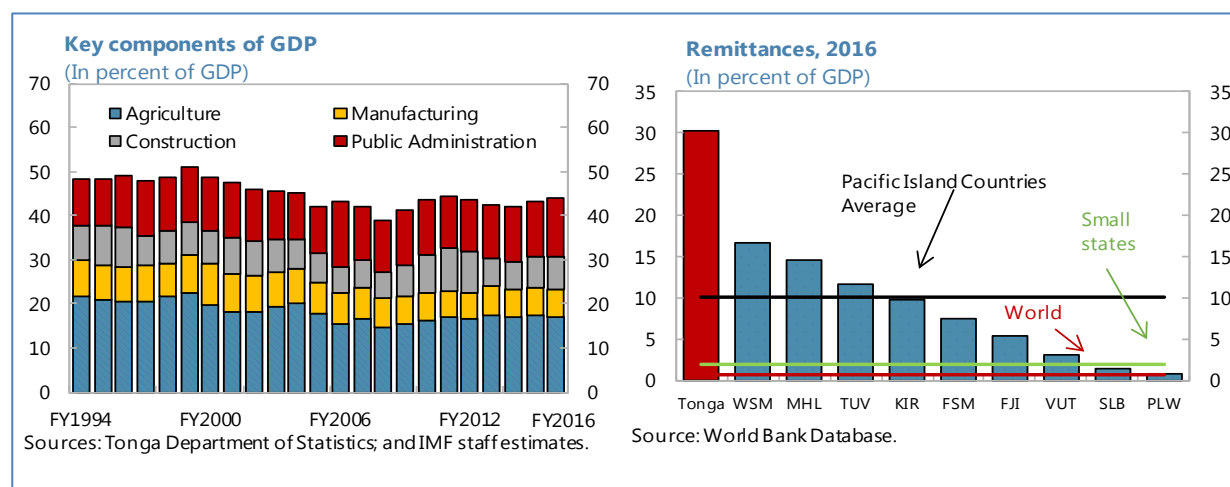


## CONTEXT

**1. Tonga is a small middle-income economy in the South Pacific, vulnerable to natural disasters.** Geographical remoteness, high transportation costs, low diversification and connectivity, a narrow production base, and limited economies of scale place Tonga at a competitive disadvantage. Tonga's economy is highly dependent on remittances flows<sup>1</sup> and donor grants, with agriculture and tourism being the main exports (Figure 1), posing sustainability challenges.



**2. Political changes in 2017 entailed the Democratic Party (DP) winning most electoral seats in the snap election in November after the dismissal of the government.** On August 25, 2017 King Tupou VI dismissed Prime Minister (PM) Pohiva and his cabinet, and dissolved the parliament. The DP led by former PM Pohiva won the majority of parliament electoral seats in the snap elections on November 16.

**3. The cancellation of the PGs may impact GDP growth.** The Tongan parliament approved in May 2017 the cancellation of Tonga's hosting of the PGs. However, the authorities have so far maintained the pledge to continue the construction of selected sport facilities and secured donor funding to this end of around five percent of GDP over three years, which could provide growth momentum. Therefore, the biggest impact on growth of the PGs cancelation is likely to be lower tourism revenue, rather than less construction. Finally, due to delays in constructions of the PGs facilities, the cancellation occurred at an early stage of infrastructure investment, so that no significant loss will be incurred by the Tongan government.

**4. The authorities made generally good progress with past recommendations.** Following advice provided in the 2016 Article IV Consultation and technical assistance (TA) provided by MCM, the NRBT has lowered its inflation reference rate and started upgrading its monetary policy framework by introducing new instruments. In terms of fiscal policy, the authorities continued to

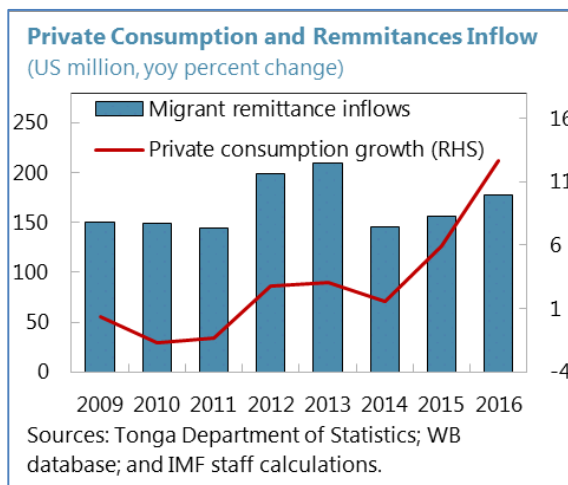
<sup>1</sup> The population has remained stable at around 100,000, despite a high birthrate, reflecting large-scale emigration. Tonga is the recipient of one of the highest levels of remittances as a share of GDP in the world.

make good progress with revenue mobilization, although more needs to be done to reduce current expenditure (particularly the wage bill).

## RECENT DEVELOPMENTS

### 5. Tonga's economy continued to grow at a strong pace, supported by construction, agriculture, tourism, and exports (Figure 2).

Real GDP growth is estimated at 2.7 percent in FY2017, following 3.4 percent in FY2016. The construction cycle related to the government's infrastructure plan and the building of sports facilities continued to be the main driver of growth. Private consumption growth remained strong supported by a steady inflow of remittances. Exports continued to grow, driven by agriculture and tourism.



