estimated to have pivoted from -4 percent of GDP in FY2020 to 3 percent in FY2021, mainly reflecting an increase in remittance inflows of 36 percent in FY2021 in T$ terms, as the Tongan diaspora intensified their support to their families, and with grants from development partners, which together more than offset a sharp drop in tourism receipts and higher imports of COVID-19-related health care supplies. The strong remittances, combined with foreign aids and the IMF's RCF-1 (US$9.7 million or 50 percent of quota), boosted foreign exchange (FX) reserves to US$318 million at end-FY2021 and then to US$360 million as of end-December 2021, partly reflecting the IMF's 2021 SDR allocation (US$18.7 million) in August 2021.

Contribution to Remittance Growth By Currency
(Year-on-year, percent changes)

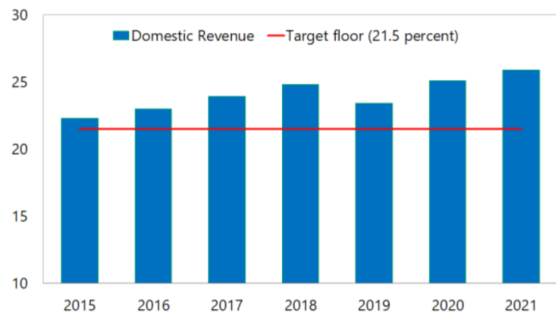


Sources: Tongan authorities; and IMF staff calculations.

10. The fiscal balance switched to a deficit in FY2021 due to COVID-related current expenditures (Figure 4). The government achieved a much-needed fiscal consolidation during FY2016–FY2020 through improvements in revenue collection, generally effective controls on current spending, and donor support. In response to the pandemic, the government implemented a fiscal package worth 5.3 percent of GDP on health care and social protection, complemented by tax relief. As a result, the fiscal balance turned from a surplus of 5.3 percent of

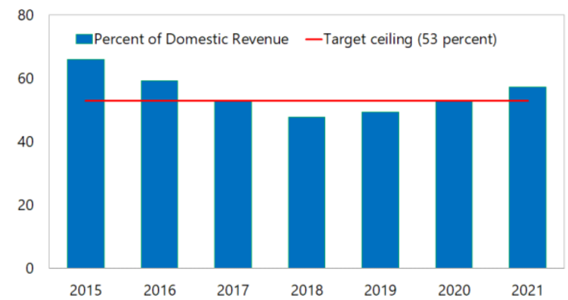
GDP in FY2020 to a deficit of 1 percent in FY2021, despite the rescheduling of debt service payments under the G-20 Debt Service Suspension Initiative (DSSI). The well-warranted fiscal policy response nonetheless entailed an increase in the public wage bill from 52.9 percent of domestic revenue in FY2020 to 57.3 percent in FY2021, breaching the authorities' target ceiling of 53 percent, although other fiscal anchors—including the floor for domestic revenue of 21.5 percent of GDP and the ceiling for the public sector wage bill of 45 percent of domestic revenue continued to be met in FY2021.

Domestic Revenue
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

Public Sector Wage Bill
(In percent of domestic revenue)

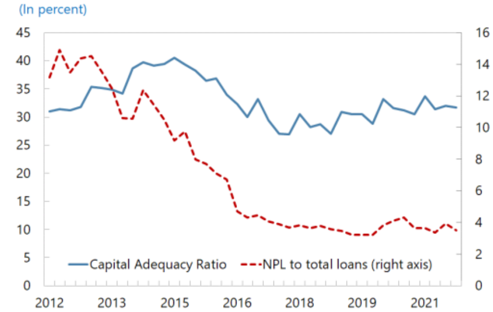


Sources: Tongan authorities; and IMF staff estimates.

11. Tonga is assessed as being at high risk of debt distress (DSA Annex). Without additional grant commitments to staff's baseline projection, the present value of public debt-to-GDP ratio is projected to rise above the 70 percent debt-distress benchmark in FY2032. This mainly reflects significant spending needs over the long term to cover infrastructure gaps and achieve Tonga's climate resilience goals and sustainable development goals (SDGs). Debt obligations are largely external, with over half of total public debt to China Exim Bank. Debt repayments are expected to pick up in FY2024, mainly to the Exim Bank, and stay elevated at over 3 percent of GDP until FY2027.

12. Bank balance sheets were strong before the volcanic eruption. Banks were profitable and well-capitalized, with declining non-performing loans (NPLs) due to loan write-offs and COVID-related loan relief measures. The high profitability reflected robust non-interest income (e.g., FX transaction fees associated with remittances) and a decline in provision-related expenses due to lower NPLs. After several years of double-digit increases, bank credit has gradually declined since mid-2020, reflecting both the weak demand for credit and banks' increased risk aversion amidst heightened economic uncertainty. Delays and cancellation of projects due to border closures and subsequent shocks have reduced credit demand.

Financial Sector Indicators
(In percent)



Sources: IMF Financial Soundness Indicators; and IMF staff estimates.

OUTLOOK AND RISKS

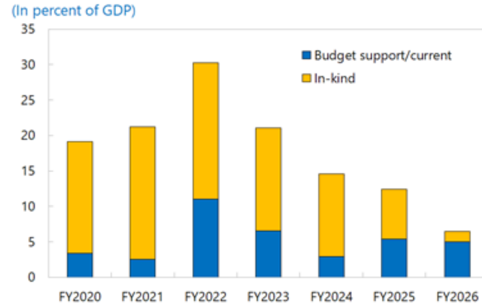
13. **The short-term growth outlook is subject to large uncertainties** (Table 1). Following a contraction of 2.7 percent in FY2021 mainly due to the border closure, Tonga's real GDP in FY2022 is projected to decline by another 1.9 percent, reflecting substantial disruptions to economic activity due to the damaged capital and COVID-19 containment measures, as well as losses in agricultural production from the tsunami and volcanic ash. Annual GDP growth is projected to rebound to 3.2 percent in FY2023, led by reconstruction. The short-term outlook is predicated on the following assumptions:

- While the authorities plan to gradually reopen international borders over FY2023, a meaningful recovery in tourism is expected be delayed to FY2024 given the time required for repairs and reconstruction of severely damaged tourism facilities.
- The reconstruction of flagship infrastructure projects is expected to accelerate in FY2023 after the border reopens in July, which would allow entries of foreign engineers.
- Crop production is expected to gradually recover over FY2023–FY2024 as the soil contamination caused by the tsunami and volcanic ash dissipates.

Average inflation is projected at 8.4 percent (y/y) in FY2022, up from 1.4 percent in FY2021, reflecting the impacts of ongoing geopolitical tensions on international commodity prices and supply-side disruptions caused by the volcanic eruption on domestic prices. In FY2023, inflation is expected to decline to an average of 4.7 percent (y/y), slightly below the NRBT's reference rate of 5 percent, as international commodity prices stabilize in line with the IMF's April 2022 World Economic Outlook forecasts.

14. **The catastrophic impacts of the volcanic eruption and the COVID-19 outbreak have led to an urgent BOP need**. The CAB is projected to switch back to a deficit (-6.1 percent of GDP) in FY2022 and deteriorate further in FY2023 (-23.1 percent). The substantial worsening of the CAB would be driven by increased imports of food—reflecting reduced domestic crop production, imports of reconstruction-related materials, subdued tourism and agricultural exports, and a decline in remittances from the exceptional levels during FY2021-FY2022. Notwithstanding the post-disaster increase in donors' aids, the deterioration in the CAB has generated a sizable external financing gap under current grant commitments (Table 7).

External Grants
(In percent of GDP)



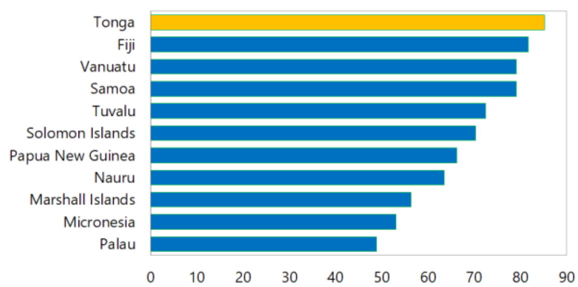
Sources: Tongan authorities; and IMF staff projections.

15. **The balance of risks is tilted to the downside** (Annex II). In addition to frequent natural disasters, a faster-than-expected rise in international food and energy prices due to geopolitical

tensions, including the war in Ukraine,[5] could significantly weaken private consumption by reducing households' real purchasing power and deteriorate the CAB. A faster-than-manageable local community transmission of COVID-19 or a new contagious virus is another important risk in the short term, especially given a high incidence of noncommunicable diseases and relatively weak health care capacity. In the medium term, loss of correspondent banking relationships (CBRs) is an important downside risk, given Tonga's heavy reliance on remittances.

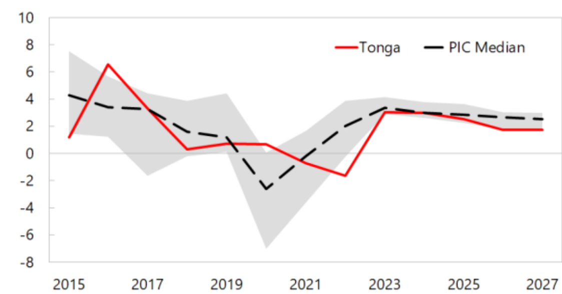
16. The medium-term outlook is weak. Tonga's growth potential is low due to its exposure to natural disasters, geographical remoteness, and a limited production base. Without bold structural reforms to boost climate resilience and private sector development, growth is expected to converge to its long-term potential rate of 1½–2 percent. Over the medium term, the CAB is expected to gradually deteriorate relative to its pre-pandemic levels, reflecting heavy import dependence, weak competitiveness, and large infrastructure needs. International reserve coverage is expected to trend down to around 3½ months of prospective imports in the medium term—but above the NRBT's minimum threshold of 3 months of imports—unless comprehensive efforts are made on several fronts as discussed in the next section, including strengthening the public finances over the medium-to-long term and developing the private sector to expand the productive capacity, together with continued strong financial support from development partners.

Distance to Economic Centers1/
(Index, 0=global min.; 100=global max.)



1/ Defined as the average distance to countries weighted by their GDP.
Sources: Cantu-Bazaldua (2021); UNCTAD, Development and globalization: Facts and figures 2021.

PIC: Real GDP Growth 1/
(In percent)



1/ The shaded region shows the interquartile range of real GDP growth rates of PICs.
Sources: IMF April 2022 World Economic Outlook for PICs except Tonga; and 2022 Article IV IMF staff projection for Tonga.

Authorities' Views

17. The authorities broadly agreed with staff's assessment of the outlook and risks. Following a 2.7 percent economic contraction in FY2021, the authorities anticipate the economy to further contract in FY2022 by 2.5 percent due to the impacts of the volcanic eruption and COVID-19 on mobility, agriculture and fishery, and damages to tourism facilities and infrastructure. They nonetheless expect a strong rebound of about 3–3½ percent in FY2023, driven by reconstruction activities and recovery in tourism following the planned border reopening. The authorities shared staff's assessment of the main downside risks to the outlook,

[5] Other direct spillovers are assessed as minimal given limited trade, tourism, or financial linkages with Russia and Ukraine. Indirect spillovers through major trading partners (Australia and New Zealand) are expected to be small considering their commodity-exporter status.

particularly from rising inflation due to global food and energy prices and natural disasters. The authorities concurred with staff's preliminary assessment of the external position in FY2021. They noted that reserves remain at record high levels due to recent large inflows of grants and remittances, while stressing the need to maintain high levels of reserves given Tonga's vulnerability to natural disasters, external shocks—especially through the remittance channel, import dependance, and the large external debt repayments coming due to the Exim Bank of China.

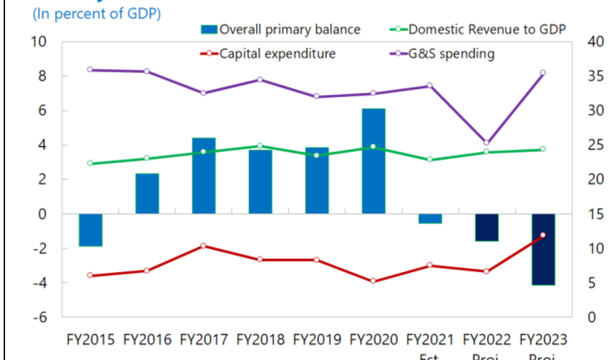
POLICIES TO REBUILD AND RECOVER STRONGER

A. Fiscal Policy

18. The government responded swiftly to address the economic impacts of the volcanic eruption, with help from the international community. Since the disaster, donors have collectively pledged in grants additional budget support worth 7 percent of GDP for FY2022 and 3.7 percent of GDP for FY2023. The support allowed the authorities to finance a set of fiscal measures targeted to affected businesses and households, including tax reliefs, loan subsidies, and cash transfers (worth a total of about 2.2 percent of projected FY2022 GDP during Q3:FY2022). Reconstruction activity is also ongoing under a comprehensive plan, with 8 out of 20 high-priority projects already completed. Notwithstanding the additional budget support, staff expect the fiscal deficit to widen from 1 percent of GDP in FY2021 to 2.1 percent in FY2022 due to lower tax revenues and additional spending needs after the volcanic eruption.

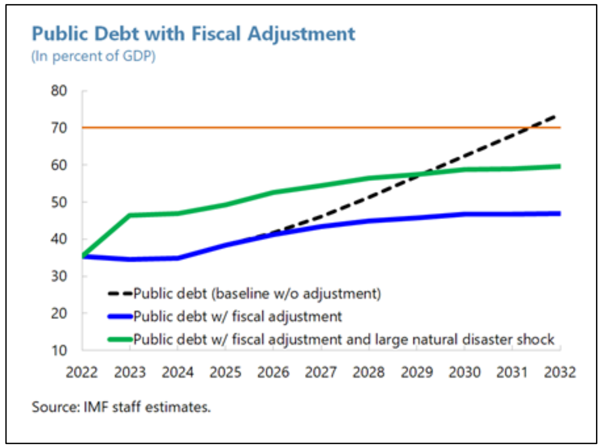
19. The envisaged expansionary fiscal stance in FY2023 is appropriate considering the urgent spending needs for reconstruction and recovery. The authorities are targeting a larger budget envelope in FY2023, which is expected to lead to an increase in the fiscal deficit from FY2022 despite higher domestic revenues expected in FY2023. Staff support an expansionary fiscal policy stance, considering the continued need for social spending, as well as the significant capital investment needed to rebuild damaged public infrastructure. The capacity for capital investment, especially for flagship infrastructure projects, is expected to improve as borders reopen in FY2023, which would allow foreign engineers to enter. The authorities' fiscal strategy also aims to bolster the economic recovery over the medium term, including by improving public services in health and education, promoting private investment, and strengthening climate resilience through facilitating relocation of properties from high-risk coastal areas and construction of stronger buildings.

Primary Balance
(In percent of GDP)



Sources: Authorities; and IMF staff estimates.

20. In the medium-to-long term, a combination of domestic fiscal measures and additional donor support is needed to meet large development spending needs while reducing the risk of debt distress. Under an illustrative fiscal adjustment scenario, the present value (PV) of the public debt-to-GDP ratio could stabilize below the 70 percent threshold over the long term, even with large natural disaster shocks. The fiscal adjustments could take place post-reconstruction and include a gradual increase of tax revenues and reduction of the public wage bill and current expenditure. New grant commitments in line with the historical trends are also essential to fund capital investment projects for SDGs and climate resilience.[6] The government's strategy to pursue additional grants from development partners and avoid any new non-concessional borrowing from external creditors is aligned with this adjustment path.



Illustrative Fiscal Adjustment Path Relative to Baseline
(In percent of GDP)

	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030
Domestic fiscal measures	0.8	1.6	2.4	3.2	4.0	4.5
Taxes	0.5	1.0	1.5	2.0	2.5	3.0
Goods and services / Wage bill	-0.3	-0.6	-0.9	-1.2	-1.5	-1.5
Additional Grants		1.9	3.1	4.2	5.0	5.0
Change in primary balance	0.8	3.5	5.5	7.4	9.0	9.5
Memo.						
Projected primary balance	-7.3	-5.3	-4.7	-4.3	-3.5	-2.2

Note: In the baseline scenario, grants would gradually decline to below 10 percent of GDP after FY2026. The adjustment path assumes additional grants as shown above. Grants averaged 18 percent of GDP between FY2016-FY2021.

21. The authorities remain committed to reforms aimed at broadening the tax base and improving spending efficiency. Tax and customs administration has improved across several areas, including enhanced management of tax arrears, the deployment of the Automated System for Customs Data (ASYCUDA World), and the ongoing implementation of the Electronic Sales Register System (ESRS). The new bill on PFM, which improves transparency and the medium-term budget processes, is expected to be submitted to the Cabinet for approval by end-FY2022. Further reforms, with CD support from the IMF including on tax policy and administration and through training of staff in the Ministry of Finance, will help facilitate the medium-long-term fiscal adjustments outlined above. Specifically, the reform efforts could focus on the following:

[6] The estimated cost of achieving Tonga's climate-resilience and development goals is large. The IMF/World Bank 2021 Climate Change Policy Assessment (CCPA) Report estimated that climate-resilience projects needed for Tonga would cost about 140 percent of 2018 GDP cumulatively, of which only half have committed donor grant funding. This cost has likely increased since the volcanic eruption due to the extensive damages to capital.

- *Revenues*. The authorities could increase revenues by about 3 percent of GDP by reducing tax exemptions and strengthening tax administration. A recent IMF Technical Assistance (TA) report estimates that additional revenue of 2½ percent of GDP could be collected by removing major tax exemptions, notably those related to the provision and consumption of electricity. Introduction of new exemptions or tax incentives should be minimized and based on a transparent process involving public disclosure of the criteria, time frame, recipients, and amounts of such exemptions. Revenue administration reforms could also increase tax revenues by ½-1 percent of GDP through better tax compliance and lower tax arrears (see also ¶33).[7]

- *Expenditures*. Since FY2021, compensation of employees has exceeded the fiscal anchor of 53 percent of domestic revenue, partly reflecting revenue losses (in T$ terms) and pandemic-related spending needs. The authorities aim to bring the public wage bill back to below the 53 percent ceiling in FY2024 onward—comparable to the FY2025 level projected by staff, including through stricter controls on hiring and overtime pay. In addition, goods and services spending in Tonga is above the median level of Pacific Island countries (PICs), which stands at 12 percent of GDP, compared with a median level of 11 percent in other PICs. Lowering spending on wages and goods and services to levels in line with peers could help improve the fiscal balance by about 1½ percent of GDP.

22. Enhanced transparency and accountability of government operations could strengthen the case for more donor support and debt relief. The government should continue current efforts to strengthen information systems for cash and financial management and to improve internal audit processes, in line with the recommendations from the 2020 IMF Public Expenditure and Financial Accountability Assessment Report. Pandemic-related spending and economic relief packages should be closely monitored, audited, and reported in a timely manner. The authorities have made progress in implementing their commitments related to RCF-1 (approved in January 2021), most notably by recently publishing information on pandemic-related procurement contracts on the Ministry of Finance's website (http://www.finance.gov.to/node/483). The authorities remain committed to further publication of such information and to publishing an audit of pandemic-related spending by the Auditor General (Appendix I, ¶8). Full implementation of these commitments has been delayed by capacity constraints, which were further exacerbated by the volcanic eruption, and the authorities plan to seek CD support from IMF staff on these issues. Staff stand ready to provide support, including on strengthening beneficial ownership transparency in procurement.

Authorities' Views

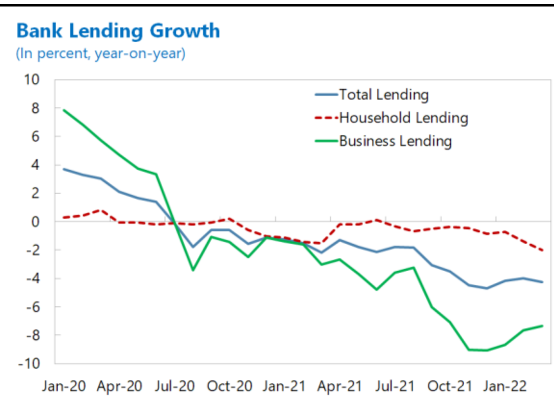
23. The authorities highlighted significant spending needs for reconstruction and recovery in the near term but agreed on the need for fiscal adjustment over the medium term once the recovery is firmly on track. They shared staff's concern regarding the high public sector wage bill and are taking necessary steps to contain it, including by improving the

[7] As of FY2020, the amount of collectable tax arrears is estimated at 2.4 percent of GDP.

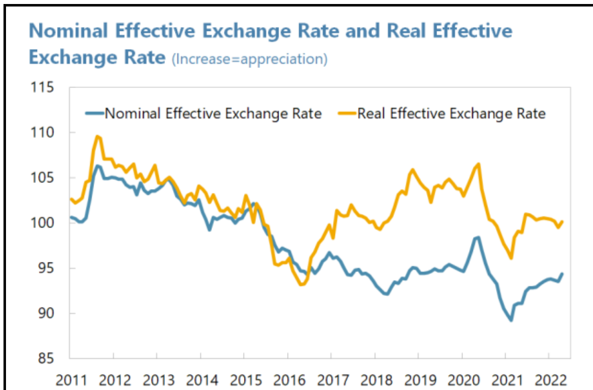
hiring practices, limiting overtime allowances, and outsourcing some services. At the same time, they underscored their intention to seek new grant financing from donor partners to put debt on a sustainable path while meeting climate-resilience and development goals. In the near term, the authorities emphasized on the urgent need for reconstruction and recovery and are seeking concessional loans from the IMF to help finance the budget deficit in FY2023. They also noted the importance of climate resilience to be incorporated during the ongoing reconstruction.

B. Monetary and Exchange Rate Policies

24. The current monetary policy stance is appropriate, but the NRBT should stand ready to tighten given significant risks to inflation. The NRBT has stayed on hold, maintaining the policy rate at zero percent, the statutory reserve deposit (SRD) ratio at 10 percent, and the inflation reference rate at five percent. Monetary conditions remain loose, with abundant banking system liquidity due to large inflows of grants and remittances in FY2021. Under the baseline outlook, staff project inflation to gradually decline to below the reference rate in FY2023 as the base effects from higher commodity prices materialize and the impacts of the volcanic eruption on domestic prices dissipate. In staff's view, the current monetary policy settings are consistent with this baseline outlook. The NRBT should nonetheless stand ready to tighten if inflation is expected to stay above the reference rate for longer, possibly signaled by rapid credit growth or persistently high inflation expectations in major trading partners. Monetary policy tightening could be achieved by increasing the SRD ratio or, if a more decisive policy action is needed, by raising the policy rate (Figure 3).[8]



Sources: National Reserve Bank of Tonga; and IMF staff estimates.



Sources: Tongan authorities; and IMF staff estimates.

25. The current exchange rate regime has served Tonga well. Tonga's nominal exchange rate is pegged to a basket of currencies. The real effective exchange rate (as of April 2022) has appreciated by 3.3 percent since January 2021, reflecting rising inflation relative to trading partners. Exchange rate stability has been maintained with the currency basket weights set in 2018.

[8] The SRD ratio was raised from 5 to 10 percent in FY2018, which was followed by a reduction in average inflation from 6.8 percent in FY2018 to 3.3 percent in FY2019. The policy rate has not been adjusted for a decade.

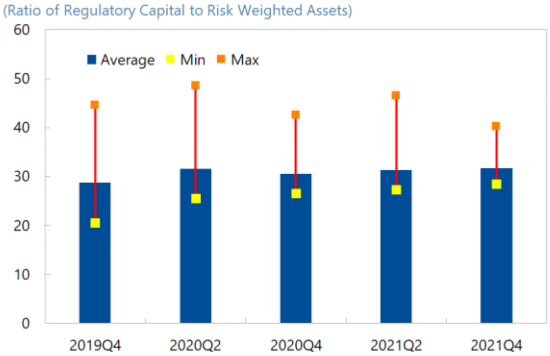
Authorities' Views

26. The NRBT viewed the current monetary stance as appropriate and underscored the need to support the ongoing recovery, given weak economic activity caused by the recent lockdowns and the volcanic eruption, and subdued credit growth. Furthermore, considering the base effects from the current high global commodity prices, the NRBT expects headline inflation to fall below the reference rate in FY2023. The authorities also noted the large excess liquidity in the banking system, which could weaken monetary policy transmission, and the ongoing monetary policy tightening in advanced economies, which would help contain Tonga's imported prices. In this context, the authorities viewed the current monetary policy stance as in line with expansionary fiscal policy to support the recovery. The NRBT continues to evaluate the pros and cons of available monetary policy tools should a tightening be needed in the near future.

