INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/361

TONGA

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

November 2023

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 2023 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 October 26 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 a lapse-of-time basis following discussions that ended on August 1, 2023, 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 October 2, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff[s] of the IMF and the World Bank.

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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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR23/378

IMF Executive Board Concludes 2023 Article IV Consultation with Tonga

FOR IMMEDIATE RELEASE

Washington, DC – **November 3, 2023**: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tonga and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

The Tongan economy is performing strongly, underpinned by resilient remittance inflows and major reconstruction activities following the Hunga Tonga–Hunga Ha'apai (HTHH) volcanic eruption in January 2022. The authorities' bold policy support measures, together with aid from the international community and the IMF's emergency financing under the Rapid Credit Facility, were instrumental in mitigating the socioeconomic fallouts. The post-HTHH recovery in FY2023 (July 2022–June 2023) has been driven by strong domestic demand and a pickup in tourist arrivals since the border reopening in August 2022. However, supply-side constraints resulting from severe labor shortages and damaged tourism facilities are acting as substantial drags on the recovery and have intensified inflation pressures.

While the economic recovery is expected to continue in the short term, the outlook is subject to significant uncertainties. Growth in FY2024 is projected at 2.5 percent, led by public investment. Although tourism-related services are recovering, tourism receipts as a share of GDP are anticipated to remain below pre-pandemic levels until FY2026 due to slow reconstruction of damaged facilities. The recovery in agricultural production is expected to proceed slowly, reflecting labor shortages and bad weather due to El Niño. Tonga's long-term growth is projected at 1.2 percent, given its exposure to increasingly frequent natural disasters, persistent loss of workers to emigration, and limited economies of scale due to geographical barriers.

[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] The Executive Board takes decisions under its lapse-of-time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.

Executive Board Assessment[3]

In concluding the 2023 Article IV consultation with Tonga, Executive Directors endorsed staff's appraisal, as follows:

Tonga's economy is performing strongly but faces growing headwinds. Economic activity has rebounded following the border reopening in August 2022, led by reconstruction projects, sustained remittances, and a pickup in tourist arrivals. However, severe labor shortages due to worker migration and damaged tourism facilities are becoming increasingly binding and contributing to high and persistent inflation pressures.

The external position in FY2023 was broadly in line with the level implied by fundamentals and desirable policy settings. Despite sizable remittances, continued grants, and a rebound in tourist arrivals, the current account deficit is estimated to have widened in FY2023 due to higher import needs for reconstruction-related capital goods. Nevertheless, foreign exchange reserves continued to increase, supported by official capital transfers and the Rapid Credit Facility disbursement in July 2022.

The current expansionary fiscal stance is appropriate, given the need to expedite reconstruction and protect the most vulnerable. Under the authorities' FY2024 budget, the primary balance for FY2024 is expected to revert to a deficit, reflecting lower external grants and continued implementation of public reconstruction projects. Considering the authorities' limited administrative capacity and prevailing inflation pressures, the execution of budget should focus on priority areas such as reconstruction and social protection, while non-urgent spending should be postponed.

Once the near-term economic recovery is firmly established, both fiscal adjustments and additional support from development partners will be needed to meet Tonga's development goals while ensuring fiscal sustainability. Tonga is assessed as being at high risk of debt distress without new grant commitments, and sizeable external debt repayments in the coming years would further strain its public finances. Gradual fiscal adjustments over the medium term involving additional tax revenue mobilization and reductions in current expenditures, are crucial to achieve Tonga's development objectives in a fiscally sustainable manner, together with securing grants in line with historical levels. Enhancing spending efficiency and fiscal transparency can help achieve the necessary fiscal adjustments and mitigate the growth impact.

Further monetary policy tightening is warranted to contain inflation pressures. Despite the increase in the statutory reserve deposit ratio and other measures taken in early 2023, banking system liquidity remains abundant, limiting the impacts on bank lending and aggregate demand. Given the significant inflation pressures, monetary policy needs to be tightened further, including by increasing the policy rate, combined with additional liquidity absorption measures. Resuming issuance of National Reserve Bank of Tonga (NRBT) notes and strengthening NRBT's operational

[3] 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.

independence can help foster financial market development and improve the monetary policy framework. The current currency basket-weight system has served Tonga well.

More proactive measures are required to tackle banks' asset quality risks. Given the recent increase in non-performing loans (NPLs), the authorities should consider requiring banks to adopt a more conservative provisioning approach and to submit concrete plans for NPL reduction. The NRBT should also enhance its risk-based supervision and broaden its regulatory and supervisory remit to cover non-bank financial institutions.

Comprehensive structural reforms aimed at enhancing climate resilience and nurturing the private sector are essential to boost Tonga's low growth potential. Stricter enforcement of Building Codes and facilitating relocation of properties to safer grounds would enhance Tonga's disaster-resilience. Reducing gender inequality and augmented public investment in training and education will help tackle labor shortages. A strong government-wide drive to accelerate the adoption of digital technologies, notably in public administration, as well as continued efforts to cut red tape and to strengthen the AML/CFT framework, are also important in this regard. Ample fiscal resources should be allocated to ensure production of timely and more reliable macroeconomic statistics.

Table 1. Tonga: Selected Economic Indicators, FY2021–FY2025 1/

Population (2021): 100 thousands
Major exports: root crops, vanilla, squash, fish

		Est.	Projections		
	FY2021	FY2022	FY2023	FY2024	FY2025
Output and prices					
Real GDP[2]	-2.7	-2.0	2.6	2.5	2.2
Consumer prices (period average)[3]	1.4	8.5	10.2	5.8	4.1
Consumer prices (end of period)[3]	6.9	11.3	7.4	6.2	3.2
Central government finance			**(In percent of GDP)**		
Revenue	48.3	45.2	47.7	41.6	37.6
of which: Grants	22.4	19.0	24.4	17.0	12.9
Expenditure	49.3	45.9	47.4	48.3	46.1
Expense	41.8	40.1	40.1	37.3	35.1
Net acquisition of nonfinancial assets	7.5	5.9	7.2	11.0	11.0
Primary balance	-0.6	-0.2	1.0	-6.3	-8.0
Overall balance	-1.0	-0.7	0.4	-6.8	-8.5
Overall balance (excl. grants)	-23.4	-19.7	-24.0	-23.8	-21.4
Money and credit			**(Annual percent change)**		
Broad money (M2)	25.0	13.4	-0.1	4.5	3.4
Domestic credit	-8.2	-3.3	3.9	16.1	8.8
Of which: Private sector credit	1.0	-1.0	6.4	5.9	4.3
Balance of payments			**(In millions of U.S. dollars)**		
Current account balance	-24.7	-31.5	-43.0	-41.0	-45.0
(In percent of GDP)	-5.2	-6.3	-7.9	-7.1	-7.4
Exports of goods, f.o.b.	16.2	15.1	16.3	18.4	19.6
Imports of goods, f.o.b.	214.5	214.9	295.7	285.7	295.4
Tourism receipts	9.1	9.6	35.6	50.9	58.5
Total remittances	217.4	215.9	239.2	227.9	224.8
(In percent of GDP)	46.2	43.4	43.7	39.2	37.0
Compensation of overseas workers	37.8	35.3	44.2	48.9	53.8
Personal remittances	179.6	180.6	195.0	179.0	171.0
Official grants	10.5	26.4	85.4	75.1	78.4
Capital account balance	69.1	84.6	53.1	29.0	5.4
Financial account balance	1.1	23.7	-6.7	25.3	47.4
Gross official foreign reserves					
In millions of U.S. dollars	317.9	375.5	388.1	401.4	409.2
(In months of next year's total imports)	11.7	10.3	10.9	10.9	10.8
Debt			**(In percent of GDP)**		
Public debt (external and domestic)	47.8	45.4	41.2	45.4	51.6
Of which: External debt	41.2	39.4	37.2	38.0	43.9
External debt service ratio	0.7	1.5	2.1	3.8	3.5
Exchange rates					
Exchange rate (National currency per US dollar)	2.3	2.3	2.3	…	…
Real effective exchange rate (2010=100; +=appreciation)	107.1	115.7	125.0	…	…
Memorandum items:					
Nominal GDP (millions of US$)	470.5	497.6	547.2	581.1	607.4

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.

INTERNATIONAL MONETARY FUND

TONGA

October 2, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

EXECUTIVE SUMMARY

Context. The Tongan economy is performing strongly, underpinned by resilient remittance inflows and major reconstruction activities following the Hunga Tonga–Hunga Ha'apai (HTHH) volcanic eruption in January 2022. However, supply-side constraints resulting from severe labor shortages and damaged tourism facilities are impeding the recovery and have intensified inflation pressures. In this context, the authorities are confronting a challenging tradeoff between supporting reconstruction and managing inflation in the short term. In the long term, Tonga's high vulnerability to natural disasters complicates its efforts to create the fiscal space necessary to finance development spending.

Capacity Development (CD)–Surveillance Integration. Tonga is one of the largest recipients of IMF CD resources in the region, and the authorities have shown strong ownership. Ongoing IMF technical assistance, including on central bank legislation, AML/CFT, macroeconomic frameworks, and statistics, is critical for strengthening Tonga's institutional capacity and staff's policy recommendations.

Policy Recommendations.

- In the short term, fiscal policy should focus on supporting reconstruction and recovery with a larger budget envelope for FY2024, as envisaged by the authorities. Monetary policy should be further tightened to durably stabilize inflation below 5 percent, including increases in the policy rate from the current zero percent level. Banks should be required to closely monitor credit risks and actively provision for loan losses.

- In the medium to long term, once the recovery becomes entrenched, Tonga should strengthen the public finances through a combination of domestic fiscal measures—including rationalization of tax exemptions and tax administration reform—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 priorities on: (i) leveraging digital technologies; (ii) increasing public investment in training and education; (iii) cutting red tape to foster investment; (iv) reducing gender inequality in the labor market; (v) improving the quality and timeliness of statistics; and (vi) strengthening the AML/CFT and anti-corruption frameworks.

Approved By
Ranil Salgado (APD) and Bergljot Bjornson Barkbu (SPR)

Discussions took place in Nuku'alofa, Tonga during July 19–August 1, 2023. The mission team comprised Minsuk Kim (Head), Choonsung Lim, Rui Xu, and Ruifeng Zhang (all APD). Neil Saker (Resident Representative, Fiji), Justin Lee (OED), and Ruth Nikijuluw (World Bank) participated in some of the meetings. Raja Anwar, Alternate Executive Director, joined the concluding meetings. To-Nhu Dao, Connor Kinsella, and Shikha Atul Rao (all APD) provided excellent research and editorial assistance for the preparation of this report. The mission met with the Minister of Finance Tiofilusi Tiueti, the Governor of the National Reserve Bank of Tonga Tatafu Moeaki, other senior government officials, development partners, and private sector representatives.

CONTENTS

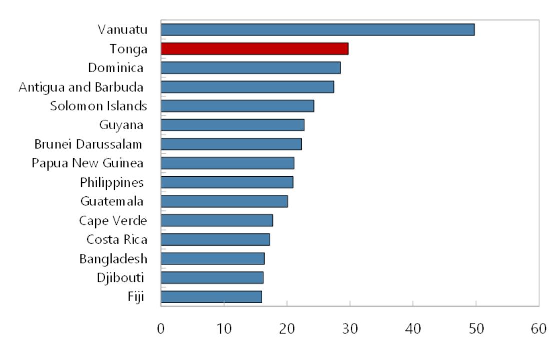
ANNEXES

CONTEXT

1. **Tonga is rebounding strongly from a major double shock in early 2022**. Following the Hunga Tonga-Hunga Ha'apai (HTHH) volcanic eruption-tsunami and the first local COVID-19 outbreak in January-February 2022, intensive reconstruction efforts have been underway, with strong support from the international community, including emergency financing under the IMF's Rapid Credit Facility (RCF) in July 2022 (50 percent of quota, equivalent to about US$9 million). However, progress on rebuilding has been uneven, with many tourism-related facilities remaining damaged.

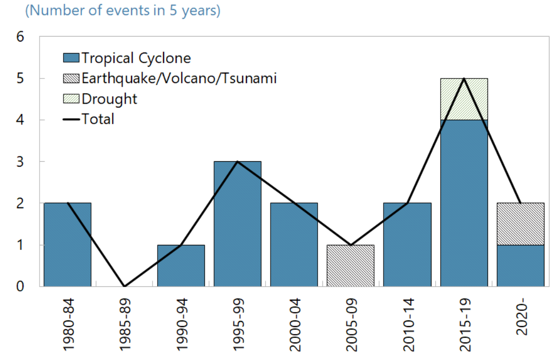
2. **The authorities' reform agenda centers around *building back better*, including by enhancing climate resilience and nurturing the private sector**. Tonga ranks as one of the most vulnerable countries to natural hazards globally and has experienced three major natural disasters since 2018, which incurred substantial capital destruction (11 percent of GDP per year on average) and economic activity-related losses. Leveraging the macroeconomic policy buffers built up before the pandemic—such as fiscal surpluses, relatively low debt, and ample reserves—the authorities deployed bold policy support packages to mitigate the socioeconomic fallouts and bolster reconstruction efforts, consistent with staff's policy recommendations (Annex I). Furthermore, they implemented several important reforms, including the enactment of the Disaster Risk Management law in 2023 aimed at improving Tonga's institutional frameworks for disaster preparedness. But further advances on enhancing climate resilience and promoting private sector development, accompanied by efforts to strengthen public finances, will be essential to meet Tonga's long-term development goals (Table 7).

2021 World Risk Index



Source: World Risk Report 2021.
Note: The World Risk Index is based on countries' exposure, vulnerability, susceptibility, lack of coping capacities and lack of adaptive capacities (Bündnis Entwicklung Hilft and Ruhr University Bochum, Institute for International Law of Peace and Armed Conflict).

Natural Disasters in Tonga
(Number of events in 5 years)

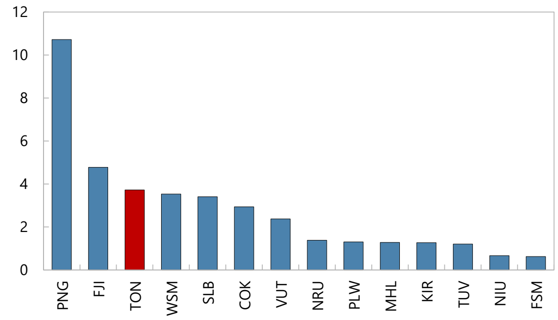


Sources: EM-DAT; and Staff calculations

3. **Tonga has benefitted from considerable capacity development (CD) assistance from the Fund, but more support is needed** (Annex II). It is one of the largest recipients of Fund CD resources in the region, including through missions led by the IMF Capacity Development Office in Thailand (CDOT) and the Pacific Financial Technical Assistance Centre (PFTAC), and the authorities have shown strong ownership and the capacity to absorb Fund CD. Recent technical assistance (TA) on climate change, public financial management (PFM), tax policy, revenue administration, macroeconomic frameworks, and AML/CFT and financial stability frameworks has informed staff's policy recommendations. Following the safeguards assessment in December 2021, the Fund is

providing TA on amending the central bank act that would facilitate implementation of the governance-related recommendations (Informational Annex). Addressing data shortcomings is a high priority in Tonga, especially for external, fiscal, and national accounts statistics, and the Fund's TA has played a critical role in mitigating the authorities' capacity constraints in these areas. Looking forward, the authorities are also seeking TA to enhance their banking sector stress testing frameworks to better manage climate-related risks.

CD Delivery to Pacific Island Countries
(Cumulative 2019-23, millions of US$)

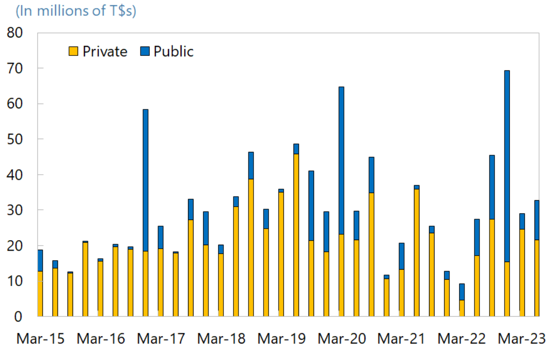


Sources: CDMAP database, and IMF staff calculations.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

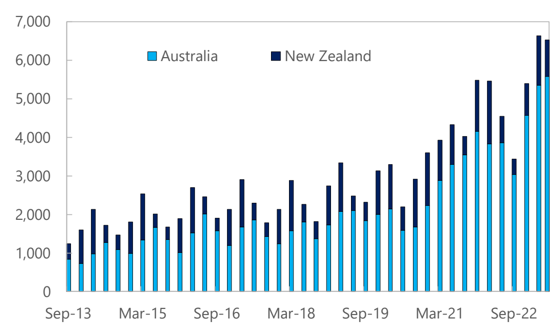
4. Economic activity has strengthened, but supply-side bottlenecks have also emerged. Due to the HTHH disaster, Tonga's real GDP is estimated to have declined by 2 percent in FY2022 (July 2021–June 2022), before rebounding by 2.6 percent in FY2023. The post-HTHH recovery has been driven by public sector reconstruction, buoyant private sector demand supported by remittances, and a pickup in tourist arrivals following the border reopening in August 2022. However, supply-side constraints have hampered reconstruction, including due to labor shortages resulting from increased demand from seasonal worker programs in Australia and New Zealand and higher-than-anticipated costs of construction materials.

Construction Permits
(In millions of T$s)



Source: Tonga authorities.

Temporary Worker Migrations
(Number of people)

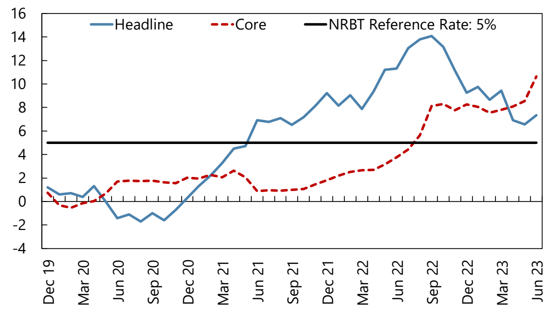


Sources: Governments of Australia and New Zealand; IMF staff calculations.

5. Inflation pressures remain elevated despite easing headline inflation. Headline inflation peaked at 14.1 percent in September 2022 and has since been trending down, reaching 2.9 percent in August 2023, driven by the moderation of global commodity prices and monetary policy tightening in major trading partners. However, core inflation remains relatively high at 8.8 percent in August 2023 amid strengthening domestic demand and supply-side constraints, with growing contributions from transport services and hotels and restaurants in FY2023.

Headline and Core Inflation1/

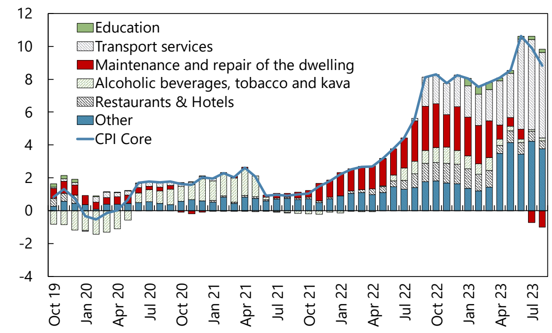
(Year-on-year percent change)



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

Contribution to Core Inflation

(Year-on-year percent change)

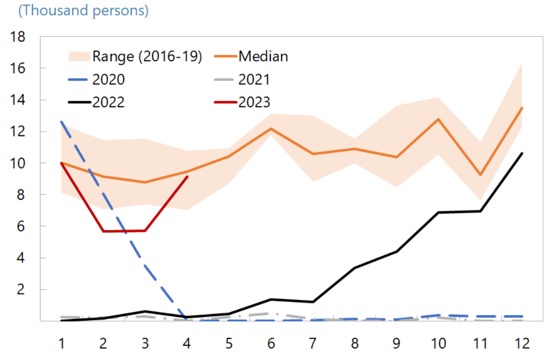


Sources: Tonga Statistics Department; and IMF staff calculations.

6. The external position for FY2023 is assessed to be broadly in line with the level implied by medium-term fundamentals and desirable policies (Annex III). Tonga continued to receive sizable remittances and budget support from donors in FY2023 and saw a rebound in tourist arrivals. However, imports have simultaneously increased, driven by higher demand for reconstruction-related capital goods. While the current account deficit (CAD) is estimated to have widened from 6.3 percent of GDP in FY2022 to 7.9 percent in FY2023, FX reserves have increased further in FY2023 and import cover strengthened to 10.9 months, supported by official capital transfers and the IMF's RCF disbursement in July 2022.[1]

Monthly Tourist Arrivals

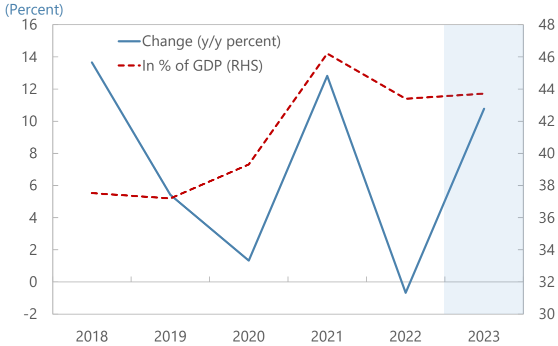
(Thousand persons)



Sources: Tongan authority; and IMF staff calculations

Total Remittances

(Percent)

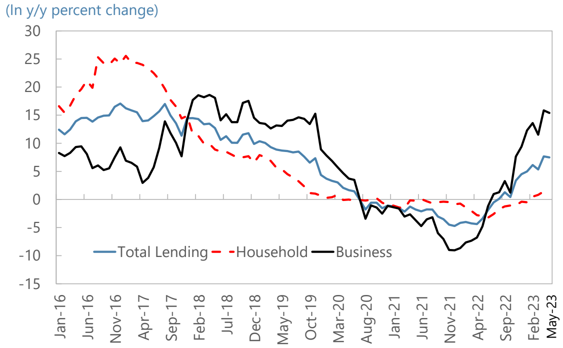


Sources: Tongan authorities; and IMF staff calculations.

[1] Tonga's outstanding RCF balance stands at 100 percent of quota, with the first RCF disbursement approved in January 2021 (50 percent of quota).

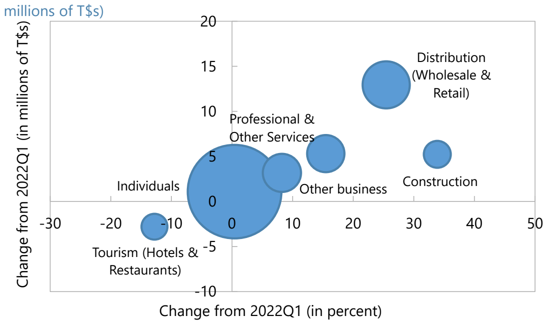
7. Credit has started to expand. Bank credit growth has turned positive since September 2022 and reached 7.5 percent (y/y) in May 2023. Bank lending to businesses has been relatively strong at 15.3 percent, especially in the professional and other services, distribution, and construction sectors, consistent with the rebound in activity in these sectors. Household lending has remained weaker at 1.6 percent, with around 80 percent directed towards housing. The authorities have also supported lending to small businesses and low-income households by providing subsidized interest rate loans under the Government Development Loan (GDL) scheme.[2]

Credit Growth
(In y/y percent change)



Sources: Tongan authorities; and IMF staff calculations.