### 6. Inflation spiked in FY2017 because of an increase in domestic food prices and a new import tax.

Annual CPI inflation stood at 7.2 percent on average in FY2017. To boost tax revenue and target unhealthy consumption, the government imposed a new tax on imported fatty meat and tobacco in July 2016, leading to a large increase of imported inflation to 7.7 percent in FY2017. The domestic component of inflation also stood at a relatively high 5.8 percent in FY2017 due to dry weather.

**7. The external position in FY2017 slightly weakened because of construction-related imports.** The sizeable current account (CA) deficit, of 12 percent of GDP, did not lead to foreign exchange (FX) reserve losses, as a large share of imports was financed by capital grants. Notwithstanding the increase in imports, the strong performance of exports and the large current and capital transfers balances resulted in a positive net international investment position (NIIP), with reserves rising to US\$169.9 million (or 5.9 months of imports). The exchange rate of the Tongan Pa'anga (T\$) against the U.S. dollar remained broadly unchanged, while the CPI-based REER appreciated owing to the spike in inflation.

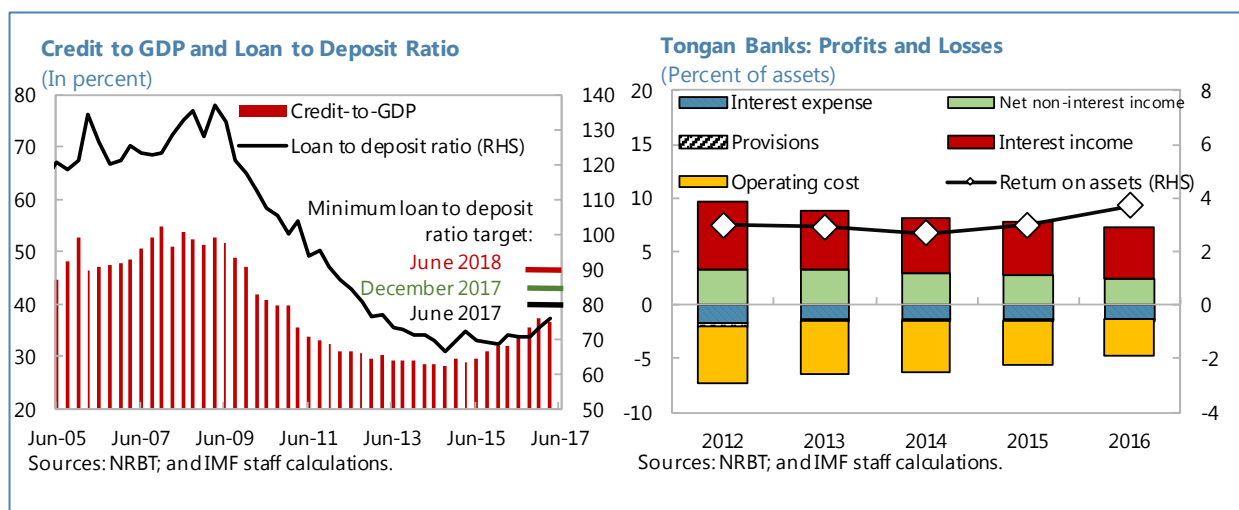
**8. The fiscal balance remained slightly negative due to wage growth and infrastructure spending.** The overall fiscal balance stood at -0.4 percent of GDP over the last two years. In FY2017, tax revenue increased due to higher excise taxes and higher-than-expected revenue from the foreign exchange (FX) levy. However, increases in expenditures, including higher wages and own-financed capital expenditure, more than offset the revenue gains, leading to a fiscal deficit.

### 9. Credit growth remained high, and the NRBT increased reserve requirements (RRs).

Despite credit growth of 18.9 percent in FY2017, the level of private sector credit remains low, with credit-to-GDP remaining below the long-term average. Most bank credit in Tonga finances the construction of owner-occupied dwellings (Box 1). To contain excess liquidity in the banking system, the National Reserve Bank of Tonga (NRBT) raised minimum RRs for banks to 10 percent of total

deposits in July 2017. The NRBT has introduced a remuneration rate for RRs set to zero, and introduced a *minimum* target for the loan-to-deposit (LTD) ratio for banks, set currently at 80 percent, in an attempt to channel banking system liquidity to private sector lending and to communicate this policy to the public.

**10. The banking system remains well capitalized and profitable, and nonperforming loans (NPLs) have decreased.** Notwithstanding the large increase in risk-weighted assets associated with the strong credit growth, the capital ratio remains high. The NPL ratio declined from 6.7 percent in June 2016 to four percent in June 2017, reflecting a decrease in NPLs, driven by a large write-off which occurred in FY2017 and high credit growth.



## OUTLOOK AND RISKS

**11. The macroeconomic outlook remains favorable.** For FY2018, GDP growth is projected at 3.4 percent, driven by construction, agriculture, and tourism. Over the medium term, growth is projected to moderate to around two percent. Inflation is expected to decline to 5.3 percent on average in FY2018 and to decline further in the medium-term, as the effect of the import tax subsidies. The CA deficit is projected to remain large in FY2018, mainly due to capital imports related to construction. Reserves will decline slightly in the medium term due to large principal loan repayments to China of approximately US\$7.9 million per year.