C. Financial Sector Policies

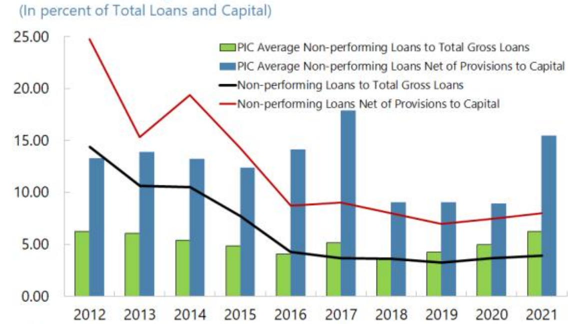
27. The NRBT should encourage banks to actively provision for potential loan losses and monitor credit risks closely. While banks are well capitalized, economic disruptions caused by the volcanic eruption would worsen bank balance sheets. NPLs could pick up significantly and impair banks' ability to supply credit. Bank profitability could also deteriorate due to the natural disaster, COVID-related mobility restrictions, and rising commodity prices. In this context, some banks have provided additional loan moratorium to affected borrowers, following the expiration of the system-wide loan relief program launched in 2020 to help borrowers hit by TC Harold (April 2020) and the border closure due to the global pandemic.[9] To avoid a sudden increase in NPLs, banks should be required to actively provision for potential loan losses and, together with the NRBT, continue to monitor credit risks closely, especially in hard-hit sectors (e.g., tourism, wholesale and retail, transport, and agriculture). In case capital buffers become inadequate, the NRBT should consider restricting dividend payouts by banks and requesting capital injections from parent banks.

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



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

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



Sources: IMF Financial Soundness Indicators; and IMF staff estimates.
Note: PIC countries includes Fiji, Micronesia, Papua New Guinea, Samoa, Solomon Islands, and Vanuatu.

[9] Under the program, banks provide loan relief to customers on a case-by-case basis (e.g., removal of fees, interest rate reductions, and delay of principal payments).

28. Ongoing reforms to improve financial supervision and develop macroprudential policy framework should continue. There are four priorities: (i) conducting risk-based offsite supervision to assess the banking sector's health after the natural disaster; (ii) expanding the NRBT's regulatory and supervisory remit to cover nonbank financial institutions (NBFIs), especially pension funds, which compete with banks in mortgage lending;[10] (iii) establishing a solvency stress testing framework that covers NBFI lending, with CD support from the IMF; and (iv) developing macroprudential instruments to operationalize the NRBT's financial stability mandate. While the amendments to the NRBT Act in 2014 contain a broad mandate for financial stability, the NRBT lacks a systematic approach to evaluate macrofinancial risks and implement macroprudential policies. As a first step to strengthen its policy capacity, the NRBT plans to establish a Financial Stability Unit, based on earlier CD support recommendations from the IMF.

29. Concerted efforts are needed to support credit and promote financial deepening and inclusion.

- In the near term, the government could provide targeted concessional credit support to micro-, small-, and medium-size enterprises (MSMEs) in hard-hit sectors, including through the Government Development Loan (GDL) Scheme. The GDL is a government-sponsored microfinance program designed to improve financial access of MSMEs in key growth-oriented sectors and to finance personal loans for higher education. The funding was increased from T$13 million to T$18.3 million in 2020 after TC Harold. Moreover, the subsidized interest rate from the GDL scheme has recently been reduced to 1 percent from 3 percent for new loans.

- The authorities are also considering introducing a partial loan guarantee scheme to further enhance access to credit, in the context of banks' increased risk aversion since the pandemic. Such a scheme could further improve access to credit by affected MSMEs and low-income households under the current circumstances, provided it is offered on a temporary basis as a crisis response measure and lenders bear appropriate credit risk to be sufficiently incentivized to exert sound underwriting and monitoring efforts.

- Further reforms are needed to reduce credit costs for banks in the long term, such as improving the coverage and quality of credit information systems, as well as strengthening insolvency regimes and debt enforcement. The plan to set up a credit registry within the NRBT is welcome,[11] and the system should eventually be expanded to include NBFIs to capture all loans extended to individual borrowers.

- Promoting financial solutions to cut the transaction costs of remittances could help improve welfare and enhance equity. Similar to other countries in the region, Tonga faces high transaction costs of remittances, which tend to be regressive. While regional efforts are

[10] Tonga's financial landscape is mainly comprised of four banks (three subsidiaries of foreign-owned banks and a government development bank, with total assets of 95 percent of GDP at end-June 2021) and NBFIs, including two major pension funds, 4 insurance companies, and a number of foreign exchange dealers.

[11] Previously Tonga participated in a regional credit registry located in Fiji, which was under-utilized by banks due to remoteness and a lack of incentives to provide credit data.

essential to tackle this issue,[12] including through harmonization of relevant regulations and supervision, promoting financial solutions such as the Ave Pa'anga Pau voucher system could also help cut the associated costs.[13]

Authorities' Views

30. The authorities broadly agreed with staff's recommendations on financial stability. The NRBT acknowledged the need to closely monitor potential loan losses from the twin shocks earlier this year. They mentioned that various measures have been taken to ensure adequate provisioning, including stress testing exercises and close monitoring of NPLs using monthly reports from banks. The stress testing results suggest that all banks' capital adequacy ratio will remain above the minimum required risk-weighted capital ratio even in the worse-case scenario. Going forward, the NRBT reiterated its commitment to setting up a solvency stress testing framework and macroprudential framework with the assistance of IMF TA. A Financial Stability Unit is to be set up to take charge of developing and implementing macroprudential policies.

D. Structural Reforms

31. Enhancing resilience to natural disasters and climate change is a top reform priority. While the Disaster Risk Management bill passed in 2021 is an important first step toward strengthening the institutional framework for disaster risk management and preparedness, effective implementation of the law and other climate-related plans will be essential, which requires enhancing coordination across relevant ministries and management of scarce resources, as highlighted by the IMF/World Bank 2021 Climate Change Policy Assessment Report.[14] The efficiency of climate-resilience capital spending could be improved by developing a more comprehensive and regularly updated public asset register, with IMF CD support on Tonga's Asset Management Framework,[15] and by expanding the classification of capital spending to better identify the climate component of public investment projects. Revisions to the Building Code to include climate resilience measures, such as for the type of construction materials used, design, and construction methods, as well as improving compliance with existing construction regulations through more effective enforcement, are also important.

[12] See IMF Report on the Pacific Roundtables: Actions to Address Correspondent Banking and Remittance Pressure, 2019, for more details on the voucher system and the regional efforts needed in this area.
[13] The Tonga Development Bank (TDB) launched the 'Ave Pa'anga Pau voucher system in February 2017, with International Finance Corporation assistance. Under this system, Tongan workers in New Zealand and Australia purchase the vouchers to send remittances to their families in Tonga. The NZD or AUD funds received are accumulated in TDB's accounts in New Zealand and Australian banks and used for payments of goods imported by Tongan businesses, who make their equivalent deposits in T$s in TDB accounts in Tonga. The deposits made by these local importers are then used to disburse the remittances to the Tongan workers' families. This netting system reduces the frequency of international settlements, leading to lower transactions fees and AML/CFT risks.

[14] https://www.imf.org/en/Publications/CR/Issues/2020/06/30/Tonga-Technical-Assistance-Report-Climate-Change-Policy-Assessment-49537

[15] The Framework aims to ensure the government's fixed assets are properly recorded, valued, and reported per its internal guidelines.

32. Developing the small private sector is critical to boost Tonga's long-term growth potential. While the government will need to focus on crisis management and humanitarian relief operations in the near term, it should gradually augment efforts to undertake reforms aimed at promoting private sector development and overall economic productivity. A priority in this regard is attracting more foreign direct investment (FDI) by lowering market entry barriers and cutting regulatory red tape. The inward FDI to Tonga during 2016-2020 increased by only a modest 1.1 percent of GDP on average, lagging behind some other peers in the region. The proposed amendments to the reserved and restricted list of industries under the draft Foreign Investment Regulation 2021 are essential to reap the full economic benefits from the Foreign Investment Act of 2020, which aims to streamline the regulatory framework for FDI. The government should also push ahead additional policy initiatives, including:

(i) Expanding and upgrading physical and ICT infrastructure, including to enhance internet connections with remote islands. The latter has taken on greater urgency since the HTHH disaster,[16] and, if not addressed quickly, it could have important long-term adverse impacts on the recovery in tourism, ease of doing business, and the quality of education in these regions.

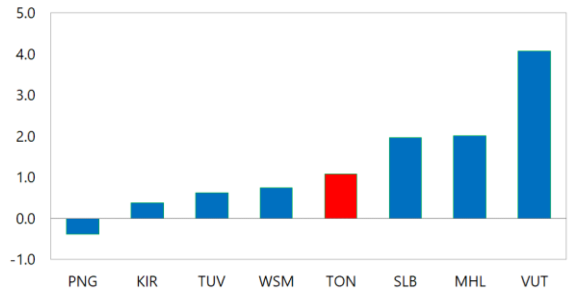
(ii) Increasing government spending on health, education, and social protection. Based on an earlier study by IMF staff,[17] additional annual spending of 5 percent of FY2030 GDP would be needed to meet select SDGs, particularly in the areas of health and education. In this context, staff support the conditional cash transfer program ("SET": Skills and Employment for Tongans) launched in 2018 with assistance from the World Bank, which provides cash transfers to poor households on the condition that their children attend and complete secondary school.

(iii) Improving land leasehold market operations. The land lease process in Tonga is complex and cumbersome, with all lease contracts requiring Cabinet approval regardless of the tenure, which poses major hurdles for attracting private investment. The urgency for land lease reform has increased even further following the HTHH disaster given the policy initiative to relocate properties to higher ground and safer areas.

[16] While the international undersea cable between Nuku'alofa, Tonga's main island, and Fiji has been repaired, internet connections in other islands (Ha'apai and Vava'u island groups) remain limited due to slow progress in restoring domestic cables.

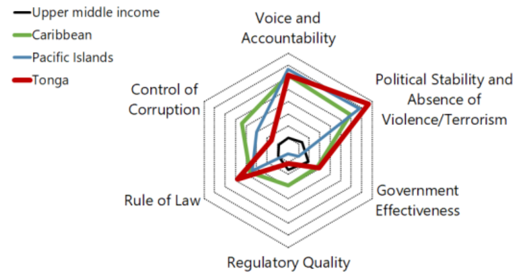
[17] See IMF Country Report No. 21/26, Annex IV.

Net Inward Foreign Directment Investment: 2016-2020 1/
(In percent of GDP, average)



Sources: World Bank World Development Indicators; and IMF staff estimates.
1/ Defined as new investment inflows less disinvestment.

Average Governance Performance: Tonga vs. Comparators (2016-2020)



Source: Kaufmann and Kraay. Worldwide Governance Indicators (2020).
Note: Higher values indicate better outcomes.

33. The design and implementation of the anti-corruption framework could be strengthened further. Tonga acceded to the United Nations Convention Against Corruption in February 2020, which marks an important move toward strengthening its anti-corruption framework. Enhancing accountability and transparency of government operations, as well as addressing the weaknesses in revenue administration identified by the IMF's 2021 Tax Administration Diagnostic Assessment Tool Report (e.g., tax dispute resolution and ease of paying tax), would further help mitigate governance and corruption risks. Implementing the Anti-Corruption Commissioner Act is also essential. While the law was enacted in 2017, Tonga has yet to set up the office and appoint the Commissioner.

34. Recent efforts to reinforce the AML/CFT framework are welcome and should continue. Given Tonga's heavy reliance on remittances and its impact on consumption and growth, loss of CBRs could have macro-critical economic impacts.[18] Staff welcome the recent progress made in this area, including the establishment of the Financial Analysis and Supervision Coordinating Unit to strengthen AML/CFT supervision and enhanced collaboration between the Financial Intelligence Unit (FIU) and regional AML/CFT supervisors and FIUs, with the aim of improving information sharing and enhancing the FIU's analytical capacity. The NRBT is setting up a national know-your-customer system and is seeking to revise the existing AML/CFT framework to make it more risk-based and aligned with the recommendations from the Asia Pacific Group on Money Laundering (APG), which notably include strengthening the regulatory framework and enforcement and reinforcing financial and human resources.

35. The international community should do their part in supporting Tonga's reconstruction and structural reform efforts. Considering the substantial impediments to growth facing Tonga, such as geographical remoteness, a narrow production base, and frequent natural disasters, continued financial support—including in the form of cash and project grants—and technical assistance by development partners will be critical for Tonga to achieve its climate resilience and sustainable development goals. The financial assistance should be well aligned

[18] Two small banks have recently lost their USD accounts with the National Bank of Australia, with one of them now using a virtual platform that provides cross-border payment services.

with Tonga's own development objectives and closely coordinated with the authorities in advance to avoid stretching their limited administrative capacity.

Authorities' Views

36. The authorities concurred with the structural reform priorities identified by staff and the need to develop the private sector to boost Tonga's long-term growth potential. Notably, the newly approved National Infrastructure Plan is expected to help improve project management and strengthen the risk and hazard assessments in the project review process. Efforts to enhance education and training are also ongoing, including through the SET Project funded by the World Bank and the Technical and Vocational Education and Training (TVET) programs that aim to improve workers' skills. In the financial sector, the authorities are undertaking the Domestic Electronic Payment System (DEPS) project to upgrade the national payment system. The authorities are also augmenting their efforts to strengthen the AML/CFT framework and planning to conduct on-site visits to review banks' compliance with AML/CFT regulations, including the applications of policies on enhanced customer due diligence for high-risk domestic politically exposed persons. The authorities underscored the importance of continued support from development partners and the IMF in achieving its SDGs under the Tonga Strategic Development Framework 2015-2025.

E. Strengthening Statistical Capacity

37. Improving the quality, timeliness, and coverage of macroeconomic statistics should be a high priority (Informational Annex). The IMF provided extensive CD support in several areas of statistics (e.g., national accounts, government finance, and balance of payments), including through missions led by the IMF Capacity Development Office in Thailand (CDOT) and the Pacific Financial Technical Assistance Centre (PFTAC). The authorities should continue to make progress in disseminating better and more statistics in a timely manner with the IMF's CD support, including publishing key macroeconomic and financial data on a regular basis through a National Summary Data Page in the context of Tonga's participation in the Enhanced General Data Dissemination System (e-GDDS).

RCF—FINANCING NEEDS AND CAPACITY TO REPAY

38. Staff assess the RCF to be the most appropriate financing instrument to meet Tonga's urgent BOP need. The estimated BOP need amounts to about US$134 million or 25 percent of FY2023 GDP (Table 7), largely due to higher import demand for food and reconstruction-related materials, combined with a surge in global energy and food prices following the war in Ukraine (¶14). If left unaddressed, Tonga would face a severe economic fallout, with disproportionately large adverse socioeconomic impacts on the poor, due to Tonga's high reliance on imports for the supply of essential goods. In this context, the authorities requested emergency financing under the RCF worth 50 percent of quota to meet the urgent BOP need (Appendix I). Although an upper credit tranche (UCT) quality Fund-supported program could help facilitate Tonga's reform efforts beyond the short term, the double blow of volcanic eruption and COVID-19 have substantially stretched Tonga's already weak administrative capacity at this juncture. Furthermore, the slow and unreliable internet connection in the midst of border closures poses another important challenge for conducting intensive discussions to reach an agreement on a multi-year program.

39. Access of 50 percent of quota under the exogenous shock window of the RCF would be appropriate. Tonga has an outstanding RCF balance of SDR 6.9 million or 50 percent of quota (approved and disbursed in January 2021). Additional access of 50 percent of quota (equivalent to about 1.8 percent of GDP) is appropriate given that the public and publicly guaranteed debt is assessed to be sustainable (DSA Annex). 50 percent of quota represents about 7 percent of total external financing needs in FY2023. The remaining gap in FY2023 would be filled by donors' aids, including those directly associated with the January 2022 volcanic eruption, and a drawdown from FX reserves. If the expected donors' aids do not fully materialize, the shortfall is expected to be met by a further drawdown of FX reserves. However, it is important that Tonga maintains higher level of reserves given that it is prone to natural disaster shocks and facing large debt repayments from FY2024, as well as considering the need to protect the credibility of the exchange rate system and to prepare for the expected slowdown in remittances.

40. Tonga's capacity to repay the IMF is adequate, but subject to risks. If approved, the disbursement of RCF-2 would increase total amount of outstanding IMF credit to 100 percent of quota. The capacity to repay the Fund (Table 8) is nonetheless assessed as adequate at this level of access, conditional on continued progress in the reform agenda and absent additional major shocks. Total credit outstanding to the Fund would remain below 3.6 percent of GDP and peak at about 14.5 percent of gross reserves. Under the baseline, total repayments to the Fund would peak at about 3.5 percent of exports and 0.6 percent of GDP, whereas overall debt service is expected to absorb a growing share of revenues and grants, especially since 2024, with a peak of about 31 percent in 2031, and sustained elevated levels afterwards. Tonga's debt service capacity would be improved by the recommended sustained revenue mobilization and fiscal consolidation. While Tonga is assessed as being at high risk of debt distress, staff assess its public and public external debt as sustainable considering the strong policy track record over recent years (Figure 4). The downside risks to the outlook (¶15) would pose risks to Tonga's capacity to repay, which could be mitigated by implementing the reforms to develop the private sector and increase climate resilience.

41. The disbursement of RCF-2 to the NRBT will be used by the government as budget support. The authorities intend to use the funds to finance ongoing reconstruction and social protection measures targeted to the vulnerable. The authorities have committed to measures to improve macroeconomic stability and debt sustainability to ensure an orderly adjustment. The Ministry of Finance and the NRBT have also signed a memorandum of understanding on their respective responsibilities for servicing the related financial obligations to the IMF.

42. A first-time safeguards assessment of the NRBT, following the RCF-1, was completed in December 2021. The NRBT has maintained basic controls in key safeguards areas, but faces several challenges, mainly owing to the lack of capacity. Governance weaknesses such as the lack of independent oversight, coupled with an incipient internal audit function, could potentially undermine the effectiveness of safeguards at the NRBT. Outstanding safeguards recommendations include drafting amendments to the NRBT Act to strengthen the autonomy of the NRBT, filling its Board vacancies, and outsourcing audits of high-risk areas. Although the authorities have committed to implement these recommendations, to date, little progress has been made. Further efforts are needed to strengthen the safeguards framework in the NRBT.

STAFF APPRAISAL

43. Tonga's economy was severely hit by the double blow from the HTHH volcanic eruption and the local outbreak of COVID-19 in early 2022. The natural disaster derailed the nascent recovery from TC Harold and border closures in early 2020 and caused substantial damages to properties and public infrastructures. Moreover, strict mobility restrictions involving two national lockdowns to contain the local spreads of COVID-19 brought virtually all activities to a halt in the first quarter of 2022. Although economic activity has been gradually normalizing since April in line with the easing of mobility restrictions and supported by strong policy measures, real GDP is nonetheless expected to decline by 1.9 percent in FY2022, following a significant contraction of 2.7 percent in FY2021.

44. The FY2021 external balance is preliminarily assessed as broadly in line with medium-term fundamentals and desirable policies. A large increase in remittance flows and grants related to COVID-19 in FY2021 following TC Harold and border closures largely offset the loss in tourism receipts during this period.

45. External balances are set to markedly worsen in the near term. Ongoing reconstruction activities, combined with reduced domestic crop production and the increase in global commodity prices following the war in Ukraine, have induced an urgent BOP need for Tonga. Substantial deterioration of the CAB is expected in FY2023 reflecting high import demand for food, energy, and reconstruction-related materials, as well as moderation in remittance inflows from the exceptional levels in FY2020-FY2021. Over the medium term, current account deficits are likely to remain large, reflecting multi-year reconstruction projects, persistently weak export competitiveness, and heavy import dependence. Without reforms to tackle these structural weaknesses and strengthen the public finances over the medium-to-long term, together with continued financial support from donors, reserve coverage is projected to decline in the medium term to below the optimal range estimated by staff—although still above the NRBT's minimum threshold of 3 months of import cover.

46. The outlook is fragile and subject to significant downside risks. Annual GDP growth is projected at 3.2 percent in FY2023, led by reconstruction and policy support. Tourism is also expected to contribute to the growth rebound following the planned gradual reopening of international borders during FY2023, although a meaningful pickup will likely materialize in FY2024 after a further progress in repairs and reconstruction. Downside risks mainly stem from natural disasters, a faster-than-expected rise in international food and energy prices, a new highly contagious and lethal COVID-19 variant or a new virus, and the loss of CBRs.

47. The macroeconomic policy response since the global pandemic has appropriately focused on protecting the vulnerable and maintaining stability. Prudent macroeconomic management in the run up to the pandemic, including by limiting the increase in the public wage bill and raising additional tax revenues, together with financial support from the international community, allowed the government to deploy adequate fiscal support measures to mitigate the socioeconomic impacts of the pandemic and natural disasters, especially in hard-hit sectors such as tourism and agriculture. Meanwhile, FX reserves have been maintained at comfortable levels (over 9 months of import cover) since FY2020.

48. Staff support the authorities' plan to facilitate reconstruction and recovery through an expansionary budget for FY2023. Significant capital investment is needed in the near term to rebuild damaged public infrastructure, and ample fiscal support to affected vulnerable businesses and households should be maintained until recovery is firmly underway.

49. Over the medium-to-long term, fiscal adjustment and additional donor support are needed to strengthen Tonga's public finances. The risk of public and external debt distress is assessed to be high for Tonga. To reduce the risk of debt distress while achieving Tonga's long-term development goals, gradual fiscal adjustment through both the expenditure- and revenue-side reforms will be essential, complemented by continued donor support in line with historical levels. Notably, the reforms should aim to boost domestic revenues by rationalizing tax exemptions and strengthening tax administration, while reinforcing current spending controls—especially on the public wage bill—and targeted support to vulnerable groups. To enhance Tonga's climate resilience, significant public investment is needed with the aids of development partners. Greater transparency and accountability of government operations would help in this regard, including through the publication of audited pandemic-related expenditures and procurement documents.

50. The current monetary policy stance is appropriate under staff's baseline inflation outlook, but the NRBT should stay vigilant. While headline inflation has remained above the NRTB's reference rate of 5 percent since mid-2021, importantly reflecting higher global commodity prices and domestic supply-side disruptions following the volcanic eruption, core inflation has been relatively modest, accompanied by continuing credit contraction since mid-2020. Under the current monetary policy settings, staff project the average headline inflation in FY2023 to stabilize below the NRBT's reference rate. But the NRBT should stand ready to act given significant risks to inflation.

51. While financial stability has been maintained, the NRBT should continue to closely monitor credit risks. Banks were profitable and well capitalized before the volcanic eruption, with declining NPL ratios. However, the NRBT should continue to monitor credit risks closely especially in hard-hit sectors such as tourism and wholesale and retail. Reforms to improve financial supervision, support credit growth, and promote financial deepening are also essential for Tonga's financial development. The ongoing efforts to strengthen the AML/CFT framework should also continue, given Tonga's heavy reliance on remittances.

52. Raising Tonga's long-term growth potential requires enhancing resilience to natural disasters and developing the private sector. The reform priorities comprise: (i) improving the efficiency of climate-resilience capital spending; (ii) streamlining the regulatory framework for FDI; (iii) enhancing internet connectivity; (iv) increasing government spending on health, education, and social protection; and (v) improving land leasehold market operations.

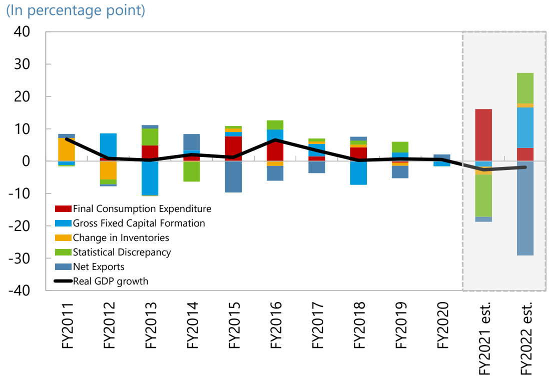
53. Staff support the authorities' request for emergency financial assistance under the RCF. The IMF's assistance through the RCF equivalent to 50 percent of quote (SDR 6.9 million), together with additional aids expected from other donors, will help Tonga meet urgent BOP and budgetary needs and could catalyze additional external financing.