Bank Credit Growth By Sector: 2022Q1-2023Q1
(The size of each bubble respresents the outstanding amount of bank loans in millions of T$s)



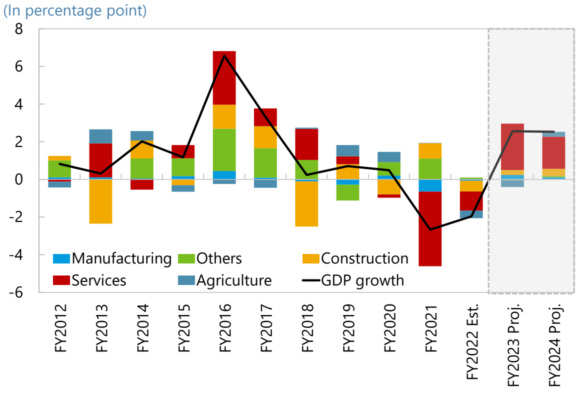
Sources: Tongan authorities; and IMF staff calculations.

8. While the economic recovery is expected to continue in the short term, the outlook is subject to significant uncertainties. Growth in FY2024 is projected at 2.5 percent, underpinned by public investment. Although tourism-related services are recovering, tourism receipts as share of GDP are anticipated to remain below pre-pandemic levels until FY2026 due to slow reconstruction of damaged facilities. The recovery in agricultural production is expected to proceed slowly, reflecting labor shortages and bad weather due to El Niño. Remittance inflows are anticipated to decline from an estimated 43.7 percent of GDP in FY2023 to 39.2 percent in FY2024. Average inflation is projected at 5.8 percent in FY2024—above the National Reserve Bank of Tonga's (NRBT's) reference rate of 5 percent.

[2] The GDL is a government-sponsored microfinance program designed to improve financial access of small businesses in key growth-oriented sectors and to finance personal loans for higher education.

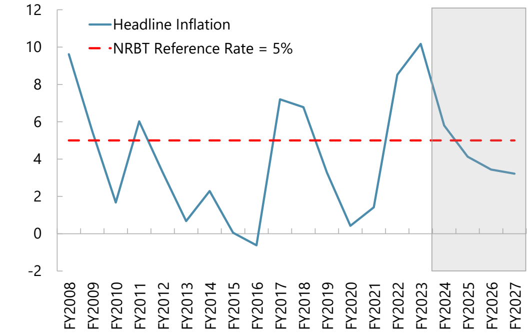
Contribution to Growth by Sector

(In percentage point)



Annual Inflation Projection

(Percent change)



Source: Tongan Authorities; and IMF staff estimates.

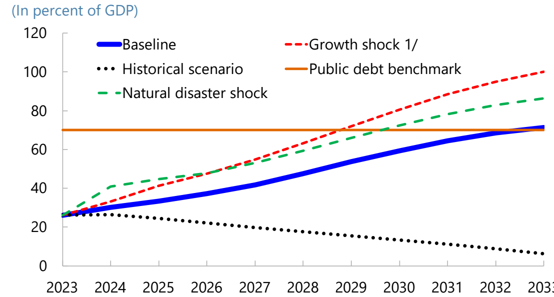
9. The medium-term growth prospects are weak. Tonga's long-term growth is projected at 1.2 percent, reflecting its exposure to increasingly frequent natural disasters, persistent loss of workers to emigration, and limited economies of scale due to geographical barriers. While remittances are expected to remain substantial, the CAD is expected to gradually widen relative to its pre-pandemic levels, reflecting heavy import dependence, weak competitiveness, and substantial infrastructure needs. FX reserve coverage is projected to stabilize over the medium term at about 10½–11 months of imports, above the NRBT's target of 7½ months, supported by external financing.

10. Risks are tilted to the downside (Annex IV). Tonga's limited productive capacity and the strong foreign demand for Tongan workers have significantly increased inflation risks. An acceleration in outward worker migration could slow down the pace of reconstruction and the economic rebound. A sharp increase in global commodity prices could further intensify inflation pressures, deteriorating households' real purchasing power and the CAD. A major natural disaster could derail the current economic recovery, place additional demands on scarce public resources, and increase asset quality risks in the banking sector. A further loss of correspondent banking relationships (CBRs) in the region, including due to AML/CFT-related weaknesses, could disrupt transfers and remittances flows. On the upside, tourism could recover faster due to a stronger-than-expected pent-up demand.

High Risk of Public Debt Distress

Present Value of Debt-to-GDP Ratio

(In percent of GDP)



Source: IMF staff estimates.

1/ The most extreme shock scenario is the growth shock (one standard deviation below the baseline for two years starting from FY2023).

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 (PV) of the external and public debt-to-GDP ratios are projected to keep rising and reach above the 55 percent threshold and the 70 percent benchmark, respectively, in FY2033. This mainly reflects significant development spending needs over the long term to achieve its climate resilience goals and SDGs. Debt obligations are largely external, with over half of the external debt to China Exim Bank. Debt repayments are expected to surge in FY2024, mainly to Exim Bank, and stay elevated at over 3 percent of GDP until FY2027.

Authorities' Views

12. The authorities broadly agreed with staff's assessment of the economic outlook and risks. The recovery is expected to maintain strong momentum in the near term, driven by ongoing major government construction projects, sustained remittance inflows, and a rebound in the agriculture sector. While the authorities shared staff's assessment of risks surrounding the inflation outlook, they noted that several one-off developments have contributed to keeping domestic inflation at high levels thus far, such as the expiration of the school fee waiver and the resumption of large social events after the border reopening. Nevertheless, the supply-side bottlenecks induced by worker outflows and damaged accommodation facilities are expected to persist for the foreseeable future, constraining Tonga's long-term growth potential.

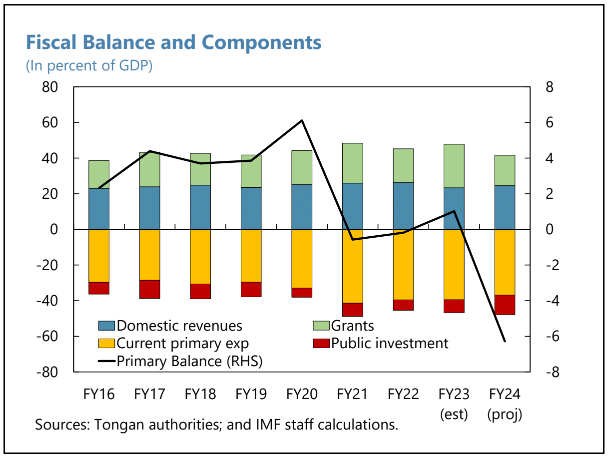
POLICIES TO PROMOTE SUSTAINABLE AND INCLUSIVE GROWTH

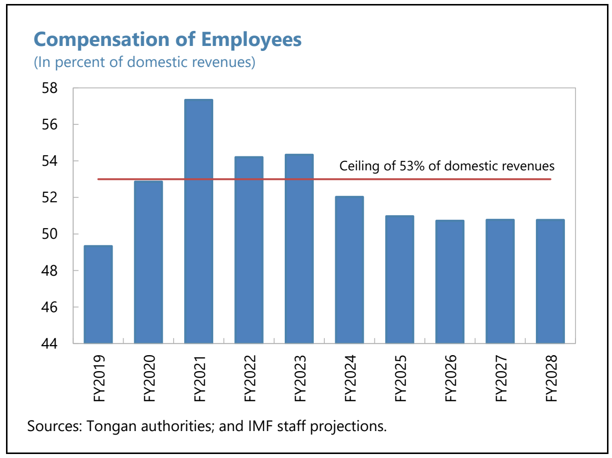
Macroeconomic policy settings should be aimed at simultaneously supporting reconstruction and tackling inflation in the near term. Both delays in reconstruction and persistently high inflation would incur substantial welfare costs, especially for low-income households and small businesses. Achieving this dual objective requires an all-government effort, with monetary policy focused on safeguarding price stability and fiscal policy on providing ample financial support to the vulnerable while postponing non-urgent spending.

A. Fiscal Policy

13. The fiscal balance continued to improve in FY2023. Despite the HTHH disaster, the primary deficit declined from 0.6 percent of GDP in FY2021 to 0.2 percent in FY2022, reflecting lower-than-targeted reconstruction expenditures due to capacity constraints and COVID-19-related mobility restrictions. The primary fiscal balance is expected to have shifted to a surplus of 1.0 percent in FY2023, as a pickup in external grants—including a large one-off budget support from Australia in FY2023—more than offset increased reconstruction-related expenditures.

14. The expanded budget envelope for FY2024 is appropriate, given the need to support reconstruction and strengthen social protection. Based on both the authorities' FY2024 budget and IMF staff's forecasts, the primary balance is expected to revert to a deficit of 6.3 percent of GDP as HTHH-related external grants unwind and implementation of public reconstruction projects gathers momentum. Concurrently, the authorities have phased out most pandemic- and HTHH-related tax exemptions and plan to gradually normalize current spending, including by limiting the public sector wage bill.[3] The government should also prioritize the execution of budgets related to reconstruction and social protection. The planned top-up of the GDL fund under the current budget would help the vulnerable to maintain access to credit at affordable costs, even under a tighter monetary policy.





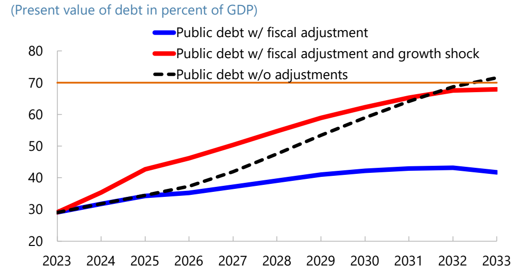
15. Beyond the near term, a combination of domestic fiscal measures and additional support from development partners is required to meet Tonga's development spending needs while minimizing the risk of debt distress. The primary fiscal deficit is projected to widen further in the long term under the baseline, primarily reflecting a decline in committed grants and sizable spending needs to achieve Tonga's SDGs and climate resilience objectives. Implementation of the development spending is predicated on sustained TA and skill transfers from development partners. The fiscal adjustments to address the accompanying deterioration in debt dynamics should include gradual increases in tax revenues and further reductions in the public wage bill and other current expenditures. Funding capital investment projects will be challenging if new grants underperform the historical trends. The government's plan to refrain from new non-concessional borrowing would further help reduce Tonga's risk of debt distress.

[3] The public sector wage bill as share of domestic revenues breached the authorities' target ceiling of 53 percent in FY2021 and has remained above this level since then, primarily reflecting increased overtime pay to support the government's response to COVID-19 and the HTHH-disaster. The authorities plan to reduce the wage bill by expanding their stricter new overtime policy to all ministries and rationalizing the structure of the public service.

16. An illustrative alternative scenario shows that Tonga can achieve these adjustments with manageable macroeconomic costs (Text Table 1). Under this scenario, Tonga implements a set of domestic fiscal measures over FY2025–FY2033, while receiving relatively moderate additional grants. The PV of public debt-to-GDP ratio would then stabilize below the 70 percent threshold over the long term, even with a multi-year growth shock. The PV of external debt-to-GDP ratio would also stabilize below the 55 percent benchmark under this scenario. Furthermore, the growth impact of the fiscal adjustments is expected to be manageable over the medium term and can be partly offset by implementing reforms that enhance public investment efficiency.

Public Debt with Fiscal Adjustment

(Present value of debt in percent of GDP)



Source: IMF staff estimates.
Note: The most extreme shock scenario is the growth shock. The red line does not include the public investment reforms which would lower the debt path further.

Text Table 1. Alternative Scenario with Fiscal Adjustment

(In percentage points of GDP, deviation from baseline)

	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033
Domestic fiscal measures	0.8	1.6	2.4	3.2	3.7	3.7	3.7	3.7	3.7
Better VAT compliance 1/	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Less tax exemptions 2/		0.5	1.0	1.5	2.0	2.0	2.0	2.0	2.0
Lower G&S			-0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Lower public sector wage bill	-0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Additional Grants		2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Change in primary balance	0.8	3.6	5.4	6.2	6.7	6.7	6.7	6.7	6.7
Impact on GDP growth 3/									
Without additional reform	-0.3	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
With additional reform 4/	-0.3	-0.2	0.0	0.1	0.2	0.3	0.4	0.4	0.5
Impact on inflation 5/									
Without additional reform	-0.2	-0.2	-0.1	-0.1					
With additional reform 4/	-0.2	-0.2	-0.1	-0.1					
Memo. (in percent of GDP)									
Projected primary balance w/adjustment	-7.2	-5.4	-4.6	-5.2	-5.0	-4.1	-3.3	-1.5	0.0

1/ For reference, World Bank (2023) estimates the potential revenue impact from such reform for Tonga at about 6.2 percent of GDP.
2/ For reference, World Bank (2023) estimates the potential revenue impact from reducing exemptions and zero ratings at about 3.2 percent of GDP.
3/ The growth impact associated with fiscal adjustment is based on an average multiplier value of 0.2-0.4 over the projection period, comparable with estimates for other emerging market and low-income countries in the literature. The growth impact associated with additional reform is obtained from the IMF's DIGNAD model calibrated to the Tongan economy and in line with other studies (e.g., Solomon Islands, 2018 Article IV consultation, Selected Issues Paper, Chapter 2).
4/ The reform, assumed to be implemented over FY2024-FY2032, enhances Tonga's public investment efficiency from 40 percent to 60 percent. The starting value of 40 percent corresponds to the median for a sample of emerging market and low-income countries in Dabla-Norris and others (2011) and the increase of 20 percentage points is equivalent to about one standard deviation.
5/ The impact on inflation under the "with additional reform" scenario is driven by the demand-dampening effects of fiscal consolidation. While the assumed increase in public investment efficiency (the rate at which a given amount of public investment is converted to public capital) would help boost Tonga's productive capacity, thereby helping ease inflationary pressures, the accompanying demand-stimulating effects (e.g., crowding-in of private investment) could offset these supply-side effects. Given the large uncertainties surrounding the long-term impacts on inflation, we do not show estimated impacts beyond FY2028 to avoid conveying a false sense of precision.

17. To achieve the necessary fiscal adjustments, reforms to improve revenue administration, spending efficiency, and transparency are essential. The authorities have already initiated several reforms in these areas, consistent with IMF TA. The ongoing rollout of the Electronic Sales Register System has the potential to improve revenue compliance and reduce administrative burden. The planned amendments to the PFM Act would improve fiscal transparency, budget allocation aligned with the national economic objectives, and the medium-term budget processes. Reducing tax exemptions and strengthening the governance for granting new exemptions would help deliver significant additional revenues and ensure that exemptions are adequately aligned with national strategic objectives. This could be achieved by setting clear eligibility criteria and limited timeframes, as well as allowing the Minister of Finance to have the ultimate authority to grant exemptions in the government. Finally, fully delivering on the authorities' commitment under the IMF's RCF to publish pandemic-related procurement contracts with information on the beneficial ownership would also be important.[4]

Authorities' Views

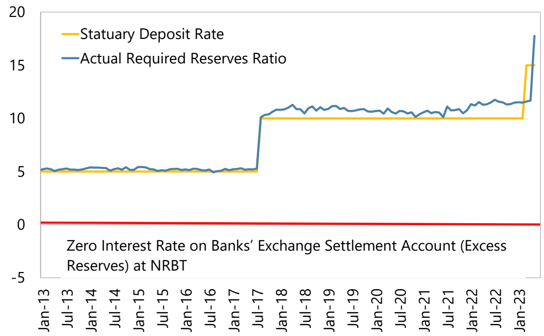
18. The authorities intend to prioritize reconstruction and social protection in the near term, while continuing with fiscal reforms to strengthen public finances in the long term. Despite the delays in FY2023, the authorities expect the post-disaster reconstruction and renewable energy projects to pick up speed in FY2024. Moreover, the FY2024 budget features new initiatives to strengthen social protection, such as free school breakfasts and affordable housing for low-income households, which should further help protect the vulnerable. On fiscal reforms, they see a need to rationalize overtime pay—which constituted about 13 percent of the total public sector payroll in FY2022—and have implemented reforms to better enforce the rules and limit exceptions. The authorities are also committed to revenue mobilization measures, including by improving revenue services administration through an electronic sales register system, reviewing existing tax exemptions, and reassessing government fees and charges. They remain committed to seeking new grant financing from development partners to ensure that debt remains on a sustainable path, all while meeting climate resilience and development goals.

B. Monetary and Exchange Rate Policies

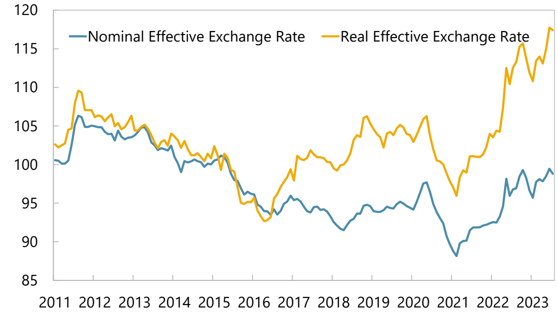
19. The NRBT has recently taken measures to tighten its monetary policy stance. The NRBT increased the statutory reserve deposit (SRD) ratio from 10 to 15 percent in February 2023, the first time since July 2017, while maintaining the policy rate (the interest rate on excess bank reserves) at zero percent. This move, together with the NRBT's newly established deposit facility for retirement funds in February 2023, has helped absorb sizable banking system liquidity, leading to more active liquidity management by some banks. However, the measures have yet to have meaningful impacts on aggregate demand, including through the bank lending channel, due to the still abundant banking system liquidity.

[4] The authorities have posted information on pandemic-related procurement contracts awarded during FY2020-FY2021 and published audited financial statements for FY2021 and FY2022 that include COVID-19-related expenditures (http://www.finance.gov.to/treasurypublications). However, procurement contracts for FY2022 have yet to be published, together with information on the beneficial ownership for contracts during FY2020-FY2022.

Monetary Policy Instrument
(In percent of total bank deposits)



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



Sources: Tongan authorities; and IMF staff estimates.

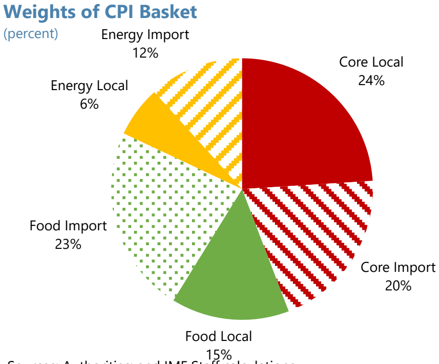
20. Further actions are needed to contain underlying inflation pressures. Under staff's baseline projection predicated on current monetary policy settings, inflation would not stabilize below the reference rate by end-FY2024 due to persistent domestic inflation pressures (Box 1). To prevent high inflation expectations from becoming entrenched, a further tightening of the monetary policy stance is warranted. This could be achieved by increasing the policy rate from the current zero percent level, possibly combined with a further hike in the SRD ratio to mop up more liquidity. This adjustment in the policy rate under the current favorable economic environment would also create room to lower the policy rate in case important downside risks (e.g., a major natural disaster) materialize.

21. The monetary policy framework could be enhanced in a few areas. The NRBT could consider resuming issuance of NRBT notes, which has been suspended since 2009. This would provide the NRBT with a market-based policy instrument to absorb excess liquidity, which can facilitate the development of financial markets in the long run. Furthermore, to ensure that increases in sterilization costs resulting from policy rate hikes do not lead to concerns about the NRBT's financial health and thus its operational independence, the NRBT and the government could consider further clarifying the operational guidelines for transfer of profits, coverage of losses, and recapitalization, based on the existing provisions in the NRBT Act and consistent with the IMF's TA recommendations on Tonga's monetary policy framework.

Box 1. Assessing Underlying Inflation in Tonga

Assessing underlying inflation in Tonga is complicated by several factors. The reliance on imported goods, which account for 55.1 percent of the household consumption basket, makes Tonga's inflation highly susceptible to external influences. Moreover, more than half of the CPI basket consists of volatile items like food and energy, making the CPI prone to large high-frequency fluctuations. To capture the underlying inflation trend, economists often turn to core inflation, which excludes food and energy prices. However, in Tonga, core inflation represents only 44.2 percent of the CPI basket, casting doubt on its ability to accurately capture the underlying inflation. Therefore, accurately assessing underlying inflation in Tonga requires careful consideration of external factors and the limitations of the core inflation measure.

Weights of CPI Basket
(percent)



Sources: Authorities; and IMF Staff calculations.

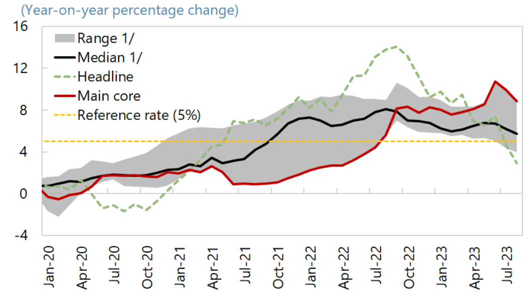
In this box, we consider six different indicators of underlying inflation, including alternative measures of core inflation (Box Table1). Indicators of underlying inflation, an inherently unobservable variable, can be divided into two broad types. Exclusion-based measures indirectly estimate underlying inflation by excluding volatile items from the CPI basket. Here, *main core* and *alternative core* exclude food and energy items, while *weighted median* excludes all but one item located at the center of the distribution of price changes in a given month. The other type is estimation-based measures, which directly estimate underlying inflation using a model that incorporates desirable characteristics of underlying inflation. This box estimates three indicators using models in Stock and Watson (2016).