**12. The overall balance of risks is tilted to the downside.** (Appendix I). Risks from weaker global growth and the potential implementation of inward looking policies could negatively impact Tonga via reduced remittances, donor funds, and tourism. Pressures on correspondent banking relationships (CBR) may also weigh on Tonga's outlook by increasing the cost of remittances. Domestic risks mainly relate to fiscal sustainability, which may be compromised should public sector employment reforms fail to contain wage growth, or grant disbursements and related infrastructure building be delayed. A potentially large burden on fiscal expenditure could result from costs of future natural disasters, especially if donor intervention falls short. In addition, the unexpected

parliamentary elections may slow the growth momentum. On the upside, a higher-than-expected short-term fiscal expansion may provide a boost to GDP growth.

**13. The risk rating for external debt distress derived from the Debt Sustainability Analysis (DSA) is increased from moderate to high, because of future potential costs of natural disasters.** The new classification is due to a change in the treatment of future spending related to natural disasters. The DSA 2017 incorporates effects of natural disasters in the baseline projections with two separate projection horizons.

#### Authorities' Views

**14. The authorities broadly agreed with staff assessment of the economic outlook and downside risks for Tonga, including with the DSA reclassification as "high risk."** The NRBT projected slightly higher growth and lower inflation for FY2018-19 compared with staff, as they did not incorporate lower growth due to the cancellation of the PGs. Staff's inflation projections are higher than those of the authorities to account for the comprehensive package of new excises introduced in July 2017. The authorities concurred with staff's assessment of risks, including with regards to fiscal sustainability, and welcomed the incorporation of natural disasters in long-term projections together with the resulting DSA reclassification as "high risk" of external debt distress.

## POLICY DISCUSSIONS

*Policy discussion focused on measures to boost the country's resilience to shocks, including from climate change and natural disasters, and preserve macrofinancial stability. This would require a sustainable fiscal position, achieved by keeping expenditure in check and building fiscal buffers to minimize the risk of having to borrow externally and to be able to deal with unforeseen events, such as natural disasters. Preserving financial stability should remain a priority, especially considering the rapid credit expansion and with only few monetary policy and macroprudential instruments available. Structural reforms aimed at sustained and inclusive growth should be a central part of the policy strategy.*

### A. Maintaining Fiscal Sustainability

**15. Staff welcomed the first-time introduction of explicit fiscal anchors in the Budget document.** The anchors reflect previous commitments (debt ceiling), and (in line with staff recommendations from past Article IV consultations) a ceiling on compensation of employees as a percent of current expenses and domestic revenues.

	FISCAL ANCHOR	FY2017	Budget FY2018	Projections FY2018
Domestic revenue (in percent of GDP)	> 22	25.4	29.1	28.2
Compensation of employees (in percent of domestic revenue)	< 53	57.7	51.3	52.9
(in percent of current expense)	< 45	47.5	43.6	43.5
Total external public debt outstanding (in percent of GDP)	< 50	41.8	42.3	43.2

Sources: Budget Statement 2018, and IMF Staff Projections.

Additionally, the budget includes a target for domestic revenue in percent of GDP, which is based on recent and projected outturns.

**16. The FY2018 Budget is expansionary, and the fiscal position is projected to weaken.**

The recently approved budget reflects spending pressures from (i) wage increases; (ii) a reform of public sector employment categories; and (iii) the government's infrastructure development strategy. The government is introducing new revenue measures in FY2018 including (i) an increase of excise rates on "sin goods" (alcohol, tobacco, and sugary drinks); (ii) replacing import duties on Non-Communicable Diseases (NCD) related goods<sup>2</sup> with excise taxes; and (iii) a new income tax system. However, the higher revenue does not cover the increase in expenditures, resulting in a fiscal deficit until FY2020.

	Estimate	Budget	Projections		
	FY2017	FY2018	FY2018	FY2019	FY2020
(In percent of GDP)					
<b>Total Revenue</b>	44.5	54.4	53.5	52.6	51.6
Tax revenue	21.3	24.9	24.0	23.1	23.8
Grants	19.0	25.3	25.3	25.6	23.7
Other Revenue	4.1	4.2	4.2	4.0	4.1
<b>Total Expenditure</b>	44.9	55.8	55.8	54.5	56.0
Expense	34.1	41.0	41.1	39.7	38.2
Wages	13.1	13.7	13.7	12.9	12.4
Use of goods and services	13.0	17.3	17.3	19.0	18.2
Other expense	7.9	10.1	10.1	7.7	7.6
Transactions in Nonfinancial Assets	10.8	14.8	14.8	14.8	17.7
<b>Overall balance</b>	-0.4	-1.3	-2.3	-1.9	-4.4

Sources: Budget Statement 2018; and IMF Staff projections.

**17. The budget's revenue projections are optimistic, even with the proposed revenue reforms.** (Appendix II). The authorities project a 3.6 percent of GDP increase in tax revenues, stemming from consumption and excise taxes. The increased consumption tax revenue is based on a general increase in consumption and projected improvements in tax collection. Staff takes a more conservative view on consumption tax, taking into account only increases in tax collection that have already been observed in recent months, while not including the possible impact of future tax administrative measures. Although the new income tax is projected as budget neutral and contains a welcome increase in progressiveness, the authorities should consider the appropriateness of raising the minimum taxable income threshold, which leaves 60 percent of employees out of the tax net. For instance, the lower threshold could be linked to the minimum wage. Finally, staff acknowledged the successful raising of T\$5 million per annum revenue through the Foreign Exchange transactions tax (FX levy),<sup>3</sup> but recommended that the FX levy be replaced with a non-distortionary tax. However, given the lack of alternatives and the large short-term spending plans, the levy could remain in place until its planned sunset period of FY2020.