54. It is recommended that the next Article IV consultation for Tonga take place on a standard 12-month cycle.

Figure 1. Tonga: Real Sector Development

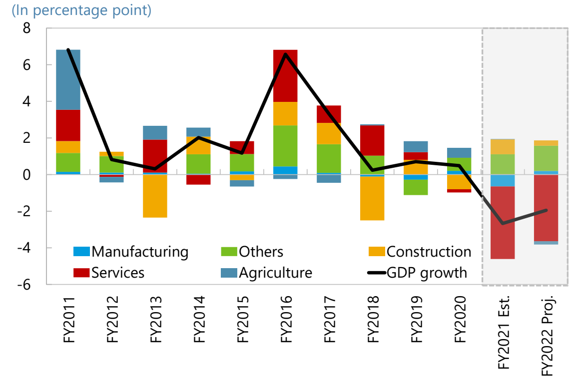
Net exports contracted due to the pandemic and the effect of the volcano eruption.

Contribution to Growth by Expenditure Category
(In percentage point)



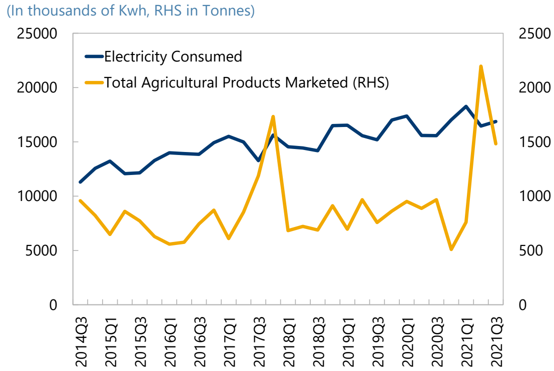
Construction activities are supporting growth.

Contribution to Growth by Sector
(In percentage point)



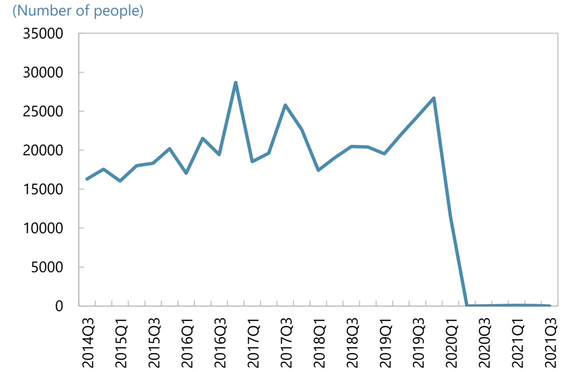
Agricultural production and electricity consumption remain strong.

Agricultural Production and Electricity Consumption
(In thousands of Kwh, RHS in Tonnes)



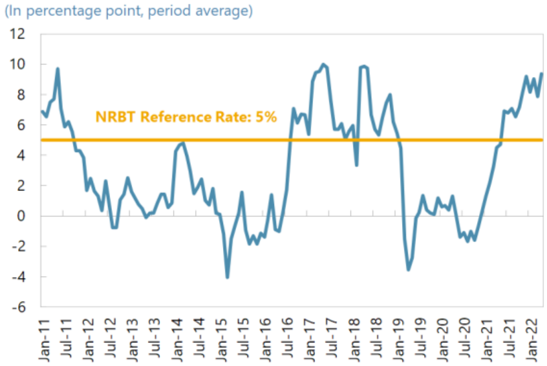
But tourist arrivals were reduced to zero due to the border closure.

Tourist Arrival
(Number of people)



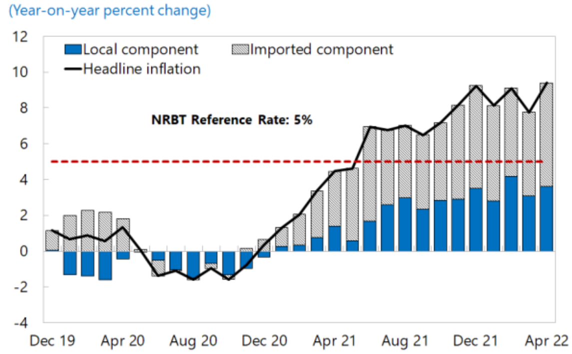
Headline inflation is above the NRBT's reference rate.

Consumer Price Index
(In percentage point, period average)



Headline inflation is mainly driven by import prices.

Tonga: Contribution to Headline Inflation
(Year-on-year percent change)

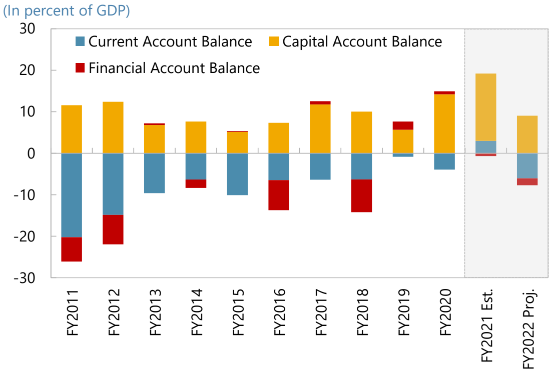


Sources: National Reserve Bank of Tonga; and IMF staff calculations.

Figure 2. Tonga: External Sector Development

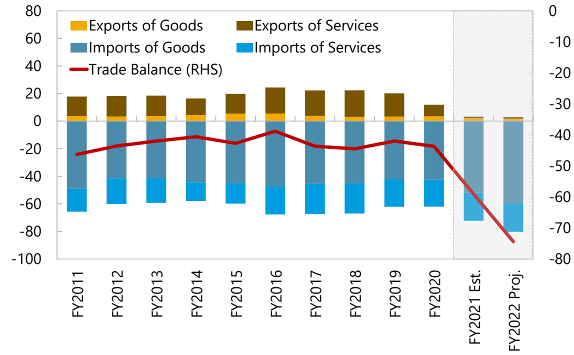
Donors' aids are boosting the capital account balance.

Balance of Payments Forecast
(In percent of GDP)



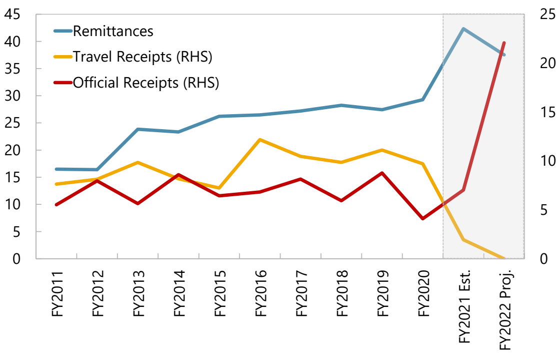
The pandemic and the volcano eruption are expected to affect the trade balance.

Trade Balance
(In percent of GDP)



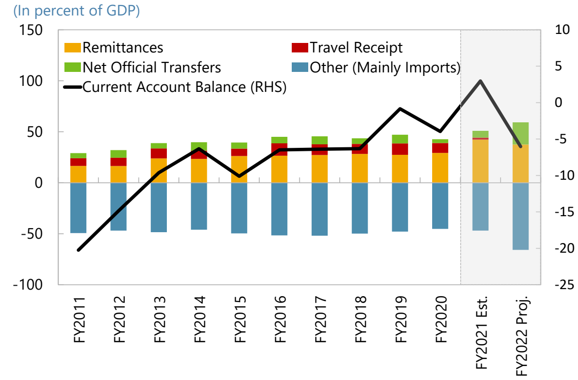
Remittances and grants are at record highs while travel receipts collapsed.

Remittances and Travel Receipts
(In percent of GDP)



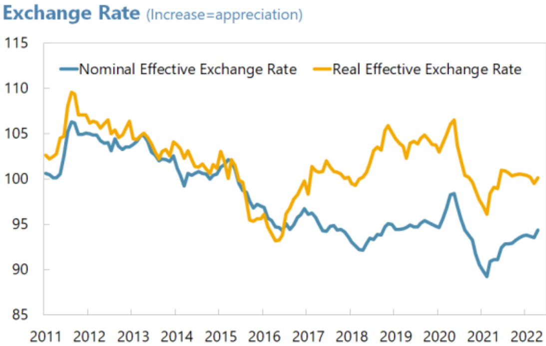
Thereby also supporting the current account balance.

Contributions to Current Account Balance
(In percent of GDP)



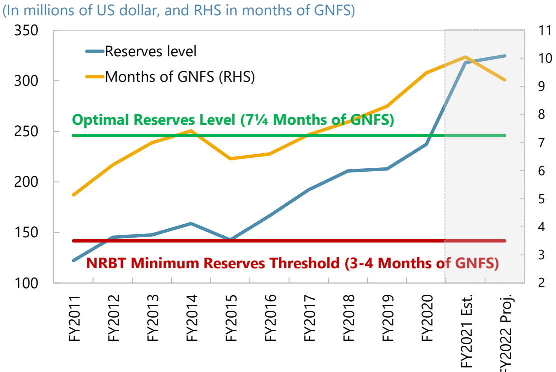
The REER has appreciated recently due to both nominal appreciation and high inflation.

Nominal Effective Exchange Rate and Real Effective Exchange Rate (Increase=appreciation)



Reserves are at all-time highs due to donors' aids and large inflows of remittances.

Reserves Level
(In millions of US dollar, and RHS in months of GNFS)



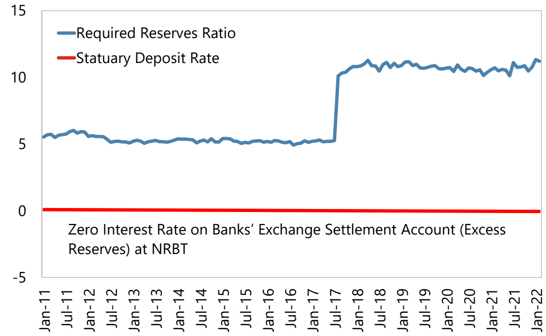
Sources: Tongan authorities; and IMF staff estimates.

Figure 3. Tonga: Monetary Sector Development

Monetary policy remains on hold.

Monetary Policy Instrument

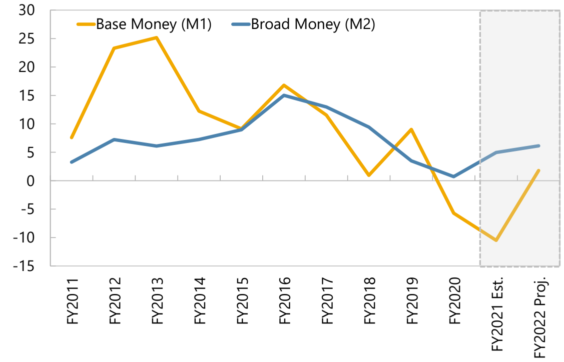
(In percent of Total Bank Deposits)



Broad money ticked up slightly.

Domestic Liquidity

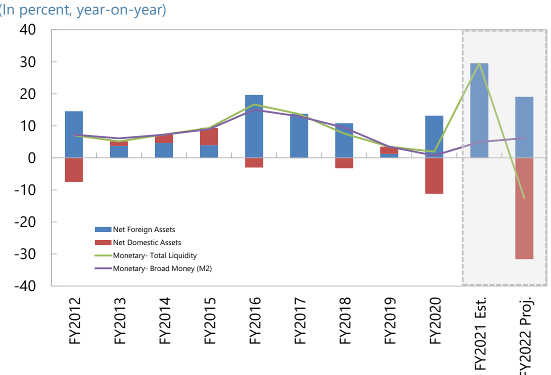
(Year-on-year percent change)



Unsterilized foreign inflows are the main drivers of liquidity.

Contribution to Total Liquidity: M3

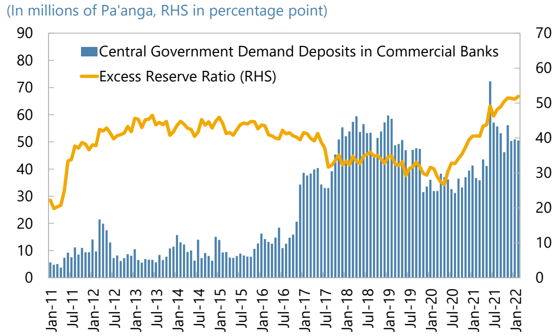
(In percent, year-on-year)



Liquidity in the banking system increased since the onset of the crisis.

Excess Reserve Ratio and Central Government Demand Deposits in Commerical Banks

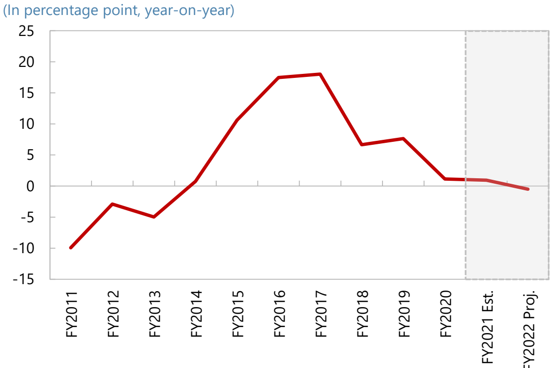
(In millions of Pa'anga, RHS in percentage point)



Credit to the private sector remains subdued.

Credit to Private Sector

(In percentage point, year-on-year)



The loan-to-deposit ratio decreased due to both a decline in lending and an increase in total deposits.

Loan to Deposit Ratio

(In percentage point)

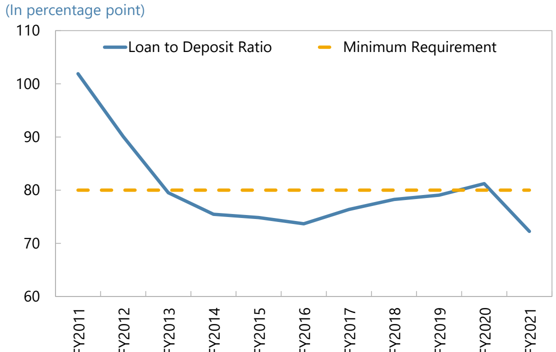
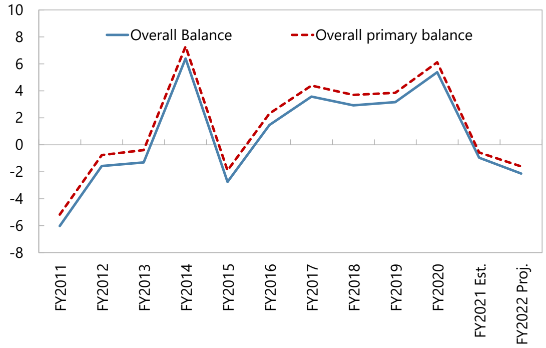


Figure 4. Tonga: Fiscal Sector Development

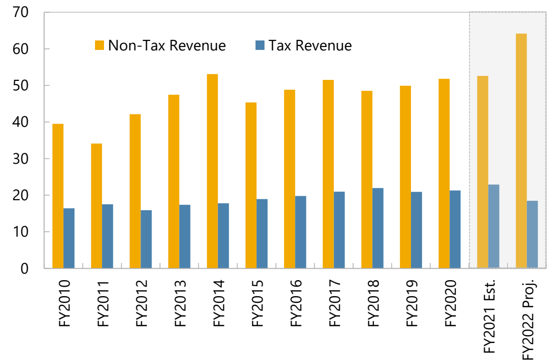
The primary fiscal balance is expected to remain close to zero in FY2022.

Overall and Primary Balance
(In percent of GDP)



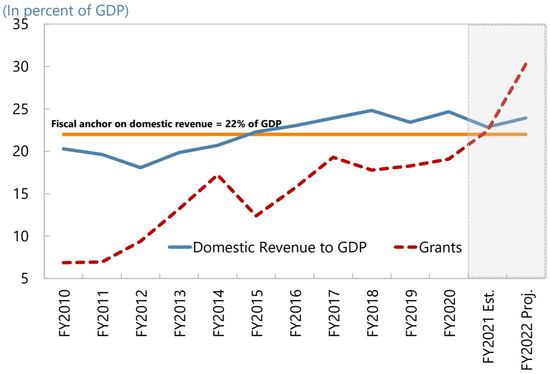
Tax revenues are expected to decline in FY2022 due to the volcanic eruption and COVID-related lockdown…

Tax Revenue
(In percent of GDP)



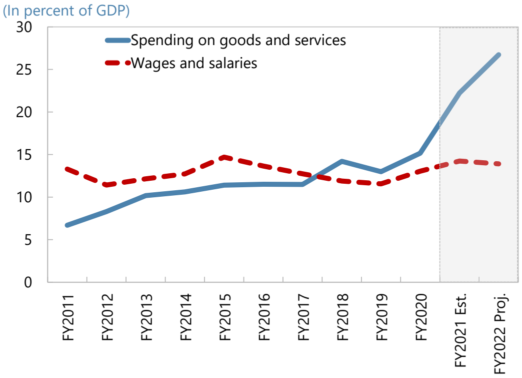
… while development partners have stepped up their grant support after the natural disaster.

Revenues and Grants
(In percent of GDP)



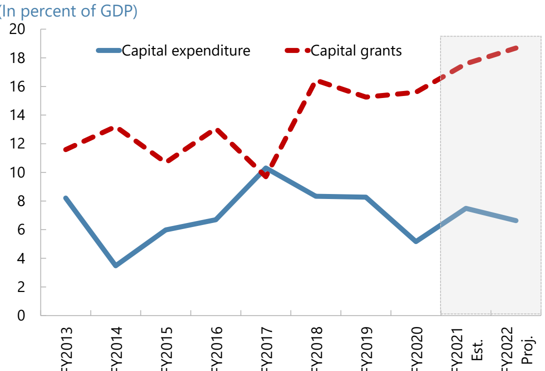
Current expenditure is expected to go up further for reconstruction and COVID responses.

Current Expenditure
(In percent of GDP)



Existing capital grants can cover the increased capital expenditure needs after the volcanic eruption.

Capital Expenditure and Capital Grants
(In percent of GDP)



Public debt has risen since the pandemic, while external debt remains below the fiscal anchor.

Total Debt and Fiscal Anchor
(In percent of GDP)

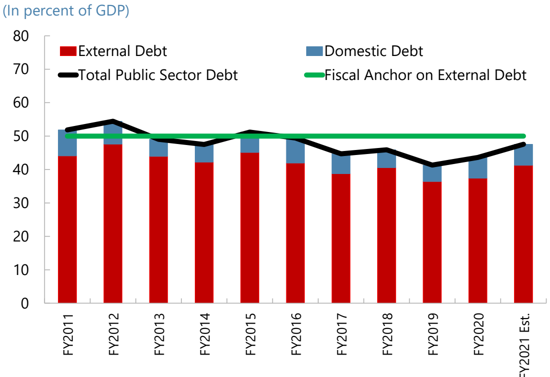
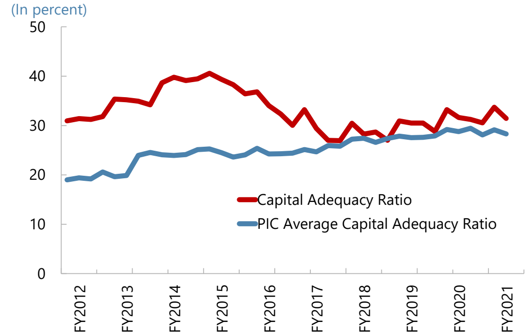


Figure 5. Tonga: Financial Sector Development

Capital buffers remain above the PIC average.

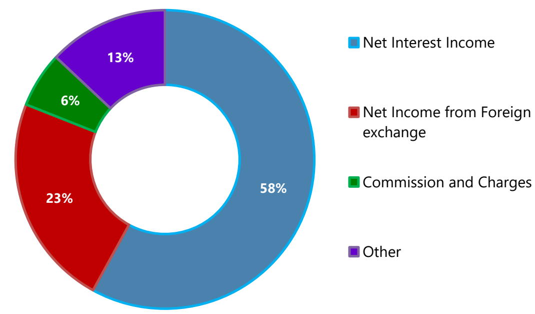
Capital Adequacy Ratio
(In percent)



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

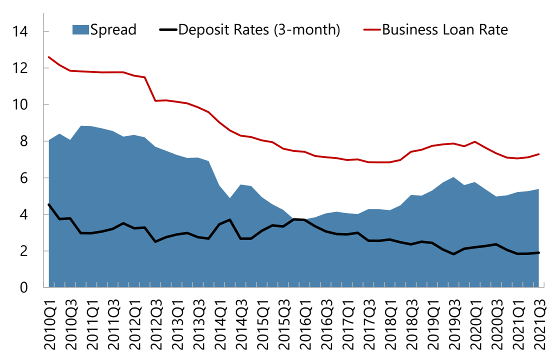
Bank income continues to rely on net interest income...

Financial Sector Operating Income Components in 2020



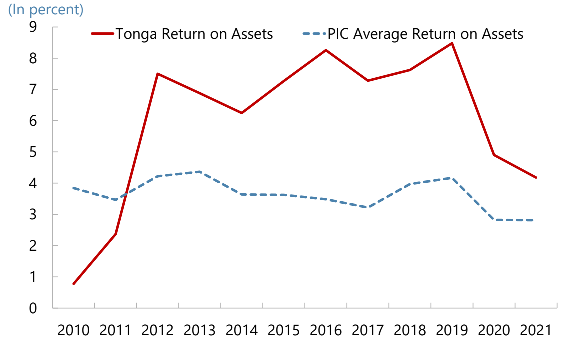
... as interest rate spreads remain wide.

Interest Rates
(In percent)



However, profitability has declined due to slow credit growth.

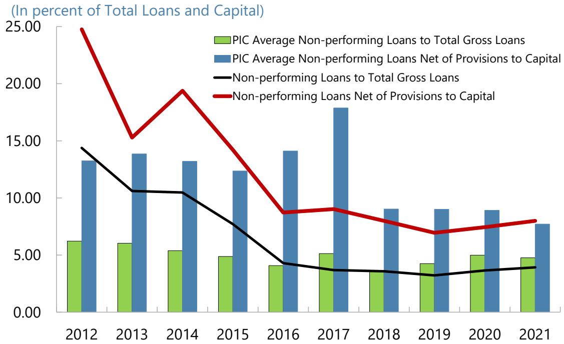
Return on Assets
(In percent)



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

NPLs ticked up slightly in FY2021.