Box Table 1. Underlying Inflation Indicators

Indicators	Types	Methods	Remarks
Main core	Exclusion-based	Excluding items: i) *Food;* ii) *Electricity, gas and other fuels;* and iii) *Operation of personal transport equipment*	Available only from September 2019, because of lack of granular data
Alternative core		Excluding items: i) *Food and non-alcoholic beverages;* ii) Local component of *Housing, water, electricity, gas and other fuels*; and iii) Import component of *Transport*	Available from 2003
Weighted median		Distribution from 37 sub-components (21 Locals and 16 Imports); Smoothed by 3 month moving average	Available only from November 2019, because of lack of granular data
SW-CPI	Estimation-based	Estimated the persistent component of the headline inflation, using univariate unobserved components/stochastic volatility outlier-adjustment (UCSVO) model (Stock & Watson, 2016)	Available from 2003
SW-Core		Estimated persistent component of the alternative core, using univariate UCSVO model	Available from 2003
SW-3C		Estimated the common and persistent component of inflation, using multivariate UCSVO model with 3 sub-categories: Alternative core, Food, and Energy	Available from 2003

Box 1. Assessing Underlying Inflation in Tonga (Continued)

Underlying Inflation
(Year-on-year percentage change)

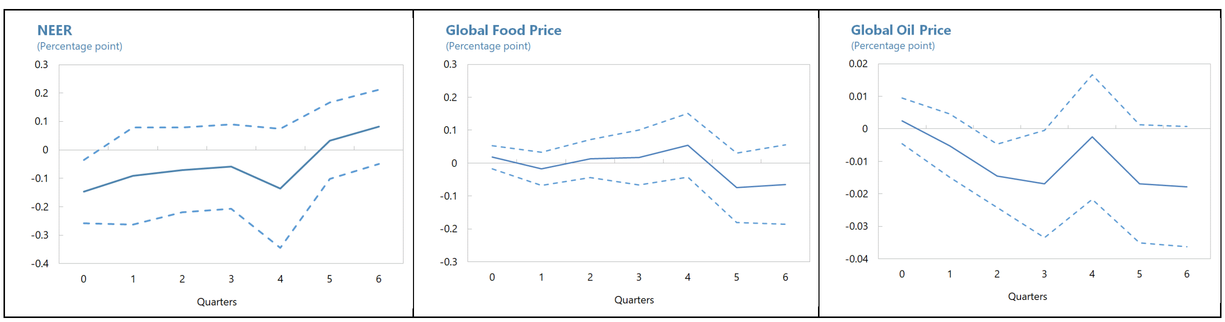


Sources: Tonga Statistics Department; IMF staff calculations.
1/ Range and Median represent, respectively, the range and the median of six underlying inflation indicators: main and alternative cores, weighted median, 3 estimation-based indicators by UCSVO models (Stock and Watson, 2016)

The indicators suggest that underlying inflation pressures stay high and persistent. Main core (red line) remains elevated at 8.8 percent in August 2023. As for the median of the indicators (black line), it has not cooled down to below the NRBT's reference rate of 5 percent, although it peaked in August 2022.

Staff's empirical analysis using the local projection method by Jorda (2005)[1] shows that underlying inflation in Tonga is more responsive to exchange rate and domestic demand shocks rather than global commodity price shocks. Specifically, a one percentage point increase in the NEER (i.e., appreciation of the Tongan pa'anga) would decrease underlying inflation by 0.15 percentage point at the time of the shock (Box Figure 1). And after controlling for the NEER, the impact of global commodity price shocks on underlying inflation is either insignificant or even deflationary. When it comes to domestic variables, our analysis indicates that electricity consumption and credit to the private sector have inflationary effects, while vehicle registration and agricultural production appear to have insignificant impacts (Box Figure 2). Notably, electricity consumption—which is often considered highly correlated with economic activities—appears to have an impact of 0.04 percentage points on year-on-year underlying inflation in response to a one percentage point electricity consumption shock. Furthermore, the impact becomes three times larger one year later.

Box Figure 1. Impulse Response of Underlying Inflation to External Shocks 1/



Source: Tongan authorities; and IMF staff calculations

1/ The impulse response is measured in percentage points of year-on-year underlying inflation in response to a 1 percentage point shock in the year-on-year growth rate of the variable. The dotted line represents confidence interval at 90 percent.

[1] The analysis is undertaken for an indicator (SW-3C) estimated using a multivariate UCSVO model by Stock and Watson (2016). The impact is estimated separately for global oil and food prices and four available high frequency indicators for Tonga, controlling for the nominal effective exchange rate. All variables are in quarterly year-on-year changes during the period from 2011Q1 to 2019Q4.

Box 1. Assessing Underlying Inflation in Tonga (Concluded)

Box Figure 2. Impulse Response of Underlying Inflation to Domestic Shocks 1/

Source: Tongan authorities; and IMF staff calculations

1/ The impulse response is measured in percentage points of year-on-year underlying inflation in response to a 1 percentage point shock in the year-on-year growth rate of the variable. The dotted line represents confidence interval at 90 percent.

22. The current currency-basket regime has served Tonga well, helping preserve exchange rate stability. The nominal effective exchange rate appreciated by 1.7 percent (y/y) in June 2023, helping partially offset the impact of higher import prices denominated in trading-partner currencies on domestic inflation. Meanwhile, the appreciation of the real effective exchange rate over the same period appears to have had relatively limited impacts on Tonga's exports due to the HTHH-induced disruption to crop production and border closures.

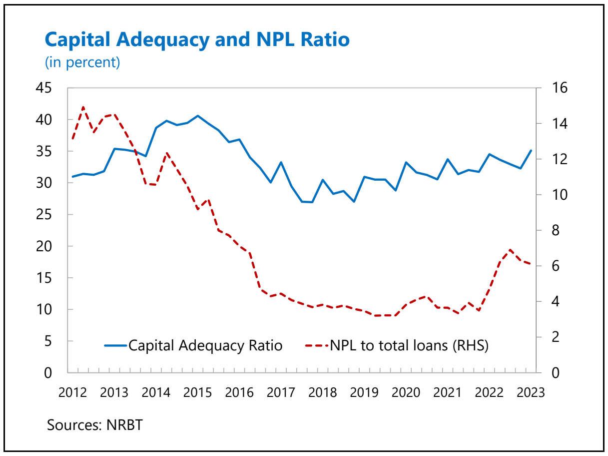
23. The NRBT is making progress in implementing the recommendations from the 2021 safeguards assessment. While the assessment found basic operational controls in key safeguards areas, it had also identified governance weaknesses, such as vacancies at the NRBT Board and capacity constraints related to internal audit. Since then, the NRBT Board has been fully constituted and reinstated their commitment to strengthen independent oversight of internal controls. Efforts to implement the recommendations should continue, including the drafting of amendments to the NRBT Act to strengthen the autonomy of the central bank, with support from the ongoing IMF TA.

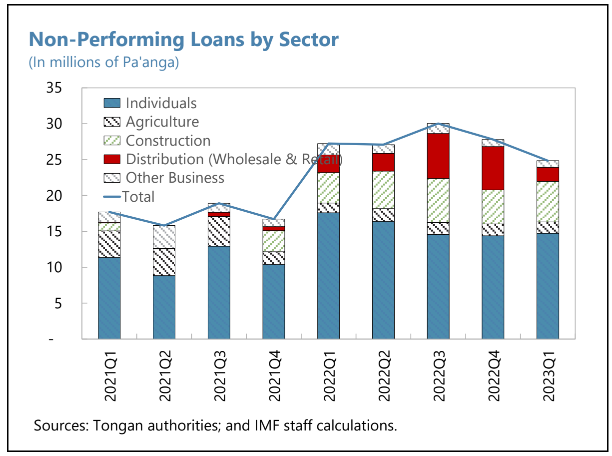
Authorities' Views

24. The authorities recognized the need for continuing efforts to suppress inflation and underscored the importance of the government's complementary role in fighting inflation. They agreed that while the measures implemented since February 2023 have helped absorb significant excess liquidity in the banking system, additional monetary policy measures should be considered to tackle inflation risks. Against the background of weak monetary policy transmission, supply-side bottlenecks such as labor shortage, and robust aggregate demand driven by remittance inflows and the government's expansionary fiscal policy, the likely impact on inflation of raising the policy rate from the current zero percent level, as well as the NRBT note issuance, is being considered. The NRBT emphasized that the pace and magnitude of tightening should be carefully calibrated so that it does not incur an undue output cost during this early stage of economic recovery, and that fiscal policy should play a complementary role in managing inflation, including through targeted policy support measures and tax rate adjustments. They noted that reserves remain at adequate levels owing to continued inflows of grants and remittances, which is crucial given Tonga's vulnerability to natural disasters, external shocks, high import dependence, and the anticipated increase in external debt repayments to China Exim Bank.

C. Financial Sector Policies

25. Systemic risks appear modest overall, with the banking sector remaining well capitalized and liquid. The system-wide capital adequacy ratio was around 35 percent in 2023Q1, well above the regulatory requirement (15 percent). Banks also remain profitable, although the average return on assets is below pre-pandemic levels and others in the region as of end-FY2022 (Figure 5). The system-wide liquidity is ample, with excess reserves standing at a sizable 30.2 percent of GDP as of April 2023 despite the NRBT's recent mop-up measures.





26. Risks to asset quality have increased, however, reflecting the impacts of HTHH and COVID-19. The banking system's non-performing loan (NPL) ratio increased from 3.6 percent at end-2021 to 7.4 percent in 2023Q1. While both business and household NPLs climbed, business NPLs grew more rapidly, led by distribution and construction. The share of household NPLs in total NPLs declined, with housing loans accounting for over 75 percent of household NPLs. Meanwhile, the NPL coverage ratio declined from 141.3 percent at end-2021 to 99.3 percent in 2023Q1. While the current level of banks' NPLs appears manageable given the existing financial buffers, the capacity to sustain another severe shock to the economy in the near term without disrupting bank credit has likely weakened. Risks associated with lending by non-bank financial institutions (NBFIs) appear modest overall, although lack of detailed published data makes a definitive assessment difficult.[5]

27. The authorities should consider more proactive measures to tackle NPLs and asset quality risks. These could include: (i) conducting more intrusive oversight for banks with relatively higher NPLs, possibly through more frequent and detailed regulatory reporting, intensified on-site supervision, and restrictions on dividend payments if needed; (ii) requiring banks to adopt a more conservative approach to provisioning, including for secured loans and overdue non-NPL loans; and (iii) requesting banks to prepare and submit their plans to address NPLs, which could include concrete operational targets (e.g., reducing NPLs to a target level over a specific time window and maintaining the provisioning level above a certain minimum threshold). The NRBT should also continue to conduct regular stress tests to ensure that banks maintain sufficient capital to absorb any potential losses. Strengthening prudential standards and regulations (e.g., for credit unions and those related to provisioning), avoiding frequent staff turnover, and expanding the scope and increasing the frequency of relevant data collection by—with support from the ongoing IMF TA in these areas—will help enhance Tonga's capacity to conduct risk-based supervision and further mitigate asset quality risks in the financial sector. The NRBT's regulatory and supervisory remit should be broadened to cover NBFIs.

[5] NBFIs lending accounts for around 20 percent of total credit. Retirement funds are major NBFI lenders, and their loans are secured against borrowers' retirement balances.

28. Reforms aimed at promoting financial deepening, stability, and inclusion should continue. The NRBT's initiative to set up a local credit registry is welcome, which should eventually be expanded to include NBFIs to capture all loans extended to individual borrowers. Moreover, the NRBT should implement its plan to expand the Domestic Electronic Payment System to include the government and NBFIs. The authorities could also strengthen their efforts to tackle low financial literacy to enhance individuals' use of financial products and services, including through financial education in schools and engagement with local communities. These efforts, together with the government's ongoing digitalization initiative (¶32), could also help foster financial inclusion.

29. The authorities are taking measures to strengthen the AML/CFT frameworks. Like other Pacific Island countries (PICs), Tonga is facing elevated risks of losing CBRs, including due to gaps in the AML/CFT framework and low profitability on the part of overseas correspondent banks. Building on the recent progress (Annex 1), including the adoption of an IT system to strengthen the analytical capacity of the Financial Intelligence Unit, the NRBT is seeking to amend the AML/CFT law to address the gaps identified by the Asia Pacific Group on Money Laundering (APG) in the Mutual Evaluation Report, with the ongoing IMF TA in this area.

Authorities' Views

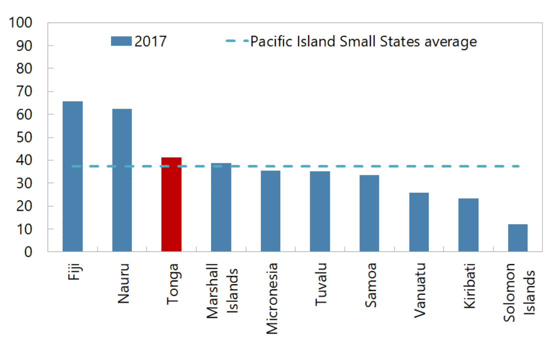
30. The authorities concurred with staff's assessment and recommendations aimed at safeguarding financial stability. They highlighted that the banking system is overall sound given the high capital buffer, adequate liquidity, and continued profitability. While agreeing on the need to take proactive measures to ensure financial stability, the authorities indicated that several measures have already been implemented to tackle high NPLs, including more frequent and intensive monitoring, requiring banks to re-evaluate collaterals, issuing directives to limit problematic exposures and diversify risks, as well as conducting sensitivity analysis to assess the impact of high NPLs on banks' capital adequacy. The NRBT is also undertaking several reforms to strengthen its regulatory and supervisory framework. These include revising the prudential banking standards related to credit risks and the implementation of IFRS 9, supported by PFTAC TA, and broadening NBRT's regulation to cover the pension funds and insurance companies, with TA from the World Bank and ADB on relevant legislations.

D. Structural Reform

31. Enhancing resilience to natural disasters and climate change is a top reform priority. The Disaster Risk Management Act of 2023 marks an important step forward in this regard. It aims to pivot the focus of Tonga's disaster management frameworks from ex-post responses to proactive ex-ante risk mitigation and preparedness, including by improving coordination across relevant ministries and management of scarce resources, consistent with the recommendations from the IMF-World Bank 2021 Climate Change Policy Assessment Report. Expanding the classification of climate change-related spending and strengthening the social protection system are other priorities. The ongoing PFM reform, as well as the initiative to establish a national database of households eligible for social protection benefits, are important in this regard. Stricter enforcement of the Building Code, especially for residential properties, and facilitating relocation to safer grounds would significantly contribute to enhancing disaster resilience, which should be supported by allocation of adequate fiscal resources.

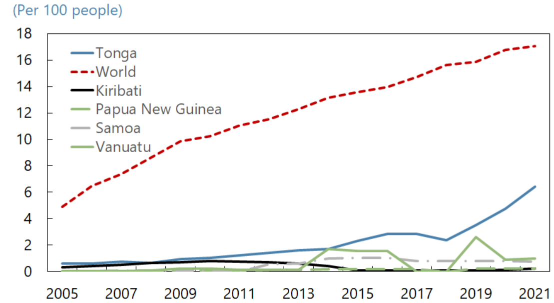
32. Developing the private sector is critical to boost Tonga's growth potential. Tonga is confronting important challenges to long-term growth posed by sustained worker outflows and increasingly frequent natural disasters. In this context, digitalization can be an effective way to enhance economy-wide efficiency and overcome geographical limitations. The authorities' ongoing efforts to launch a national digital ID system are a significant measure in this regard and could create synergies with other reforms, like facilitating timely delivery of social assistance and enhancing access to credit.[6] To reap the full benefits, however, this initiative should be reinforced by a government-wide drive to make public administration less paper-based and greater investment in information and communication infrastructure to improve the coverage and quality of internet connectivity. Other important reform priorities include: increasing government spending on education and training, especially to reduce the skill mismatch in the domestic labor market in the context of continuing worker outflows; and cutting red tape hindering private sector investment, especially by improving the efficiency of land leasehold administration (e.g., adoption of necessary IT systems) and relaxing foreign ownership restrictions in certain industries. The Foreign Investment law enacted in October 2020, together with the accompanying regulations approved in 2021, removed inward investment restrictions for non-residents in 10 industries and activities, such as retail, education, and health.[7]

Individuals Using the Internet
(In percent of population)



Source: World Bank, World Development Indicators.

Fixed-Broadband Subscriptions1/
(Per 100 people)



Sources: International Telecommunication Union; and IMF staff calculations.
1/ Fixed subscriptions to high-speed access to the public Internet (a TCP/IP connection), at downstream speeds equal to, or greater than, 256 kbit/s divided by population and multiplied by 100.

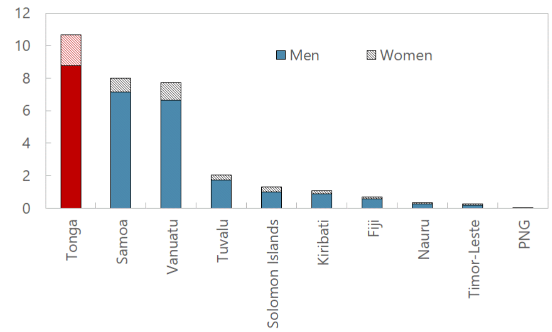
33. Reducing gender inequality in the labor market is essential, especially given persistent migration pressures. Temporary worker programs in Australia and New Zealand are estimated to have hired about 11 percent of Tonga's working-age population as of mid-2022, the highest share in the region, predominantly consisting of male workers. Creating a more enabling environment for

[6] This can be fostered by facilitating the customer due diligence process and supporting the creation of credit histories (World Bank, 2018).

[7] This measure is being assessed under the IMF's Institutional View on the Liberalization and Management of Capital Flows by the IMF interdepartmental working group.

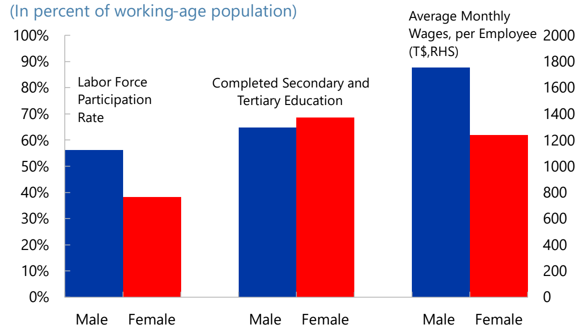
female labor force participation can help fill the gap created by the departure of male workers from the domestic labor market. In Tonga's context, possible measures to achieve this objective include strengthening government support for early childhood education and childcare services and allowing more flexible work arrangements (e.g., work from home). Enacting the pending Employment Relations Bill, which requires all employers to implement sexual harassment policies in the workplace, is also important in this regard.

Temporary PIC Migrants in Australia and New Zealand
(By gender, percent of the total working-age population in each PIC)



Sources: S. Howes, R. Curtain, and E. Sharman (October, 2022), "Labour mobility in the Pacific: transformational and/or negligible?" DEVPOLICY blog, Development Policy Centre.

Labor Indicators
(In percent of working-age population)



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

34. **Tonga is facing severe capacity constraints in producing timely macroeconomic statistics, which needs to be urgently addressed**. Delays in publishing core macroeconomic data, like national accounts and external sector statistics, have become more prolonged and frequent in recent years. To tackle this problem, the requirements under the current law on data sharing and cooperation by relevant ministries need to be more strictly enforced, supported by allocation of additional fiscal resources to retain, hire, and train staff in critical areas. The IMF has provided extensive TA in several areas of statistics (Informational Annex). The authorities should publish key macroeconomic and financial data on a regular basis through a National Summary Data Page at the IMF website in the context of Tonga's participation in the Enhanced General Data Dissemination System (e-GDDS).

Authorities' Views

35. **The authorities agreed that broad-based structural reforms are needed to achieve Tonga's development goals**. The recent worker outflows to neighboring countries have resulted in severe labor shortages, especially in sectors and occupations that require skilled workers (e.g., government, construction, and education). The authorities shared staff's view that promoting digitalization in public administration can bring meaningful benefits in this regard, while emphasizing that the initiative should be accompanied by augmented efforts to break down silos and broader reforms on the work process and operating procedures. They also underscored the importance of education and training to mitigate the skill mismatch in the domestic labor market, noting the presence of the young underemployed and low-skilled labor force in outer islands. The authorities concurred that strengthening the capacity to produce accurate and timely macroeconomic statistics has become a top priority and that closer inter-agency cooperation and data sharing are needed to

overcome the capacity constraints. On climate change, the authorities agreed with the staff's assessment that natural disasters have become more frequent recently, requiring more investment and proactive measures to manage related risks, and that effective implementation of the Disaster Risk Management Act would be crucial in this regard.

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36. Tonga's economy is performing strongly but faces growing headwinds. Economic activity has rebounded following the border reopening in August 2022, led by reconstruction projects, sustained remittances, and a pickup in tourist arrivals. However, severe labor shortages due to worker migration and damaged tourism facilities are becoming increasingly binding and contributing to high and persistent inflation pressures.

37. The external position in FY2023 was broadly in line with the level implied by fundamentals and desirable policy settings. Despite sizable remittances, continued grants, and a rebound in tourist arrivals, the CAD is estimated to have widened in FY2023 due to higher import needs for reconstruction-related capital goods. Nevertheless, FX reserves continued to increase, supported by official capital transfers and the RCF disbursement in July 2022.

38. The current expansionary fiscal stance is appropriate, given the need to expedite reconstruction and protect the most vulnerable. Under the authorities' FY2024 budget, the primary balance for FY2024 is expected to revert to a deficit, reflecting lower external grants and continued implementation of public reconstruction projects. Considering the authorities' limited administrative capacity and prevailing inflation pressures, the execution of budget should focus on priority areas such as reconstruction and social protection, while non-urgent spending should be postponed.

39. Once the near-term economic recovery is firmly established, both fiscal adjustments and additional support from development partners will be needed to meet Tonga's development goals while ensuring fiscal sustainability. Tonga is assessed as being at high risk of debt distress without new grant commitments, and sizeable external debt repayments in the coming years would further strain its public finances. Gradual fiscal adjustments over the medium term involving additional tax revenue mobilization and reductions in current expenditures, are crucial to achieve Tonga's development objectives in a fiscally sustainable manner, together with securing grants in line with historical levels. Enhancing spending efficiency and fiscal transparency can help achieve the necessary fiscal adjustments and mitigate the growth impact.

40. Further monetary policy tightening is warranted to contain inflation pressures. Despite the increase in the SRD ratio and other measures taken in early 2023, banking system liquidity remains abundant, limiting the impacts on bank lending and aggregate demand. Given the significant inflation pressures, monetary policy needs to be tightened further, including by increasing the policy rate, combined with additional liquidity absorption measures. Resuming issuance of NRBT notes and strengthening NRBT's operational independence can help foster financial market development and improve the monetary policy framework. The current currency basket-weight system has served Tonga well.

41. More proactive measures are required to tackle banks' asset quality risks. Given the recent increase in NPLs, the authorities should consider requiring banks to adopt a more conservative provisioning approach and to submit concrete plans for NPL reduction. The NRBT should also enhance its risk-based supervision and broaden its regulatory and supervisory remit to cover NBFIs.

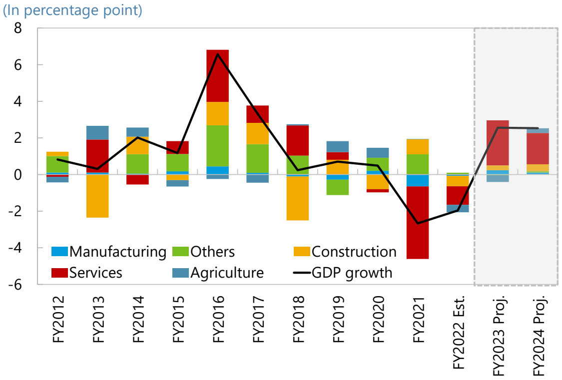
42. Comprehensive structural reforms aimed at enhancing climate resilience and nurturing the private sector are essential to boost Tonga's low growth potential. Stricter enforcement of Building Codes and facilitating relocation of properties to safer grounds would enhance Tonga's disaster-resilience. Reducing gender inequality and augmented public investment in training and education will help tackle labor shortages. A strong government-wide drive to accelerate the adoption of digital technologies, notably in public administration, as well as continued efforts to cut red tape and to strengthen the AML/CFT framework, are also important in this regard. Ample fiscal resources should be allocated to ensure production of timely and more reliable macroeconomic statistics.