**18. The authorities need to carefully prioritize own-financed capital expenditure.**

(Appendix III). Should revenues during FY2018 fall below target, expenditures should be contained in line with realized revenue and absorption capacity, to balance the need for capital investment with keeping the deficit sustainable. In choosing investment projects, the authorities should prioritize those aimed at improving inclusive growth potential and resilience to natural disasters, and stand ready to postpone projects with lower expected long-term returns. The development of sports facilities should continue to focus on developing only necessary infrastructure and be based largely on donor funding, and the authorities should ensure that an assessment of future maintenance costs is factored in the decision to build the facilities. Risks to sustainability of investment projects were outlined by recent findings of Tonga's Auditor General and recent FAD and STA technical

<sup>2</sup> NCD-related goods comprise sugary drinks, fatty meat, and tobacco.

<sup>3</sup> See the 2016 Article IV Staff Report for a description of the FX levy.

assistance (TA), which pointed towards a systematic under-recording of capital expenditure by up to 13 ministries outside the Ministry of Finance and National Planning (MOFNP).

**19. To maintain fiscal sustainability in the medium term, prudent public finance management (PFM) and fiscal adjustment are necessary.** These could be achieved by

a combination of revenue and expenditure measures (Table 7). With limited own resources and high donor-dependency, Tonga needs to balance its expenditure needs with available resources to maintain fiscal sustainability, ensure efficient PFM, and build fiscal buffers. While the current cash buffers (equivalent to 5.3 months of expenses) appear sound, the projected fiscal deficit and resulting financing needs could endanger fiscal

	Estimates		Projections			
	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
<b>(In percent of GDP)</b>						
<i>Baseline</i>						
Revenue and grants	44.5	53.5	52.6	51.6	49.0	49.5
Total Expenditure	44.9	55.8	54.5	56.0	51.0	50.9
Expense	34.1	41.1	39.7	38.2	38.4	38.4
Transactions in nonfinancial assets	10.8	14.8	14.8	17.7	12.5	12.5
Primary balance	0.4	-1.4	-1.0	-3.6	-1.2	-0.8
<b>Fiscal balance (1)</b>	-0.4	-2.3	-1.9	-4.4	-1.9	-1.4
<b>Total public debt</b>	48.0	49.2	50.3	52.0	51.9	51.3
<i>Revenue and Current Expenditure</i>						
Primary balance	0.4	-0.8	-0.7	-0.3	0.5	1.0
<b>Fiscal balance (2)</b>	-0.4	-1.7	-1.5	-1.1	-0.2	0.3
<b>Total public debt</b>	48.0	48.9	49.8	48.4	46.8	44.8
<i>Capital Expenditure Reduction</i>						
Primary balance	0.4	-0.7	-0.5	0.0	0.6	1.1
<b>Fiscal balance</b>	-0.4	-1.5	-1.3	-0.7	-0.2	0.4
<b>Total public debt</b>	48.0	48.6	49.2	47.5	45.8	43.7
<b>(2)-(1) Savings Required<sup>1</sup></b>		<b>0.6</b>	<b>0.4</b>	<b>3.3</b>	<b>1.7</b>	<b>1.7</b>

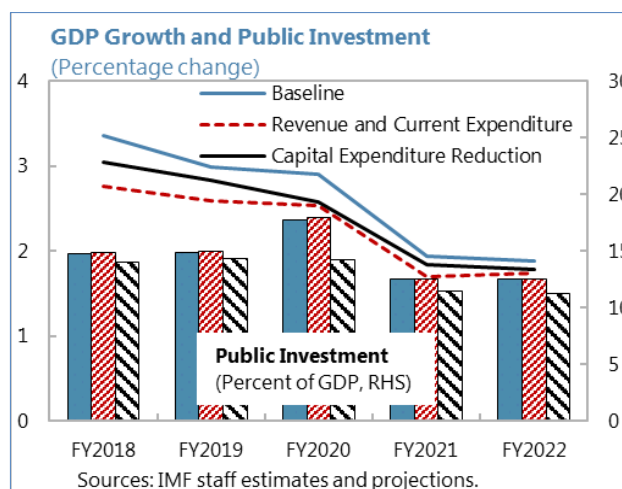
Sources: Tongan authorities; and IMF staff estimates and projections.

1/Measures to close the gap and achieve the primary surplus need to be identified.

sustainability, particularly due to Tonga's exposure to external shocks. The fiscal adjustment should be calibrated to achieve a primary surplus of one percent of GDP in the medium term, aimed at stabilizing public debt at about 40 percent of GDP, which would provide an extra buffer to address the impact of potential future natural disasters.

**20. Staff presented two scenarios to improve fiscal sustainability and achieve necessary adjustments.** These scenarios maintain a constant level of public debt at around 40 percent of GDP

by achieving primary surplus of one percent of GDP by FY2022. In both, the impact on the GDP growth would be limited, given the low multiplier stemming from a large import component in consumption and Tonga's openness. Fiscal consolidation would help to bring the external sector position in line with fundamentals. In the short term, in addition to implementing tax policy measures, the authorities need to focus on administrative tax measures and current expenditure adjustments. In the medium term, the focus should be placed on growth enhancing measures. The required savings could be achieved as follows:



- A "revenue and current expenditure adjustment" scenario proposes a combination of revenue measures and reallocation of current expenditure (wages) into capital investment to sustainably finance the investment projects. In this scenario, the growth rate would be reduced in the short



run by approximately 0.5 percentage points, but all the needed capital investments are accomplished and would provide future dividends in terms of improved infrastructure, enhancing long-run growth prospects.