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)

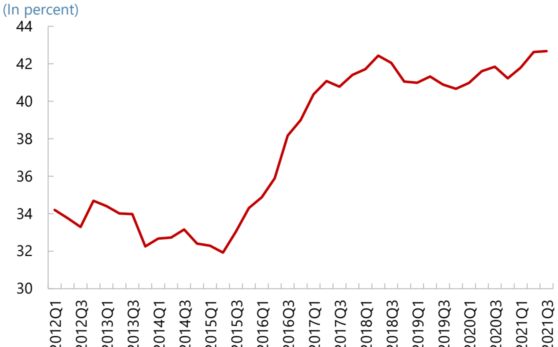


Table 1. Tonga: Selected Economic Indicators, FY2019–FY2024 1/

Population (2020): 106 thousands
Major exports: root crops, vanilla, squash, fish
Quota: SDR 13.2 million

			Est.	Projections		
	FY2019	FY2020	FY2021	FY2022	FY2023	FY202
Output and prices			(Annual percent change)			
Real GDP[2]	0.7	0.5	-2.7	-1.9	3.2	3
Consumer prices (period average)[3]	3.3	0.4	1.4	8.4	4.7	3
Consumer prices (end of period)[3]	-0.1	-1.4	6.9	9.7	3.8	2
GDP deflator	7.7	-4.2	-1.9	8.4	4.7	3
Central government finance			(In percent of GDP)			
Total Revenue	41.7	44.2	48.3	51.5	45.8	39
Revenue (excluding grants)	23.4	25.1	25.9	21.2	25.3	25
Grants	18.3	19.1	22.4	30.2	20.5	14
Total Expenditure	38.6	38.8	49.3	53.6	50.6	45
Expense	30.3	33.7	41.8	47.0	38.8	36
Transactions in Nonfinancial Assets (Net)	8.3	5.2	7.5	6.6	11.8	8
Overall balance	3.2	5.4	-1.0	-2.1	-4.8	-5
Net Acquisition of Financial Assets	2.0	6.1	1.7	0.0	-3.3	-3
External financing (net)	-1.2	-0.4	2.9	-0.4	0.2	-1
Domestic financing (net)	0.0	1.1	-0.2	2.5	1.4	3
Money and credit			(Annual percent change)			
Total liquidity (M3)	4.3	1.2	7.0	6.0	7.7	6
Of which: Broad money (M2)	3.5	-0.6	-4.6	6.3	8.1	6
Domestic credit	6.0	-16.1	-8.2	16.6	4.4	16
Of which: Private sector credit	7.6	1.1	1.0	-0.5	0.3	0
Interest rates (end of period)						
Average deposit rate	2.3	2.3	2.2	2.3	...	
Average lending rate	8.2	8.1	8.0	7.9	...	
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	15.7	18.2	16.3	4.5	13.3	21
Imports, f.o.b.	221.1	211.6	205.4	284.2	313.9	321
Services balance	-9.3	-20.6	-88.9	-92.2	-100.4	-82
Investment income balance	39.6	41.8	61.9	49.9	51.8	50
Transfers balance	170.8	152.9	230.1	291.5	225.4	218
Of which: Remittances	140.2	143.4	199.2	187.4	160.9	171
Of which: Official grants	44.8	20.1	33.1	110.2	77.1	60
Current account balance	-4.4	-19.4	14.0	-30.6	-123.8	-112
(In percent of GDP)	-0.9	-4.0	3.0	-6.1	-23.1	-19
Overall balance	2.1	24.3	64.7	6.2	-101.8	-99
(In percent of GDP)	0.4	5.0	13.7	1.2	-19.0	-17
Gross official foreign reserves						
In millions of U.S. dollars	212.8	237.2	317.9	324.1	231.8	132
(In months of next year's total imports)	8.3	9.5	10.0	9.2	6.2	3
Debt (in percent of GDP)						
Public debt (external and domestic)	41.3	43.6	47.5	47.6	45.5	47
Of which: External debt	36.4	37.4	41.2	39.3	35.8	32
External debt service ratio	1.7	1.5	0.7	1.4	2.1	4
Exchange rates						
Nominal effective exchange rate (2005=100)	91.6	93.0	88.5	...	...	
Real effective exchange rate (2005=100)	108.1	108.4	104.4	...	...	
Memorandum items:						
Remittances (in percent of GDP)	27.4	29.3	42.3	37.5	30.1	30
Tourism (in percent of GDP)	11.1	8.2	0.8	0.5	1.0	5
FDI (in percent of GDP)	-0.1	-0.7	-1.5	-1.2	-1.2	-0
Nominal GDP (millions of US$)	511.3	490.2	470.5	499.7	534.9	569

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

Table 2. Tonga: Balance of Payments Summary, FY2019–FY2024

	FY2019	FY2020	Est. FY2021	Projections FY2022	FY2023	FY2024
	(In millions of U.S. Dollars)					
Current account balance	**-4.4**	**-19.4**	**14.0**	**-30.6**	**-123.8**	**-112.6**
Trade balance	-205.4	-193.5	-189.1	-279.7	-300.6	-299.5
Exports, f.o.b.	15.7	18.2	16.3	4.5	13.3	21.4
Imports, f.o.b.	-221.1	-211.6	-205.4	-284.2	-313.9	-321.0
Services balance	-9.3	-20.6	-88.9	-92.2	-100.4	-82.2
Receipts	96.7	75.6	5.8	3.7	8.5	44.7
Payments	-105.9	-96.3	-94.8	-95.9	-108.8	-126.9
Investment income balance	39.6	41.8	61.9	49.9	51.8	50.3
Receipts	55.2	57.5	78.5	67.6	69.1	68.1
Payments	-15.7	-15.7	-16.6	-17.8	-17.3	-17.8
Transfers balance	170.8	152.9	230.1	291.5	225.4	218.8
Official transfers (net)[1]	43.5	18.4	31.4	108.4	75.2	58.6
Private transfers (net)	127.2	134.6	198.7	183.1	150.1	160.2
Capital account balance	**29.0**	**69.6**	**76.3**	**45.2**	**37.1**	**27.3**
Financial account balance	**10.1**	**3.6**	**-3.2**	**-8.3**	**-15.1**	**-14.3**
FDI (net)	-0.3	-3.7	-7.1	-6.1	-6.6	-4.8
Other investment (net)	-6.7	-6.3	-3.9	2.2	8.5	9.5
Of which: Loan disbursements	0.0	2.8	6.6	3.1	0.0	11.2
Errors and omissions	-32.5	-29.4	-16.1	0.0	0.0	0.0
Overall balance	**2.1**	**24.3**	**64.7**	**6.2**	**-101.8**	**-99.6**
Financing	**-2.1**	**-24.3**	**-64.7**	**-3.1**	**101.8**	**99.6**
Change in reserve assets (- decrease)	2.1	24.3	80.8	6.2	-92.4	-99.6
Use of IMF credit (net)	0.0	0.0	9.7	0.0	9.4	0.0
Disbursement (RCF)[2]	0.0	0.0	9.7	0.0	9.4	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	6.4	3.1	0.0	0.0
	(In percent of GDP)					
Current account balance	-0.9	-4.0	3.0	-6.1	-23.1	-19.8
Trade balance	-40.2	-39.5	-40.2	-56.0	-56.2	-52.6
Exports, f.o.b.	3.1	3.7	3.5	0.9	2.5	3.8
Imports, f.o.b.	-43.2	-43.2	-43.7	-56.9	-58.7	-56.4
Services balance	-1.8	-4.2	-18.9	-18.5	-18.8	-14.4
Receipts	18.9	15.4	1.2	0.7	1.6	7.9
Payments	-20.7	-19.6	-20.1	-19.2	-20.3	-22.3
Investment income balance	7.7	8.5	13.2	10.0	9.7	8.8
Receipts	10.8	11.7	16.7	13.5	12.9	12.0
Payments	-3.1	-3.2	-3.5	-3.6	-3.2	-3.1
Transfers balance	33.4	31.2	48.9	58.3	42.1	38.4
Official transfers (net)[1]	8.5	3.7	6.7	21.7	14.1	10.3
Private transfers (net)	24.9	27.5	42.2	36.6	28.1	28.1
Capital account balance	5.7	14.2	16.2	9.0	6.9	4.8
Financial account balance	2.0	0.7	-0.7	-1.7	-2.8	-2.5
FDI (net)	-0.1	-0.7	-1.5	-1.2	-1.2	-0.8
Other investment (net)	-1.3	-1.3	-0.8	0.4	1.6	1.7
of which : Loan disbursements	0.0	0.6	1.4	0.6	0.0	2.0
Overall balance	0.4	5.0	13.7	1.2	-19.0	-17.5
Financing	-0.4	-5.0	-13.7	-0.6	19.0	17.5
Change in reserve assets (- decrease)	0.4	5.0	17.2	1.2	-17.3	-17.5
Use of IMF credit (net)	0.0	0.0	2.1	0.0	1.8	0.0
Disbursement (RCF)[2]	0.0	0.0	2.1	0.0	1.8	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	1.4	0.6	0.0	0.0
Memorandum items:						
Gross official foreign reserves	212.8	237.2	317.9	324.1	231.8	132.2
In months of next year's total imports	8.3	9.5	10.0	9.2	6.2	*3.8*
Exchange rate						
T$ per U.S. dollar (period average)	2.3	2.3	2.3	…	…	…
T$ per U.S. dollar (end of period)	2.3	2.3	2.2	…	…	…
Nominal GDP (in millions of US$)	511.3	490.2	470.5	499.7	534.9	569.5
Commodity price indexes (2005 = 100)						
Food	100.9	100.2	115.1	138.1	142.8	137.1
Fuel	144.1	110.9	137.9	265.5	304.4	243.2

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, FY2019-FY2024 1/

	FY2019	FY2020	Est. FY2021	Projections FY2022	FY2023	FY2024
	(In millions of T$, end of period)					
Net foreign assets	492.3	570.6	749.8	899.6	942.3	731.9
Claims on nonresidents	531.3	601.9	782.0	937.2	972.8	766.1
NRBT	484.3	555.9	721.4	892.8	921.7	709.4
Other depository corporations	47.0	46.0	60.6	44.4	51.1	56.8
Liabilities to nonresidents	-39.0	-31.2	-32.2	-37.5	-30.5	-34.2
NRBT	-20.9	-20.8	-22.1	-20.7	-21.3	-21.8
Other depository corporations	-18.0	-10.4	-10.1	-16.8	-9.2	-12.5
Net domestic assets	86.1	36.5	36.6	-211.3	-200.9	55.2
Net domestic credit	300.1	251.9	231.3	269.7	281.7	328.2
Net claims on government	-190.9	-244.8	-257.6	-228.9	-213.7	-166.0
Claims on public nonfin. corps.	60.2	61.6	50.3	62.3	57.8	53.1
Claims on private sector	427.9	432.7	436.9	434.7	436.0	439.5
Other items, net	-214.0	-215.4	-194.7	-481.0	-482.6	-273.0
Total liquidity (M3)	600.1	607.1	649.5	688.3	741.4	787.1
Broad money (M2)	574.5	578.5	607.3	645.3	697.7	742.5
Narrow money	262.2	247.3	221.4	225.3	229.4	233.5
Quasi money	312.2	331.3	386.0	420.0	468.3	509.0
FX deposits	25.6	28.5	42.2	43.0	43.8	44.5
	(Annual percentage change)					
Net foreign assets	1.5	15.9	31.4	20.0	4.7	-22.3
Net domestic assets	-4.7	-57.6	0.1	-677.6	-4.9	-127.5
Net domestic credit	6.0	-16.1	-8.2	16.6	4.4	16.5
Claims on private sector	7.6	1.1	1.0	-0.5	0.3	0.8
Total liquidity	4.3	1.2	7.0	6.0	7.7	6.2
Broad money (M2)	3.5	0.7	5.0	6.3	8.1	6.4
Memorandum items:						
Nominal GDP (in millions T$)	1162.9	1119.7	1068.7	1135.6	1227.7	1306.6
Velocity (GDP/M2)	2.0	1.9	1.8	1.8	1.8	1.8
T$ per U.S. dollar (end of period)	2.3	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 Government Operations, FY2019-FY2027 1/

				Projections					
	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027
			(In percent of GDP)						
Total Revenue	41.7	44.2	48.3	51.5	45.8	39.9	37.7	36.1	34.3
Memo: Revenue (excluding grants)	23.4	25.1	25.9	21.2	25.3	25.3	25.0	25.0	25.1
Tax revenue	20.9	21.3	22.9	18.5	22.8	23.0	22.9	22.9	23.0
Taxes on income/profits	4.7	4.7	4.5	3.7	4.3	4.5	4.8	4.8	4.9
Taxes on property	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on goods and services	13.4	14.4	16.2	13.0	16.2	16.2	16.2	16.2	16.2
Taxes on international trade and transactions	2.8	2.2	2.1	1.7	2.3	2.2	1.9	1.8	1.9
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants[1]	18.3	19.1	22.4	30.2	20.5	14.6	12.7	11.1	9.3
Current grants (cash)	3.0	3.4	2.5	11.0	6.0	2.9	5.4	5.2	4.2
Capital grants (cash)	4.7	9.1	15.4	8.2	6.1	4.0	0.5	5.9	5.0
Grants in-kind	10.5	6.6	4.5	11.1	8.4	7.7	6.8	0.0	0.0
Other Revenue	2.5	3.8	3.0	2.8	2.5	2.3	2.1	2.1	2.1
Property income	0.9	1.3	1.2	1.0	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Total Expenditure	38.6	38.8	49.3	53.6	50.6	45.0	46.6	45.9	45.6
Memo: Expenditure (excluding grants in-kind)	28.0	32.2	44.8	42.5	42.2	37.3	39.9	45.9	45.6
Expense	30.3	33.7	41.8	47.0	38.8	36.3	35.5	35.0	35.0
Salaries and wages	10.6	12.3	13.8	13.5	13.0	12.2	11.6	11.5	11.5
Employers' social contribution	1.0	1.0	1.0	1.1	1.1	1.1	1.0	1.0	1.0
Interest	0.7	0.7	0.4	0.5	0.6	0.7	0.9	1.0	1.1
Of which: External	0.5	0.6	0.2	0.4	0.5	0.4	0.4	0.5	0.5
Use of goods and services	13.0	15.2	22.2	26.7	19.2	17.7	17.2	17.2	17.2
Subsidies	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants	0.3	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Social benefits	2.2	2.0	1.7	2.3	2.3	2.1	2.1	2.1	2.1
Other expense	2.5	2.1	2.2	2.4	2.2	2.0	2.3	1.8	1.8
Net investment in nonfinancial assets	8.3	5.2	7.5	6.6	11.8	8.7	11.1	10.9	10.6
Buildings and structures	2.3	2.9	5.6	4.5	10.0	6.2	6.6	6.3	6.1
Machinery and equipment	5.5	1.8	1.1	1.0	1.2	1.7	2.5	2.5	2.5
Other fixed assets and non-produced assets	0.5	0.4	0.8	1.2	0.7	0.8	2.0	2.0	2.0
Gross Operating Balance	11.4	10.5	6.5	4.5	7.0	3.6	2.2	1.1	-0.7
Overall balance	3.2	5.4	-1.0	-2.1	-4.8	-5.2	-8.9	-9.8	-11.3
Primary balance	3.9	6.1	-0.6	-1.6	-4.2	-4.4	-8.1	-8.8	-10.2
Net acquisition of financial assets	2.0	6.1	1.7	0.0	-3.3	-3.1	0.0	0.0	0.0
External financing (loans)	-1.2	-0.4	2.9	-0.4	0.2	-1.7	8.1	9.0	10.4
New disbursement	0.0	0.6	3.4	0.6	1.8	2.0	11.5	12.2	13.4
Of which: IMF RCF[2]	0.0	0.0	2.1	0.0	1.8	0.0	0.0	0.0	0.0
Of which: G20 DSSI	0.0	0.0	1.3	0.6	0.0	0.0	0.0	0.0	0.0
Repayment	1.2	1.0	0.6	1.1	1.6	3.6	3.4	3.2	3.0
Domestic financing (debt securities)	0.0	1.1	-0.2	2.5	1.4	3.8	0.9	0.8	0.9
Memorandum items:									
Nominal GDP (in millions of T$)	1162.9	1119.7	1068.7	1135.6	1227.7	1306.6	1377.3	1438.7	1500.7
Fiscal anchors[3]									
Compensation of employees									
(in percent of domestic revenue) **< 53**	49.3	52.9	57.3	68.9	55.7	52.6	50.5	50.3	49.9
(in percent of current expense) **< 45**	38.2	39.4	35.6	31.2	36.3	36.6	35.5	35.8	35.7
Domestic revenue (in percent of GDP) **> 22**	23.4	25.1	25.9	21.2	25.3	25.3	25.0	25.0	25.1
External debt (in percent of GDP) **< 50**	36.4	37.4	41.2	39.3	35.8	32.0	38.5	46.2	55.2

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

[1] Grant projections are based only on existing and highly likely commitments, consistent with the IMF's "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] SDR 6.9 million, equivalent to 50 percent of Tonga's quota.

[3] Numbers in bold indicate the thresholds in Tonga's fiscal anchors.

Table 5. Tonga: Medium-Term Baseline Scenario, FY2019–FY2027 1/

			Est.	Projections					
	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027
Output and prices				(Annual percentage change)					
Real GDP	0.7	0.5	-2.7	-1.9	3.2	3.0	2.5	1.8	1.8
Consumer prices (end of period)	-0.1	-1.4	6.9	9.7	3.8	2.9	2.7	2.6	2.5
Consumer prices (period average)	3.3	0.4	1.4	8.4	4.7	3.4	2.8	2.7	2.5
GDP deflator	7.7	-4.2	-1.9	8.4	4.7	3.4	2.8	2.7	2.5
Central government finance[2]				(In percent of GDP)					
Total Revenue	41.7	44.2	48.3	51.5	45.8	39.9	37.7	36.1	34.3
Memo: Total Revenue (excluding grants)	23.4	25.1	25.9	21.2	25.3	25.3	25.0	25.0	25.1
Tax revenue	20.9	21.3	22.9	18.5	22.8	23.0	22.9	22.9	23.0
Grants	18.3	19.1	22.4	30.2	20.5	14.6	12.7	11.1	9.3
Other Revenue	2.5	3.8	3.0	2.8	2.5	2.3	2.1	2.1	2.1
Total Expenditure	38.6	38.8	49.3	53.6	50.6	45.0	46.6	45.9	45.6
Memo: Total Expenditure (excluding grants in-kind)	28.0	32.2	44.8	42.5	42.2	37.3	39.9	45.9	45.6
Expense	30.3	33.7	41.8	47.0	38.8	36.3	35.5	35.0	35.0
Salaries and wages	10.6	12.3	13.8	13.5	13.0	12.2	11.6	11.5	11.5
Employers' social contribution	1.0	1.0	1.0	1.1	1.1	1.1	1.0	1.0	1.0
Use of goods and services	13.0	15.2	22.2	26.7	19.2	17.7	17.2	17.2	17.2
Interest expense	0.7	0.7	0.4	0.5	0.6	0.7	0.9	1.0	1.1
Other expense	5.0	4.5	4.3	5.1	4.9	4.6	4.8	4.3	4.3
Transactions in Nonfinancial Assets	8.3	5.2	7.5	6.6	11.8	8.7	11.1	10.9	10.6
Gross Operating Balance	11.4	10.5	6.5	4.5	7.0	3.6	2.2	1.1	-0.7
Overall Balance	3.2	5.4	-1.0	-2.1	-4.8	-5.2	-8.9	-9.8	-11.3
Primary Balance	3.9	6.1	-0.6	-1.6	-4.2	-4.4	-8.1	-8.8	-10.2
Net Acquisition of Financial Assets	2.0	6.1	1.7	0.0	-3.3	-3.1	0.0	0.0	0.0
External financing (net)	-1.2	-0.4	2.9	-0.4	0.2	-1.7	8.1	9.0	10.4
Domestic financing (net)	0.0	1.1	-0.2	2.5	1.4	3.8	0.9	0.8	0.9
Balance of payments				(In percent of GDP)					
Trade balance	-40.2	-39.5	-40.2	-56.0	-56.2	-52.6	-43.4	-42.9	-42.3
Exports, f.o.b.	3.1	3.7	3.5	0.9	2.5	3.8	3.8	4.0	4.1
Imports, f.o.b.	-43.2	-43.2	-43.7	-56.9	-58.7	-56.4	-47.2	-46.8	-46.4
Services balance	-1.8	-4.2	-18.9	-18.5	-18.8	-14.4	-13.0	-12.3	-11.4
Investment income balance	7.7	8.5	13.2	10.0	9.7	8.8	8.1	8.0	7.8
Transfers balance	33.4	31.2	48.9	58.3	42.1	38.4	39.9	33.0	31.6
Of which: Remittances	27.4	29.3	42.3	37.5	30.1	30.1	30.1	30.1	29.8
Of which: Official grants	8.8	4.1	7.0	22.0	14.4	10.6	12.2	5.2	4.2
Current account balance	-0.9	-4.0	3.0	-6.1	-23.1	-19.8	-8.4	-14.2	-14.3
Capital account balance	5.7	14.2	16.2	9.0	6.9	4.8	1.4	6.8	5.9
Financial account balance	2.0	0.7	-0.7	-1.7	-2.8	-2.5	7.0	8.0	9.1
Gross international reserves (end of period)									
In millions of U.S. dollars	212.8	237.2	317.9	324.1	231.8	132.2	132.2	135.3	137.5
In months of next year's goods and services imports	8.3	9.5	10.0	9.2	6.2	3.8	3.7	3.7	3.4
External debt (in percent of GDP)									
Public sector external debt	36.4	37.4	41.2	39.3	35.8	32.0	38.5	46.2	55.2
Debt service ratio	1.7	1.5	0.7	1.4	2.1	4.1	3.8	3.7	3.6
Public sector total debt (in percent of GDP)	41.3	43.6	47.5	47.6	45.5	47.9	54.5	62.2	71.4
Memorandum items:									
Private transfers (net, in millions of U.S. dollars)	127.2	134.6	198.7	183.1	150.1	160.2	168.2	175.0	178.0
(In percent of imports of goods and services)	38.9	43.7	66.2	48.2	35.5	35.8	40.7	40.8	40.2
Commodity price indexes (2005 = 100)									
Food	100.9	100.2	115.1	138.1	142.8	137.1	135.4	135.2	135.2
Fuel	144.1	110.9	137.9	265.5	304.4	243.2	216.6	204.7	198.2
Nominal GDP (millions of T$)	1162.9	1119.7	1068.7	1135.6	1227.7	1306.6	1377.3	1438.7	1500.7

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

[1] From FY2025 onwards, the macroeconomic forecasts incorporate the average long-term effects of natural disasters and climate change.

[2] See footnotes in Table 4 regarding underlying assumptions for fiscal projections.

Table 6. Tonga: Financial Soundness Indicators, FY2014-FY2021

									PIC Average[1]
	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2016-18
Banks									
Net domestic credit			(Year-on-year percent change)						
Public non-financial corporations	148.4	14.0	-3.0	-5.9	20.5	15.2	2.4	-18.4	...
Private sector	0.8	10.6	17.5	18.0	6.7	7.6	1.1	1.0	…
			(In percent of GDP)						
Credit/GDP	35.7	37.3	38.8	40.9	41.9	42.0	44.2	45.6	…
Private Sector Credit/GDP	30.5	31.7	33.9	36.6	37.1	36.8	38.6	40.9	…
Public Nonfinancial Corporations/GDP	5.2	5.6	4.9	4.3	4.9	5.2	5.5	4.7	…
			(In percent)						
Regulatory Capital to Risk-Weighted Assets	39.8	39.4	34.0	29.4	28.3	30.5	31.6	31.4	26.1
Return on Assets	2.4	2.9	3.6	3.8	4.5	4.4	2.8	2.4	2.7
Return on Equity	10.0	11.8	15.5	13.7	17.8	15.3	9.0	11.2	18
Non-performing Loans to Total Gross Loans	12.4	9.8	6.7	4.1	3.6	3.2	4.1	3.3	4.6
Non-performing Loans Net of Provisions to Capital	19.7	17.3	13.5	8.8	8.4	6.2	9.1	5.3	11.6
Liquid Assets to Total Assets	31.9	31.4	33.5	32.4	27.1	25.6	27.9	40.2	35.4
Liquid Assets to Short-term Liabilities	68.0	66.5	65.0	63.3	51.0	49.8	60.2	73.0	48.9
Large Exposures to Capital	91.2	94.8	108.3	110.4	122.9	116.4	113.3	88.6	118.4
Personnel Expenses to Non-interest Expenses	32.4	31.1	32.7	27.4	29.8	29.3	28.9	31.5	37.4
Foreign-Currency-Denominated Loans to Total Loans	0.0	0.0	0.3	1.0	1.4	2.3	0.7	0.7	7.4
Foreign-Currency-Denominated Liabilities to Total Liabilities	3.2	3.2	4.7	6.9	5.7	7.1	6.2	6.5	11.9
Residential Real Estate loans to Total Loans	32.7	31.9	35.9	41.1	42.4	41.3	41.6	42.6	26.4
Commercial Real Estate Loans to Total Loans	2.2	2.3	2.3	2.4	2.5	2.2	2.4	4.2	11.3
Memorandum Items:									
Nominal GDP (millions T$)	797.2	849.1	932.6	1,017.7	1,072.6	1,162.9	1,119.7	1,068.7	

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

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

Table 7. Tonga: External Financing Requirements and Sources, FY2021-FY2023 1/

(In millions of U.S. dollars, unless otherwise indicated)

	Projections		
	FY2021	FY2022	FY2023
(In millions of U.S. dollars, unless otherwise indicated)			
Total requirement	**1.0**	**91.3**	**164.5**
(In percent of GDP)	0.2	18.3	30.8
Current account deficit (excl. budget support from Development Partners)	-1.8	86.0	156.1
Amortization	2.8	5.3	8.5
Total sources	**53.4**	**39.0**	**30.5**
(In percent of GDP)	11.4	7.8	5.7
Capital account	76.3	45.2	37.1
Official medium- and long-term loans	0.0	0.0	0.0
Multilateral	0.0	0.0	0.0
Bilateral	0.0	0.0	0.0
Other loans	0.0	0.0	0.0
Others (including errors and omissions)	-22.9	-6.1	-6.6
Financing gap (- = excess of financing)	**-52.4**	**52.3**	**134.0**
Additional financing sources	**-52.4**	**52.3**	**134.0**
(In percent of GDP)	-11.1	10.5	25.1
Use of IMF credit (net)	9.7	0.0	9.4
Disbursement (RCF)[1]	9.7	0.0	9.4
Repayments	0.0	0.0	0.0
Development Partners	12.2	55.4	32.3
Suspended debt service under G20 DSSI[2]	6.4	3.1	0.0
Change in reserves (increase = +)	80.8	6.2	-92.4
Remaining gap	**0.0**	**0.0**	**0.0**
(In percent of GDP)	**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 Sep. 2020 and Mar. 2021 suspended. Repayments due over 3 and 5 years respectively, with 1 year grace period.