43. 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

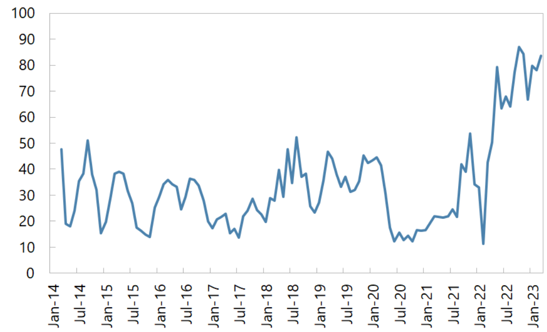
Construction and tourism-related services are leading the recovery.

Contribution to Growth by Sector
(In percentage point)



The labor market has strengthened significantly.

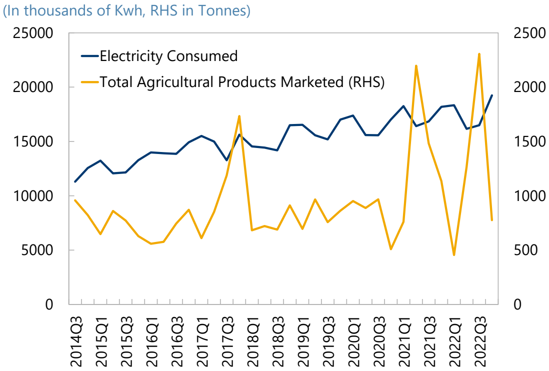
Monthly New Job Vacancy Posting
(Persons, 3-month MA)



Sources: Tongan authority; and IMF staff calculations

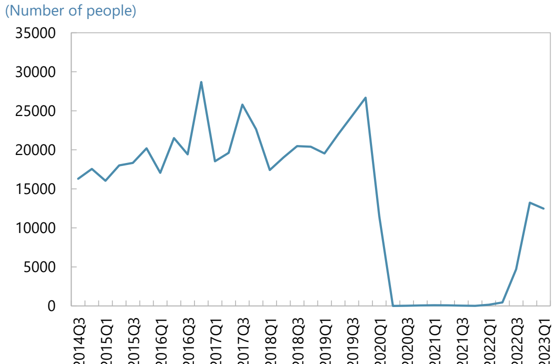
Electricity consumption has been strong, while agricultural production has yet to show signs of a sustained rebound.

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



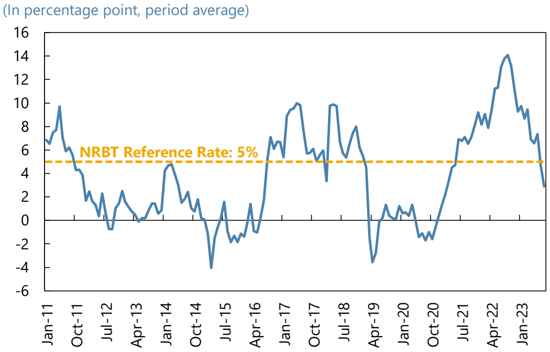
Tourists are returning after the border reopening in August 2022.

Tourist Arrival
(Number of people)



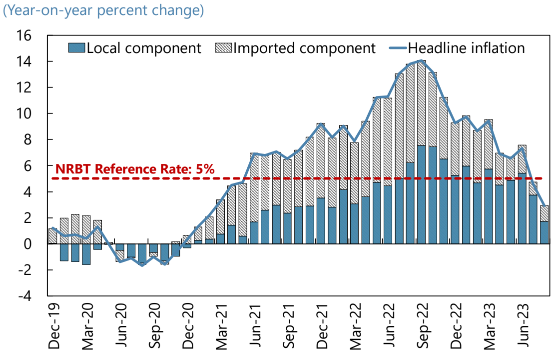
Headline inflation has declined …

Consumer Price Index
(In percentage point, period average)



…driven mainly by easing import price inflation.

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

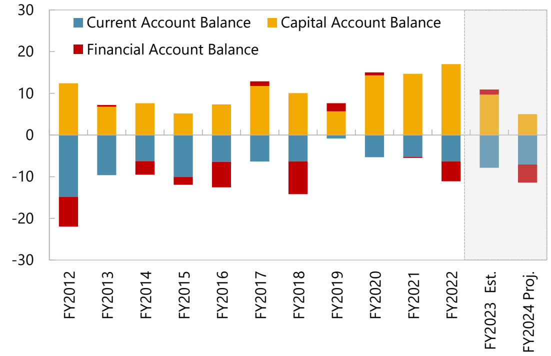


Sources: National Reserve Bank of Tonga; and IMF staff calculations.

Figure 2. Tonga: External Sector Development

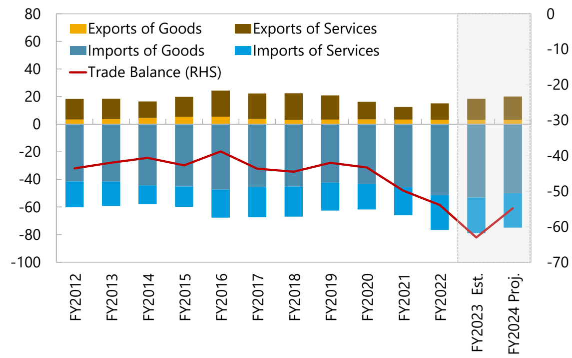
Donors' aids are expected to moderate post-pandemic.

Balance of Payments Forecast
(In percent of GDP)



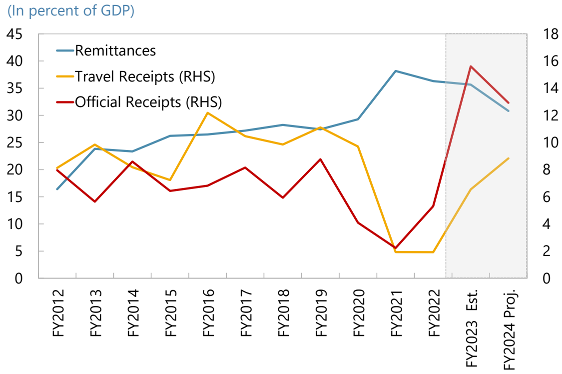
Trade deficits remain large due to rebuilding needs.

Trade Balance
(In percent of GDP)



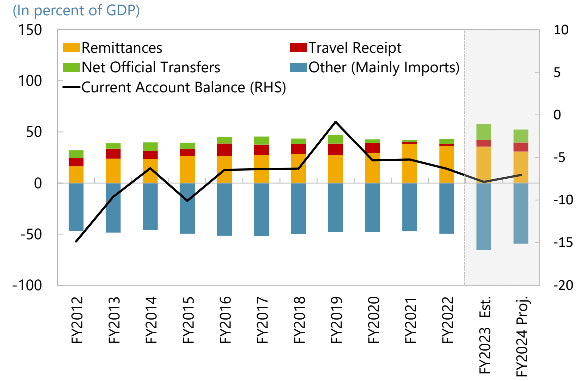
The increase in travel receipts is expected to be more than offset by the moderation of remittances and grants…

Remittances and Travel Receipts
(In percent of GDP)



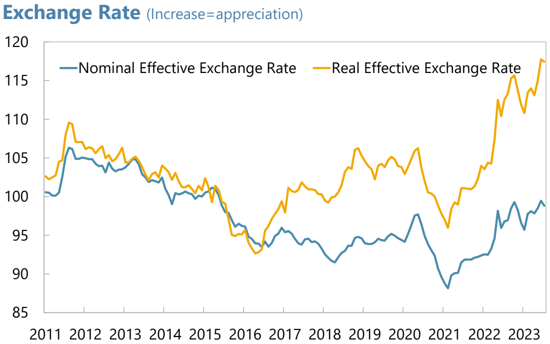
…contributing to widening of CAD in FY2024.

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 expected to remain stable and adequate.

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

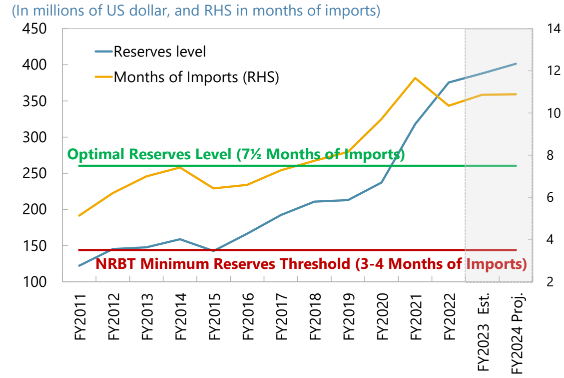
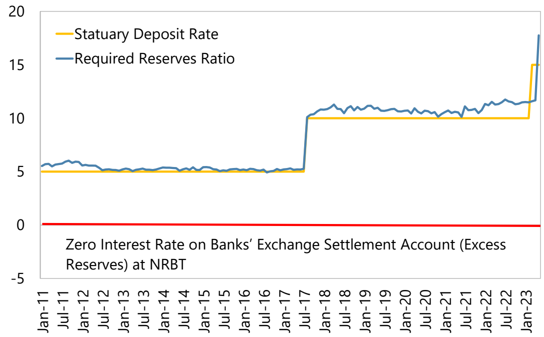


Figure 3. Tonga: Monetary Sector Development

Monetary policy was tightened in February 2023.

Monetary Policy Instrument

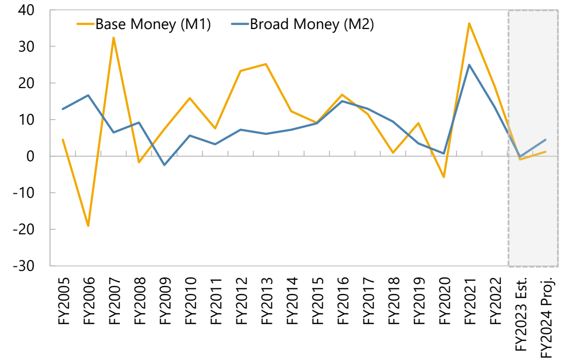
(In percent of Total Bank Deposits)



The stock of broad money is expected to remain largely unchanged.

Domestic Liquidity

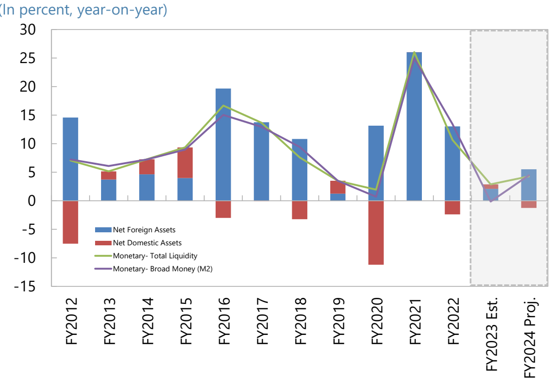
(Year-on-year percent change)



Net domestic assets and net foreign assets both are expected to increase marginally.

Contribution to Total Liquidity: M3

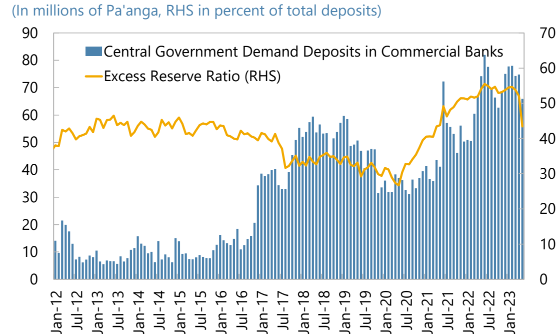
(In percent, year-on-year)



The liquidity in the banking system decreased due to recent tightening but remains high.

Excess Reserve Ratio and Central Government Demand Deposits in Commerical Banks

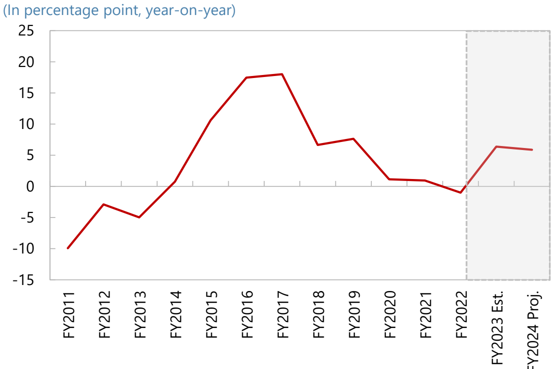
(In millions of Pa'anga, RHS in percent of total deposits)



Credit to the private sector is picking up.

Credit to Private Sector

(In percentage point, year-on-year)



However, the loan-to-deposit ratio has been low due to increase in total deposits.

Loan to Deposit Ratio

(In percent)

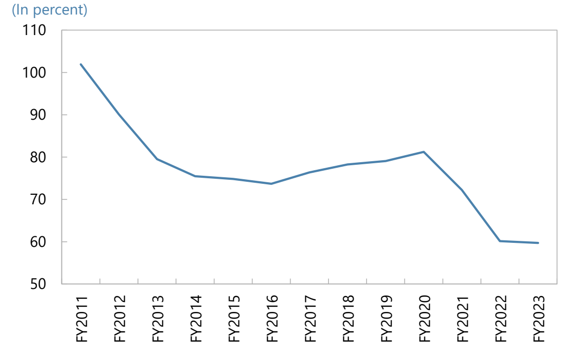
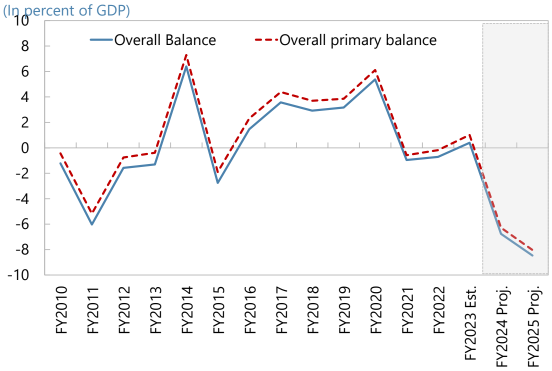


Figure 4. Fiscal Sector Development

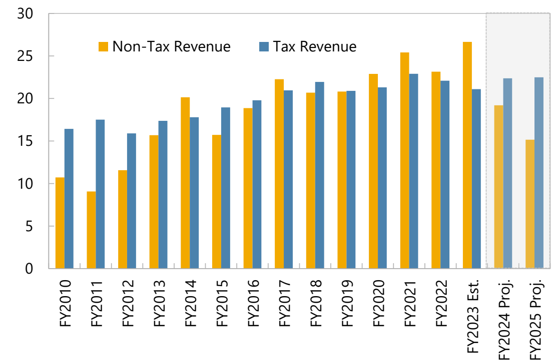
The primary fiscal balance is expected to deteriorate in FY2024.

Overall and Primary Balance
(In percent of GDP)



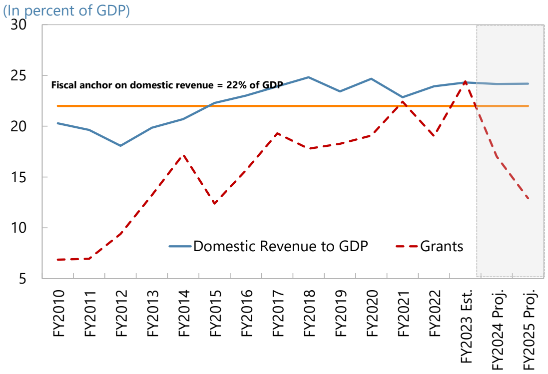
Tax revenues are expected to gradually recover in the short term…

Tax Revenue
(In percent of GDP)



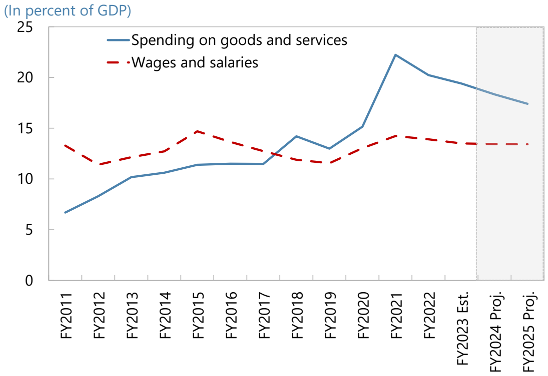
… while external grants from development partners are expected to decline from the exceptional pandemic levels.

Revenues and Grants
(In percent of GDP)



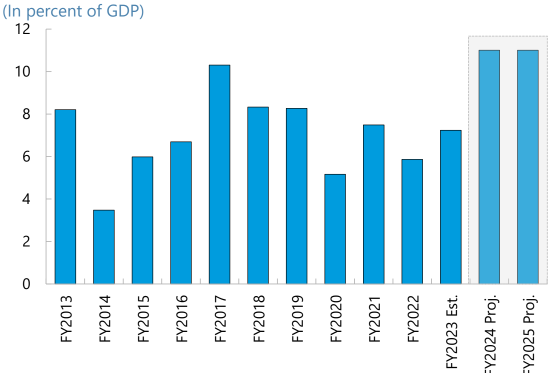
Current expenditure is expected to stay elevated in the short term to support reconstruction.

Current Expenditure
(In percent of GDP)



Existing capital grants are expected to cover the increased post-HTHH capital expenditure needs.

Capital Expenditure
(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)

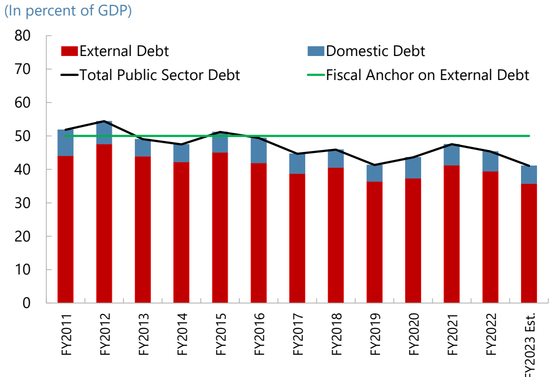
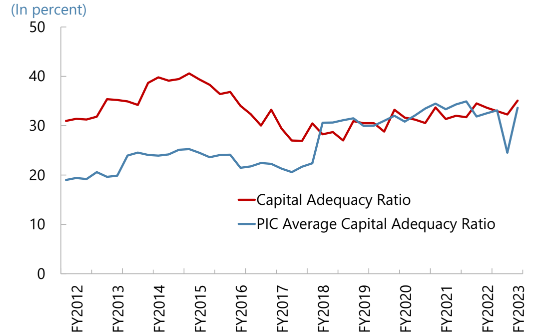


Figure 5. Financial Sector Development

Capital buffers are comparable to the PIC average.

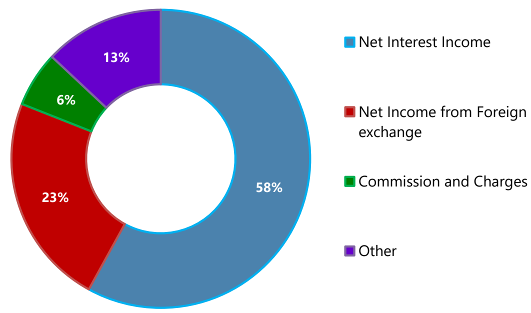
Capital Adequacy Ratio
(In percent)



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

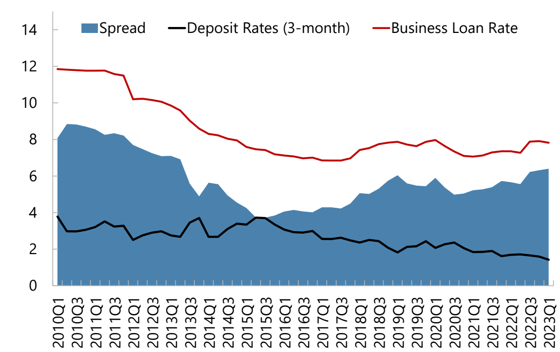
Bank income continues to rely on net interest income...

Financial Sector Operating Income Components in 2020



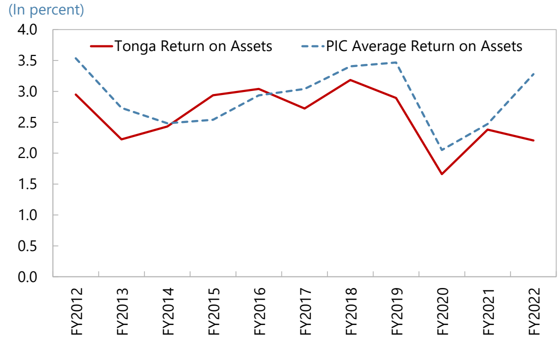
... as interest rate spreads remain wide.

Interest Rates
(In percent)



Banks remain profitable despite a slight decline in profitability.

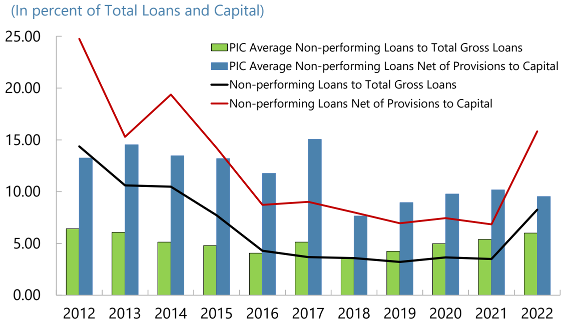
Return on Assets
(In percent)



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

NPLs increased notably in FY2022.

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.

Bank lending remains concentrated in residential loans.