- A “*capital expenditure reduction scenario*” reduces capital expenditure to match effectively collected revenue. This scenario would have a lower negative growth impact in the short term, attributable to the large import component of construction and the lower multiplier of capital expenditure. However, in this scenario the lower accumulation of capital stock means that the improvement in long-run growth would be smaller.

Fiscal Savings Measures	
	(In percent of GDP)
<b>Overall Savings</b>	<b>Up to 7.5</b>
Total Revenue	up to 1.5
Modify PAYE reform <sup>1</sup>	0.1
Increase excises on NCDs related goods	0.2-0.6
Keep consumption tax rate at 15 percent and improve compliance	0.7
Total Expenditure	Up to 6
Contain civil servants wage increases <sup>2</sup>	1-3
Prioritize Capital Expenditure and/or obtain donor funding	Up to 3
Sources: IMF Staff estimates.	
1/Measures to modify PAYE reform include keeping minimum threshold unchanged at T\$7400 (or raising it by a smaller amount) and lowering the threshold for the maximum rate to T\$50000.	
2/Freeze wage increases to bring the wage bill to around 12 percent of GDP, and limit increases to GDP growth thereafter.	

Overall, staff expressed a preference for the first scenario, given its positive impact on longer-term growth, but noted that both scenarios are preferable to the baseline.

**21. The fiscal adjustment needs to target the underlying sources of the deficits.** Savings options include (i) amending the proposed PAYE reform to avoid shrinking the tax base; (ii) further boosting revenue from excises; and (iii) implementing measures to increase consumption tax effectiveness. On the expenditure side, potential measures include (i) bringing the wage bill back to around 12 percent of GDP; and (ii) rationalizing capital spending, possibly replacing own-financing with donor grants for some projects.

#### Authorities' views

**22. The authorities fully concurred with staff assessment of the fiscal stance and risks to sustainability.** They acknowledged that revenue projections are optimistic and may not be realized in full. Among expenses, the authorities recognized that wage growth continues to pose the biggest risk to the fiscal outlook, including with the further postponing of the civil servants' employment framework reform. The authorities maintained their view that developing sports and related facilities is a policy priority, with expected positive effects on the population's health and possibly a boost to tourism given the regional importance of rugby. The discussion of possible adjustment strategies was well received, though the authorities did not commit to specific measures. They agreed with the need to continue building fiscal buffers and indicated some of the planned capital expenditure could be postponed or scaled down based on actual revenue collection.

## B. External Assessment

**23. The external position is moderately weaker compared with fundamentals and desirable policies, and the authorities should maintain adequate reserve buffers** (Box 2). The EBA-lite CA model estimates an adjusted CA gap of -1.5 percent of GDP, slightly wider than the EBA-lite threshold of 1 percent of GDP, from a norm of -6.2 percent of GDP. Reserves coverage is projected at 5.9 months of imports in FY2017, slightly below an estimated optimal level of 6.3

months. The projected decline in reserves coverage is due to the higher construction-related imports and the principal repayments of the China EXIM bank loan. The exchange rate remains on the border of being broadly in line with fundamentals, with no sign of a deterioration in Tonga's competitiveness. However, should pressure on reserves emerge, the NRBT should allow the pa'anga to depreciate against the basket of currencies to safeguard external stability.

### Authorities' Views

**24. The authorities saw the external position as broadly in line with fundamentals.** The volatility of Tonga's current account flows makes the model estimation difficult, which may skew the assessment. The authorities agreed with staff's assessment that the current level of reserves is broadly adequate and should be maintained.

## C. Improving Monetary Policy and Preserving Financial Stability

**25. The NRBT made progress on introducing new monetary policy instruments, which could be developed further.** The current monetary policy instruments consist of reserve requirements--the main instrument—and the rate of remuneration on required reserves. In a major step to improve their monetary policy operations and following recent MCM TA, the NRBT introduced the remuneration rate, which is currently set at zero. Following the recent amendment of the NRBT Act, the NRBT can use part of its revaluation reserve to remunerate RRs. While currently not binding, given excess liquidity in the banking system, the RR remuneration rate could become an effective policy rate by functioning as a floor to guide bank lending interest rates.

**26. The current monetary policy stance, while accommodative, is still appropriate, as long as no signs of overheating and credit misallocation appear.** Inflation has been moderating with the dissipation of the one-off tax increase. The NRBT maintains the stance to support credit growth, while keeping excess liquidity under scrutiny. It should stand ready to adjust its monetary policy stance if risks emerge. A large part of the recent credit growth was supported by the implementation of the government-managed loan-subsidy scheme, lower lending rates, and an increase in construction.

**27. Looking ahead, the authorities should consider using more flexible liquidity management tools in addition to RRs,** such as the issuance of short-term NRBT securities. This would establish a more effective transmission mechanism that would help the NRBT to complement fiscal policy, particularly during fiscal tightening. Following the recent TA on reserves management, the NRBT is encouraged to prepare legal documentation underpinning its risk framework methodology, and adopt this as a decision of its Executive Board.