Table 8. Tonga: Indicators of Capacity to Repay the Fund, 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
							(In millions of SDRs, unless otherwise indicated)						
IMF obligations based on existing credit (millions of SDR)													
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
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
IMF Obligations based on prospective drawings (millions of SDRs)													
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7	1.4	1.4	1.4	1.4
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
Outstanding IMF credit													
Millions of SDRs	0.0	6.9	6.9	13.8	13.8	13.8	13.8	12.4	10.4	7.6	4.8	2.1	0.7
Millions of T$	0.0	22.3	21.4	43.2	43.7	44.1	44.7	40.6	34.1	25.2	16.1	6.9	2.3
Percent of revenue	0.0	4.8	4.7	9.4	10.4	10.4	8.6	7.9	6.7	4.9	2.9	1.2	0.4
Percent of total exports	0.0	44.4	114.5	86.4	28.8	25.7	22.6	17.9	14.1	9.7	5.7	2.3	0.7
Percent of external debt service	0.0	284.0	132.3	169.8	82.2	84.2	83.9	75.9	63.6	55.3	44.4	18.7	5.0
Percent of net foreign assets	0.0	3.2	2.4	4.8	6.4	9.6	9.7	8.6	7.1	5.6	3.0	1.2	0.4
Percent of GDP	0.0	2.1	1.9	3.5	3.3	3.2	3.1	2.7	2.2	1.5	0.9	0.4	0.1
Percent of quota	0.0	50.0	50.0	100.0	100.0	100.0	100.0	90.0	75.0	55.0	35.0	15.0	5.0
Net use of IMF credit[1]	0.0	6.9	0.0	6.9	0.0	0.0	0.0	-1.4	-2.1	-2.8	-2.8	-2.8	-1.4
Disbursments	0.0	6.9	0.0	6.9	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	2.1	2.8	2.8	2.8	1.4
Memorandum items:													
Nominal GDP (millions of T$)	1,119.7	1,068.7	1,135.6	1,227.7	1,306.6	1,377.3	1,438.7	1,500.7	1,565.6	1,636.2	1,712.1	1,792.7	1,879.5
Exports of goods and services (millions of $T)	214.2	50.3	18.6	50.0	151.8	171.7	197.3	226.9	241.6	260.1	280.2	303.7	332.5
Government revenue (millions of T$)	420.8	468.6	458.7	459.1	420.5	425.7	519.5	515.4	510.8	514.9	546.4	570.3	584.0
External debt service (millions of T$)	17.2	7.9	16.1	25.4	53.2	52.4	53.2	53.5	53.7	45.5	36.2	36.9	46.0
Net Foreign Assets Central Bank (millions of T$)	535.0	699.3	872.1	900.4	687.6	460.2	460.6	470.4	479.6	452.7	529.3	577.9	625.1
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

Source: IMF staff estimates and projections.

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

Table 9. Tonga: SDGs Mapped to Tonga's Strategic Development Framework (FY2015-2025)

Priority Areas	Select Tongan Outcome	Corresponding SDGs	
1. Economic Institutions	1. Improved macroeconomic management and stability with deeper financial markets.	8. Decent Work & Economic Growth	10. Reduce 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 an 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 Tangan 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 Techonology	11. More reliable, safe and affordable enery services	7. Affordable and clean energy	13. Climate Action
	12. More reliable, safe and affordable transport services	9. Industry, Innovation, and Infrastructure	13. Climate Action
	13. More reliable, safe, affordable innovative ICT	9. Industry, Innovation, and Infrastructure	
	14. More reliable, safe and affordable water supply and sanitatation 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 waster 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

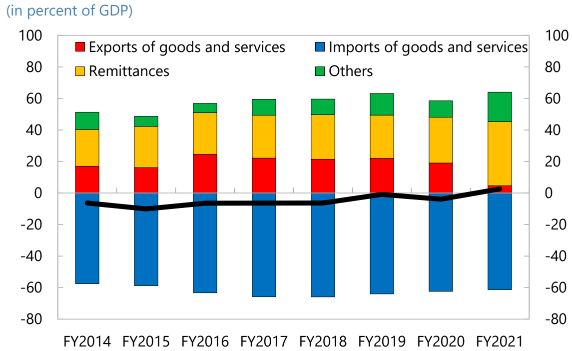
Annex I. External Sector Assessment

The external sector position for FY2021 is preliminarily assessed to be broadly in line with the level implied by fundamentals and desirable policies but was affected heavily by the impact of the pandemic, protracted closure of the border, the sharp loss in foreign exchange earnings from tourism, and an unprecedented increase in remittances inflows. However, this assessment is subject to large uncertainty due to the use of estimated data for FY2021 and the volatility in Tonga's external sector statistics. Higher public spending in the near term, which is needed to support reconstruction and the fight against COVID, is expected to contribute to moving the current account back into a deficit. International reserves stood at a comfortable 10 months of prospective imports at end-FY2021 but is projected to decline to 3½ months over the medium term, below the adequate range assessed by staff. Efforts are required on several fronts to mitigate this decline in reserves, including strengthening the public finances and promoting private sector development, together with continued strong financial support from development partners.

Current Account

1. **Background**. From FY2014 to FY2020, Tonga's current account (CA) deficit averaged about 6 percent of GDP. The current account is estimated to have turned to a surplus of 3 percent of GDP due to exceptionally large inflows of remittances and some import compression associated with weaker domestic demand amid the pandemic (text chart). Remittance inflows are estimated to have increased by about 13 percentage points of GDP to reach about 42 percent of GDP in FY2021. The U.S. dollar, followed by the Australian dollar and New Zealand dollar, are the main currencies used for remittances in Tonga. The CA balance is projected to shift to a deficit of 6 percent of GDP in FY2022 and further deteriorate to a deficit of 23 percent in FY2023, driven by: (i) higher import demand for reconstruction-related capital goods and food following the volcanic eruption in January 2022; (ii) moderation in remittances from the unusually high level in FY2021; (iii) a slowdown in exports of agricultural products due to the contamination of soil from volcanic ash; and (iv) a slow recovery in tourism due to damaged infrastructure and properties.

Current Account Developments
(in percent of GDP)



Sources: Tonga authorities; and IMF staff estimates.

2. **Assessment**. The EBA-lite CA model estimates the cyclically-adjusted CA balance at -2.5 percent of GDP and the adjusted CA norm at -2.6 percent of GDP (text table). With a gap of 0.02 percent of GDP,[1] the external position in FY2021 is assessed to be broadly in line with medium-term fundamentals and desirable policies. The policy gap (3.5 percent of GDP) reflects loose fiscal policy in

[1] See the EBA-Lite Methodology. The EBA-Lite REER model for Tonga cannot be calculated due to data limitations. This external sector assessment is based on staff's estimated data for FY2021.

the rest of the world, among other factors. The overall assessment considers the impacts of the border closure on tourism and remittance developments. The adjusted CA incorporates a -5.3 percent of GDP adjustment due to the exceptional COVID-19 shock,[2] while the adjustments to the CA norm reflect Tonga's limited external financial capacity and low FDI inflows.[3] Looking forward, near-term needs to increase public spending on reconstruction and recovery and the fight against the COVID-19 outbreak are expected to contribute to pushing the current account back into a deficit.

Tonga: Model Estimates for 2021 (in percent of GDP)

	CA model
CA-Actual	**3.0**
Cyclical contributions (from model) (-)	-0.9
COVID-19 adjustor (+) 1/	-5.3
Additional temporary/statistical factors (+)	0.0
Natural disasters and conflicts (-)	1.1
Adjusted CA	**-2.5**
CA Norm (from model) 2/	**-4.5**
Adjustments to the norm (+)	1.9
Adjusted CA Norm	**-2.6**
CA Gap	**0.02**
o/w Relative policy gap	3.5
Elasticity	-0.26
REER Gap (in percent)	**-0.1**

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (+1.2 percent of GDP) and remittances (-6.7 percent of GDP).

2/ Cyclically adjusted, including multilateral consistency adjustments. The adjustments to the norm (1.9 percent of GDP) remain the same as in the FY2020 assessment and reflect Tonga's limited external financing capacity and low FDI inflows.

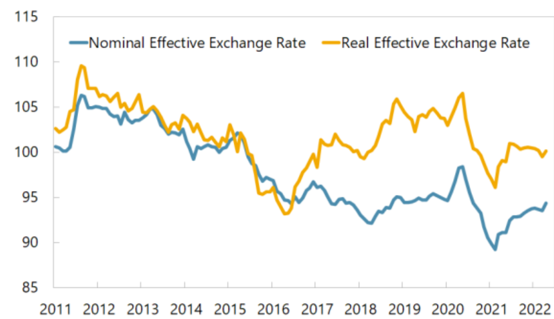
[2] The adjustment is calculated using the difference in the projected net remittances balance and net tourism balance pre-COVID-19 (January 2020) and current projections.

[3] Tonga does not have FDI inflows sufficient to cover protracted and large CA deficits and does not have access international capital markets, reducing the size of CA deficits that can be financed in the medium term.

Real Exchange Rate

3. Background. The Tonga pa'anga exchange rate is determined by a weighted-basket of currencies comprising the US dollar, Australian dollar, New Zealand dollar, and Fijian dollar. The basket weights are determined based on the share of trade with each trading partner country. The currency basket weights remain unchanged since 2018 and were last reviewed in March 2022. The real effective exchange rate (REER) depreciated by about 5.1 percent on average in FY2021 reflecting the depreciation of the nominal effective exchange rate (NEER) by about 4.1 percent (text chart). However, both the REER and the NEER appreciated during April 2021–April 2022 (1.1 percent and 3.6 percent, respectively) due to the relatively higher inflation in Tonga over this period (text chart).

Nominal Effective Exchange Rate and Real Effective Exchange Rate (Increase=appreciation)



Sources: Tongan authorities; and IMF staff estimates.

4. Assessment. The CA gap model implied a small REER undervaluation of about 0.1 percent (applying an estimated elasticity of the trade balance with respect to changes in the REER of -0.26). However, there is a large uncertainty surrounding our assessment given that: (i) the official BOP data for FY2021 are yet to be published; (ii) the expected changes in grants, tourism receipts, and remittances are unusually large; and (iii) the recent swing in global commodity prices are affecting both the current account and the REER.

Capital and Financial Accounts

5. Background. Tonga's recent current account deficits have been largely financed by large capital account credits in the form project support grants and grants in-kind. Foreign direct investment (FDI) inflows have been limited due to structural impediments, such as cumbersome land leasehold market operations and regulatory barriers. Recent external borrowings have been limited and exclusively on concessional terms, including the IMF's RCF-1 disbursed in FY2021.

6. Assessment. The authorities' plan to pursue additional grants from development partners and avoid any new non-concessional borrowing from external creditors is appropriate and would help strengthen Tonga's reserve buffer, together with the ongoing reform to promote FDI including by reducing market entry barriers.

International Reserves

7. Background. Gross official reserves stood at US$318 million (about 10 months of the following year's imports) in FY2021, compared to US$237 million (9½ months of imports) in FY2020. Reserves remained at a comfortable level due to inflows of foreign grants to help Tonga cope with COVID-19 and a surge in remittances inflows. Reserve coverage is projected to decline significantly in

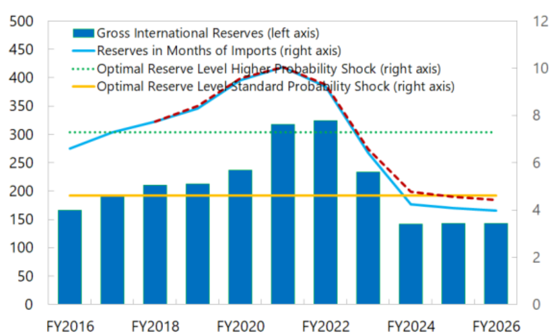
FY2023, largely reflecting the worsening of the CA balance due to the drivers discussed in Paragraph 1, and to decline further over the medium term to about 3½ months of imports in FY2027, reflecting moderation in remittances to pre-pandemic levels, lower grants after current commitments are met, and rising debt repayments—although still above the NRBT's minimum threshold of 3 months of imports.

8. Assessment. A cost-benefit analysis on the level of reserves suggests an optimal level between 4½ and 7½ months of imports. Staff's reserves adequacy framework is tailored to small credit-constrained economies. If the probability of a large shock is set at the sample average of 50 percent, the estimated optimal level of reserves would be 4½ months of imports—above the NRBT's minimum threshold of 3 months of imports. However, once Tonga's high vulnerability to natural disasters is incorporated into the assessment, the estimated adequate level of reserves would rise to about 7½ months of imports. Additional reserve buffers may be needed to cover the pickup in debt repayments from FY2024 onwards, mostly due to China Exim Bank (text chart). To tackle the projected decline in reserves over the medium term to below the adequate range, strong efforts are required in several areas, including strengthening the public finances (as illustrated in Paragraph 20 of the staff report) and implementing structural reforms aimed at enhancing Tonga's climate resilience and promoting private sector development. Donors will also need to help, including through new grant commitments.

International Reserve Adequacy Metric	FY2021
Actual Reserves (months of prospective imports)	10.0
Optimal level with standard shock probability	4.6
Optimal level with higher shock probability	7.3
Broad Money coverage	256%

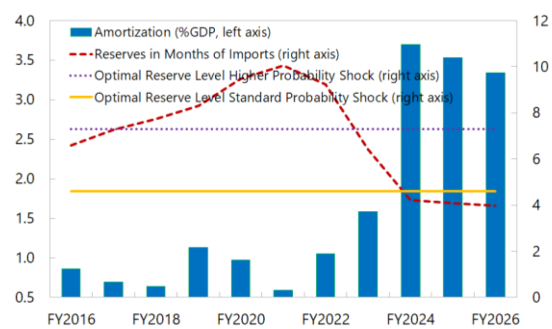
Source: IMF staff estimates.

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



Sources: Tongan authorities; and IMF staff calculations.

Amortization
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

Annex II. Risk Assessment Matrix[1]

	Source of Risks	Likelihood	Expected Impact	Policy Recommendation
Global	**Outbreaks of lethal and highly contagious COVID-19 variants lead to subpar/volatile growth, with increased divergence across countries** 1/	High	High. Weaker remittance inflows; slower recovery in tourism; more stringent containment measures leading to larger disruptions in economic activity; and higher poverty rate.	Increase fiscal spending on health and social protection, while containing wage bill increases. Monetary and macroprudential policies should remain accommodative. Accelerate structural reforms aimed at promoting private sector development.
Global	**Rising and volatile food and energy prices** 2/	High	Medium-High. Larger import bill and current account deficit, leading to lower FX reserves; higher domestic inflation and weaker private consumption due to lower real income.	Provide targeted fiscal support to the vulnerable. Monetary policy should be tightened using the NRBT's usual monetary policy instruments if strong second-round effects materialize. In the long-term, increase public investment to expand the productive capacity.
Domestic	**Faster community transmission of COVID-19** 3/	High	Medium-High. Lower GDP growth due to disruptions in domestic demand and supply; increase in nonperforming loans; slower reconstruction and larger economic scarring through reduced investment and productivity.	Accelerate the booster vaccination campaign. Increase fiscal spending on health and social protection and other measures to support the adaptation to the new COVID-19 norm (e.g., digital infrastructure). Monetary should remain accommodative, and banks should be required to ensure adequate provisioning.
Domestic	**Partial withdrawal of CBRs due to gaps in AML/CFT framework**	Medium	High. Lower remittance inflows, leading to weaker private consumption and larger current account deficit.	Strengthen the AML/CFT framework and enhance the implementation, including by improving risk-based supervision and enforcement in line with the Asia-Pacific Group assessment.
Domestic	**Natural disasters related to climate change** 4/	High	Medium-High. Disruptions in economic activity; lower GDP growth; damages to properties and infrastructure, resulting in lower growth potential.	Prioritize expenditure to support the affected households. If the economic impact is large, provide fiscal stimulus to boost aggregate demand. Maintain easy monetary policy while strengthening the monitoring of potential debt service problems in the banking sector.

[1] Rapidly increasing hospitalizations and deaths, due to low vaccination rates or caused by vaccine-resistant variants, force lockdowns and increased uncertainty about the course of the pandemic. Policies to cushion the economic impact are prematurely withdrawn or for many EMDEs, constrained by lack of space. In addition to declines in external demand, a reassessment of growth prospects triggers capital outflows, financial tightening, currency depreciations, and debt distress in some EMDEs, with spillovers to AEs, leading to growing divergence of economic recovery paths.
[2] Commodity prices are volatile and trend up amid pent-up demand and supply disruptions, conflicts, or a bumpy transition to renewable energy sources. This leads to bouts of price and real sector volatility, including acute energy crises in some countries.
[3] COVID-19 spreads faster than expected and imposes burden on Tonga's health care system, dampening confidence and economic activity.
[4] Higher frequency of natural disasters cause severe economic damage to smaller vulnerable economies and accelerate emigration. Severe events in large economies reduce global GDP, cause further supply chain disruptions and inflationary pressures, and prompt a recalculation of risk and growth prospects. Disasters hitting key infrastructure or disrupting trade raise commodity price levels and volatility.

[1] 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 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 III. Integration Matrix of Surveillance Issues and Capacity Building

Surveillance Issues	International Monetary Fund			World Bank		Asian Development Bank	
	Past	2020-2021	Planned/ Ongoing	Past	Planned/ Ongoing	Past	Planned/ Ongoing
Fiscal Sector							
Public Financial Management	√	√	√	√	√	√	√
Expenditure framework		√	√	√	√	√	√
Revenue Framework	√	√	√	√	√		
Macroeconomic Frameworks							
Macroeconomic forecasting		√	√				
Macro-Financial Issues							
Financial supervision and regulation	√	√	√	√	√		
Financial market development	√	√	√	√	√		√
Correpondent Banking		√					√
Macro-Structural iIssues							
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, and Asian Development Bank (ADB).

Annex IV. Recommendations from 2021 Article IV Consultation

Sector	Main Recommendations	Actions Since 2021 Article IV Consultation
Fiscal Policies	Improve the targeting of exemptions and broaden the tax base	Fiscal policy in FY2022 has been focused on lifting the economy from the pandemic and the volcanic eruption. The authorities reiterated their commitment to rationalize tax exemptions post-pandemic.
	Improve efficiency of government spending, including by containing public sector wages	Ongoing. Reforms are underway to contain the public sector wage bill by improving the hiring practices, limiting overtime allowances, and outsourcing some services. The authorities are commited to bringing the public wage bill back to below the 53 percent ceiling in FY2024 onward.
	Further enhance transparency and accountability of government operations	The authorities have published a summary table of COVID-19-related procurements on the MOF website.
Monetary Policy	Maintain supportive monetary policy and ensure adequate liquidity	The NRBT has stayed on hold, maintaining its accommodative monetary policy. This is appropriate under staff's baseline outlook, in which inflation is expected to fall below the NRBT's reference rate of 5 percent by end-FY2023.
Financial Sector Policies	Accelerate improvements in financial supervision	Ongoing. The authorities have taken various measures to ensure adequate provisioning, including stress testing exercises and close monitoring of NPLs on a monthly basis. The NRBT plans to set up a solvency stress testing framework and macroprudential framework with the assistance of IMF TA.
	Strengthen the AML/CFT framework	The NRBT is setting up a national know-your-customer system and is seeking to revise the existing AML/CFT framework to make it more risk-based and aligned with the recommendations from the Asia Pacific Group on Money Laundering (APG). A Financial Analysis and Supervision Coordinating Unit has been established to strengthen AML/CFT supervision and enhance collaboration between the Financial Intelligence Unit (FIU) and regional AML/CFT supervisors and FIUs.
Structural Policies	Improve the business environment and develop the private sector.	The government continued to provide funding for MSMEs through the Government Development Loan (GDL) Scheme. To help MSMEs rebound after the volcanic eruption, the subsidized interest rate offered under the GDL Scheme has been recently reduced to 1 percent from 3 percent for new loans.
	Invest in climate-resilient infrastructure	After the January 2022 volcanic eruption, the government drafted a recovery plan with a focus on better climate resilience through building better quality infrastructure. For instance, new residential houses will now be built with stricter application of building codes to mitigate damages from future disasters.

Appendix I. Letter of Intent

Ministry of Finance
Government of Tonga

Ref. M.F. 180/1 18 June 2022

Ms. Kristalina Georgieva

Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Georgieva,

1. Tonga's economy suffered a double blow from the Hunga Tonga Hunga Ha'apai (HTHH) volcanic eruption and the first local outbreak of COVID-19 at the start of 2022. The damages to physical capital and estimated loss[1] from the HTHH disaster are extensive and amount to 37 percent of GDP (US$182 million). Community transmission of COVID-19 is continuing despite strict containment measures and a series of national lockdowns. In the face of this unprecedented crisis, our policy efforts are directed towards providing humanitarian relief, supporting reconstruction, and coping with COVID-19, in close collaboration with the international community.

2. The catastrophic impacts of the HTHH disaster and the COVID-19 outbreak, together with the surge in global food and energy prices following the war in Ukraine, have generated an urgent balance of payments (BOP) need. Tonga's current account deficit is expected to substantially widen to about 6 percent of GDP in FY2022 (July 2021-June 2022) and 23 percent in FY2023, largely reflecting higher imports of food, energy, and reconstruction-related materials, and weaker agricultural exports. Real GDP is projected to contract by 1.9 percent in FY2022, before rebounding by 3.2 percent in FY2023 led by reconstruction activity.

3. Against this backdrop, the Government of Tonga requests emergency financing of SDR 6.9 million (50 percent of our quota) under the exogenous shock window of the IMF's Rapid Credit Facility (RCF). The IMF assistance, together with drawdown from our foreign exchange reserves and additional financing assistance from our other multilateral and bilateral development partners, will help meet our urgent BOP need (estimated at about US$121 million). Since the

[1] The World Bank: Tonga Second Resilience Development Policy Financing: Supplementary Financing (P178698}.

HTHH disaster, our development partners have pledged additional budget support in grants worth about 7 percent of GDP for FY2022 and 4 percent for FY2023, which will help cover our emergency spending, including on health care, social protection, and repairs. The funds disbursed under the previous RCF in 2021 (SDR 6.9 million) helped Tonga address an urgent financing gap induced by Tropical Cyclone (TC) Harold and a sharp decline in tourism due to the global pandemic.

4. While our short-term policy priority is on assisting the vulnerable and supporting reconstruction, we recognize the need to strengthen our public finances over the medium term to reduce the risk of debt distress while achieving our long-term development goals.

5. Our overall risk of public and external debt distress remains high, notwithstanding the pre-pandemic fiscal consolidation over FY2016-FY2020 through improvements in revenue collection and effective controls on current spending. Our debt repayments, especially those to China Exim Bank, are expected to rise sharply from FY2024 onwards. Our ability to service our public debt continues to be constrained by our weak growth potential due to Tonga's structural impediments and high exposure to natural disasters. To ensure that our public and xternal debt levels remain sustainable, we are committed to continuing to strengthen our debt management framework and seeking grants from development partners while avoiding any non-concessional borrowing from external creditors. Furthermore, we will continue to pursue debt relief from China Exim Bank, in addition to the debt service suspension received under the G-20 Debt Service Suspension Initiative.

6. We are committed to undertaking reforms aimed at broadening the tax base and strengthening tax administration, with capacity development (CD) support from the IMF. We recognize that revenue costs of tax exemptions are sizable and rising in Tonga. We will review and rationalize current tax exemptions and improve the process for approving new tax exemptions, including by setting clear eligibility criteria and limited time frames and allowing the Minister of Finance (MOF) to have the ultimate authority to grant exemptions. We will closely monitor outstanding tax exemptions by publishing the list of all exemptions and the estimated foregone revenue on a regular basis, with CD support from the IMF. Furthermore, we are committed to enhancing tax compliance, including by facilitating electronic filing of taxes and reducing the processing time for tax dispute resolutions.

7. We will continue to prioritize our budget to reduce poverty, strengthen climate resilience, and promote private sector development. To this end, we will gradually bring down public sector wage bill to below the fiscal anchor of 53 percent of domestic revenue, including by strengthening controls on overtime and non- permanent staff costs, and curb increases in spending on goods and services. We will accelerate implementation of climate- and development-related investments through more consistent prioritization, better sequencing, and improved cross-governmental coordination.

8. We recognize the importance of good governance, transparency and accountability. We are committed to publishing on the MOF website (i) an audit of COVID-19 related expenditures by the Auditor General and (ii) pandemic-related public procurement contracts and related documents, including owners of awarded companies, within 12 months following the approval of our RCF request by the IMF Board. The implementation of these commitments from the 2021 RCF has been delayed due to capacity constraints, which have been further exacerbated by the HTHH disaster and COVID-19. We have nonetheless published some procurement contracts on our MOF website, which include information on the names of contracting government agencies and awarded legal entities, the amounts of contracts, and the nature of goods and services procured. We remain firmly committed to delivering on these two commitments, including by seeking the IMF's CD support.