Residential Real Estate Loans to Total Loans
(In percent)

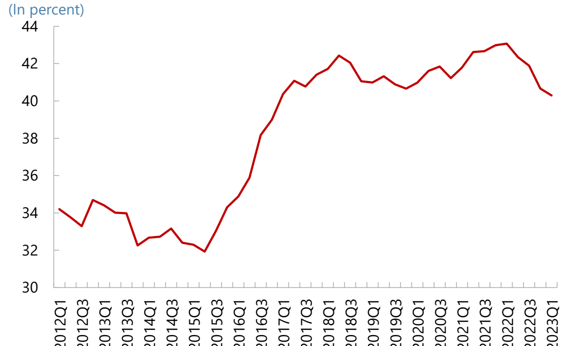


Table 1. Tonga: Selected Economic Indicators, FY2021–FY2025 1/

Population (2021): 100 thousands
Major exports: root crops, vanilla, squash, fish

	FY2021	FY2022	Est. FY2023	Projections FY2024	Projections FY2025
Output and prices			**(Annual percent change)**		
Real GDP[2]	-2.7	-2.0	2.6	2.5	2.2
Consumer prices (period average)[3]	1.4	8.5	10.2	5.8	4.1
Consumer prices (end of period)[3]	6.9	11.3	7.4	6.2	3.2
Central government finance			**(In percent of GDP)**		
Revenue	48.3	45.2	47.7	41.6	37.6
of which: Grants	22.4	19.0	24.4	17.0	12.9
Expenditure	49.3	45.9	47.4	48.3	46.1
Expense	41.8	40.1	40.1	37.3	35.1
Net acquisition of nonfinancial assets	7.5	5.9	7.2	11.0	11.0
Primary balance	-0.6	-0.2	1.0	-6.3	-8.0
Overall balance	-1.0	-0.7	0.4	-6.8	-8.5
Overall balance (excl. grants)	-23.4	-19.7	-24.0	-23.8	-21.4
Money and credit			**(Annual percent change)**		
Broad money (M2)	25.0	13.4	-0.1	4.5	3.4
Domestic credit	-8.2	-3.3	3.9	16.1	8.8
Of which: Private sector credit	1.0	-1.0	6.4	5.9	4.3
Balance of payments			**(In millions of U.S. dollars)**		
Current account balance	-24.7	-31.5	-43.0	-41.0	-45.0
(In percent of GDP)	-5.2	-6.3	-7.9	-7.1	-7.4
Exports of goods, f.o.b.	16.2	15.1	16.3	18.4	19.6
Imports of goods, f.o.b.	214.5	214.9	295.7	285.7	295.4
Tourism receipts	9.1	9.6	35.6	50.9	58.5
Total remittances	217.4	215.9	239.2	227.9	224.8
(In percent of GDP)	46.2	43.4	43.7	39.2	37.0
Compensation of overseas workers	37.8	35.3	44.2	48.9	53.8
Personal remittances	179.6	180.6	195.0	179.0	171.0
Official grants	10.5	26.4	85.4	75.1	78.4
Capital account balance	69.1	84.6	53.1	29.0	5.4
Financial account balance	1.1	23.7	-6.7	25.3	47.4
Gross official foreign reserves					
In millions of U.S. dollars	317.9	375.5	388.1	401.4	409.2
(In months of next year's total imports)	11.7	10.3	10.9	10.9	10.8
Debt			**(In percent of GDP)**		
Public debt (external and domestic)	47.8	45.4	41.2	45.4	51.6
Of which: External debt	41.2	39.4	37.2	38.0	43.9
External debt service ratio	0.7	1.5	2.1	3.8	3.5
Exchange rates					
Exchange rate (National currency per US dollar)	2.3	2.3	2.3	...	...
Real effective exchange rate (2010=100; +=appreciation)	107.1	115.7	125.0	...	...
Memorandum items:					
Nominal GDP (millions of US$)	470.5	497.6	547.2	581.1	607.4

Sources: Tonga authorities; and IMF staff estimates and projections.
[1]Fiscal year beginning July 1.
[2] Real GDP data for FY2022 are estimated by staff.
[3]CPI basket and methodology changed in September 2018.

Table 2. Tonga: Balance of Payments Summary, FY2020–FY2028

				Est.			Projections		
	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028
				(In millions of U.S. Dollars)					
Current account balance	**-26.1**	**-24.7**	**-31.5**	**-43.0**	**-41.0**	**-45.0**	**-47.9**	**-50.7**	**-55.6**
Trade balance	-193.5	-198.2	-199.8	-279.4	-267.3	-275.8	-281.4	-286.8	-291.0
Exports, f.o.b.	18.2	16.2	15.1	16.3	18.4	19.6	21.7	23.5	25.1
Imports, f.o.b.	-211.6	-214.5	-214.9	-295.7	-285.7	-295.4	-303.1	-310.3	-316.1
Services balance	-18.8	-36.3	-68.2	-65.5	-51.0	-44.0	-41.2	-40.0	-38.6
Receipts	82.8	42.1	44.1	74.4	91.9	103.1	111.8	118.8	125.3
Payments	-101.6	-78.4	-112.4	-139.8	-143.0	-147.1	-153.1	-158.8	-163.9
Investment income balance	37.6	27.7	23.7	25.6	32.1	37.1	41.5	46.0	50.8
Receipts	53.3	41.0	37.9	47.1	51.9	56.9	62.0	67.2	72.5
Payments	-15.7	-13.3	-14.2	-21.4	-19.8	-19.8	-20.4	-21.2	-21.7
Transfers balance	148.6	182.2	212.9	276.2	245.2	237.6	233.2	230.0	223.2
Official transfers (net)[1]	18.4	8.8	25.3	84.1	73.7	77.0	68.3	60.6	49.2
Private transfers (net)	130.2	173.4	187.6	192.1	171.5	160.7	164.9	169.4	174.0
Capital account balance	**70.1**	**69.1**	**84.6**	**53.1**	**29.0**	**5.4**	**10.6**	**10.8**	**11.0**
Financial account balance	**-3.6**	**1.1**	**23.7**	**-6.7**	**25.3**	**47.4**	**53.7**	**58.3**	**66.2**
FDI (net)	3.7	0.4	2.4	1.2	1.3	1.8	1.3	1.5	1.4
Other investment (net)	-2.3	5.0	21.6	-9.0	24.3	45.8	52.6	57.0	65.0
Of which: Loan disbursements	2.8	6.6	3.1	0.1	43.9	65.3	71.8	75.7	82.7
Errors and omissions	-16.1	25.5	-22.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**24.3**	**64.7**	**54.5**	**3.4**	**13.3**	**7.8**	**16.4**	**18.3**	**21.6**
Financing	**-24.3**	**-64.7**	**-54.5**	**-3.4**	**-13.3**	**-7.8**	**-16.4**	**-18.3**	**-21.6**
Change in reserve assets (- decrease)	24.3	80.8	57.6	12.6	13.3	7.8	16.4	16.3	17.5
Use of IMF credit (net)	0.0	9.7	0.0	9.3	0.0	0.0	0.0	-2.0	-4.1
Disbursement (RCF)[2]	0.0	9.7	0.0	9.3	0.0	0.0	0.0	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.0	4.1
Suspended debt service under G20 DSSI[3]	0.0	6.4	3.1	0.0	0.0	0.0	0.0	0.0	0.0
				(In percent of GDP)					
Current account balance	-5.3	-5.2	-6.3	-7.9	-7.1	-7.4	-7.6	-7.8	-8.2
Trade balance	-39.5	-42.1	-40.2	-51.1	-46.0	-45.4	-44.6	-44.0	-43.2
Exports, f.o.b.	3.7	3.5	3.0	3.0	3.2	3.2	3.4	3.6	3.7
Imports, f.o.b.	-43.2	-45.6	-43.2	-54.0	-49.2	-48.6	-48.1	-47.6	-46.9
Services balance	-3.8	-7.7	-13.7	-12.0	-8.8	-7.2	-6.5	-6.1	-5.7
Receipts	16.9	8.9	8.9	13.6	15.8	17.0	17.7	18.2	18.6
Payments	-20.7	-16.7	-22.6	-25.6	-24.6	-24.2	-24.3	-24.4	-24.3
Investment income balance	7.7	5.9	4.8	4.7	5.5	6.1	6.6	7.1	7.5
Receipts	10.9	8.7	7.6	8.6	8.9	9.4	9.8	10.3	10.8
Payments	-3.2	-2.8	-2.8	-3.9	-3.4	-3.3	-3.2	-3.2	-3.2
Transfers balance	30.3	38.7	42.8	50.5	42.2	39.1	37.0	35.3	33.1
Official transfers (net)[1]	3.7	1.9	5.1	15.4	12.7	12.7	10.8	9.3	7.3
Private transfers (net)	26.6	36.9	37.7	35.1	29.5	26.5	26.2	26.0	25.8
Capital account balance	14.3	14.7	17.0	9.7	5.0	0.9	1.7	1.7	1.6
Financial account balance	-0.7	0.2	4.8	-1.2	4.4	7.8	8.5	8.9	9.8
FDI (net)	0.7	0.1	0.5	0.2	0.2	0.3	0.2	0.2	0.2
Other investment (net)	-0.5	1.1	4.3	-1.6	4.2	7.5	8.3	8.7	9.6
of which : Loan disbursements	0.6	1.4	0.6	0.0	7.6	10.7	11.4	11.6	12.3
Overall balance	5.0	13.7	11.0	0.6	2.3	1.3	2.6	2.8	3.2
Financing	-5.0	-13.7	-11.0	-0.6	-2.3	-1.3	-2.6	-2.8	-3.2
Change in reserve assets (- decrease)	5.0	17.2	11.6	2.3	2.3	1.3	2.6	2.5	2.6
Use of IMF credit (net)	0.0	2.1	0.0	1.7	0.0	0.0	0.0	-0.3	-0.6
Disbursement (RCF)[2]	0.0	2.1	0.0	1.7	0.0	0.0	0.0	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.6
Suspended debt service under G20 DSSI[3]	0.0	1.4	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Gross official foreign reserves	237.2	317.9	375.5	388.1	401.4	409.2	425.6	441.9	459.5
In months of next year's total imports	9.7	11.7	10.3	10.9	*10.9*	*10.8*	*10.9*	*11.0*	*11.1*
Exchange rate									
T$ per U.S. dollar (period average)	2.3	2.3	2.3	2.3	...	...	...	...	...
T$ per U.S. dollar (end of period)	2.3	2.2	2.3	2.4	...	...	...	...	...
Nominal GDP (in millions of US$)	490.2	470.5	497.6	547.2	581.1	607.4	630.3	651.6	673.9
Commodity price indexes (2005 = 100)									
Food	100.2	114.7	137.9	143.4	138.8	136.6	134.3	133.6	133.9
Fuel	110.5	137.4	241.3	242.5	187.9	185.7	175.4	165.5	158.6

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, FY2020-FY2025 1/

				Est.	Projections	
	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
			(In millions of T$, end of period)			
Net foreign assets	570.6	728.6	828.4	846.0	894.1	933.5
Claims on nonresidents	601.9	782.0	922.8	964.3	1011.5	1051.8
NRBT	555.9	721.4	878.1	921.4	973.3	1006.7
Other depository corporations	46.0	60.6	44.6	42.9	38.2	45.1
Liabilities to nonresidents	-31.2	-53.4	-94.4	-118.3	-117.4	-118.3
NRBT	-20.8	-43.3	-83.4	-107.2	-107.2	-107.2
Other depository corporations	-10.4	-10.1	-11.0	-11.1	-10.2	-11.1
Net domestic assets	36.5	36.6	18.3	25.0	14.1	8.1
Net domestic credit	251.9	231.3	223.6	232.4	269.8	293.4
Net claims on government	-244.8	-257.6	-257.0	-286.3	-271.5	-279.0
Claims on public nonfin. corps.	61.6	50.3	46.0	40.0	35.6	45.7
Claims on private sector	432.7	436.9	432.5	460.0	487.1	508.0
Other items, net	-215.4	-194.7	-205.3	-207.4	-255.7	-285.3
Total liquidity (M3)	607.1	765.2	846.7	871.1	908.2	941.7
Broad money (M2)	578.5	723.0	820.0	818.9	855.4	884.6
Narrow money	247.3	337.0	401.5	397.9	402.6	434.9
Quasi money	331.3	386.0	418.5	420.9	452.8	449.7
FX deposits	28.5	42.2	26.7	52.2	52.8	57.0
			(Annual percentage change)			
Net foreign assets	15.9	27.7	13.7	2.1	5.7	4.4
Net domestic assets	-57.6	0.1	-50.0	36.7	-43.5	-42.4
Net domestic credit	-16.1	-8.2	-3.3	3.9	16.1	8.8
Claims on private sector	1.1	1.0	-1.0	6.4	5.9	4.3
Total liquidity	1.2	26.1	10.6	2.9	4.3	3.7
Broad money (M2)	0.7	25.0	13.4	-0.1	4.5	3.4
Memorandum items:						
Nominal GDP (in millions T$)	1119.7	1068.7	1137.0	1283.2	1391.8	1481.1
Velocity (GDP/M2)	1.9	1.5	1.4	1.6	1.6	1.7
T$ per U.S. dollar (end of period)	2.3	2.2	2.3	...	...	...

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, FY2021-FY2028 1/

	FY2021	FY2022	Est. FY2023	Projections FY2024	FY2025	FY2026	FY2027	FY2028
				(In percent of GDP)				
Total Revenue	48.3	45.2	47.7	41.6	37.6	35.9	34.5	32.5
Memo: Revenue (excluding grants)	25.9	26.2	23.3	24.6	24.7	24.8	24.9	25.0
Tax revenue	22.9	22.1	21.1	22.4	22.5	22.6	22.7	22.8
Taxes on income/profits	4.5	4.9	4.0	4.5	4.6	4.7	4.8	4.9
Taxes on property	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on goods and services	16.2	15.4	14.8	15.0	15.0	15.0	15.0	15.0
Taxes on international trade and transactions	2.1	1.8	2.3	2.8	2.9	2.9	2.9	2.9
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants[1]	22.4	19.0	24.4	17.0	12.9	11.1	9.5	7.5
Budget support (cash)	3.7	5.8	8.4	4.1	4.0	4.0	4.0	4.0
Other grants	18.7	13.3	16.0	12.9	8.9	7.1	5.5	3.5
Other Revenue	3.0	4.1	2.2	2.2	2.2	2.2	2.2	2.2
Property income	1.2	1.0	0.8	0.7	1.0	1.0	1.0	1.0
Sales of goods and services	1.3	0.8	1.2	1.2	1.2	1.2	1.2	1.2
Total Expenditure	49.3	45.9	47.4	48.3	46.1	45.5	45.1	44.7
Memo: Expenditure (excluding grants in-kind)	33.1	36.7	40.2	39.5	37.2	38.4	39.5	41.2
Expense	41.8	40.1	40.1	37.3	35.1	33.7	32.8	33.1
Salaries and wages	13.8	13.1	11.7	11.8	11.6	11.6	11.7	11.7
Employers' social contribution	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0
Interest	0.4	0.5	0.6	0.5	0.4	0.5	0.6	0.7
Of which: External	0.2	0.4	0.5	0.4	0.2	0.3	0.4	0.5
Use of goods and services	22.2	20.2	19.4	18.3	17.4	16.4	15.4	15.4
Subsidies	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants	0.4	0.4	1.8	1.7	0.3	0.3	0.3	0.3
Social benefits	1.7	2.3	2.5	2.0	2.0	2.0	2.0	2.0
Other expense	2.2	2.4	3.1	1.9	2.3	1.8	1.8	1.9
Net investment in nonfinancial assets	7.5	5.9	7.2	11.0	11.0	11.8	12.3	11.6
Buildings and structures	5.6	3.8	3.7	5.1	6.5	7.6	7.6	6.9
Machinery and equipment	1.1	1.0	3.2	3.7	2.5	2.2	2.7	2.7
Other fixed assets and non-produced assets	0.8	1.2	0.3	2.2	2.0	2.0	2.0	2.0
Gross Operating Balance	6.5	5.2	7.6	4.2	2.5	2.2	1.7	-0.5
Overall balance	-1.0	-0.7	0.4	-6.8	-8.5	-9.6	-10.6	-12.2
Primary balance	-0.6	-0.2	1.0	-6.3	-8.0	-9.0	-10.0	-11.4
Net acquisition of financial assets	1.7	-1.3	0.5	-1.4	0.0	0.0	0.0	0.0
External financing (loans)	2.9	-0.5	0.1	4.3	7.6	8.4	9.1	10.3
New disbursement	3.4	0.6	1.7	7.6	10.8	11.5	12.0	13.0
Of which : IMF RCF[2]	2.1	0.0	1.7	0.0	0.0	0.0	0.0	0.0
Of which : G20 DSSI	1.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Repayment	0.6	1.2	1.7	3.4	3.2	3.1	2.9	2.6
Domestic financing (debt securities)	-0.2	0.0	0.1	1.1	0.8	1.1	1.5	1.8
Memorandum items:								
Nominal GDP (in millions of T$)	1068.7	1137.0	1283.2	1391.8	1481.1	1556.5	1626.2	1701.7
Fiscal anchors[3]								
Compensation of employees								
(in percent of domestic revenue) **< 53**	57.3	54.2	54.3	52.0	51.0	50.7	50.8	50.8
(in percent of current expense) **< 45**	35.6	35.4	31.6	34.2	35.9	37.4	38.6	38.4
Domestic revenue (in percent of GDP) **> 22**	25.9	26.2	23.3	24.6	24.7	24.8	24.9	25.0
External debt (in percent of GDP) **< 50**	41.2	39.4	37.2	38.0	43.9	50.7	58.2	66.7

Sources: Tonga authorities; and IMF staff estimates and projectior

[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

Table 5. Tonga: Medium-Term Baseline Scenario, FY2021–FY2028 1/

	FY2021	FY2022	Est. FY2023	Projections FY2024	FY2025	FY2026	FY2027	FY2028
Output and prices			(Annual percentage change)					
Real GDP	-2.7	-2.0	2.6	2.5	2.2	1.6	1.2	1.2
Consumer prices (end of period)	6.9	11.3	7.4	6.2	3.2	3.1	3.3	3.3
Consumer prices (period average)	1.4	8.5	10.2	5.8	4.1	3.4	3.2	3.4
Central government finance[2]			(In percent of GDP)					
Total Revenue	48.3	45.2	47.7	41.6	37.6	35.9	34.5	32.5
Memo: Total Revenue (excluding grants)	25.9	26.2	23.3	24.6	24.7	24.8	24.9	25.0
Tax revenue	22.9	22.1	21.1	22.4	22.5	22.6	22.7	22.8
Grants	22.4	19.0	24.4	17.0	12.9	11.1	9.5	7.5
Other Revenue	3.0	4.1	2.2	2.2	2.2	2.2	2.2	2.2
Total Expenditure	49.3	45.9	47.4	48.3	46.1	45.5	45.1	44.7
Memo: Total Expenditure (excluding grants in-kind)	33.1	36.7	40.2	39.5	37.2	38.4	39.5	41.2
Expense	41.8	40.1	40.1	37.3	35.1	33.7	32.8	33.1
Salaries and wages	13.8	13.1	11.7	11.8	11.6	11.6	11.7	11.7
Employers' social contribution	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0
Use of goods and services	22.2	20.2	19.4	18.3	17.4	16.4	15.4	15.4
Interest expense	0.4	0.5	0.6	0.5	0.4	0.5	0.6	0.7
Other expense	4.3	5.1	7.4	5.7	4.7	4.1	4.1	4.2
Transactions in Nonfinancial Assets	7.5	5.9	7.2	11.0	11.0	11.8	12.3	11.6
Gross Operating Balance	6.5	5.2	7.6	4.2	2.5	2.2	1.7	-0.5
Overall Balance	-1.0	-0.7	0.4	-6.8	-8.5	-9.6	-10.6	-12.2
Primary Balance	-0.6	-0.2	1.0	-6.3	-8.0	-9.0	-10.0	-11.4
Net Acquisition of Financial Assets	1.7	-1.3	0.5	-1.4	0.0	0.0	0.0	0.0
External financing (net)	2.9	-0.5	0.1	4.3	7.6	8.4	9.1	10.3
Domestic financing (net)	-0.2	0.0	0.1	1.1	0.8	1.1	1.5	1.8
Balance of payments			(In percent of GDP)					
Trade balance	-42.1	-40.2	-51.1	-46.0	-45.4	-44.6	-44.0	-43.2
Exports, f.o.b.	3.5	3.0	3.0	3.2	3.2	3.4	3.6	3.7
Imports, f.o.b.	-45.6	-43.2	-54.0	-49.2	-48.6	-48.1	-47.6	-46.9
Services balance	-7.7	-13.7	-12.0	-8.8	-7.2	-6.5	-6.1	-5.7
Investment income balance	5.9	4.8	4.7	5.5	6.1	6.6	7.1	7.5
Transfers balance	38.7	42.8	50.5	42.2	39.1	37.0	35.3	33.1
Of which: Remittances	38.2	36.3	35.6	30.8	28.2	27.9	27.8	27.6
Of which: Official grants	2.2	5.3	15.6	12.9	12.9	11.1	9.5	7.5
Current account balance	-5.2	-6.3	-7.9	-7.1	-7.4	-7.6	-7.8	-8.2
Capital account balance	14.7	17.0	9.7	5.0	0.9	1.7	1.7	1.6
Financial account balance	-0.2	-4.8	1.2	-4.4	-7.8	-8.5	-8.9	-9.8
Gross international reserves (end of period)								
In millions of U.S. dollars	317.9	375.5	388.1	401.4	409.2	425.6	441.9	459.5
In months of next year's goods and services imports	11.7	10.3	10.9	10.9	10.8	10.9	11.0	11.1
External debt (in percent of GDP)								
Public sector external debt	41.2	39.4	37.2	38.0	43.9	50.7	58.2	66.7
Debt service ratio	0.7	1.5	2.1	3.8	3.5	3.4	3.2	3.1
Public sector total debt (in percent of GDP)	47.8	45.4	41.2	45.4	51.6	59.1	67.7	77.5
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	173.4	187.6	192.1	171.5	160.7	164.9	169.4	174.0
(In percent of imports of goods and services)	59.2	57.3	44.1	40.0	36.3	36.2	36.1	36.3
Commodity price indexes (2005 = 100)								
Food	114.7	137.9	143.4	138.8	136.6	134.3	133.6	133.9
Fuel	137.4	241.3	242.5	187.9	185.7	175.4	165.5	158.6
Nominal GDP (millions of T$)	1068.7	1137.0	1283.2	1391.8	1481.1	1556.5	1626.2	1701.7

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, FY2016-FY2023

	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023 1/
Banks								
Net domestic credit				(Year-on-year percent change)				
Public non-financial corporations	-3.0	-5.9	20.5	15.2	2.4	-18.4	-8.7	-13.0
Private sector	17.5	18.0	6.7	7.6	1.1	1.0	-1.0	6.4
				(In percent of GDP)				
Credit/GDP	38.8	40.9	41.9	42.0	44.2	45.6	42.1	39.0
Private Sector Credit/GDP	33.9	36.6	37.1	36.8	38.6	40.9	38.0	35.9
Public Nonfinancial Corporations/GDP	4.9	4.3	4.9	5.2	5.5	4.7	4.0	3.1
				(In percent)				
Regulatory Capital to Risk-Weighted Assets	34.0	29.4	28.3	30.5	31.6	31.4	33.6	35.1
Return on Assets	3.6	2.7	3.2	2.9	1.7	2.4	2.2	2.2
Return on Equity	15.5	10.7	13.7	10.7	5.7	9.3	9.0	8.8
Non-performing Loans to Total Gross Loans	6.7	4.1	3.6	3.2	4.1	3.3	6.3	8.0
Non-performing Loans Net of Provisions to Capital	13.5	8.8	8.4	6.2	9.1	6.6	12.9	13.5
Liquid Assets to Total Assets	33.5	32.4	27.1	25.6	27.9	40.2	44.6	42.8
Liquid Assets to Short-term Liabilities	65.0	63.3	51.0	49.8	60.2	73.0	76.7	72.4
Large Exposures to Capital	44.6	56.9	49.4	48.0	60.1	55.7	53.7	37.8
Personnel Expenses to Non-interest Expenses	32.3	28.0	29.8	29.5	29.1	31.5	29.5	30.1
Foreign-Currency-Denominated Loans to Total Loans	0.3	1.0	1.4	2.3	0.7	0.7	0.7	0.6
Foreign-Currency-Denominated Liabilities to Total Liabilities	4.7	6.9	5.7	7.1	6.2	6.5	4.3	3.9
Residential Real Estate loans to Total Loans	35.9	41.1	42.4	41.3	41.6	42.6	42.3	40.3
Commercial Real Estate Loans to Total Loans	2.3	2.4	2.5	2.2	2.4	4.2	3.5	4.2
Memorandum Items:								
Nominal GDP (millions T$)	932.6	1,017.7	1,072.6	1,162.9	1,119.7	1,068.7	1,137.0	1,283.2

Sources: National Reserve Bank of Tonga; and IMF, Financial Soundness Indicators.
1/ 2023Q1 data for financial soundness indicators.