**28. Introduction of the minimum loan-to-deposits (LTD) ratio may increase banking sector credit risk.** Staff emphasized that structural reforms may offer a better approach towards encouraging sound credit extension. While it cannot be enforced (banks cannot be obliged to lend), the ratio may nevertheless provide an incentive for banks to lend to substandard borrowers, which may increase financial stability vulnerabilities. Conversely, banks could stop accepting new cash deposits from individuals to meet the requirements. Staff doubted the appropriateness of the minimum LTD, as demand for credit could be boosted by developing opportunities for the private



sector and structural reforms. In this regard, the authorities should continue their efforts to improve access to bank credit, including by (i) developing a domestic credit register; (ii) improving the collateral framework for borrowers; (iii) enhancing insolvency frameworks; and (iv) closely monitoring the provision of credit through the Government Loan Scheme, to ensure creditworthiness of borrowers. The NRBT needs to develop credit growth indicators to monitor risks stemming from potential credit booms.

**29. The new Banking Act and other financial institutions legislation should be finalized, and the NRBT's supervisory capacity should be strengthened further.** Staff encourages the NRBT to speed up the finalization of the Banking Act, which will enhance regulatory capacity of the NRBT, especially regarding bank liquidation. In addition, the NRBT needs to develop and implement comprehensive supervision and disclosure frameworks covering the entire financial sector, beyond the banking system. While the banking system has a simple structure<sup>4</sup> and is appropriately regulated, the legislation to regulate non-bank financial institutions (NBFIs) is currently being finalized, and little information is available on NBFI intermediation.

**30. Macroprudential policies should be used to address systemic risks to financial stability.** Given the current credit growth, though from a low level, the authorities should consider introducing macroprudential tools to ensure that vulnerabilities do not build up in the financial sector, such as (i) limits to loan-to-value (LTV) ratio for property loans; (ii) diversification principles to avoid concentration to specific sectors or related borrowers; (iii) maximum LTD ratio; and (iv) maintenance of adequate provision of NPLs.

**31. Loss of CBR remains a source of concern.** Although remittances have remained broadly unaffected, some Tongan money operators have recently seen their bank accounts closed. The NRBT should ensure that regulations continue to satisfy relevant international standards with regards to anti-money laundering and combating financial terrorism (AML/CFT). The NRBT is preparing for a new AML/CFT assessment expected to be conducted by the Asia Pacific Group on Money Laundering in 2019 and is in the process of strengthening AML/CFT laws and discussing mechanisms to reduce costs of money transfer services.

### **Authorities' views**

**32. The authorities agreed with the need to safeguard financial stability.** The NRBT maintains as a priority to support credit growth, as the banking system remains sound with NPLs being low, capital position remaining strong, and liquidity remaining high. However, the authorities welcomed staff's suggestions to develop tools to monitor credit growth and stand ready to tighten monetary policy should overheating pressures emerge. The NRBT welcomed recent TA on reserves management and expressed interest in a follow-up TA on monetary policy and macroprudential measures.

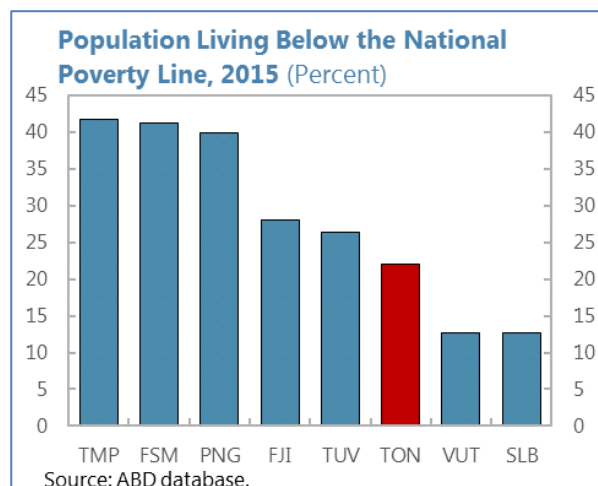
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<sup>4</sup> Tonga's banking system is composed of three subsidiaries of foreign-owned banks, and a government-owned development bank.

## D. Supporting Inclusive Growth and Building Resilience to Natural Disasters

### 33. An overarching goal is to raise Tonga's inclusive growth potential and reduce poverty.

Limited business opportunities and difficult access to credit constrain private sector development, particularly for micro, small, and medium enterprises (MSMEs). Structural reforms are needed to attract private investments and increase inclusive growth. The government's Tonga Strategic Development Framework (TSDF II) addresses some of these structural issues, particularly on development of resilient infrastructure, enhancing health and education to build human capital, and promoting the diversification of domestic production, notably in agriculture, manufacturing, and tourism.



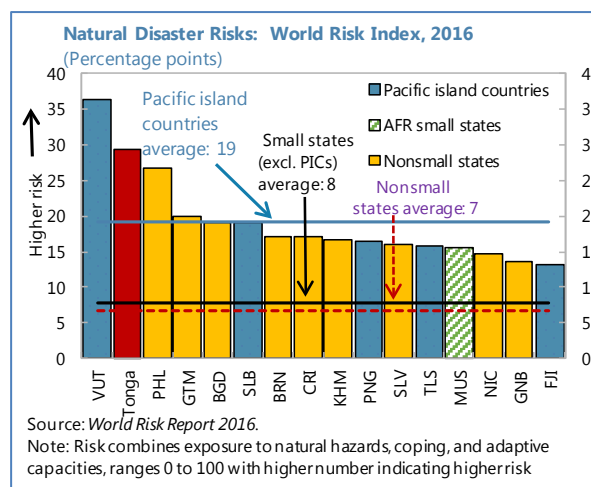
**34. Private sector development should entail improving the business climate, expanding market access for exports, and increasing the value added of domestic production.** The authorities are developing Tonga's National Trade Framework (TNTF) strategy for enhancing export-oriented production and an MSME development strategy. To maximize the returns of private sector development, policies should focus on broadening the production base and increasing the value added, through building manufacturing and packaging capacity in Tonga. This would move part of the value chain onshore, providing skilled jobs opportunities and increasing the value added of exports. To broaden export markets, the strategies should tackle the inclusion of relevant international standards<sup>5</sup> to ensure that products can be exported to partner countries, particularly New Zealand and Australia. Tonga joined the Pacific Agreement on Closer Economic Relations Plus (PACER Plus) in July 2017.