9. We note that headline inflation has remained elevated since December 2021, well above the NRBT's reference rate of five percent, largely reflecting the rise in global commodity prices following the war in Ukraine and supply-side disruptions caused by the HTHH disaster and local spreads of COVID-19. The NRBT expects inflation to decline below the reference rate by end-March 2023 and is closely monitoring the ongoing contraction in bank credit since June 2020. In this context, the NRBT plans to maintain the current accommodative monetary policy stance, with the policy rate kept at zero percent and the statutory reserve deposit rate at 10 percent. At the same time, the NRBT stands ready to tighten if inflation is expected stay to above the reference rate for longer, possibly due to the second-round effects of higher commodity prices. We will continue to improve the effectiveness of monetary policy transmission through better liquidity management, communication, and financial market reforms, with CD support from the IMF.

10. We assess our financial sector to be resilient to the impacts of the HTHH disaster and COVID-19 while acknowledging that credit risks have increased. Banks were well-capitalized before these catastrophic events, which should help absorb the expected deterioration in loan quality. We will nonetheless remain vigilant and intensify our monitoring of financial sector vulnerabilities as banks continue to offer loan relief programs to assist borrowers affected by the HTHH disaster and COVID-10 outbreak, and until the full effects of the HTHH disaster and COVID-19 outbreak on banks' balance sheets become clearer. This would ensure that banks are adequately provisioned and capitalized to withstand the adverse economic shocks. To this end, we are strengthening the capacity of the Financial Stability Unit to develop and implement the macroprudential policy framework, including the conduct of more robust risk assessments and stress testing, improving the data collected for developing systemic risk indicators, and preparing a financial stability report. The NRBT continues to develop the regulatory framework for non-bank financial institutions. Consultation on draft legislations for the licensing and supervision of pension funds and insurance are in progress while legislations are being drafted for the licensing and supervision of capital markets, credit information system, and payment systems including digital financial services. Meanwhile, we are in the process of implementing the newly enacted legislation for the licensing and supervision of credit unions.

11. 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, including to address the weaknesses identified by the 2021 Mutual Evaluation Report of the Asia Pacific Group. Our reform efforts will comprise amending the legal framework to establish risk-based supervision and enhance the enforceability of regulations, strengthening regulations and enforcement through increased awareness of AML/CFT risks by reporting entities, provisioning of adequate financial and human resources to the AML/CFT supervisor, and implementing appropriate measures in relation to beneficial ownership and politically exposed persons.

12. In line with the IMF's safeguards policy, we completed a safeguards assessment of the NRBT in December 2021, in collaboration with IMF staff. We commit to address the recommendations from the safeguards assessment, including drafting amendments to the NRBT Act to strengthen the autonomy of the NRBT, filling its Board vacancies, and outsourcing audits of high-risk areas. Since the funds obtained under this RCF will be received by the NRBT as the fiscal agent of the Government and the IMF and used for budget financing, we will also prepare a memorandum of understanding between the MOF and the NRBT on their respective responsibilities for servicing the related financial obligations to the IMF.

13. We reaffirm our willingness to remain engaged with the IMF and to benefit from its policy advice and CD support. 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 or intensify exchange and trade restrictions and other measures or policies that would compound Tonga's 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.

14. We authorize the IMF to publish this letter, along with the staff report and related documents for the 2022 Article IV consultation and the request for disbursement under the RCF.

Sincerely yours,

…………………………………	…………………………………
Hon. Tatafu Moeaki	Dr. Sione Ngongo Kioa
Minister of Finance	Governor, National Reserve Bank of Tonga

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INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY—INFORMATIONAL ANNEX

June 29, 2022

Prepared By

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

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FUND RELATIONS

(As of May 31, 2022)

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	19.81	100.00
Holdings	18.68	94.32

Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
RCF Loans	6.90	50.00

Latest Financial Arrangements:

Outright Loans

Type	Date of Commitment	Date Drawn/Expired	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
RCF	Jan 25, 2021	Jan 27, 2021	6.90	6.90

Projected Payments to the Fund [1]

(SDR million; based on existing use of resources and presenting holdings of SDRs)

	Forthcoming											
	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033
Principal	0.0	0.0	0.0	0.0	0.0	1.4	2.1	2.8	2.8	2.8	1.4	0.7
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	1.4	2.1	2.8	2.8	2.8	1.4	0.7

[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 currency of Tonga is the Tongan pa'anga. 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 percent 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 system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

Safeguards Assessment

A first-time safeguards assessment of the NRBT was completed in December 2021, in connection with Tonga's drawing under the Rapid Credit Facility in January 2021. The assessment found some key elements of the safeguards framework in place, which included a tailored legal framework, external audits by an international firm, transparent financial statements, and basic operational controls. However, the prolonged absence of an internal audit mechanism created a hiatus in the governance framework, the impact of which is exacerbated by weak independent oversight of the system of internal controls. As such, priority recommendations should be advanced by the NRBT, including drafting amendments to the NRBT Act to strengthen the autonomy of the NRBT, filling its Board vacancies, and outsourcing audits of high-risk areas.

Article IV Consultation

Tonga is on a 12–month consultation cycle. The previous Article IV consultation was concluded on January 25, 2021 (Country Report No. 21/26), reflecting discussions that took place during February 10-20, 2020.

Technical Assistance: APD, FAD, ICD, MCM, PFTAC, and STA have provided technical assistance on Climate Change Policy Assessments, Financial Stability, Monetary Policy Framework, Macroeconomic Frameworks, 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. Mr. Neil Saker 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 June 16, 2022)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance, with some shortcomings in national accounts, prices statistics, fiscal, and external 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. A PFTAC technical assistance mission in November 2020 assisted the authorities in 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): The MOF compiles and disseminates annual budgetary central government statistics aligned with the *Government Finance Statistics Manual 2014 (GFSM 2014)*, and a time series from 2013 to 2019 is available. A 2019 PFTAC mission assisted the authorities with the compilation and dissemination of GFS and public sector debt statistics (PSDS). The compilation and dissemination of GFS and PSDS has improved, 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 integrated financial management information system (IFMIS) 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 and expense data are 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 IFMIS data and the annual public accounts is not systematically performed.
Monetary and Financial Statistics: The NRBT reports timely 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. Tonga has reported data on some key series and indicators of the Financial Access Survey until 2018, 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.
Financial Sector Surveillance: Tonga compiles financial soundness indicators for deposit takers and reports them to STA on a quarterly basis.

I. Assessment of Data Adequacy for Surveillance (concluded)	
External Sector Statistics: Source data have shortcomings in accuracy, completeness, timeliness, and classification, reflecting capacity constraints which affect the timely dissemination of quarterly balance of payments statistics. An October 2020 technical assistance mission assisted the authorities in reducing delays in the compilation of balance of payments data and helped improve the data on goods and services, current and capital transfers to the government, direct investment, and international reserves. Net errors and omissions were reduced but remain large. A 2021 mission assisted the authorities in developing international investment position statistics.	
II. Data Standards and Quality	
Tonga participates in the Enhanced General Data Dissemination System (e-GDDS). An e-GDDS mission took place in October 2020 to assist the authorities in publishing key economic data through a National Summary Data Page (NSDP) which is yet to be launched, aiming 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 June 14, 2022)

	Date of Latest Observation	Date Received	Data Frequency[1]	Reporting Frequency[1]	Frequency of Publication[1]
Exchange Rates	3/2022	5/2022	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	3/2022	5/2022	M	M	M
Reserve/Base Money	3/2022	5/2022	M	M	M
Broad Money	3/2022	5/2022	M	M	M
Central Bank Balance Sheet	3/2022	5/2022	M	M	M
Consolidated Balance Sheet of the Banking System	3/2022	5/2022	M	M	M
Interest Rates[3]	3/2022	5/2022	M	M	M
Consumer Price Index	3/2022	5/2022	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government	2020/21	4/2022	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[4,5]—Central Government	2020/21	4/2022	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2020/21	4/2022	A	A	A
External Current Account Balance	Q2/2021	4/2022	Q	Q	Q
Export and Import of Goods and Services	Q2/2021	4/2022	Q	Q	Q
GDP/GNP	2020/21	4/2022	A	A	A
Gross External Debt	2020/21	4/2022	A	A	A
International Investment Position	Q2/2021	4/2022	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.

TONGA

June 29, 2022

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY—DEBT SUSTAINABILITY ANALYSIS

Approved By
Ranil Salgado, Kevin Fletcher (IMF), and Marcello Estevão and Hassan Zaman (IDA)

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 remains high.[1] Before the pandemic, Tonga's indebtedness gradually declined from FY2015[2] to FY2019 owing to much-needed fiscal consolidation efforts. Since 2020, however, the economy has been hit by multiple shocks, including the COVID-19 pandemic, tropical cyclone Harold in April 2020, and the volcanic eruption in January 2022. Against this backdrop, the public debt-to-GDP ratio rose in 2020 and 2021, reflecting increased expenditures related to reconstruction and COVID-19 response. The present value (PV) of the external debt-to-exports ratio is expected to breach the indicative threshold in FY2022-23 mainly due to the decline of exports triggered by the aforementioned external shocks. Moreover, under the baseline scenario, the PV of the external debt-to-GDP ratio is expected to breach the threshold starting in FY2032, reflecting large spending needs for climate resilience and SDGs, declining grant inflows, and rising debt repayments to multilateral development banks and China Exim Bank. The PV of the public debt-to-GDP ratio is expected to breach the benchmark starting from FY2032 under the baseline scenario. A tailored one-time large natural disaster shock would imply a significant deterioration in debt sustainability. Long-term debt sustainability hinges on fiscal adjustment and continued donor grant inflows to finance the necessary fiscal spending for climate resilience and SDGs. To rebuild fiscal buffers and enhance resilience against shocks, stronger revenue mobilization measures and expenditure rationalization, as well as external donor support in line with the historical trend are needed.

[1] The Tonga Composite Indicator (CI) index, calculated on the basis of the October 2021 World Economic Outlook (WEO) and the 2020 Country Policy and Institutional Assessment (CPIA) released in June 2021, is at 3.12, indicating that Tonga's debt-carrying capacity is strong.

[2] All the figures are computed using fiscal year beginning in July, e.g., FY2021 runs from July 1, 2020, to June 30, 2021.

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 2021, 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 due to data limitations, 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] The DSA is conducted on residency basis.

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

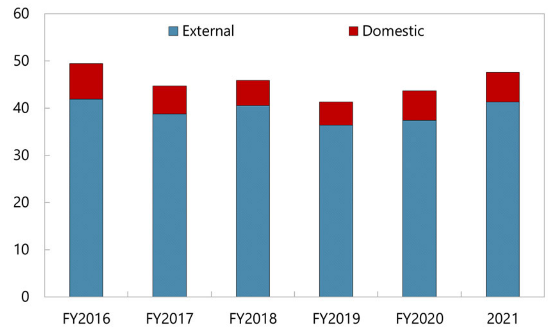
2. After years of decline, public debt level rose modestly since 2020. The public debt-to-GDP ratio declined from 51 percent at end-June 2015 to 41 percent at end-June 2019 (chart) as a result of fiscal consolidation efforts since FY2016. The recent increase reflects new issuance of domestic debt and the concessional loan under the IMF Rapid Credit Facility (RCF). 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. Other than the RCF, Tonga has not contracted any external loans since 2018, although it is still receiving disbursements from prior loan commitments.[4]

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

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

3. Tonga's debt obligations are largely external, and over 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 USD196 million (about 41 percent of GDP) as of end-June 2021, accounting for 87 percent of total public debt. Outstanding debt to all multilateral creditors stood at USD75 million (about 15 percent of GDP), or about 41 percent of the total external debt stock. The single largest creditor remains the Export-Import Bank of China (China Exim Bank), which accounts for 58 percent of total external debt stock (chart).[5] Tonga started repayments to China Exim Bank in FY2019 with larger repayments coming due starting in FY2024. The spike reflects both the previously extended grace period and the DSSI rescheduling. Tonga's request for a temporary suspension of its calendar year 2020 debt service to the China Exim Bank under the G20 Debt Service Suspension Initiative (DSSI) has been accepted and the rescheduled debt repayments are included in the baseline scenario (text table). Reflecting the extension of the DSSI to the end of the calendar year 2021, the baseline scenario also incorporates rescheduled debt service repayments to China Exim Bank coming due during that period. Under the DSSI, debt deferral amounts to 1.4 percent of GDP in FY2021 and 0.7 percent of GDP in FY2022.

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



Sources: Ministry of Finance; and IMF staff estimates.

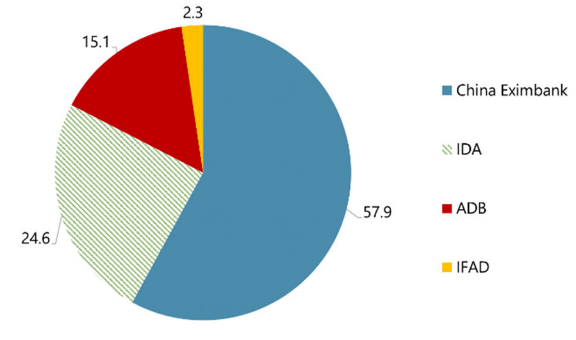
Tonga: Repayment Schedule for Existing External Debt, FY2022–32

	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032
	(In percent of GDP)										
Total external debt	1.1	1.6	3.6	3.4	3.2	3.0	2.8	1.8	1.0	0.4	0.3
Multilateral	0.5	0.5	0.5	0.6	0.6	0.5	0.4	0.4	0.4	0.4	0.3
ADB	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1
IDA/WB	0.1	0.1	0.2	0.2	0.2	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
IMF	0.0	0.0	0.0	0.0	0.2	0.3	0.3	0.3	0.3	0.0	0.0
Bilateral	0.5	1.1	3.1	2.9	2.7	2.5	2.4	1.4	0.6	0.0	0.0
EXIM Bank of China	0.5	1.1	3.1	2.9	2.7	2.5	2.4	1.4	0.6	0.0	0.0

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

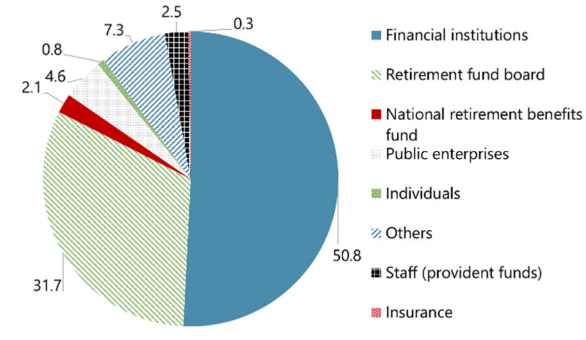
[5] The loans from China Exim Bank are denominated in Chinese renminbi.

Outstanding External PPG Debt by Creditor, June 2021
(in percent of total external PPG debt)



Source: Ministry of Finance.

Outstanding Domestic Debt by Creditor, June 2021
(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 2021, accounting for 13 percent of total public debt. 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 FY2022 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 2022 Article IV consultation and the second request for disbursement under the Rapid Credit Facility.** The baseline projections reflect the authorities' commitments to undertake reforms to enhance growth and achieve Tonga's climate resilience and SDGs under its Strategic Development Framework (SDF) 2015–2025, which comprise: enhancing trade facilitation and access to credit; building more climate-resistant public infrastructure as envisaged in the newly approved National Infrastructure Plan; boosting domestic revenues, including through tax administration reforms and rationalization of tax exemptions; and containing the public sector wage bill within the fiscal target while strengthening social protection and targeted support for the vulnerable.[6] Implementation of the SDF 2015–2025 has been sound.

- **Real GDP growth** is projected at 1.7 percent on average during FY2022–32 (Table), consistent with Tonga's long term GDP growth. Economic activity is expected to contract by 1.9 percent in FY2022 due to the effect of the volcano eruption and the ongoing war in Ukraine which pushed up fuel and food prices. With the planned gradual reopening of borders starting in early FY2023, GDP growth is expected to pick up pace in FY2023–24 in line with the global recovery and major

[6] The socioeconomic impacts from the volcanic eruption and ashfalls and COVID-19 are expected to be disproportionately larger for households relying on agriculture and tourism, likely leading to higher overall poverty given Tonga's dependence on these sectors. Two-thirds of Tonga's households derive income from agriculture, and a third of the total households had at least one member working in tourism-linked sector before the global pandemic. Furthermore, the recent increase in commodity prices has pushed up the cost of living for all households, but the economic impact is expected to be especially acute for the poor and vulnerable.

reconstruction activities. But post the reconstruction phase, GDP growth is expected to trend down to a potential growth rate of 1.8 percent over the medium- to longer-term, reflecting Tonga's remoteness and limited production base.[7] The risks to the projections are mainly on the downside. They stem from a weaker global recovery due to a new variant of the COVID-19 pandemic, faster-than-expected increase in fuel and food prices, extended global supply chain disruptions, delays in the resumption of tourism, and rising forces of deglobalization, that could have an adverse impact on Tonga via reduced remittances and donor funds from development partners. Tonga is also highly vulnerable to natural disasters and the threat of rising sea levels. Given the importance of remittance inflows and aid to Tonga's economy, disruptions in correspondent banking relationships would have knock on effects on the economy, the financial sector, and debt sustainability. On the upside, an earlier-than-anticipated resumption in tourism 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.

- **Natural disaster**: The baseline scenario incorporates the effect of natural disasters and climate change over the longer-term, as well as the recent progress in strengthening contingency planning through the ongoing implementation of the Tonga Disaster Risk Financing Strategy 2021 – 2025. The years FY2023–25 are assumed to be disaster-free to simplify the policy discussion of the near-term outlook. From FY2026 onwards, the baseline incorporates the average long-term effects of natural disasters and climate change by lowering annual GDP 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]

- **Inflation** (measured by GDP deflator in USD terms) is projected to average 3 percent during FY2022–32 (Table). Inflation is expected to peak in FY2022, reflecting both the impacts of the recent increase in global commodity prices induced by the war in Ukraine and disruptions in domestic supply-side conditions (e.g., reduced agriculture production) following the volcanic eruption in January 2022, before trending down to lower levels in the medium term as global commodity prices stabilize in line with the IMF's April 2022 World Economic Outlook forecasts.

- The **non-interest current account deficit** is projected to reach 22.7 percent of GDP in FY2023 due to rising food and fuel prices, imports of reconstruction-related materials, slow recovery of tourism exports, and a decline in remittances from the exceptional levels during FY2021-FY2022. Over the medium- to long- term, the non-interest current account deficit is projected to average over FY2022–32 reflecting persistent weakness in export competitiveness, continued heavy

[7] Under the baseline projection, the spillover impacts from the war in Ukraine are mainly reflected in the form of a temporary increase in inflation pressures in 2022, which are expected to have some dampening effects on private consumption through the real income channel. Indirect spillovers through major trading partners (Australia and New Zealand), notably through the remittance channel, are expected to be small considering their commodity-exporter status.

[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.

import-reliance to support domestic demand, large imports in FY2023 for reconstruction and lower official transfer inflows after current commitments are met (Table).

- **Net FDI inflows** are expected to stand at 0.1 percent of GDP over FY2022–32.

Tonga: Baseline Macroeconomic Projections
(In percent of GDP, unless otherwise stated)

Current DSA	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2011-21 Historical average	FY2022-32 average
Real GDP growth (in percent)	-1.9	3.2	3.0	2.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.3	1.7
GDP deflator in US dollars (change in percent)	8.3	3.7	3.4	2.6	2.0	1.5	1.6	2.2	2.6	2.6	2.6	0.2	3.0
Non-interest current account deficit	5.8	22.7	19.3	8.1	13.8	13.8	16.1	9.9	10.6	9.9	9.6	5.6	12.7
Net FDI (negative = inflow)	1.2	1.2	0.8	1.0	1.0	0.9	0.0	-1.0	-1.0	-1.0	-1.2	1.3	0.1
Primary deficit	1.6	4.2	4.4	8.1	8.8	10.2	11.7	12.5	11.7	11.5	11.9	-2.4	8.8
Grants	30.2	20.5	14.6	12.7	11.1	9.3	7.4	6.5	5.0	4.9	4.1	16.5	11.5
Previous DSA													
Real GDP growth (in percent)	4.0	3.0	2.5	1.8	1.8	1.8	1.8	1.8	1.8				
GDP deflator in US dollars (change in percent)	3.1	1.9	1.9	1.9	2.0	2.1	2.1	2.1	2.1				
Inflation rate (GDP deflator, in percent)	2.1	2.0	1.9	2.3	2.4	2.7	2.6	2.2	1.9				
Non-interest current account deficit	9.1	8.1	11.5	11.3	13.6	13.2	13.2	13.0	13.1				
Net FDI (negative = inflow)	-0.9	-0.8	-0.7	-0.7	0.0	-0.7	-0.7	-1.0	-1.0				
Primary deficit	-0.4	-1.5	7.4	9.3	16.0	16.4	16.7	16.7	16.7				
Grants	18.1	20.1	10.5	8.1	0.8	0.8	0.7	0.7	0.7				

- Except for the IMF's second RCF-supported financing and rescheduled China EXIM Bank repayments under the DSSI, new external borrowing is expected to commence in FY2024 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 FY2028–2032. 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 to meet their existing loan repayments.[9,10] 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 EXIM Bank start coming due beginning in FY2024 (annual payments of about 2.6 percent of GDP in FY2024–29 on average), the authorities would not have enough cash buffers for debt repayments unless they borrow, or drawdown international reserves.

- **Fiscal outlook:** The primary deficit is expected to increase from 1.6 percent of GDP in FY2022 to 4.2 percent in FY2023 and then to 11.9 percent of GDP in FY2032 (Table). The higher deficit in FY2023 reflects the government's larger budget envelope aimed to support reconstruction and recovery despite higher domestic revenues. The deterioration over the long term is mainly due to lower grant inflows after existing commitments are met, and large spending needs to cover

[9] 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).

[10] 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 percent service charge. The discount rate used to calculate the net PV of external debt is the default value set at 5 percent.

infrastructure gaps and meet climate resilience and Sustainability Development Goals (SDGs). At the same time, domestic revenues are expected to improve over time reflecting the authorities' ongoing efforts in revenue administration and tax arrears collection. Public sector wages are also projected to decline gradually to a level below the fiscal target of 53 percent of domestic revenue in FY2025. The fiscal deficit as share of GDP is expected to decline beyond 2032 as capital spending needs moderate after the completion of the authorities' multi-year reconstruction program and accumulation of climate-resilient capital in the next decade.

6. **The realism tools indicate that the primary balance projections are reasonable** (Figure 4). The fiscal forecasts between FY2022 and FY2025 are not overly optimistic as the projected three-year adjustment lies in the left section of the distribution of past adjustments of the primary fiscal deficit (Figure 4). The real growth forecast for FY2022 is within the range calculated by the model, while a strong rebound is expected in FY2023 as the economy emerges from the twin shock in FY2022. 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 2022 DSA is strong**. Tonga's Composite Indicator (CI) index, which has been calculated based on the October 2021 WEO and the 2020 CPIA is 3.12, indicating that the county's debt-carrying capacity is strong according to the revised low-income country (LIC)-DSA framework.

8. **Given the severity and frequency of natural disasters in Tonga, a tailored one-time stress test for natural disaster shocks was conducted.**[11] As a small developing state prone to natural disasters, Tonga is automatically subject to the standard natural disaster shock in the DSA. 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. Since only part of the economic damage is expected to be financed by external debt, the DSA assumes a one-off shock of 14 percentage points (ppts) to the debt to-GDP ratio in FY2023. Real GDP growth and exports are lowered by 3 and 7 ppts, respectively, in the year of the shock (Lee et al., 2018).

[11] 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).

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

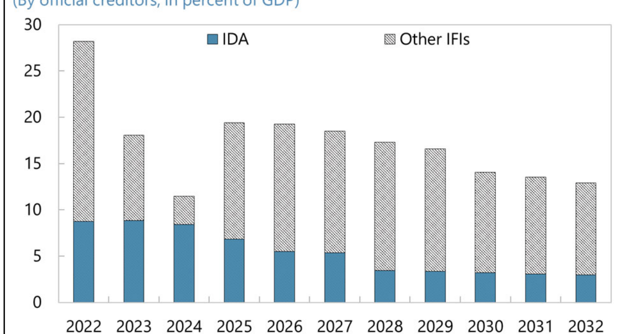
APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	240
GDP	55
Debt service in % of	
Exports	21
Revenue	23

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

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

9. **Under the baseline scenario, PV of external debt-to-GDP ratio will breach its threshold from FY2032** (Figure 1 and Table 3). In the near term, the external debt-to-GDP ratio is expected to decline from 41 percent in FY2021 to 32 percent in FY2024, reflecting large repayments to China Exim Bank and a shift to domestic debt financing and the second RCF. From FY2025 onwards, Tonga will need to incur new external debt to help finance its large investment needs to achieve SDGs and climate resilience. As a result, external debt-to-GDP ratio will breach the authorities' fiscal anchor of 50 percent in FY2027. The PV of the external debt-to-GDP ratio is expected to breach the threshold of 55 percent starting from FY2032. Under a combination of diverse shocks, which is the most extreme scenario, the PV of external debt-to-GDP ratio would breach the threshold earlier in FY2028.