Table 7. 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. Recommendations from 2022 Article IV Consultation

Sector	Main Recommendations	Actions Since 2022 Article IV Consultation
Fiscal Policies	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.	The authorities pursued additional grants from development partners and received additional budget support from Australia, which mitigates the budget deficit.
	Continue reform efforts to broaden the tax base and improve spending efficiency.	The Electronic Sales Register System regulations were gazetted in June 2022. By March 2023, 54 business across 163 outlets (particularly wholesale and retail outlets) in the two major islands (Tongatapu and Vava'u) have been registered onto the system. The authorities expect more than 200 businesses to be registered by end FY23.
	Manage debt repayment to the China EXIM Bank.	The government has set up a Debt Repayment Sinking Fund to facilitate timely repayments of the China EXIM Bank loans.
Monetary Policy	Tighten monetary policy stance if inflation is expected to stay above the reference rate for longer.	The NRBT increased the statutory reserve deposit (SRD) ratio from 10 to 15 percent and established a deposit facility in February 2023, given the more intense and persistent inflation pressures than anticipated in the 2022 Article IV consultation.
Financial Sector Policies	Improve financial supervision and develop a macroprudential policy framework	With assistance from the PFTAC, the NBRT is working on developing/reviewing regulatory and supervisory frameworks for non-banking credit institutions and foreign exchange dealers.
	Support credit and promote financial deepening and inclusion	The authorities continue to support lending to micro-, small-, and medium-sized enterprises (MSMEs) and low-income households, including by providing subsidized interest rate loans under the Government Development Loan scheme.
Structural Policies	Enhance resilience to natural disasters and climate change.	The authorities are implementing reconstruction projects under a comprehensive plan and enacted the Disaster Risk Management Act in 2023 that focuses on ex-ante disaster preparedness.
	Develop the private sector to boost Tonga's long-term growth potential.	The authorities are working on promoting digitalization including through ongoing efforts to launch a national digital ID system.
	Continue to reinforce the AML/CFT framework	Tonga has advanced further on amending AML/CFT legislation with IMF technical assistance that is aimed to address deficiencies identified in the Asia-Pacific Group's Mutual Evaluation Report. The draft amendments to the legal framework and implementing regulations are expected to be submitted to Parliament in late 2023. The NRBT has also established a dedicated unit to strengthen AML/CFT supervision and to enhance collaboration with regional AML/CFT supervisors and financial intelligence units.

Annex II. Integration Matrix of Surveillance Issues and Capacity Building

Surveillance Issues	International Monetary Fund			World Bank		Asian Development Bank	
	Past	2021-2022	Planned/ Ongoing	Past	Planned/ Ongoing	Past	Planned/ Ongoing
Fiscal Sector							
Public Financial Management	√	√		√	√	√	√
Expenditure framework	√			√	√	√	√
Revenue Framework	√	√		√	√		
Real Sector							
Macroeconomic Frameworks		√	√				
Macro-Financial Issues							
Financial supervision and regulation	√	√	√	√	√		
Financial market development	√	√	√	√	√		√
AML/CFT			√				√
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 III. External Sector Assessment

Overall Assessment: Tonga's external position in FY2023 was broadly in line with the level implied by fundamentals and desirable policy settings, based on the results of the IMF's EBA-lite current account model.[1]

Potential Policy Responses: Strengthening public finances and promoting private sector development, together with continued strong financial support from development partners, would help Tonga preserve its external sector stability in the presence of large development spending needs.

Foreign Assets and Liabilities: Position and Trajectory[2]

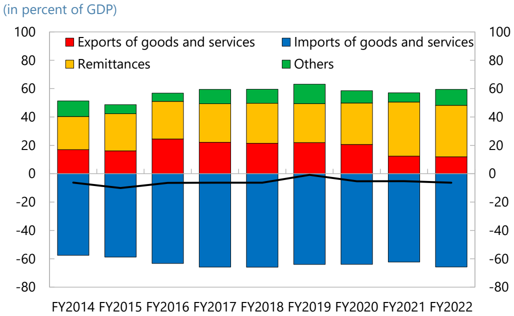
Background. Tonga's debt obligations are largely external, and over half of its external public debt is to China, with a sharp spike in debt repayments due from FY2024 onwards. Total public and publicly guaranteed (PPG) external debt stood at about 38 percent of GDP as of end FY 2022, accounting for 86 percent of total public debt. Outstanding debt to all multilateral creditors stood at about 16 percent of GDP, or about 43 percent of the total external debt stock (see the DSA Annex).

Assessment. New external borrowing is expected to commence in FY2025 and to gradually increase over the medium term due to debt repayments and high primary deficits (see the DSA Annex).

Current Account

Background. From FY2014 to FY2022, Tonga's current account (CA) deficit averaged about 6 percent of GDP. For FY2023, Tonga continued to receive high levels of remittance and budget support from donors, and tourist arrivals rebounded strongly following the border reopening in August 2022. However, goods imports increased notably due to higher import demand for reconstruction-related capital goods. Overall, the current account deficit is estimated to widen from 6.3 percent of GDP in FY2022 to 7.9 percent of GDP in FY2023. The CA deficit is projected to narrow slightly in FY2024, reflecting continued tourism recovery and lower good imports that are partially offset by the decline in both official grants and private remittance.

Current Account Developments
(in percent of GDP)



Sources: Tonga authorities; and IMF staff estimates.

Assessment. The EBA-lite CA model estimates the cyclically adjusted CA balance at -8.2 percent of GDP and the adjusted CA norm at -8.2 percent of GDP. With a gap close to 0, the external position in FY2023 is assessed to be broadly in line with medium-term fundamentals and desirable policies (text table). The overall assessment considers the impacts of the COVID-19 pandemic on tourism developments, with a total adjustment of 0.9 percent of GDP. The policy gap (2.6 percent of GDP) primarily reflects the relatively looser fiscal policy in the rest of the world.

Tonga: EBA-lite Estimates for FY2023 (in percent of GDP)

	CA model 1/ (in percent of GDP)
CA-Actual	**-7.9**
Cyclical contributions (from model) (-)	0.5
COVID-19 adjustors (-) 2/	-0.9
Additional temporary/statistical factors (-)	0.0
Natural disasters and conflicts (-)	0.7
Adjusted CA	**-8.2**
CA Norm (from model) 3/	**-8.2**
Adjustments to the norm (-)	0.0
Adjusted CA Norm	**-8.2**
CA Gap	**0.0**
o/w Relative policy gap	2.6
Elasticity	-0.3
REER Gap (in percent)	**-0.1**

1/ Based on the EBA-lite 3.0 methodology.
2/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (0.9 percent of GDP).
3/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

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 February 2023. The real effective exchange rate (REER) appreciated by about 8.9 percent on average in FY2023 (July 2022-June 2023), reflecting the appreciation of the nominal effective exchange rate (NEER) by about 4.9 percent and Tonga's higher inflation compared with its major trading partners.

Assessment. The CA gap model implied that the REER gap is around -0.1 percent (applying an estimated elasticity of the trade balance with respect to changes in the REER of -0.25). However, there is a large uncertainty surrounding our assessment given that: (i) the official BOP data for FY2023 are yet to be published; (ii) the expected changes in grants, tourism receipts, and remittances are unusually large; and (iii) the recent inflation developments are affecting both the current account and the REER.

Capital and Financial Accounts: Flows and Policy Measures

Background. Tonga's recent current account deficits have been largely financed by large capital account credits in the form of project support grants and grants in-kind. The Foreign Investment Act 2020 reduced restrictions for foreign investment and opened sectors such as tourism, fisheries, and agriculture. However, foreign direct investment (FDI) inflows have been limited due to structural impediments, such as cumbersome land leasehold market operations and regulatory barriers, including longstanding restrictions that prohibit non-residents' ownership in certain sectors. Recent external borrowings have been limited and exclusively on concessional terms, including the IMF's RCF disbursed in FY2021 and FY2023.

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

FX Intervention and Reserves Level

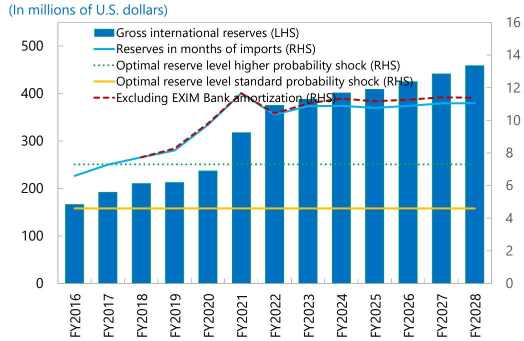
Background. Gross official reserves were US$388 million (about 10.9 months of the following year's imports) in FY2023, compared to US$375.5 million (10.3 months of imports) in FY2022. Reserves remained at a comfortable level due to inflows of foreign grants to help Tonga cope with COVID-19 and rebuilding needs, continued remittances inflows, and the tourism recovery. Over the medium term, the pressures to reserve coverage come from moderation in remittances to pre-pandemic levels, lower grants after current commitments are met, and rising debt repayments, while external government borrowings are expected to support reserves. Overall, reserve coverage is projected to remain stable in FY2024 and over the medium term.

International Reserve Adequacy Metric	FY2023
Actual Reserves (months of prospective imports)	10.9
Optimal level with standard shock probability	4.6
Optimal level with higher shock probability	7.3
Optimal level taking into account debt repayment	8.0
Broad Money coverage	283%

Source: IMF staff estimates.

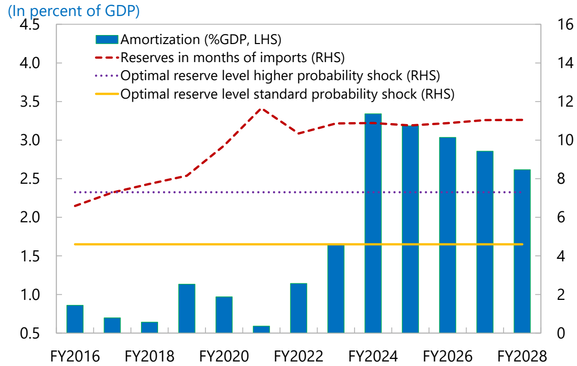
Assessment. A cost-benefit analysis on the level of reserves suggests an optimal level between 4½ and 7½ months of imports. Staff's reserves adequacy framework is tailored to small credit-constrained economies. If the probability of a large shock is set at the sample average of 50 percent, the estimated optimal level of reserves would be 4½ months of imports—above the NRBT's minimum threshold of three 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). Strengthening public finances (as illustrated in the main text of the staff report), implementing structural reforms aimed at enhancing Tonga's climate resilience and promoting private sector development, and new grant commitments from donors would help Tonga further enhance reserve adequacy.

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.

[1] The external sector assessment is based on staff's estimates.
[2] Data limitations do not allow an analysis of the net foreign asset position (with the latest IIP as of 2020). The assessment in this section is based on Debt Sustainability Analysis.

Annex IV. Risk Assessment Matrix[1]

	Source of Risks	Likelihood	Expected Impact	Policy Recommendation
Global	**Commodity price volatility** 1/	High	Medium-High. If prices increase, a larger import bill and current account deficit, leading to lower FX reserves; higher inflation and weaker private consumption due to lower real income; delays in reconstruction or investment projects if wage inflation pressures or construction material prices increase.	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. Prioritize public investment in the most necessary projects. In the long-term, increase public investment to expand the productive capacity.
Global	**Abrupt global slowdown or recession** 2/	Medium	Medium-High. Weaker remittance and grant inflows; slower recovery in tourism; lower foreign demand for agricultural products; lower fiscal revenue.	Provide targeted fiscal support to the vulnerable. Improve the private sector business climate and diversify the economy. In the long-term, increase public investment to expand the productive capacity. Accelerate the reforms aimed at broadening the tax base and improving spending efficiency.
Domestic	**Extreme climate events** 3/	High	High. Disruptions in economic activity; lower GDP growth; amplifying inflationary pressures; damages to properties and infrastructure, resulting in lower growth potential; larger fiscal burden and public debts.	Prioritize ex-ante adaptation investment and ex-post expenditure to support the affected households. Strengthen the monitoring of potential asset quality problems in the banking sector. Strengthen fiscal buffers by accelerating reforms to mobilize additional revenues.
Domestic	**Acceleration of outward migration**	High	Medium-High. Higher inflation pressures owing to tighter domestic labor market; lower long-term growth due to increased difficulties in expanding the narrow domestic production base.	Create economic opportunities by developing the small private sector, attracting FDI, and diversifying the economy. Enhance education and skill development.
Domestic	**Higher or more persistent inflation**	Medium	High. Lower private consumption that results in decreased real purchasing power if wages adjust with significant lags; wage-price spiral accompanied with de-anchored inflation expectations.	Monetary policy should be tightened using the NRBT's usual monetary policy instruments. Provide targeted fiscal support to the low-income households.
Domestic	**Partial withdrawal of CBRs, including due to gaps in the AML/CFT framework**	Medium	High. Lower remittance inflows, leading to weaker private consumption and a 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	**Further increase in non-performing loans (NPLs)**	Medium	Medium. Lower lending activities or tighter lending conditions, resulting in lower GDP growth.	Consider requesting banks to prepare a comprehensive plan to tackle NPLs, including with a minimum target provisioning level.

1/ A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability.
2/ Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs.
3/ Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.

[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.

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 2, 2023

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

CONTENTS

FUND RELATIONS

(As of September 21, 2023)

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	18.73	94.55

Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
RCF Loans	13.80	100.00

Latest Financial Arrangements:

Outright Loans

Type	Date of Commitment	Date Drawn/Expired	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
RCF	Jul 15, 2022	Jul 19, 2022	6.90	6.90
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				
	2023	2024	2025	2026	2027
Principal				0.69	1.38

[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.

Charges/Interest	0.02	0.04	0.04	0.04	0.04
Total	0.02	0.04	0.04	0.73	1.42

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 (NRBT) within a band of ±5 percent a month. Because the composite weights cannot be confirmed, the de facto exchange rate arrangement is classified as "other managed." 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 completed in December 2021 found some key elements of the safeguards framework in place, including a tailored legal framework, external audits by an international firm, transparent financial statements, and basic operational controls. However, the prolonged absence of a functioning internal audit mechanism created a hiatus in the governance framework, exacerbated by vacancies at the Board-level. Since then, the Board has been fully reconstituted and reinstated their commitment to implement safeguards assessment recommendations, including through approving an audit committee charter and an external auditor selection policy. Oversight of external audit has also been strengthened. Going forward, the NRBT should continue to advance priority safeguards assessment recommendations, including drafting amendments to the NRBT Act to strengthen the autonomy of the NRBT (for which technical assistance was requested), outsourcing audits of high-risk areas, and establishing a business continuity plan.

Article IV Consultation

Tonga is on a 12–month consultation cycle. The previous Article IV consultation was concluded on July 15, 2022 (Country Report No. 22/282) reflecting discussions that took place during April 24-May 10, 2022.

Technical Assistance: FAD, ICD, LEG, MCM, PFTAC, and STA have provided technical assistance on macroeconomic frameworks, revenue administration, banking supervision, AML/CFT, financial supervision, public financial management, debt management, government finance, 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 (PFTAC):

- Pacific Financial Technical Assistance Center:

https://www.pftac.org/content/PFTAC/en1.html

STATISTICAL ISSUES

(As of September 21, 2023)

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 Ministry of Finance 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 have improved, but the timeliness, consistency, 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 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. Two missions in 2021 and 2022 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.

Table 1. Tonga: Common Indicators Required for Surveillance
(As of September 21, 2023)

	Date of Latest Observation	Date Received	Data Frequency[1]	Reporting Frequency[1]	Frequency of Publication[1]
Exchange Rates	5/2023	7/2023	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	6/2023	8/2023	M	M	M
Reserve/Base Money	5/2023	7/2023	M	M	M
Broad Money	5/2023	7/2023	M	M	M
Central Bank Balance Sheet	5/2023	7/2023	M	M	M
Consolidated Balance Sheet of the Banking System	5/2023	7/2023	M	M	M
Interest Rates[3]	5/2023	7/2023	M	M	M
Consumer Price Index	7/2023	8/2023	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government	2021/22	5/2023	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[4,5]—Central Government	2021/22	5/2023	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2021/22	5/2023	A	A	A
External Current Account Balance	Q2/2022	3/2023	Q	Q	Q
Export and Import of Goods and Services	Q2/2022	3/2023	Q	Q	Q
GDP/GNP	2020/21	12/2022	A	A	A
Gross External Debt	2021/22	3/2023	A	A	A
International Investment Position	Q4/2020	4/2022	A	A	A

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), and Not Available (N/A).
[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[3] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[4] Foreign and domestic financing.
[5] The central government is only the budgetary central government.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION —DEBT SUSTAINABILITY ANALYSIS

October 2, 2023

Approved By
Ranil Salgado, Bergljot Bjornson Barkbu (IMF), and Manuela Francisco and Lalita Moorty (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	Yes

The risk of debt distress rating for Tonga remains high.[1] *Before the pandemic, Tonga's indebtedness had gradually declined from FY2015*[2] *to FY2019 owing to much-needed fiscal consolidation. Since 2020, however, the economy has been hit by multiple shocks, including the COVID-19 pandemic, tropical cyclone Harold in April 2020, and the Hunga Tonga–Hunga Ha'apai (HTHH) volcanic eruption and tsunami in January 2022. In response, the international community has stepped up financial support to Tonga through grants, concessional loans, and debt service suspensions. Against this backdrop, the public debt-to-GDP ratio in FY2023 is expected to rise slightly from pre-pandemic levels. The budget deficit is expected to rise sharply in the coming years due to a gradual decrease in grants under the current commitments and growing spending needs for sustainable development goals (SDG) and climate resilience. Debt service payments will spike in FY2024 due to scheduled repayment to the China Exim Bank. Under the baseline scenario, the present value (PV) of the external debt-to-GDP ratio is expected to breach the threshold starting in FY2033, while the PV of the public debt-to-GDP ratio is also expected to exceed the benchmark in the same year. The breach will continue after FY2033 as both external and public debt continue to rise until 2043. A tailored, large one-time natural disaster shock would result in a significant deterioration in debt sustainability. Long-term debt sustainability hinges on fiscal adjustments and continued donor grant inflows to finance the necessary spending for climate resilience and SDGs. To rebuild fiscal buffers and enhance resilience against shocks, measures for stronger revenue mobilization and expenditure rationalization will be essential, together with external donor support consistent with the historical trends.*

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[1] The Tonga Composite Indicator (CI) index, calculated based on the April 2023 World Economic Outlook (WEO) and the 2021 Country Policy and Institutional Assessment (CPIA), is at 3.06, indicating that Tonga's debt-carrying capacity remains strong.

[2] All the figures are computed using fiscal year beginning in July, e.g., FY2022 runs from July 1, 2021, to June 30, 2022.

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 2023, other government-guaranteed debt was small, about 1.1 percent of GDP. Since the Debt Sustainability Analysis (DSA) coverage does not include debt of state-owned enterprises (guaranteed and non-guaranteed) due to data limitations,[3] 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.[4] The DSA is conducted on a 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	

	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

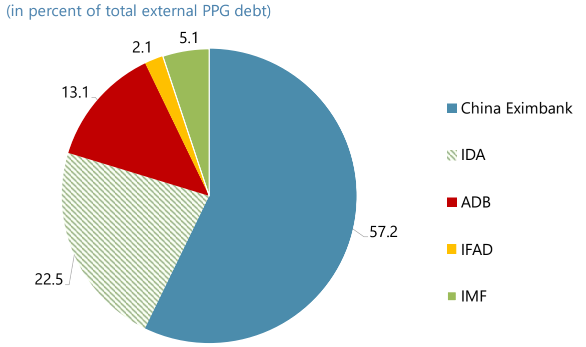
2. After years of decline, public debt level rose modestly since 2019. The public debt-to-GDP ratio declined from 51 percent at end-June 2015 to 41 percent at end-June 2019 (chart) due to fiscal consolidation since FY2016. The recent increase reflects new issuance of domestic debt and the two concessional emergency loans 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. Tonga has not contracted any external non-concessional loans since FY2011, in line with their debt management strategy.

[3] The public debt data shared by the authorities do not include any guaranteed debt, although based on the FY2024 budget document, government guaranteed debt is projected to be about 1.1 percent of GDP by end-2023. The government is working to include guaranteed debt in their public debt data, including through improving quality and timely reporting of debt bulletin.

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

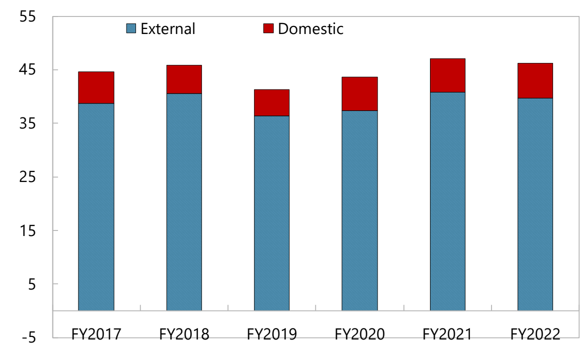
3. Tonga's debt obligations are largely external, and over half of its external public debt is to China, with a sharp spike in debt repayments due from FY2024 onwards. Total public and publicly guaranteed (PPG) external debt stood at USD185 million (about 38 percent of GDP) as of end-June 2022, accounting for 86 percent of total public debt. Outstanding debt to all multilateral creditors stood at USD79 million (about 16 percent of GDP), or about 43 percent of the total external debt stock. The single largest creditor remains the Export-Import Bank of China (China Exim Bank), which accounts for 57 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 and 2021 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). Under the DSSI, debt deferral amounts to 1.4 percent of GDP in FY2021 and 0.7 percent of GDP in FY2022.

Outstanding External PPG Debt by Creditor, June 2022
(in percent of total external PPG debt)



Source: Ministry of Finance.

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, FY2023–33

	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033
	(In percent of GDP)										
Total external debt	1.6	3.3	3.1	2.9	2.7	2.5	1.6	0.9	0.3	0.3	0.3
Multilateral	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.3	0.3	0.3
ADB	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1
IDA/WB	0.1	0.2	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	0.3	0.4	0.5	0.5	0.4	0.2	0.1
Bilateral	1.1	2.8	2.6	2.4	2.3	2.0	1.2	0.5	0.0	0.0	0.0
EXIM Bank of China	1.1	2.8	2.6	2.4	2.3	2.0	1.2	0.5	0.0	0.0	0.0

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

4. Tonga's domestic debt obligations are relatively small. Public domestic debt stood at USD30 million (about 6.1 percent of GDP) at end-June 2022, accounting for 14 percent of total public debt.