**35. A continued focus on bringing the informal economy into the formalized MSMEs would help ensure that economic growth benefits the entire population.** Unemployment, particularly in the youth segment (approximately 40 percent in FY2016), remains high with a significant part of the population working in the informal economy and/or relying on remittances. The formalization of informal businesses, such as the introduction of a flat "small-business tax" in FY2015, helps them to grow and improves their access to finance. Formalization of employment would contribute to broadening the tax base and equalizing the tax burden.

**36. Continued investment in development and infrastructure to boost resilience to natural disasters is needed** (Appendix IV). In the 2016 World Risk Index, Tonga is ranked as the second

<sup>5</sup> For agricultural products, international standards include specific size of the products as well as strict processing and traceability rules, which could be achieved through constructing appropriate pack houses and registering farmers.

most vulnerable country worldwide. The high risk reflects the exposure to natural disasters and a low coping capacity. The risk of external debt distress from the DSA 2017 increases to high, due to the recognition of long-term negative effects of natural disasters on GDP growth and macroeconomic balances. An important feature of the government's infrastructure strategy is the mainstreaming of natural disasters resilience and climate proofing by increasing the standards of newly built buildings, roads, and the electricity grid. Ongoing priority projects include (i) improving opportunities for secondary school completion and facilitating the transition to jobs in the domestic and overseas labor markets for Tongan youth; (ii) upgrading of the road, aviation and maritime transportation systems; and (iii) the introducing of technological advancements in the government and health administrations.



Top Priority Projects Financed by Donors FY2018-20					
Project Title	Total	Financed by			Other
		WB	ADB	Government	
(\$ million)					
Second Inclusive Growth	30	15	15	...	...
Tonga youth/skills project	15	15	...	...	...
Integrated Urban Sector Resilience	35.6	...	12 1/	6.1	17.5 1/
Transport Sector (Bridge over the lagoon)	45	...	20	5	20 2/
Transport/Maritime 3/	27.8	27.8	...	...	...
Digital Health and e-Government	15	5	7.5 4/	...	...
Sources: ADB; and WB.					
1/ Includes \$5.24 million disaster risk reduction financing (\$2.62 million COL, \$2.62 million ADF grant), of which \$1.34 million was allocated for 2017; \$12 million financing from ADB to leverage \$10 million in cofinancing and \$7.5 million from Australia's Department of Foreign Affairs and Trade.					
2/ Cofinancing to be determined.					
3/ Three separate projects of different nature (\$5 mill. aviation, \$5 mill. maritime and \$17 mill. roads).					
4/ Includes \$5 million from the national allocation (\$1.25 million COL, \$1.25 million ADF grants) and \$2.5 million from the concessional resources regional pool (\$2.5 million COL, \$2.5 million ADF grants).					

### Authorities' Views

**37. The authorities agreed that promoting the formalization of the economy and improving the business climate are crucial priorities.** They noted that developing the private sector further, including by supporting access to finance of MSME, could raise Tonga's growth potential in the long run. The authorities have included roads and transportation as the main priority, followed by construction and upgrading of education facilities. Finally, they noted that improved resilience to natural disasters includes the incorporation of higher construction standards, when new infrastructure is built.

## E. Strengthening Statistical Capacity

**38. The statistical capacity in Tonga is weak, due to insufficient resources at the Tonga Department of Statistics (TDS) and MOFNP.** The insufficient resources are causing a delay in the absorption of recent TA provided by PFTAC, particularly with regards to external sector and national accounts statistics. Tonga also needs to develop statistics on labor and demographics for effective surveillance. These surveys are particularly important to measure the effectiveness of structural reforms in tackling unemployment, inequality, and bringing a more inclusive growth to the economy.

**39. The TDS's development of a country-wide strategy for statistics is welcome.** The strategy will tackle two main issues of statistical compilation: (i) the recognition that good statistics are essential for policy making and should be a common goal for all institutions involved in the process (data providers and compilers); and (ii) the reduction of existing barriers to sharing data and information between different institutions, which cause delays in the production and release of macroeconomic statistics. Staff emphasized the need to achieve a broad consensus in the preparation of the strategy, to ensure buy-in and therefore maximize its effectiveness.

**40. Bottlenecks in the compilation of external sector statistics need to be addressed.** Currently, the compilation of the quarterly and annual balance of payments (BOP) is shared between the NRBT (compiling flows based on the Overseas Transaction Exchange—OET) and the TDS (integrating OET flows with other data sources to compile the comprehensive flows based on the free-on-board—fob principle). The NRBT and TDS need to clarify data sharing arrangements and ensure an efficient and timely compilation of BOP. The authorities should resume the compilation of the International Investment Position (IIP), which stopped in 2013. Staff welcomed the recent recruitment of new compilers for the external sector statistics and encouraged the authorities to take advantage of IMF capacity building opportunities.