Projected External Net Financing Flows
(By official creditors, in percent of GDP)



Sources: IMF Staff Projections
Note: net financing flows are calculated as grants plus new debt disbursement minus repayment

10. **Due to Tonga's narrow export base and temporarily depressed export levels due to the COVID-19 outbreak and volcanic eruption, the debt service-to-exports ratio will breach the threshold in the near and medium term, and PV of the external debt-to-exports ratio will breach its threshold in the next two years and again after FY2029.** Debt service-to-revenue ratio is also expected to increase sharply in FY2024 to 16 percent as the larger debt payments to China Exim Bank start coming

due in FY2024. As Figure 3 shows, the main driver of external debt dynamics is worsening current account balances reflecting the large import content of public infrastructure projects, unless there are new commitments for official transfers.[12] Under an export shock, the PV of the external debt-to-exports ratio will remain breached in all future years.

11. The tailored natural disaster shock would significantly worsen the external debt path (Table 3)**.** The PV of external debt-to-GDP ratio would jump up in FY2023 when the one-off shock is assumed, breach the threshold two years earlier in FY2030. Given recent experience, there is a significant 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 breach 70 percent from FY2032 onwards (Figure 2). The public debt dynamic is driven by large primary fiscal deficit, as shown in Figure 3. Compared to the previous DSA, nominal public debt-to-GDP ratio is higher in FY2023 due to reconstruction activity, while the ratio improved after FY2024 with more grants assumed in the baseline in line with historical trends.

13. The standardized sensitivity analysis indicates an earlier breach of debt threshold (Figure 2, Table 4).[13] The PV of the public debt-to-GDP ratio would cross 70 percent of GDP in FY2028 under a multi-year GDP growth shock and breach the threshold in FY2029 under a capital inflow shock.

14. The tailored one-time natural disaster shock worsens public debt sustainability. The PV of public debt relative to both GDP and exports is expected be higher compared to the baseline scenario. In particular, the PV of the public debt-to-GDP ratio would cross 70 percent of GDP in FY2029.

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 percentage points from the baseline.

[12] 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).

[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

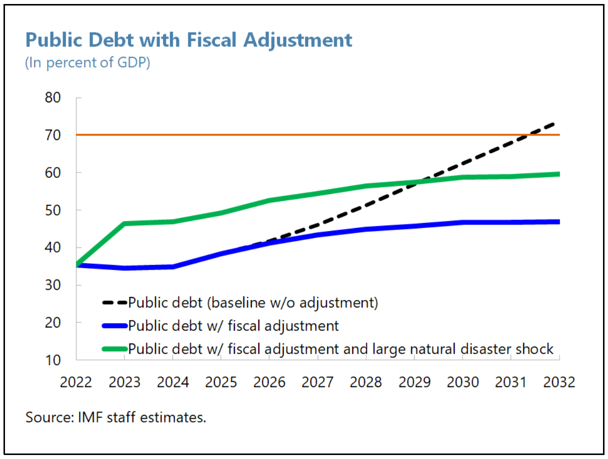
16. The 2022 debt sustainability analysis under the new LIC debt sustainability framework suggests that Tonga's risk of external debt distress remains high. Under the baseline scenario, the indicative threshold for the PV of the external debt-to-GDP ratio is expected to be breached starting from FY2032. Due to Tonga's narrow export base, the PV of the external debt-to-exports ratio will breach its threshold in the next two years and again after FY2029. The external debt service-to-export ratio is expected to breach the threshold from FY2022 to FY2028.

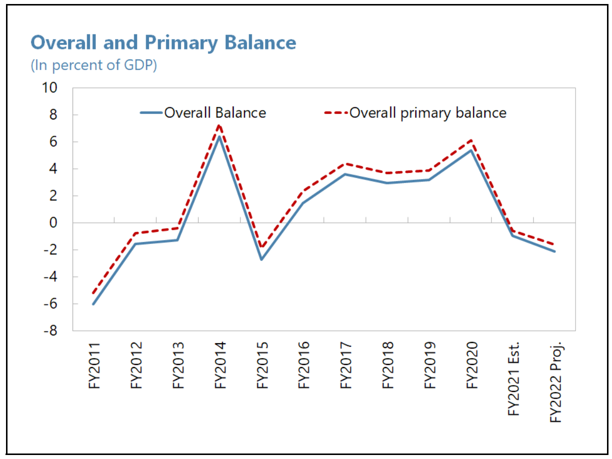
17. The DSA suggests that the overall risk of debt distress is also high. The PV of the public debt-to-GDP ratio is projected to breach the indicative benchmark from FY2032 onwards, reflecting large investment needs, and declining capital grant commitments over the medium-to-long term.[14] In addition, Tonga is highly vulnerable to natural disaster, growth, and exports shocks.

18. The government can mitigate the adverse socioeconomic impacts of recent shocks by adopting an expansionary fiscal stance in FY2023, with focus on reconstruction and social protection. A set of well-targeted financial assistance measures, including cash transfers and concessional loans, will be essential to protect the vulnerable households and businesses, especially in sectors hit hard by border closures, the volcanic eruption, COVID-related mobility restrictions, and the high inflation driven by global commodity prices and disruptions in domestic supply conditions following the volcanic eruption. Furthermore, accelerating reconstruction of damaged infrastructure, together with efforts to improve the build quality and relocate away from high-risk areas, will be important to strengthen Tonga's climate resilience. The government's FY2023 budget is consistent with these priorities.

19. Beyond the short term, staff assess that Tonga's public debt could be put on a sustainable path with feasible domestic fiscal measures and additional external donor support. Under an illustrative fiscal adjustment scenario, the PV of public debt-to-GDP ratio could stabilize below the 70 percent threshold over the long term, even with a large natural disaster shock. The fiscal adjustments could take place post-reconstruction and include a gradual increase of tax revenues and reduction of current expenditure to levels similar to other PICs. New grant commitments consistent with the historical trends are also essential under this fiscal path to fund capital investment projects for SDGs and climate resilience. The government's strategy to further improve revenue administration, collect tax arrears, contain public wage bill within the fiscal target, and pursue additional grants from development partners and avoid any new non-concessional borrowing from external creditors is aligned with this fiscal adjustment path and feasible considering Tonga's strong policy track record in the run up to the global pandemic.

[14] Cash and in-kind grants averaged 16.7 percent of GDP annually over FY2015–2019. Under the baseline, staff assume continued budget support in line with historical levels and capital grants falling to zero from FY2028 onwards.





Illustrative Fiscal Adjustment Path Relative to Baseline
(In percent of GDP)

	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030
Domestic fiscal measures	0.8	1.6	2.4	3.2	4.0	4.5
Taxes	0.5	1.0	1.5	2.0	2.5	3.0
Goods and services / Wage bill	-0.3	-0.6	-0.9	-1.2	-1.5	-1.5
Additional Grants		1.9	3.1	4.2	5.0	5.0
Change in primary balance	0.8	3.5	5.5	7.4	9.0	9.5
Memo.						
Projected primary balance	-7.3	-5.3	-4.7	-4.3	-3.5	-2.2

Note: In the baseline scenario, grants would gradually decline to below 10 percent of GDP after FY2026. The adjustment path assumes additional grants as shown above. Grants averaged 18 percent of GDP between FY2016-FY2021.

AUTHORITIES' VIEWS

20. **The authorities agreed with the debt sustainability assessment and stressed the need for continued donor support in the medium-to-long term.** They recognized the need to build adequate fiscal buffers over the medium term after the recovery is firmly underway. In this regard, they reiterated the commitment to rationalize tax exemptions, improve the targeting of economic support, further enhance revenue administration, and implement spending controls in line with recommendations from IMF and World Bank technical assistance. The authorities will continue to seek new concessional and grant financing commitments from bilateral donors and international financial institutions to contain external debt levels and to refrain from non-concessional borrowing (consistent with Tonga's compliance with a non-concessional external borrowing ceiling as part of the World Bank's Sustainable Development Finance Policy, SDFP). These priorities are reflected in the government's medium-term debt strategy, which is being used to guide fiscal policy and debt management decisions. Revised public financial management (PFM) legislation, currently under preparation, is also expected to improve debt management. Both the debt strategy and PFM legislation are supported by the World Bank's SDFP.

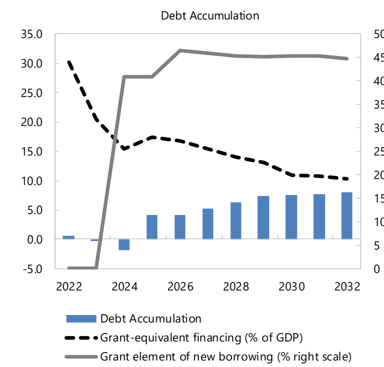
Table 1. Tonga: External Debt Sustainability Framework, Baseline Scenario, FY2019–2042

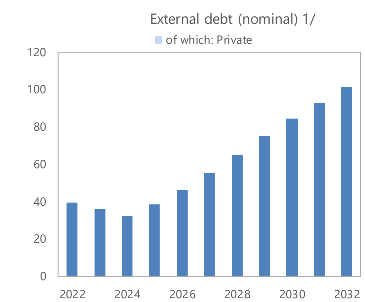
(In percent of GDP, unless otherwise indicated)

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
External debt (nominal) 1/	36.4	37.4	41.2	39.3	35.8	32.0	38.5	46.2	55.2	101.2	133.6	**41.5**	**60.5**
of which: public and publicly guaranteed (PPG)	36.4	37.4	41.2	39.3	35.8	32.0	38.5	46.2	55.2	101.2	133.6	**41.5**	**60.5**
Change in external debt	-4.2	1.0	3.9	-2.0	-3.5	-3.8	6.6	7.7	9.0	8.6	3.8		
Identified net debt-creating flows	-1.5	6.3	0.1	8.1	23.2	19.6	8.6	14.6	14.4	7.8	-16.0	**7.0**	**12.5**
Non-interest current account deficit	0.0	3.4	-3.1	5.8	22.7	19.3	8.1	13.8	13.8	9.6	-13.9	**5.6**	**12.7**
Deficit in balance of goods and services	42.0	43.7	59.1	74.4	75.0	67.0	56.5	55.2	53.7	49.0	27.1	**44.1**	**58.0**
Exports	22.0	19.1	4.7	1.6	4.1	11.6	12.5	13.7	15.1	17.7	40.3		
Imports	64.0	62.8	63.8	76.1	79.0	78.6	68.9	68.9	68.9	66.7	67.4		
Net current transfers (negative = inflow)	-33.4	-31.2	-48.9	-58.3	-42.1	-38.4	-39.9	-33.0	-31.6	-31.6	-33.4	**-33.0**	**-36.7**
of which: official	-8.8	-4.1	-7.0	-22.0	-14.4	-10.6	-12.2	-5.2	-4.2	-4.1	-4.0		
Other current account flows (negative = net inflow)	-8.6	-9.1	-13.3	-10.3	-10.2	-9.3	-8.5	-8.4	-8.4	-7.8	-7.6		
Net FDI (negative = inflow)	0.1	0.7	1.5	1.2	1.2	0.8	1.0	1.0	0.9	-1.3	-1.2	**1.3**	**0.1**
Endogenous debt dynamics 2/	-1.5	2.1	1.7	1.1	-0.7	-0.6	-0.4	-0.2	-0.3	-0.5	-0.8		
Contribution from nominal interest rate	0.9	0.5	0.2	0.4	0.5	0.4	0.4	0.5	0.5	1.0	1.4		
Contribution from real GDP growth	-0.3	-0.2	1.0	0.8	-1.2	-1.0	-0.8	-0.7	-0.8	-1.6	-2.2		
Contribution from price and exchange rate changes	-2.2	1.7	0.5	...	...	...	...	...	...	...	...		
Residual 3/	-2.6	-5.3	3.8	-10.1	-26.7	-23.4	-2.1	-6.9	-5.4	0.8	19.8	**-7.3**	**-7.0**
of which: exceptional financing	0.0	0.0	-1.4	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	27.8	26.7	24.7	21.4	24.3	27.5	31.6	58.6	79.5		
PV of PPG external debt-to-exports ratio	...	...	590.4	1624.7	605.4	184.3	195.2	200.2	209.1	331.4	197.3		
PPG debt service-to-exports ratio	9.1	7.9	15.6	86.6	50.9	35.0	30.5	27.0	23.6	13.8	14.5		
PPG debt service-to-revenue ratio	8.6	6.0	2.8	6.7	8.2	16.1	15.2	14.8	14.2	9.1	21.6		
Gross external financing need (Million of U.S. dollars)	10.4	27.8	-4.2	42.0	138.9	138.0	76.9	114.8	117.2	84.3	-104.9		
Key macroeconomic assumptions													
Real GDP growth (in percent)	0.7	0.5	-2.7	-1.9	3.2	3.0	2.5	1.8	1.8	1.8	1.8	**1.3**	**1.7**
GDP deflator in US dollar terms (change in percent)	5.6	-4.6	-1.4	8.3	3.7	3.4	2.6	2.0	1.5	2.6	0.9	**0.2**	**3.0**
Effective interest rate (percent) 4/	2.3	1.4	0.4	0.9	1.3	1.3	1.2	1.2	1.2	1.2	1.1	**1.5**	**1.2**
Growth of exports of G&S (US dollar terms, in percent)	9.2	-16.6	-76.4	-62.9	165.7	203.6	12.9	14.2	13.9	9.0	5.9	**-2.8**	**35.0**
Growth of imports of G&S (US dollar terms, in percent)	3.2	-5.9	-2.5	26.7	11.2	5.9	-7.8	3.8	3.3	4.5	1.4	**1.7**	**5.5**
Grant element of new public sector borrowing (in percent)	...	...	20.1	...	...	41.0	41.0	46.5	45.9	44.8	44.2	**...**	**44.5**
Government revenues (excluding grants, in percent of GDP)	23.4	25.1	25.9	21.2	25.3	25.3	25.0	25.0	25.1	27.0	27.0	**22.7**	**25.3**
Aid flows (in Million of US dollars) 5/	516.6	512.0	517.6	551.2	490.4	421.9	396.5	357.1	307.0	189.5	158.9	**...**	
Grant-equivalent financing (in percent of GDP) 6/	18.3	19.1	22.4	30.2	20.5	15.4	17.4	16.8	15.4	10.3	9.1	**...**	**15.9**
Grant-equivalent financing (in percent of external financing) 6/	100.0	100.0	100.0	98.0	92.1	93.0	72.0	72.0	68.0	57.5	58.6	**...**	**72.6**
Nominal GDP (Million of US dollars)	511	490	470	500	535	570	599	622	643	786	1,125		
Nominal dollar GDP growth	6.4	-4.1	-4.0	6.2	7.1	6.5	5.2	3.8	3.3	4.4	2.6	**1.5**	**4.8**
Memorandum items:													
PV of external debt 7/	...	...	27.8	26.7	24.7	21.4	24.3	27.5	31.6	58.6	79.5		
In percent of exports	...	...	590.4	1624.7	605.4	184.3	195.2	200.2	209.1	331.4	197.3		
Total external debt service-to-exports ratio	9.1	7.9	15.6	86.6	50.9	35.0	30.5	27.0	23.6	13.8	14.5		
PV of PPG external debt (in Million of US dollars)			130.7	133.3	131.9	122.0	145.9	170.8	203.1	460.6	894.8		
(PVt-PVt-1)/GDPt-1 (in percent)				0.5	-0.3	-1.9	4.2	4.2	5.2	8.1	4.5		
Non-interest current account deficit that stabilizes debt ratio	4.1	2.4	-7.0	7.7	26.1	23.2	1.5	6.1	4.7	1.0	-17.7		

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

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.

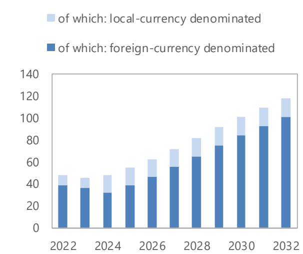
Table 2. Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, FY2019–2042

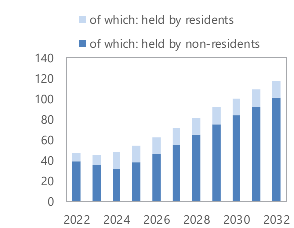
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 6/	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
Public sector debt 1/	41.3	43.6	47.5	47.6	45.5	47.9	54.5	62.2	71.4	117.9	143.9	**47.5**	**75.5**
of which: external debt	36.4	37.4	41.2	39.3	35.8	32.0	38.5	46.2	55.2	101.2	133.6	**41.5**	**60.5**
Change in public sector debt	-4.6	2.3	3.9	0.1	-2.1	2.4	6.6	7.7	9.2	8.6	2.8		
Identified debt-creating flows	-6.4	-3.5	2.3	1.9	2.5	3.0	6.9	7.8	9.1	9.8	2.0	**-2.0**	**7.4**
Primary deficit	-3.9	-6.1	0.6	1.6	4.2	4.4	8.1	8.8	10.2	11.9	4.9	**-2.4**	**8.8**
Revenue and grants	41.7	44.2	48.3	51.5	45.8	39.9	37.7	36.1	34.3	31.1	31.0	**39.2**	**36.7**
of which: grants	18.3	19.1	22.4	30.2	20.5	14.6	12.7	11.1	9.3	4.1	4.0		
Primary (noninterest) expenditure	37.9	38.1	48.9	53.1	50.0	44.3	45.8	44.9	44.6	43.0	35.9	**36.8**	**45.5**
Automatic debt dynamics	-2.5	2.6	1.7	0.4	-1.7	-1.4	-1.2	-1.0	-1.1	-2.2	-2.9		
Contribution from interest rate/growth differential	-0.3	0.1	1.1	0.4	-1.7	-1.4	-1.2	-1.0	-1.1	-2.2	-2.9		
of which: contribution from average real interest rate	0.0	0.3	-0.1	-0.6	-0.2	-0.1	0.0	0.0	0.0	-0.3	-0.5		
of which: contribution from real GDP growth	-0.3	-0.2	1.2	0.9	-1.5	-1.3	-1.2	-0.9	-1.1	-1.9	-2.4		
Contribution from real exchange rate depreciation	-2.2	2.5	0.6	...	...	...	...	...	...	...	...		
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**
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		
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		
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		
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		
Residual	1.8	5.8	1.6	-1.9	-4.5	-0.6	-0.3	-0.1	0.1	-1.1	0.8	**1.6**	**-1.0**
Sustainability indicators													
PV of public debt-to-GDP ratio 2/	...	...	33.8	35.2	34.4	37.4	40.4	43.6	48.0	75.5	90.5		
PV of public debt-to-revenue and grants ratio	...	...	70.0	68.5	75.0	93.7	107.2	120.8	139.8	242.9	291.6		
Debt service-to-revenue and grants ratio 3/	8.7	8.1	5.4	5.8	8.9	13.6	24.5	23.6	31.0	25.7	34.1		
Gross financing need 4/	-0.2	-2.6	3.2	4.6	8.2	9.9	17.3	17.3	20.9	19.9	15.5		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	0.7	0.5	-2.7	-1.9	3.2	3.0	2.5	1.8	1.8	1.8	1.8	**1.3**	**1.7**
Average nominal interest rate on external debt (in percent)	2.3	1.4	0.4	0.9	1.4	1.3	1.2	1.2	1.2	1.2	1.1	**1.5**	**1.2**
Average real interest rate on domestic debt (in percent)	-4.3	7.9	5.6	-5.1	-1.6	-0.1	0.5	0.7	0.9	0.4	1.0	**-0.1**	**-0.1**
Real exchange rate depreciation (in percent, + indicates depreciation)	-5.5	6.8	1.6	...	...	...	...	...	...	...	...	**2.3**	**...**
Inflation rate (GDP deflator, in percent)	7.7	-4.2	-1.9	8.4	4.7	3.4	2.8	2.7	2.5	3.0	2.4	**2.2**	**3.5**
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.0	1.1	25.0	6.4	-2.8	-8.7	5.9	-0.2	1.0	1.1	1.7	**6.3**	**0.6**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	0.7	-8.4	-3.4	1.5	6.2	2.0	1.5	1.1	1.0	3.3	2.1	**-3.7**	**2.4**
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		

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, FY2022–2032

(In percent)

		Projections 1/									
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
PV of debt-to GDP ratio											
Baseline	27	25	21	24	27	32	37	42	48	53	**59**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	27	17	8	11	10	10	11	16	20	25	31
B. Bound Tests											
B1. Real GDP growth	27	26	24	28	31	36	42	48	55	**61**	**67**
B2. Primary balance	27	26	23	26	30	34	40	45	51	**56**	**62**
B3. Exports	27	26	29	32	35	39	44	50	**55**	**60**	**66**
B4. Other flows 3/	27	33	37	39	42	47	52	**57**	**63**	**68**	**73**
B5. Depreciation	27	31	17	21	25	30	36	43	50	**57**	**64**
B6. Combination of B1-B5	27	37	37	40	44	48	54	**61**	**67**	**73**	**79**
C. Tailored Tests											
C1. Combined contingent liabilities	27	27	23	27	30	35	40	46	51	**56**	**62**
C2. Natural disaster	27	30	26	31	35	40	46	52	**58**	**64**	**70**
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	**1625**	**605**	184	195	200	209	238	**267**	**292**	**314**	**331**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**1625**	**427**	71	84	71	65	69	98	124	150	176
B. Bound Tests											
B1. Real GDP growth	**1625**	**605**	184	195	200	209	238	**267**	**292**	**314**	**331**
B2. Primary balance	**1625**	**627**	200	212	218	227	**256**	**285**	**310**	**331**	**348**
B3. Exports	**1625**	**2627**	**4671**	**4783**	**4778**	**4861**	**5391**	**5910**	**6368**	**6747**	**7046**
B4. Other flows 3/	**1625**	**816**	**315**	**315**	**309**	**308**	**335**	**361**	**383**	**401**	**415**
B5. Depreciation	**1625**	**605**	117	133	144	158	188	218	**245**	**269**	**289**
B6. Combination of B1-B5	**1625**	**2728**	**278**	**3443**	**3406**	**3429**	**3765**	**4090**	**4375**	**4608**	**4788**
C. Tailored Tests											
C1. Combined contingent liabilities	**1625**	**654**	201	217	220	229	**258**	**286**	**311**	**333**	**349**
C2. Natural disaster	**1625**	**724**	226	**249**	**252**	**264**	**295**	**326**	**353**	**376**	**394**
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	**87**	**51**	**35**	**31**	**27**	**24**	**22**	17	13	12	14
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**87**	**54**	**37**	**31**	**28**	**24**	**22**	16	10	10	12
B. Bound Tests											
B1. Real GDP growth	**87**	**51**	**35**	**31**	**27**	**24**	**22**	17	13	12	14
B2. Primary balance	**87**	**51**	**35**	**31**	**27**	**24**	**23**	18	13	13	14
B3. Exports	**87**	**208**	**674**	**611**	**540**	**472**	**446**	**355**	**267**	**251**	**281**
B4. Other flows 3/	**87**	**51**	**37**	**34**	**30**	**26**	**25**	20	15	14	16
B5. Depreciation	**87**	**51**	**35**	**29**	**25**	**22**	21	16	12	11	13
B6. Combination of B1-B5	**87**	**167**	**456**	**403**	**356**	**312**	**295**	**235**	**178**	**168**	**187**
C. Tailored Tests											
C1. Combined contingent liabilities	**87**	**51**	**35**	**31**	**28**	**24**	**23**	18	13	13	14
C2. Natural disaster	**87**	**52**	**37**	**32**	**29**	**25**	**24**	19	15	14	15
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	7	8	16	15	15	14	14	11	8	8	9
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	7	9	17	16	15	14	13	10	6	6	8
B. Bound Tests											
B1. Real GDP growth	7	9	18	17	17	16	16	13	9	9	10
B2. Primary balance	7	8	16	15	15	14	14	11	8	8	9
B3. Exports	7	8	16	16	16	15	14	12	9	8	10
B4. Other flows 3/	7	8	17	17	16	16	15	13	9	9	10
B5. Depreciation	7	10	20	18	17	17	16	13	9	9	11
B6. Combination of B1-B5	7	9	20	19	18	18	17	14	10	10	11
C. Tailored Tests											
C1. Combined contingent liabilities	7	8	16	15	15	15	14	11	8	8	9
C2. Natural disaster	7	8	17	16	15	15	14	12	9	8	10
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/	49	49	49	49	49	49	49	49	49	49	**49**

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, FY2022–2032
(In percent)

	Projections 1/										
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**	**2032**
	PV of Debt-to-GDP Ratio										
Baseline	35.2	34.4	37.4	40.4	43.6	48.0	53.4	59.1	64.5	69.9	**75.5**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	35	31	30	30	26	21	23	24	23	22	21
B. Bound Tests											
B1. Real GDP growth	35	38	47	52	58	65	**73**	**81**	**90**	**98**	**106**
B2. Primary balance	35	37	42	45	47	52	57	62	68	**73**	**79**
B3. Exports	35	36	44	47	51	55	60	66	**71**	**77**	**82**
B4. Other flows 3/	35	43	53	55	59	63	68	**74**	**79**	**85**	**90**
B5. Depreciation	35	41	42	41	40	41	42	45	47	50	53
B6. Combination of B1-B5	35	36	40	42	45	49	55	61	67	**72**	**78**
C. Tailored Tests											
C1. Combined contingent liabilities	35	39	42	44	48	52	57	63	68	**73**	**79**
C2. Natural disaster	35	46	49	51	55	59	65	**71**	**77**	**83**	**89**
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	68	75	94	107	121	140	164	188	202	220	243
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	68	66	73	77	69	59	68	75	71	68	66
B. Bound Tests											
B1. Real GDP growth	68	81	111	132	154	182	217	251	275	300	334
B2. Primary balance	68	80	105	118	131	150	174	198	212	230	253
B3. Exports	68	78	112	126	140	160	185	210	224	242	265
B4. Other flows 3/	68	94	132	147	162	184	210	235	249	266	290
B5. Depreciation	68	93	107	111	115	122	132	144	150	159	172
B6. Combination of B1-B5	68	78	98	110	124	143	168	193	208	226	250
C. Tailored Tests											
C1. Combined contingent liabilities	68	86	106	118	132	150	175	199	213	230	254
C2. Natural disaster	68	99	123	135	151	171	198	224	240	259	285
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	6	9	14	24	24	31	29	25	28	26	26
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	6	9	14	18	16	32	10	6	28	25	24
B. Bound Tests											
B1. Real GDP growth	6	9	15	29	30	40	39	36	40	38	39
B2. Primary balance	6	9	14	28	28	33	31	27	29	27	26
B3. Exports	6	9	14	25	24	32	29	26	29	27	26
B4. Other flows 3/	6	9	14	26	25	32	30	27	29	27	27
B5. Depreciation	6	9	17	27	26	33	31	27	28	27	27
B6. Combination of B1-B5	6	9	14	25	24	32	29	26	29	27	27
C. Tailored Tests											
C1. Combined contingent liabilities	6	9	14	32	24	35	29	27	29	27	26
C2. Natural disaster	6	9	15	41	26	41	32	32	32	31	29
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.