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

Domestic financial institutions hold about half of the total domestic debt with the rest held mainly by domestic pension funds. The authorities plan to issue domestic debt in FY2023 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 2023 Article IV consultation. 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]

- **Real GDP growth** is projected at 1.6 percent on average during FY2023–33 (Text Table). The economy is set to recover with the reopening of the border and resumed activities in FY2023 and FY2024. Tourist arrivals, construction projects, and pent-up demand are expected to support growth. However, the rebound is limited by high inflation and labor shortages that may delay reconstruction and investment projects. Over the medium to long term, GDP growth is projected to gradually converge to a potential rate of 1.2 percent, underpinned by continued remittances and sizable government development expenditures. This low long-term growth rate reflects Tonga's remoteness, limited production base, and vulnerability to natural disasters. The risks to the growth projections are tilted to the downside, stemming from an abrupt global slowdown or recession, commodity price volatility, an acceleration of outward migration, and deepening geo-economic fragmentation that could affect Tonga through supply chain disruptions. Tonga is also highly vulnerable to natural disasters and the threat of rising sea levels. Given the importance of remittance and aid inflows to Tonga's economy, disruptions in correspondent banking relationships (CBRs) would have significant knock-on effects on the economy, the financial sector, and debt sustainability. On the upside, a faster-than-anticipated rebound in tourism can help support consumption, while higher capital spending on climate-resilient infrastructure projects could increase climate resilience and lift potential growth.

- **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–FY2025 are assumed to be disaster-free to simplify the policy discussion of the near-term outlook. From FY2026 onwards, the baseline incorporates the

[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.

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.[7]

- **Inflation** is projected to average 4.3 percent during FY2023–33 (Text Table). Inflation is expected to peak in FY2023, reflecting both imported inflation and rising domestic prices due to the ongoing labor shortages. Afterwards, inflation is expected to gradually decline and converge to the steady state level of 3½ percent.[8]

- The **non-interest current account deficit** is estimated to have reached 7.5 percent of GDP in FY2023, owing to higher food and fuel prices and imports of reconstruction-related materials. In the medium to long term, the non-interest current account deficit is projected to average 7.7 percent of GDP over FY2023–FY2033, reflecting persistent weakness in export competitiveness, continued heavy reliance on imports to support domestic demand, a return of remittances to pre-pandemic levels as share of GDP, and a reduction in official transfer inflows after current commitments are met (Text Table). Beyond FY2033, the export-to-GDP ratio is expected to gradually increase, reflecting enhanced competitiveness and productivity in the service sector including tourism due to continued investment in climate resilience and infrastructure and trading partners' growth rates being higher than Tonga's.

- **Net FDI inflows** are expected to stand at 0.2 percent of GDP over FY2023–33.

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

[8] The upward revision of the long-term inflation forecast from the 2022 DSA mainly reflects the recent increase in the frequency of natural disasters in Tonga, which we expect to continue due to climate change. Over the period of 2015-2019, during which Tonga experienced a total of five natural disasters that led to supply disruptions, the annual average inflation rate recorded 3.3 percent.

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

Current DSA	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2012-22 Historical average	FY2023-33 average
Real GDP growth (in percent)	2.6	2.5	2.2	1.6	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.0	1.6
GDP deflator in US dollars (change in percent)	7.2	3.6	2.3	2.1	2.1	2.2	2.0	2.2	2.1	2.1	2.1	-0.3	2.7
Inflation rate (GDP deflator, in percent)	10.0	5.8	4.1	3.4	3.2	3.4	3.2	3.4	3.5	3.5	3.5	2.7	4.3
Non-interest current account deficit	7.5	6.8	7.2	7.3	7.4	7.8	8.3	8.9	8.5	7.8	7.1	5.7	7.7
Net FDI (negative = inflow)	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.1	0.2
Primary deficit	-1.0	6.3	8.0	9.0	10.0	11.4	11.7	10.8	10.0	8.2	6.7	-2.5	8.3
Grants	24.4	17.0	12.9	11.1	9.5	7.5	6.5	5.1	4.5	4.0	4.0	17.4	9.7

Previous DSA	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2011-21 Historical average	FY2023-33 average
Real GDP growth (in percent)	3.2	3.0	2.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.3	2.1
GDP deflator in US dollars (change in percent)	3.7	3.4	2.6	2.0	1.5	1.6	2.2	2.6	2.6	2.6	2.4	0.2	2.5
Inflation rate (GDP deflator, in percent)	4.7	3.4	2.8	2.7	2.5	2.5	2.7	2.8	2.9	3.0	2.9	2.2	3.0
Non-interest current account deficit	22.7	19.3	8.1	13.8	13.8	16.1	9.9	10.6	9.9	9.6	9.0	5.6	13.0
Net FDI (negative = inflow)	1.2	0.8	1.0	1.0	0.9	-1.0	-1.0	-1.0	-1.2	-1.3	-1.2	1.3	-0.2
Primary deficit	4.2	4.4	8.1	8.8	10.2	11.7	12.5	11.7	11.5	11.9	6.5	-2.4	9.2
Grants	20.5	14.6	12.7	11.1	9.3	7.4	6.5	5.0	4.9	4.1	4.0	16.5	9.1

- **External borrowing**: Except for the IMF's second RCF-supported financing (disbursed in July 2022), new external borrowing is expected to commence in FY2025 and to gradually increase over the medium term to refinance debt repayments coming due and the primary deficit that is expected to reach double digits over FY2027–2031. Even if the authorities were to rely only on grants for their budget spending needs, under the baseline scenario, they would still need to borrow externally to meet their existing loan repayments while maintaining sufficient international reserves.[9] With the new external borrowing, the level of international reserves, currently estimated at 10.9 months of next year's imports at end-FY2023, is expected to remain stable in the coming years despite the large repayments to China EXIM Bank that start coming due beginning in FY2024 (annual payments of about 2.2 percent of GDP in FY2024–29 on average). The authorities will continue to seek new concessional and grant financing commitments from bilateral donors and international financial institutions to contain external debt 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). This commitment is reflected in the government's medium-term debt strategy, which is being used to guide fiscal policy and debt management decisions. The new public financial management (PFM) legislation, currently under preparation, is also

[9] 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). World Bank IDA financing will remain fully grants until FY2025, then a mix of grants and loans until FY2028, after which it is fully loans. The IDA loans are assumed to be on regular concessional credit terms for small economies. For other multilateral donors, new commitments from 2026 onwards are assumed to be on concessional loan terms. The 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.

expected to improve debt management. Both the debt strategy and PFM legislation are supported by the World Bank's SDFP. [10]

- **Fiscal outlook:** The primary fiscal balance is expected to shift from 1 percent of GDP surplus in FY2023 to 6.3 percent of GDP deficit in FY2024 and then double-digit deficits during FY2027-FY2031 (Table). The surplus in FY2023 was mainly driven by a higher level of grants and slower than anticipated budget execution of reconstruction projects. The higher deficit in FY2024 reflects the normalization of grants from an exceptionally high level. The long-term deterioration is primarily due to lower grant inflows after existing commitments are met, as well as to sizable spending needs for covering infrastructure gaps and achieving climate resilience and 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 wage bills are projected to drop below the fiscal target of 53 percent of domestic revenue in FY2024 thanks to recovering revenues and reforms to limit overtime pay. The fiscal deficit in percent of GDP is expected to decline after FY2029 as capital spending needs moderate following the completion of the authorities' multi-year reconstruction program and the accumulation of climate-resilient capital over the next decade.

6. The realism tools indicate that the primary balance projections are reasonable (Figure 4). The fiscal forecasts between FY2023 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 FY2023 reflects a strong rebound as the economy emerges from the twin shocks 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 private investment data.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

7. Tonga's debt-carrying capacity applied in the 2023 DSA remains strong. Tonga's Composite Indicator (CI) index, which has been calculated based on the April 2023 WEO and the 2021 CPIA is 3.06, indicating that the county's debt-carrying capacity remains 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,

[10] The Performance and Policy Action (PPA) for FY21 was cabinet approval of a medium-term debt strategy (covering fiscal years commencing FY21) which includes targets for external and domestic debt. The PFM bill is a PPA for FY22, FY23 and FY24, which outlines key fiscal responsibility principles to guide fiscal policy and a numerical limit on the stock of government guaranteed debt.

[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 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).

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	3.442	1.33	43%
Real growth rate (in percent)	2.719	0.837	0.02	1%
Import coverage of reserves (in percent)	4.052	57.963	2.35	77%
Import coverage of reserves^2 (in	-3.990	33.597	-1.34	-44%
Remittances (in percent)	2.022	15.494	0.31	10%
World economic growth (in percent)	13.520	2.856	0.39	13%
CI Score			3.06	100%
CI rating			Strong	

Applicable thresholds

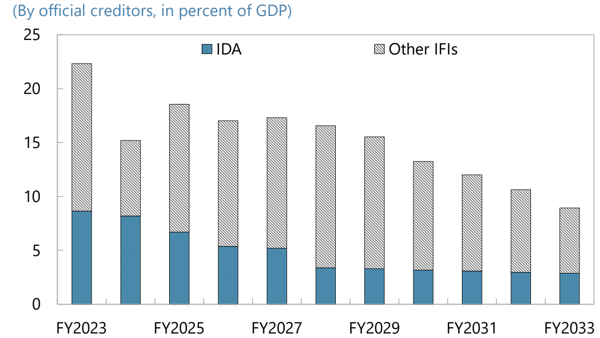
APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	240
GDP	55
Debt service in % of	
Exports	21
Revenue	23

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

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

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

9. **Under the baseline scenario, PV of external debt-to-GDP ratio will breach its threshold starting from FY2033** (Figure 1 and Table 3). In the near term, the external debt-to-GDP ratio is expected to decline from 39.4 percent in FY2022 to 38 percent in FY2024, reflecting large repayments to China Exim Bank and the second RCF. From FY2025 onwards, Tonga will need to incur new external debt to help finance its large spending 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 FY2026. The PV of the external debt-to-GDP ratio is expected to breach the threshold of 55 percent starting from FY2033. The breach is not a single one-off event as external debt will continue to rise until FY2043 (Table 1). 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.

10. 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 FY2024 when the one-off shock is assumed, breach the threshold three 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 the long-term growth.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

11. Under the baseline scenario, the PV of the public debt-to-GDP ratio would breach 70 percent from FY2033 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 lower from FY2023 onward due to additional grants committed in FY2023 and FY2024.

12. The standardized sensitivity analysis indicates an earlier breach of debt threshold (Figure 2, Table 4).[12] The most extreme shock scenario is the growth shock, where growth rate is one standard deviation below the baseline for two years starting from 2023. The breach is not a single one-off event as public debt will continue to rise until FY2043 (Table 2). The PV of the public debt-to-GDP ratio would cross 70 percent of GDP in FY2029 under a multi-year GDP growth shock and breach the threshold in FY2030 under an exports shock.

13. The tailored one-time natural disaster shock worsens public debt. The PV of the public debt-to-GDP ratio would cross 70 percent of GDP in FY2030, three years earlier than in the baseline scenario.

14. 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] 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

15. Tonga's risk of external debt distress is assessed as high. The analysis using the LIC debt sustainability framework (DSF) indicates a "moderate" mechanical risk rating for external debt distress. However, under the baseline scenario, the PV of the external debt-to-GDP ratio is expected to breach its indicative threshold from FY2033 until FY2043, due to a sustained and persistent increase in the external debt ratio over this period because of high financing needs to address risks from climate change in the long term. Given the expected significant breach over this extended projection horizon, staff applied judgement and assessed the risk rating of external debt distress as "high."

16. The overall risk of debt distress is also assessed as high. The analysis using the LIC DSF indicates a "moderate" mechanical rating. However, the PV of the public debt-to-GDP ratio is projected to breach its indicative benchmark from FY2033 until FY2043, reflecting both large investment needs and decreasing capital grant commitments over this period.[13] Considering the expected significant breach over this extended projection horizon, together with the average long-term effects of natural disasters on Tonga's growth and fiscal position, staff assess the risk rating of the overall debt distress as "high."

17. In the short term, fiscal policy should prioritize reconstruction and protecting vulnerable groups, while containing public sector wages. Fiscal policy should focus on rebuilding and repairs while supporting vulnerable households and businesses amid high inflation. On the other hand, current spending, especially the recurrent portions such as public sector wages, should be contained to ease inflation pressures and preserve fiscal buffers.

18. 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 multi-year growth shock, while the PV of external debt-to-GDP ratio would stabilize below the 55 percent benchmark under this scenario. 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.[14] 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.

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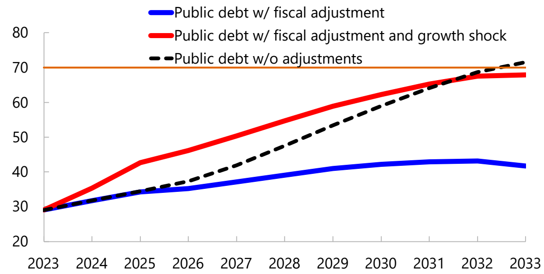
[13] Cash and in-kind grants averaged 16.7 percent of GDP annually over FY2015–2019. Under the baseline, staff assume continued budget support in line with historical levels and capital grants falling to zero from FY2030 onwards.

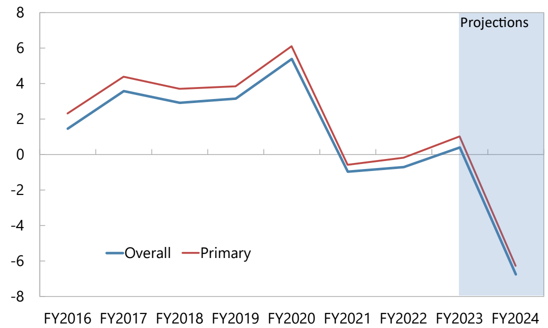
[14] The amount of grants declines over time in the baseline scenario since it only includes committed or highly likely grants, in line with the LIC DSA guidance note. Given the authorities' prudent fiscal policies in the past and various reform initiatives supported by development partners, public debt can feasibly be put on a sustainable path.

Public Debt with Fiscal Adjustment
(Present value of debt in percent of GDP)



Source: IMF staff estimates.
Note: The most extreme shock scenario is the growth shock. The red line does not include the public investment reforms which would lower the debt path further.

Overall and Primary Balance
(in percent of GDP)



Sources: Authorities and Staff Projections

Alternative Scenario with Fiscal Adjustment
(In percentage points of GDP, deviation from baseline)

	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033
Domestic fiscal measures	0.8	1.6	2.4	3.2	3.7	3.7	3.7	3.7	3.7
Better VAT compliance 1/	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Less tax exemptions 2/		0.5	1.0	1.5	2.0	2.0	2.0	2.0	2.0
Lower G&S			-0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Lower public sector wage bill	-0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Additional Grants		2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Change in primary balance	0.8	3.6	5.4	6.2	6.7	6.7	6.7	6.7	6.7
Impact on GDP growth 3/									
Without additional reform	-0.3	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
With additional reform 4/	-0.3	-0.2	0.0	0.1	0.2	0.3	0.4	0.4	0.5
Impact on inflation 5/									
Without additional reform	-0.2	-0.2	-0.1	-0.1					
With additional reform 4/	-0.2	-0.2	-0.1	-0.1					
Memo. (in percent of GDP)									
Projected primary balance w/adjustment	-7.2	-5.4	-4.6	-5.2	-5.0	-4.1	-3.3	-1.5	0.0

1/ For reference, World Bank (2023) estimates the potential revenue impact from such reform for Tonga at about 6.2 percent of GDP.
2/ For reference, World Bank (2023) estimates the potential revenue impact from reducing exemptions and zero ratings at about 3.2 percent of GDP.
3/ The growth impact associated with fiscal adjustment is based on an average multiplier value of 0.2-0.4 over the projection period, comparable with estimates for other emerging market and low-income countries in the literature. The growth impact associated with additional reform is obtained from the IMF's DIGNAD model calibrated to the Tongan economy and in line with other studies (e.g., Solomon Islands, 2018 Article IV consultation, Selected Issues Paper, Chapter 2).
4/ The reform, assumed to be implemented over FY2024-FY2032, enhances Tonga's public investment efficiency from 40 percent to 60 percent. The starting value of 40 percent corresponds to the median for a sample of emerging market and low-income countries in Dabla-Norris and others (2011) and the increase of 20 percentage points is equivalent to about one standard deviation.
5/ The impact on inflation under the "with additional reform" scenario is driven by the demand-dampening effects of fiscal consolidation. While the assumed increase in public investment efficiency (the rate at which a given amount of public investment is converted to public capital) would help boost Tonga's productive capacity, thereby helping ease inflationary pressures, the accompanying demand-stimulating effects (e.g., crowding-in of private investment) could offset these supply-side effects. Given the large uncertainties surrounding the long-term impacts on inflation, we do not show estimated impacts beyond FY2028 to avoid conveying a false sense of precision.

AUTHORITIES' VIEWS

The authorities agreed on the need for fiscal adjustment and emphasized the importance of sustained support from development partners. They shared staff's concern regarding the high public sector wage bill relative to the narrow domestic revenue base and are taking necessary steps to contain it, including by limiting overtime allowances and undertaking a comprehensive organizational review of the government. However, growing pay differentials with New Zealand and Australia in a context of strong labor demand there have made it difficult to retain civil servants, thereby exerting upward pressure on public sector wages. The authorities underscored their intention to seek new grant financing from development partners to meet climate resilience and development goals, while ensuring debt remains on a sustainable path.

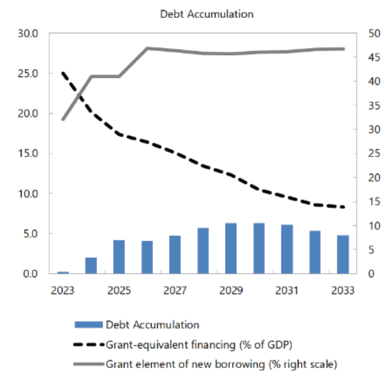
Table 1. Tonga: External Debt Sustainability Framework, Baseline Scenario, FY2020–2043

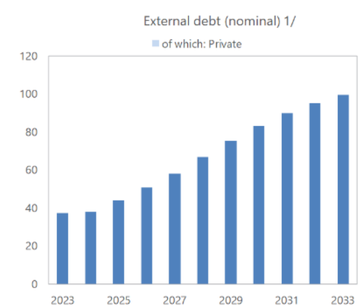
(In percent of GDP, unless otherwise indicated)

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2033	2043	Historical	Projections
External debt (nominal) 1/	37.4	41.2	39.4	37.2	38.0	43.9	50.7	58.2	66.7	99.3	99.9	40.7	67.0
of which: public and publicly guaranteed (PPG)	37.4	41.2	39.4	37.2	38.0	43.9	50.7	58.2	66.7	99.3	99.9	40.7	67.0
Change in external debt	1.0	3.9	-1.8	-2.2	0.7	5.9	6.8	7.5	8.5	4.2	0.2		
Identified net debt-creating flows	7.6	6.9	4.6	7.2	6.4	6.9	7.1	7.4	7.8	7.1	4.7	7.3	7.6
Non-interest current account deficit	4.8	5.1	6.0	7.5	6.8	7.2	7.3	7.4	7.8	7.1	4.7	5.7	7.7
Deficit in balance of goods and services	43.3	49.9	53.9	63.0	54.8	52.7	51.2	50.2	48.9	45.5	43.7	44.1	50.6
Exports	20.6	12.4	11.9	16.6	19.0	20.2	21.2	21.8	22.3	24.5	28.1		
Imports	63.9	62.3	65.8	79.6	73.8	72.8	72.4	72.0	71.2	70.0	71.8		
Net current transfers (negative = inflow)	-30.3	-38.7	-42.8	-50.5	-42.2	-39.1	-37.0	-35.3	-33.1	-30.2	-30.5	-33.5	-35.7
of which: official	-4.1	-2.2	-5.3	-15.6	-12.9	-12.9	-11.1	-9.5	-7.5	-4.0	-4.0		
Other current account flows (negative = net inflow)	-8.2	-6.0	-5.1	-5.0	-5.8	-6.4	-6.9	-7.4	-8.0	-8.2	-8.4		
Net FDI (negative = inflow)	0.7	0.1	0.5	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.1	1.1	0.2
Endogenous debt dynamics 2/	2.1	1.7	-1.9	-0.6	-0.6	-0.6	-0.4	-0.2	-0.2	-0.2	-0.2		
Contribution from nominal interest rate	0.5	0.2	0.4	0.4	0.3	0.2	0.3	0.4	0.5	0.9	1.0		
Contribution from real GDP growth	-0.2	1.0	0.8	-0.9	-0.9	-0.8	-0.7	-0.6	-0.7	-1.1	-1.2		
Contribution from price and exchange rate changes	1.7	0.5	-3.0	...	...	...	...	...	...	...	...		
Residual 3/	-6.7	-3.0	-6.4	-9.4	-5.7	-1.0	-0.4	0.1	0.7	-2.8	-4.5	-8.1	-2.1
of which: exceptional financing	0.0	-1.4	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	23.8	21.9	22.5	25.5	28.6	32.2	36.6	57.1	58.0		
PV of PPG external debt-to-exports ratio	...	...	199.9	132.1	118.6	126.5	135.1	147.7	164.5	232.9	206.6		
PPG debt service-to-exports ratio	7.4	5.9	12.8	12.2	19.2	17.1	15.9	14.9	13.8	11.9	16.7		
PPG debt service-to-revenue ratio	6.0	2.8	5.8	8.7	14.8	14.0	13.5	13.0	12.3	11.2	16.5		
Gross external financing need (Million of U.S. dollars)	34.6	27.8	39.7	53.4	62.1	66.4	68.6	71.1	75.0	81.1	105.1		
Key macroeconomic assumptions													
Real GDP growth (in percent)	0.5	-2.7	-2.0	2.6	2.5	2.2	1.6	1.2	1.2	1.2	1.2	1.0	1.6
GDP deflator in US dollar terms (change in percent)	-4.6	-1.4	7.9	7.2	3.6	2.3	2.1	2.1	2.2	2.1	2.1	-0.3	2.7
Effective interest rate (percent) 4/	1.4	0.4	0.9	1.0	0.7	0.7	0.7	0.8	0.8	1.0	1.0	1.4	0.8
Growth of exports of G&S (US dollar terms, in percent)	-10.2	-42.2	1.6	53.0	21.7	11.2	8.8	6.6	5.7	5.7	4.6	-0.5	12.1
Growth of imports of G&S (US dollar terms, in percent)	-4.2	-6.5	11.8	33.1	-1.6	3.2	3.1	2.8	2.3	3.1	4.1	1.6	5.3
Grant element of new public sector borrowing (in percent)			20.1	32.1	41.0	41.0	46.8	46.3	45.8	46.7	46.4	...	44.0
Government revenues (excluding grants, in percent of GDP)	25.1	25.9	26.2	23.3	24.6	24.7	24.8	24.9	25.0	26.3	28.4	23.5	25.2
Aid flows (in Million of US dollars) 5/	512.0	517.6	493.7	511.2	451.7	394.4	352.0	300.6	249.0	145.2	67.6	...	
Grant-equivalent financing (in percent of GDP) 6/	19.1	22.4	19.0	25.0	20.1	17.3	16.4	15.1	13.5	8.3	7.3	...	14.2
Grant-equivalent financing (in percent of external financing) 6/	100.0	100.0	100.0	95.5	81.7	73.1	72.9	70.1	65.7	62.7	65.7	...	70.2
Nominal GDP (Million of US dollars)	490	470	498	547	581	607	630	652	674	794	1,100		
Nominal dollar GDP growth	-4.1	-4.0	5.8	10.0	6.2	4.5	3.8	3.4	3.4	3.3	3.3	0.7	4.4
Memorandum items:													
PV of external debt 7/	...	...	23.8	21.9	22.5	25.5	28.6	32.2	36.6	57.1	58.0		
In percent of exports	...	...	199.9	132.1	118.6	126.5	135.1	147.7	164.5	232.9	206.6		
Total external debt service-to-exports ratio	7.4	5.9	12.8	12.2	19.2	17.1	15.9	14.9	13.8	11.9	16.7		
PV of PPG external debt (in Million of US dollars)			118.5	119.7	130.8	155.1	180.2	210.0	247.1	453.7	638.2		
(PVt-PVt-1)/GDPt-1 (in percent)				0.3	2.0	4.2	4.1	4.7	5.7	4.8	2.0		
Non-interest current account deficit that stabilizes debt ratio	3.8	1.2	7.8	9.7	6.1	1.3	0.5	-0.1	-0.7	2.9	4.5		

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





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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.

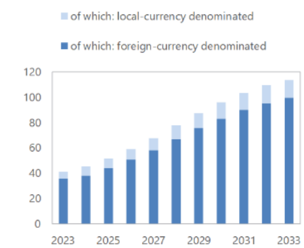
Table 2. Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, FY2020–2043

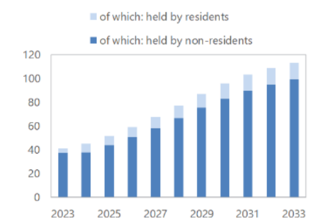
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 6/	
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2033	2043	Historical	Projections
Public sector debt 1/	**42.5**	**47.8**	**45.4**	**41.2**	**45.4**	**51.6**	**59.1**	**67.6**	**77.5**	**113.3**	**110.4**	**46.4**	**77.4**
of which: external debt	**37.4**	**41.2**	**39.4**	**37.2**	**38.0**	**43.9**	**50.7**	**58.2**	**66.7**	**99.3**	**99.9**	**40.7**	**67.0**
Change in public sector debt	1.2	5.3	-2.4	-4.1	4.1	6.2	7.5	8.6	9.8	4.1	-0.4		
Identified debt-creating flows	**-3.5**	**2.2**	**-0.9**	**-2.8**	**4.8**	**6.6**	**7.8**	**8.9**	**10.2**	**4.8**	**1.6**	**-2.2**	**6.8**
Primary deficit	**-6.1**	**0.6**	**0.2**	**-1.0**	**6.3**	**8.0**	**9.0**	**10.0**	**11.4**	**6.7**	**1.9**	**-2.5**	**8.3**
Revenue and grants	44.2	48.3	45.2	47.7	41.6	37.6	35.9	34.5	32.5	30.3	32.4	**41.0**	**34.9**
of which: grants	19.1	22.4	19.0	24.4	17.0	12.9	11.1	9.5	7.5	4.0	4.0		
Primary (noninterest) expenditure	38.1	48.9	45.4	46.7	47.9	45.7	44.9	44.5	44.0	36.9	34.3	**38.5**	**43.2**
Automatic debt dynamics	**2.6**	**1.6**	**-1.1**	**-1.8**	**-1.5**	**-1.4**	**-1.2**	**-1.1**	**-1.2**	**-1.8**	**-0.3**		
Contribution from interest rate/growth differential	0.1	1.0	0.4	-1.8	-1.5	-1.4	-1.2	-1.1	-1.2	-1.8	-0.3		
of which: contribution from average real interest rate	0.3	-0.2	-0.6	-0.6	-0.5	-0.4	-0.4	-0.4	-0.4	-0.5	1.0		
of which: contribution from real GDP growth	-0.2	1.2	1.0	-1.1	-1.0	-1.0	-0.8	-0.7	-0.8	-1.3	-1.3		
Contribution from real exchange rate depreciation	2.5	0.6	-1.5	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
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	**4.7**	**3.1**	**-1.5**	**-1.4**	**-0.7**	**-0.4**	**-0.3**	**-0.3**	**-0.3**	**-0.7**	**-2.1**	**1.2**	**-0.6**
Sustainability indicators													
PV of public debt-to-GDP ratio 2/	...	...	**30.1**	**26.1**	**30.1**	**33.4**	**37.2**	**41.9**	**47.7**	**71.5**	**68.8**		
PV of public debt-to-revenue and grants ratio	...	...	**66.5**	**54.7**	**72.5**	**88.8**	**103.5**	**121.5**	**146.5**	**236.2**	**212.0**		
Debt service-to-revenue and grants ratio 3/	**7.2**	**6.0**	**7.3**	**7.0**	**10.1**	**14.1**	**12.6**	**21.5**	**20.0**	**28.1**	**28.3**		
Gross financing need 4/	-2.9	3.5	3.5	2.3	10.5	13.3	13.6	17.4	17.9	15.2	11.1		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	0.5	-2.7	-2.0	2.6	2.5	2.2	1.6	1.2	1.2	1.2	1.2	**1.0**	**1.6**
Average nominal interest rate on external debt (in percent)	1.4	0.4	0.9	1.0	0.7	0.7	0.7	0.8	0.8	1.0	1.0	**1.5**	**0.9**
Average real interest rate on domestic debt (in percent)	7.5	5.4	-4.5	-7.2	-3.7	-1.4	-0.5	-0.2	-0.2	0.0	0.4	**-0.5**	**-1.2**
Real exchange rate depreciation (in percent, + indicates depreciation)	7.0	1.6	-3.5	...	...	...	...	...	...	...	...	**1.8**	**...**
Inflation rate (GDP deflator, in percent)	-4.2	-1.9	8.5	10.0	5.8	4.1	3.4	3.2	3.4	3.5	3.1	**2.7**	**4.3**
Growth of real primary spending (deflated by GDP deflator, in percent)	1.1	25.0	-8.9	5.5	5.0	-2.5	0.0	0.2	0.1	-2.6	4.0	**6.5**	**-0.3**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	-7.3	-4.7	2.6	3.1	2.1	1.8	1.6	1.4	1.6	2.6	2.3	**-3.1**	**2.1**
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, FY2023–2033

(In percent)

	Projections 1/										
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
PV of debt-to GDP ratio											
Baseline	22	23	26	29	32	37	42	46	51	54	**57**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	22	24	27	30	34	38	43	47	52	**56**	**59**
B. Bound Tests											
B1. Real GDP growth	22	24	29	32	37	42	47	52	**57**	**61**	**65**
B2. Primary balance	22	24	28	32	35	40	45	50	54	**58**	**61**
B3. Exports	22	27	38	41	45	50	**55**	**60**	**65**	**68**	**71**
B4. Other flows 3/	22	31	41	44	48	53	**58**	**62**	**67**	**70**	**72**
B5. Depreciation	22	28	23	27	32	37	43	49	54	**59**	**63**
B6. Combination of B1-B5	22	37	45	49	53	**58**	**64**	**69**	**74**	**78**	**80**
C. Tailored Tests											
C1. Combined contingent liabilities	22	25	28	32	36	40	45	50	55	**58**	**61**
C2. Natural disaster	22	29	33	38	42	47	53	**58**	**63**	**67**	**71**
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	132	119	127	135	148	164	184	201	216	226	233
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	132	124	134	143	156	172	191	206	221	232	**243**
B. Bound Tests											
B1. Real GDP growth	132	119	127	135	148	164	184	201	216	226	233
B2. Primary balance	132	125	139	149	163	180	199	216	231	**241**	**247**
B3. Exports	132	222	**411**	**426**	**453**	**490**	**534**	**573**	**606**	**626**	**634**
B4. Other flows 3/	132	164	204	209	220	236	**255**	**271**	**285**	**292**	**294**
B5. Depreciation	132	119	92	102	115	132	152	170	185	195	204
B6. Combination of B1-B5	132	**246**	198	**356**	**375**	**403**	**437**	**465**	**490**	**501**	**505**
C. Tailored Tests											
C1. Combined contingent liabilities	132	134	141	152	164	182	201	218	233	**243**	**249**
C2. Natural disaster	132	159	167	183	198	218	**241**	**261**	**278**	**290**	**298**
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	12	19	17	16	15	14	11	10	9	11	12
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	12	20	19	18	17	16	13	12	11	13	15
B. Bound Tests											
B1. Real GDP growth	12	19	17	16	15	14	11	10	9	11	12
B2. Primary balance	12	19	17	16	15	14	12	10	10	11	13
B3. Exports	12	**30**	**40**	**39**	**36**	**34**	**28**	**24**	**24**	**29**	**35**
B4. Other flows 3/	12	19	18	17	16	15	13	11	11	14	17
B5. Depreciation	12	19	17	15	14	13	11	9	9	10	10
B6. Combination of B1-B5	12	**27**	**32**	**30**	**28**	**26**	**22**	19	18	**26**	**29**
C. Tailored Tests											
C1. Combined contingent liabilities	12	19	17	16	15	14	12	10	10	11	12
C2. Natural disaster	12	20	19	17	17	15	13	11	11	12	13
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	21	21	21	21	21	21	21	21	21	21	21
Debt service-to-revenue ratio											
Baseline	9	15	14	14	13	12	10	9	9	10	11
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	9	16	15	15	15	14	12	10	10	12	14
B. Bound Tests											
B1. Real GDP growth	9	16	16	15	15	14	12	10	10	11	13
B2. Primary balance	9	15	14	14	13	13	10	9	9	10	12
B3. Exports	9	15	15	15	15	14	12	10	10	12	15
B4. Other flows 3/	9	15	15	15	14	13	11	10	10	13	16
B5. Depreciation	9	19	18	16	16	15	12	10	10	12	11
B6. Combination of B1-B5	9	16	17	17	16	15	13	11	11	15	18
C. Tailored Tests											
C1. Combined contingent liabilities	9	15	14	14	13	13	11	9	9	10	11
C2. Natural disaster	9	15	14	14	14	13	11	9	9	11	12
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/	44	44	44	44	44	44	44	44	44	44	**44**

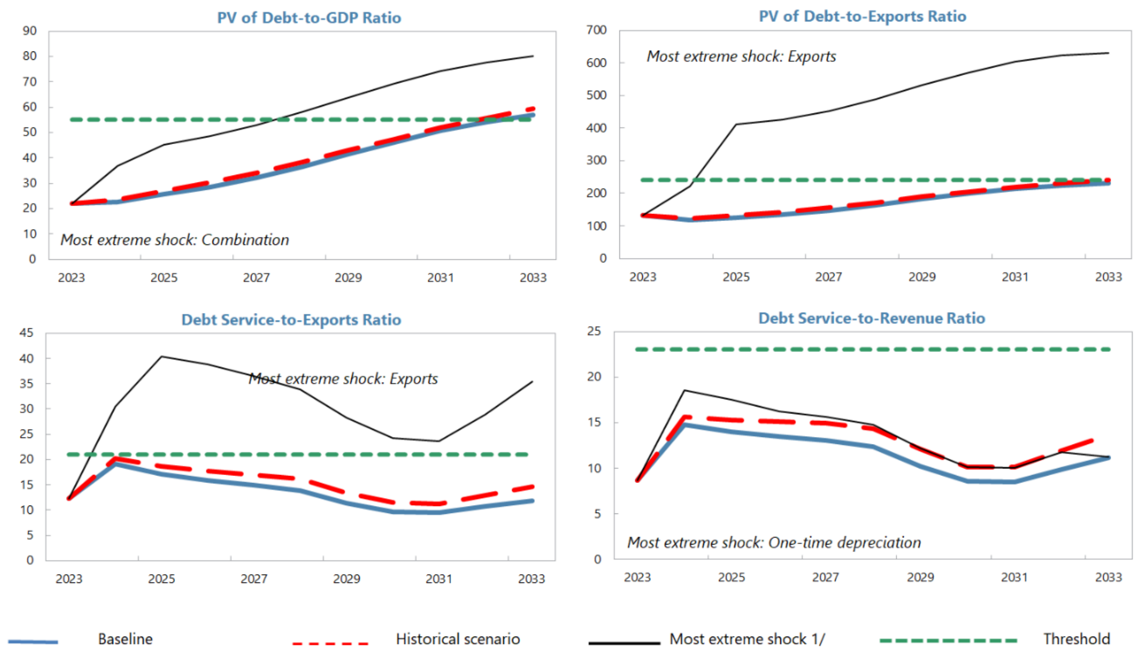
Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private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

Table 4. Tonga: Sensitivity Analysis for Key Indicators of Public Debt, FY2023–2033
(In percent)

	Projections 1/										
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
PV of Debt-to-GDP Ratio											
Baseline	26.1	30.1	33.4	37.2	41.9	47.7	53.7	59.4	64.6	68.7	**71.5**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	26	26	25	22	20	18	16	13	11	9	6
B. Bound Tests											
B1. Real GDP growth	26	33	41	47	55	63	**72**	**81**	**89**	**95**	**100**
B2. Primary balance	26	32	38	41	46	51	57	63	68	**72**	**75**
B3. Exports	26	34	44	48	52	58	64	**70**	**76**	**79**	**82**
B4. Other flows 3/	26	39	49	53	58	64	70	**76**	**81**	**85**	**87**
B5. Depreciation	26	34	34	34	36	38	41	44	47	49	50
B6. Combination of B1-B5	26	31	35	38	43	48	55	60	66	70	**73**
C. Tailored Tests											
C1. Combined contingent liabilities	26	35	38	41	46	52	58	63	69	**73**	**76**
C2. Natural disaster	26	41	45	48	53	59	66	**72**	**78**	**83**	**86**
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	55	72	89	103	121	146	169	190	211	228	236
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	55	63	64	60	56	53	48	42	36	29	21
B. Bound Tests											
B1. Real GDP growth	55	78	105	127	153	189	221	253	283	310	326
B2. Primary balance	55	78	100	114	132	158	181	202	223	240	248
B3. Exports	55	82	117	133	152	179	203	225	246	264	270
B4. Other flows 3/	55	94	131	147	167	196	220	242	264	281	286
B5. Depreciation	55	85	93	98	106	119	132	143	155	165	168
B6. Combination of B1-B5	55	76	93	105	123	149	172	193	214	231	240
C. Tailored Tests											
C1. Combined contingent liabilities	55	84	101	115	133	159	182	203	224	241	250
C2. Natural disaster	55	97	117	132	153	181	207	231	254	274	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	7	10	14	13	22	20	16	23	23	22	28
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	7	10	14	13	22	20	16	23	23	20	25
B. Bound Tests											
B1. Real GDP growth	7	10	15	15	26	25	22	29	30	29	36
B2. Primary balance	7	10	14	15	24	21	17	23	24	23	29
B3. Exports	7	10	14	13	22	21	17	23	24	23	31
B4. Other flows 3/	7	10	15	13	22	21	17	24	24	25	32
B5. Depreciation	7	11	17	15	23	22	18	24	24	23	29
B6. Combination of B1-B5	7	10	14	13	22	20	16	23	23	22	28
C. Tailored Tests											
C1. Combined contingent liabilities	7	10	14	17	22	21	17	23	23	22	28
C2. Natural disaster	7	10	15	23	23	24	18	26	25	24	30
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, FY2023–2033



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	1.1%	1.1%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	28	28
Avg. grace period	7	7

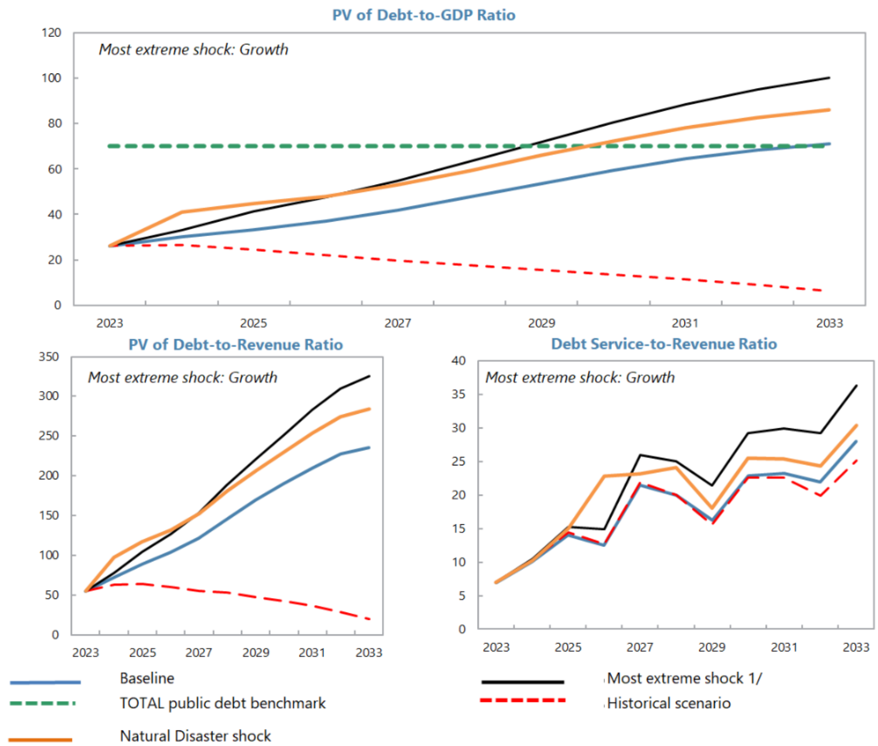
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

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 2033. 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, FY2023–2033



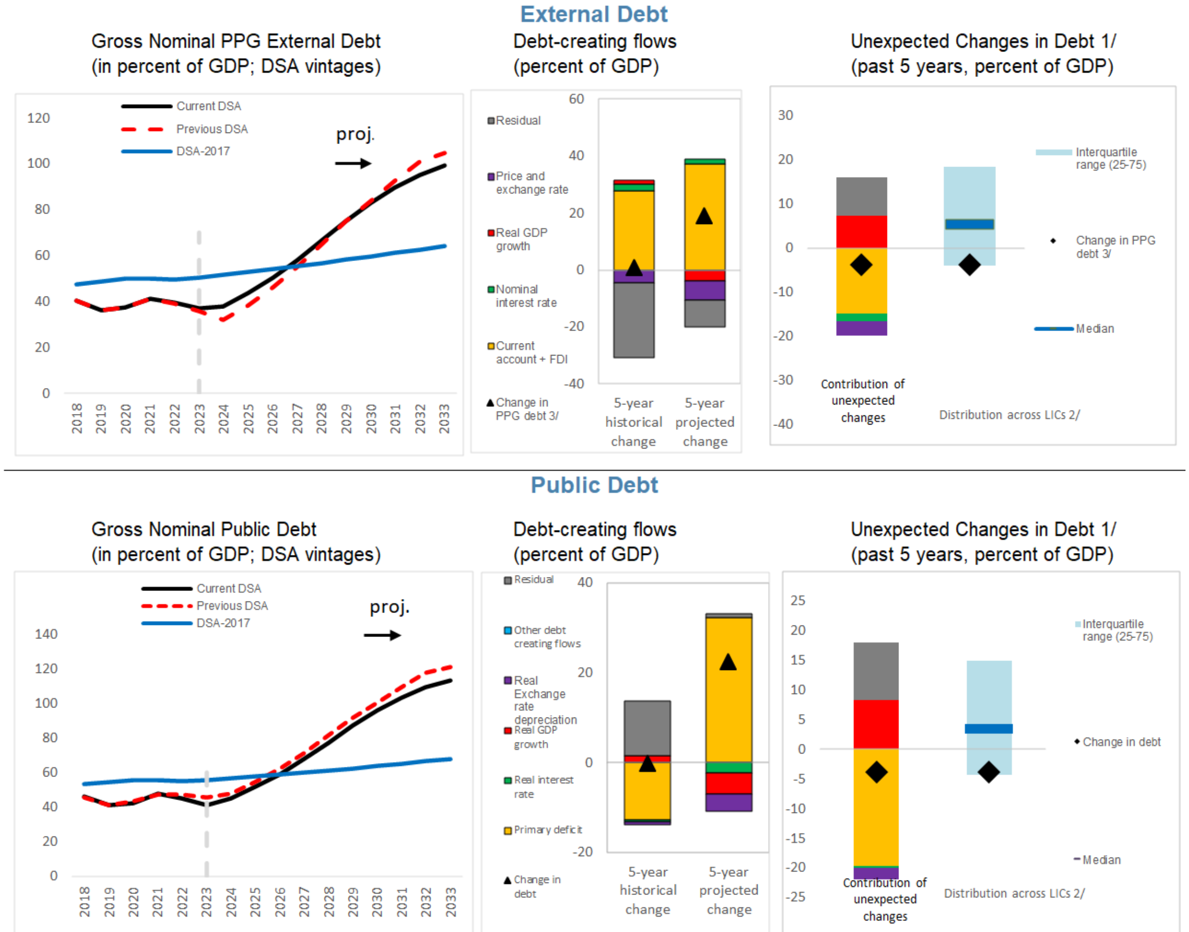
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	74%	74%
Domestic medium and long-term	26%	26%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.1%	1.1%
Avg. maturity (incl. grace period)	28	28
Avg. grace period	7	7
Domestic MLT debt		
Avg. real interest rate on new borrowing	-0.8%	-0.8%
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 2033. 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



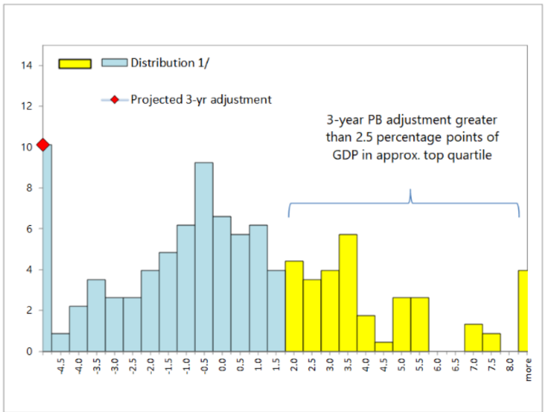
1/ Difference between anticipated and actual contributions on debt ratios.

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.

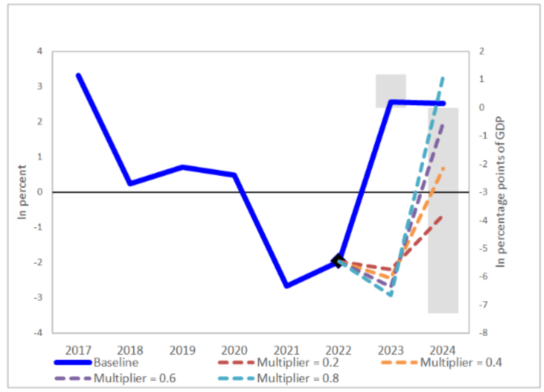
Figure 4. Tonga: Realism Tools

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).