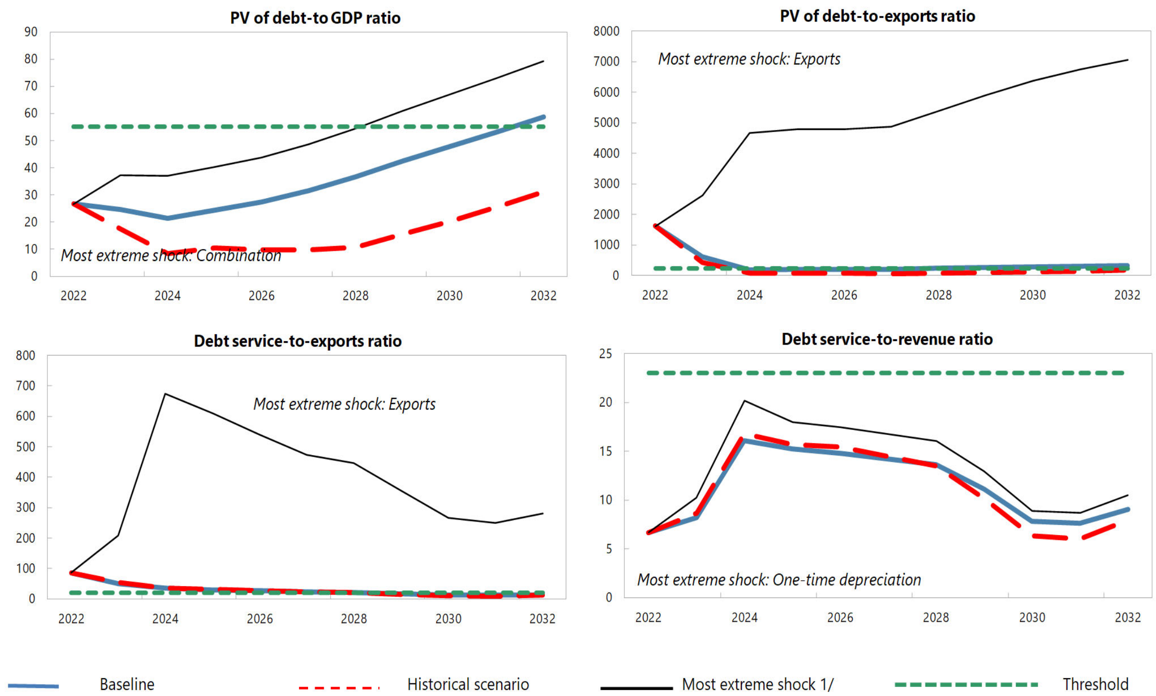
Sources: Country authorities; and staff estimates and projections.

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, FY2022–2032



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	1.5%	1.5%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	34	34
Avg. grace period	16	16

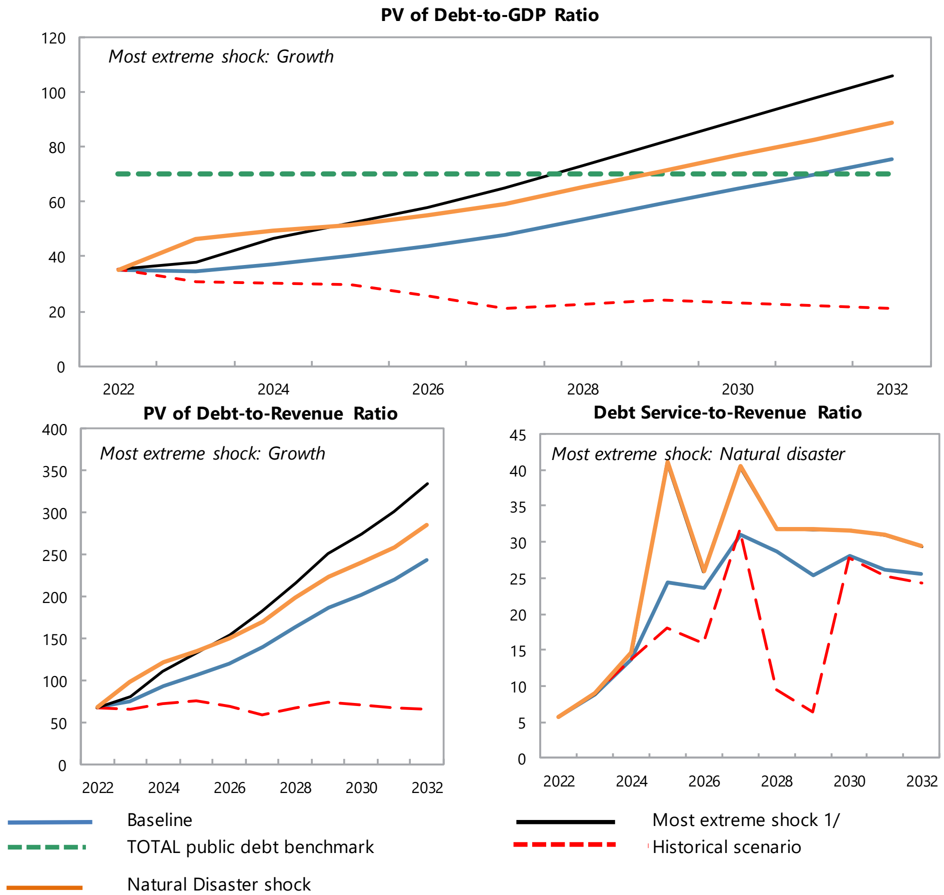
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

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 2032. 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, FY2022–2032



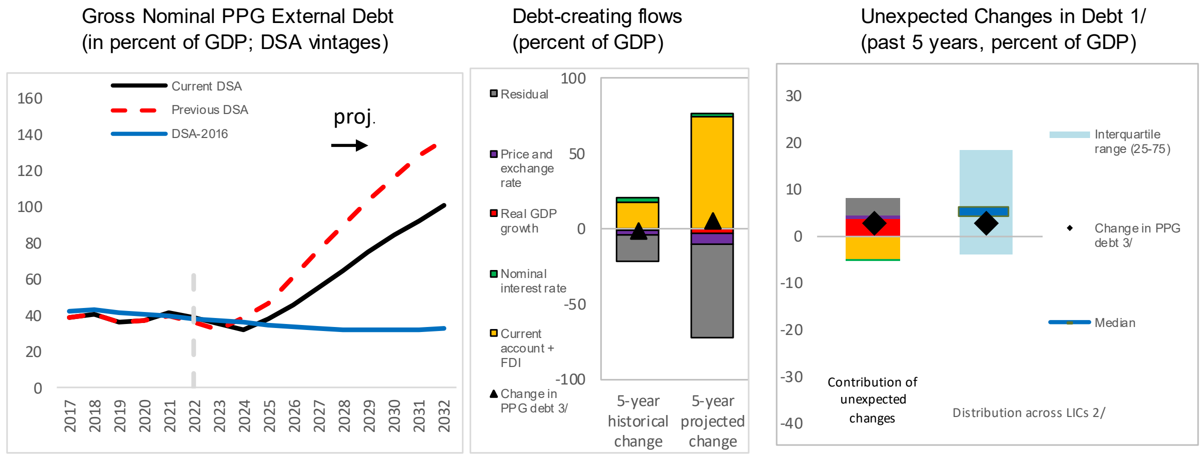
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	56%	56%
Domestic medium and long-term	44%	44%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.5%	1.5%
Avg. maturity (incl. grace period)	34	34
Avg. grace period	16	16
Domestic MLT debt		
Avg. real interest rate on new borrowing	-0.1%	-0.1%
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.

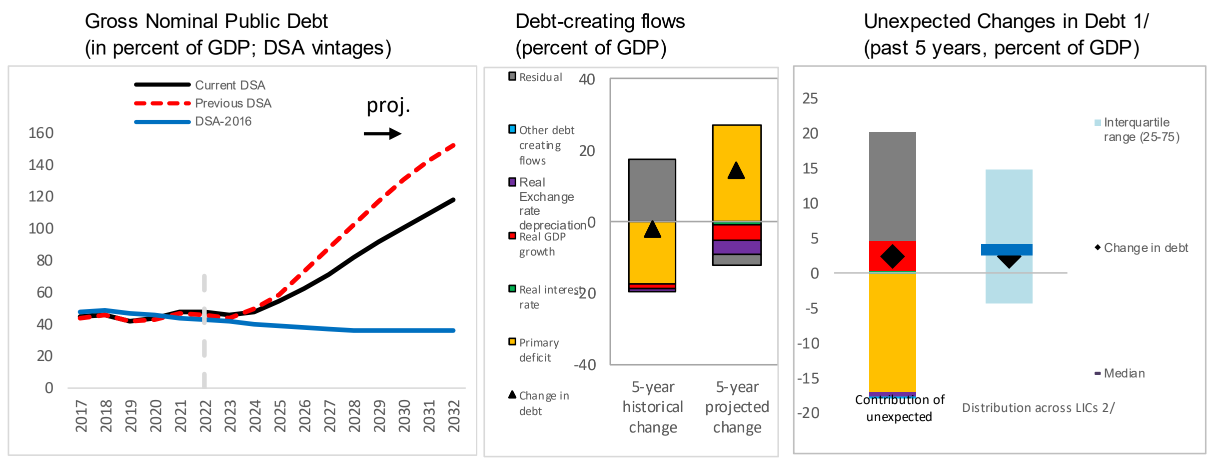
Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2032. 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



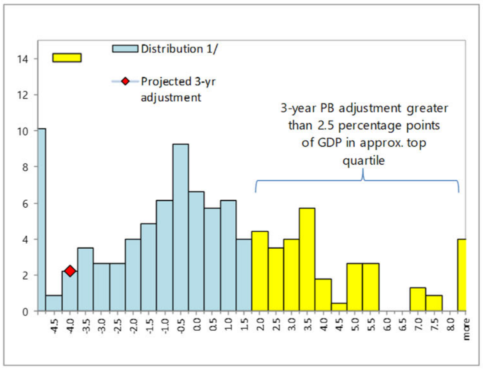
1/ Difference between anticipated and actual contributions on debt ratios.

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.

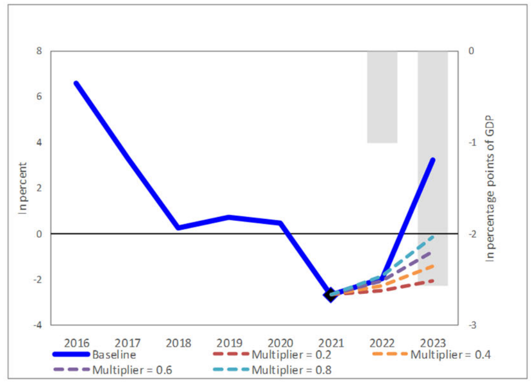
Figure 4. Tonga: Realism Tools

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. Lim, Mr. Mochtar, and Mr. Nghiem on Tonga Executive Board Meeting
Senior Advisor to Executive Director
July 15, 2022

On behalf of the Tongan authorities, we would like to thank the IMF mission team led by Mr. Minsuk Kim for the candid and constructive policy dialogues during the 2022 Article IV consultation. Our authorities broadly concur with staff's assessment and policy recommendations and appreciate and greatly value staff's continuous engagement and policy advice.

Recent Macroeconomic Developments and Request for RCF-2

1. Tonga has been hard hit by a double blow from the Hunga Tonga Hunga Ha'apai (HTHH) volcanic eruption and the first local outbreak of COVID-19 in early 2022, disrupting a nascent economy recovery in the second half of FY2021 (July 2020–June 2021). Consequently, the economy is projected to contract by 2.5 percent in FY2022. Inflation is elevated over the year to 9.4 percent as of April 2022, above the 5 percent target by the National Reserve Bank of Tonga (NRBT). Risks are tilted to the downside, reflecting the adverse impacts of ongoing geopolitical tensions, and rising international commodity and energy prices globally, as well as supply-side disruptions caused by the volcanic eruption on domestic prices.

2. Against this backdrop, the Tongan authorities have requested emergency financing of SDR 6.9 million (50 percent of quota) under the exogenous shock window of the IMF's Rapid Credit Facility (RCF) to meet BOP needs and help with rebuilding efforts. Tonga's current account deficit is estimated to increase to about 6 percent of GDP in FY2022 and 22.5 percent in FY2023. The authorities expect that the Fund's financing program coupled with financing support from multilateral and bilateral development partners, as well as foreign exchange reserves will help address the country's urgent BOP issue (estimated at about US$121 million). In this regard, the development partners have pledged additional budget support in grants worth about 7 percent of GDP for FY2022 and 4 percent for FY2023 to cover emergency spending, including on health care, social protection, and reconstruction.

Policy Priorities and Outlook

3. Near-term policy priorities will be on assisting the vulnerable and poor, supporting reconstruction, ensuring macroeconomic stability, and containing inflationary pressures. Our authorities underscore the importance of effective implementation of support measures to entrench the economic recovery and promote sustainable and inclusive growth in the long term.

4. A swift vaccination campaign[1] allowed the authorities to envisage a plan to open the border fully in October 2022. The authorities have issued the HTHH Recovery Plan, which outlines

[1] Nearly 100 percent of population aged 18 and above received one vaccine shot, 91 percent two doses, and56 percent with boosters as of end April 2022.

the targeted areas of support for long-term recovery and resilience of the Tongan economy, and restoration and stabilization of Government services including telecommunications.

5. The authorities have also continued the accommodative fiscal and monetary policy mix to support firms and households to quickly restore production and businesses. The authorities forecast the economy to grow moderately at 3.2 percent in FY2023, mainly owing to the recovery in the construction and tourism sectors. Inflation is expected to remain elevated in the near term before easing to below the 5 percent reference rate in FY2023 supported by the rebound in domestic crop production and easing of global supply disruptions.

6. The authorities would remain vigilant to challenges that have been surfacing, including geopolitical tensions, higher global food and energy prices and the possibility of subsequent natural disasters, which could adversely affect domestic production and consumption. Upside risks include the FX reserves remaining at record high levels due to recent large inflows of grants, relief funds and remittances. Official foreign reserves increased substantially by US$86.7 million yoy to US$375 million as at end June, 2022, which is equivalent to 12.6 months of import cover. The reserves will help provide financing buffers to tackle possible natural disasters and external shocks.

Fiscal Policy

7. Fiscal policy remains accommodative to entrench economic recovery in the near term. The authorities, in partnership with development partners, will continue to support recovery initiatives and build a more resilient economy through measures including providing relief assistance for businesses and employees, tax exemptions, and electricity price subsidy, among others. In this regard, the authorities have deferred and exempted some of the tax and non-tax revenue in FY2021/2022 in order to assist the affected citizens during the recovery stage. Exemptions include duty on goods imported by citizens in the affected areas until June 2022, and payment of school fees (Term 1) for all students in Tongatapu, Ha’apai and ‘Eua.

8. The authorities aim to sustain macroeconomic stability through continuous monitoring of fiscal performance. Budget deficit is expected to narrow in FY2022 due to the significant drop in the estimated revenue by US$17.1 million (7 percent), greater than the fall in total expenditure by US$13.5 million (6.2 percent), along with the delays in ongoing project implementation caused by the COVID-19 pandemic. The authorities continue to observe prudence in fiscal management and prioritization of essential activities for FY2022.

9. The authorities are committed to maintaining fiscal sustainability and continuing to strengthen revenue collection. Some measures that have been implemented include the introduction of electronic sales register system to reduce fraudulent activities, and E-tax services in an effort to modernize the tax administration system. They are also reviewing the affordability and relevance of selected government fees and charges for education, electricity, water, waste, and communications (internet and telephone).

10. Over the medium term, the authorities recognize the need to strengthen public finances to reduce the risk of debt distress, while prioritizing financing plans drawing on additional

donor support from development partners to meet large development spending needs. They will improve expenditure prioritization in key areas such as education, health and infrastructures. They will also reduce tax exemptions in certain areas and adjust public spending through addressing the public sector wage bill and implementing commitments to other fiscal anchors. Transparency of expenditures and better alignment to the Government's priority areas will be enhanced. Further, the authorities are making efforts to improve the percentage of competitive contract awards with a focus on quality and value for money.

Monetary Policy

11. The NRBT continues to maintain the current accommodative monetary policy stance to support economic recovery and macroeconomic stability. Core inflation has remained below the NRBT's 5 percent reference rate while credit growth has turned negative since July 2020. Against this background, the current accommodative stance is maintained to work in tandem with the fiscal policies in reviving the economy. Anticipating the impact of monetary policy tightening by AE central banks and associated pass-through via imported prices, the authorities continue to engage in discussions with relevant stakeholders on measures that could help to curb inflation and address domestic food inflation. The NRBT will remain vigilant and stands ready to tighten the monetary policy if inflation rises beyond the reference rate for longer, possibly due to the second-round effects of higher commodity prices.

Financial Sector Policies

12. The financial system remains sound, supported by strong capital positions, high liquidity, and adequate profitability. However, non-performing loans (NPLs) increased to 4.8 percent of total loans reflecting the impact of the HTHH disaster and the COVID-19 lockdowns on both businesses and households. Ongoing close monitoring of affected sectors and customers including those customers taking up the relief packages, risk assessments and stress testing of banks' resilience to further shocks to the financial system continue. Banks' adherence to provisioning requirements are also scrutinised, as they continue to align with the IFRS9 provisioning requirements. The Financial Stability Unit has been established to develop and implement macroprudential policies, including better monitoring of household and corporate indebtedness, a factor that had also contributed to the more subdued credit growth trend. The IMF PFTAC is assisting in reviewing the banks' prudential standards to enhance the conduct of risk-based supervision, while establishing prudential standards for the newly regulated non-bank financial institutions.

13. The NRBT has also implemented a strategy to modernize and improve the resilience and the efficiency of the payments system, including by completing the rollout of the Domestic Electronic Payment System (DEPS) for increased automation of the clearing and settlement system.

14. The NRBT continues to improve the regulatory framework for non-bank financial institutions. Consultation on draft legislations for the licensing and supervision of pension funds and insurers are in progress while legislations are being drafted for the licensing and supervision of capital markets, credit information system, and payment systems including

digital financial services. The authorities are also in the process of implementing the newly enacted legislation for the licensing and supervision of credit unions.

Structural Reforms

15. The authorities are committed to strengthening the AML/CFT framework to help alleviate de-risking and de-banking risks. In implementing the recommendations in the Asia-Pacific Group's mutual evaluation report, the IMF Legal Department is assisting in the review of the Money Laundering and Proceeds of Crime Act (MLPC Act) and the AML/CFT supervision capacity has been augmented to facilitate enhanced supervision and the extension of supervision to all financial institutions and cash dealers under the MLPC Act. Other measures adopted to enhance AML/CFT risk assessments include strengthening of the FIU's information database and analytical tools, the establishment of the NRBT's e-KYC database, and deepened collaboration with regional AML/CFT supervisors and FIUs for the exchanges of relevant intelligence and supervisory information.

16. The authorities are also committed to implementing the recommendations of the safeguards assessment. Some of the recommendations may take time to implement given the local context and priorities, however work is in progress to review the National Reserve Bank of Tonga Act and fully address the audit-related recommendations. Meanwhile, the Board vacancies have been filled and an internal audit function has been established.

17. Tonga is among the most vulnerable countries to climate change. The authorities developed and launched the Monitoring and Evaluation (M&E) System Guide, and its Standard Operating Procedure (SOP) in October 2019 to strengthen monitoring and evaluation of the 2nd Joint National Action Plan on Climate Change and Disaster Risk Management (JNAP2)[2] activities, as well as reporting on progress and achievements. These documents are intended to guide national processes for tracking and updating progress toward the 6 objectives and 22 targets outlined in the JNAP2. The authorities have also implemented recommendations in the 2020 IMF/WB Climate Change Policy Assessment to mainstream climate resilience into all sectoral plans and strengthen cooperation across ministries.

18. The authorities have made good progress to increase employment and reduce poverty. In this regard, the authorities have developed the Labor Mobility Policy framework aiming to maximize the ability of workers to move overseas to get jobs. Thousands of Tongans have been employed in labor mobility schemes in New Zealand and Australia. Accordingly, Australia has streamlined the Seasonal Workers' Program (SWP) and the Pacific Labor Scheme (PLS) to have only one process under the Pacific Australia Labor Mobility (PALM) scheme. This alignment allows transfer of workers that have accumulated skills over the years of work to be transferred from unskilled to low-skilled and then to semi-skilled, and

[2] The authorities issued the JNAP2 for the period 2018-2028 in May 2018. Under the JNAP2 M&E Framework: (i) the System Guide provides a description and linkage of the M&E framework to all levels of the policy framework from the global to regional and national scale and the reporting requirements that it seeks to support; and (ii) JNAP2 SOP provides more detailed instructions for gathering, synthesizing and reporting on nationalresilience process indicators and outcome indicators.

also from employers who are unable to provide minimum hours of work to be transferred to another employer.

Conclusion

19. Our authorities remain committed to strengthening macroeconomic policy to support economic recovery while enhancing economic resilience. In the short term, they would stay vigilant to the rising inflationary risks, and respond in an agile manner to contain inflation and ensure macroeconomic stability. They are committed to medium-term fiscal targets and would calibrate the fiscal policy in sync with macroeconomic developments. Our authorities would also continue to closely monitor and supervise the financial sector to mitigate macro-financial risks. Structural reforms would be accelerated to meet higher development need of the economy, further strengthen climate mitigation measures and promote the development of the private sector. The Tongan authorities remain committed to use the RCF resources to meet their urgent BOP needs in an accountable and transparent manner