**41. More resources are required for a robust compilation of fiscal accounts.** The compilation of timely and transparent fiscal accounts is required to safeguard the accountability of the use of public resources. The authorities should address the sources of discrepancies, including under recording of capital expenditure financed by donors. Progress on implementing the recommendations of FAD and STA TAs is ongoing and, once the follow up is finalized, the authorities should consider reporting annual government finance statistics (GFS) to the IMF.

### Authorities' Views

**42. The authorities agreed on the need for Tonga to improve statistical compilation.** The TDS supported the expected benefits from the envisaged country-wide long term strategy for statistics, but acknowledged the need to have all involved stakeholders on board for it to be successful. They welcomed the foreseen budget increase for statistical compilation and underlined the urgent need to train newly hired staff. This is due to the large demand for all official statistics related to the sustainable development goals (SDGs) and the TSDF framework where not only the number of indicators and targets is increased (from MDGs to SDGs), but also new thematic areas appear that needs in-depth analytical skills. The MOFNP agreed on the need to further strengthen

the compilation of GFS and to address the accountability and transparency issues raised in the latest Auditor General's report.

## STAFF APPRAISAL

**43. Tonga has continued to experience strong economic growth and moderating inflation.**

Economic growth is projected to remain high in FY2018, slowing to the historic average over the medium term, while inflation is expected to moderate. The authorities have been successful in developing the agriculture and tourism sectors, which retain potential, and growth has been supported largely by construction.

**44. Risks to the outlook are tilted to the downside and stem from external and domestic sources.** Risks associated with potentially weaker economic growth and inward looking policies globally may adversely affect the future path of grant financing, private remittances, and revenues from tourism. While the government's infrastructure strategy may provide a short-term boost to growth and increase future growth potential, the government needs to carefully manage its expenditures and avoid fiscal slippage resulting in non-concessional external borrowing.

**45. The external sector is moderately weaker than warranted by fundamentals and desirable policies.** The CA balance is below its estimated norm, largely due to Tonga's reliance on grants and reflecting a significant share of imports. The exchange rate is estimated to be in line with fundamentals, with no sign of a deterioration in Tonga's competitiveness. Reserve adequacy has been strong in recent years, but is projected to decline due to increased prospective imports and loan repayments. A more prudent fiscal policy would also help to bring the external position back in line with fundamentals.

**46. Staff supports more prudent fiscal management, while recognizing the need to build capital stock in Tonga.** The introduction of explicit fiscal anchors in the FY2018 Budget Document is welcome. At the same time, expected budget revenue are optimistic, even with the proposed tax revenue reforms. As advised in previous Article IV Consultations, the authorities should contain the large wage bill to ensure that fiscal sustainability is not compromised. In terms of own-financed capital expenditure, the authorities should aim at prioritizing those projects that are more likely to deliver long term returns, including project areas of education, health, and roads, and building resilience to natural disasters. The FX levy should be replaced by a non-distortionary tax and be phased out no later than its sunset clause in FY2020.

**47. In the medium term, the authorities should maintain fiscal sustainability through prudent PFM and fiscal adjustment as needed to secure fiscal space for growth-enhancing spending.** To steer the fiscal stance on a more sustainable path, the authorities should target a gradual adjustment of the primary balance to approximately one percent of GDP by FY2022 to maintain the external public debt broadly unchanged. The required adjustment is achievable through several revenue and expenditure measures. PFM should be further strengthened to ensure appropriate medium-term planning, accountability, and budget control and the efficient use of public funds.

**48. The stance of monetary policy is appropriate, and the NRBT should stand ready to adjust should risks emerge.** The current stance is supporting credit growth, which is consistent with financial deepening. However, the NRBT should be ready to adjust monetary policy should signs of overheating emerge. The authorities' efforts in modernizing its monetary policy framework through the introduction of a policy rate and amendments of the NRBT Act are commendable. The NRBT should consider using more flexible monetary policy tools in addition to the RRs. Staff welcome the reforms to the NRBT Act and the Banking Act, the latter of which still needs to be finalized to enhance NRBT's supervisory powers. Loss of CBR may become an increasing source of concern, and given the importance of remittances, the potential impact should be minimized through compliance with relevant international standards with regards to the AML/CFT.

**49. Macprudential policies should be used to address systemic risks to financial stability.** The banking sector remains stable and profitable. However, high credit growth merit continued monitoring. Staff encourages the authorities to develop macroprudential policies, such as limits to LTV ratio for property loans, loan diversification principles, and maximum LTD ratio. The NRBT should develop credit monitoring indicators to catch early signs of potential distress.

**50. Staff supports ongoing reforms aimed at raising Tonga's growth potential and reducing poverty.** In line with the TSDF II, the authorities are appropriately focusing on investing in infrastructure, enabling business climate, enhancing private sector development, developing human capital, and improving access to finance. Bringing the informal economy into the formalized MSMEs would promote inclusiveness and help ensure economic growth benefits the broader population. Staff supports the focus on expanding export market access and increasing the value added of domestic production.

**51. Improving macroeconomic statistics is a priority.** Although data are broadly adequate for surveillance, data quality and timeliness affect the formulation of economic policy and assessment of macroeconomic conditions. Staff recognizes recent improvements in some of the datasets, but efforts are needed to improve main macroeconomic datasets including BOP, fiscal accounts, and national accounts statistics. Staff encourages the authorities to resume or initiate timely official reporting of all relevant datasets to the IMF.

**52. At the authorities' suggestion, it is proposed that the next article IV consultation with Tonga be held on the 24-month cycle.** Tonga satisfies all relevant criteria to be moved to the 24-month cycle.



### Box 1. Tonga's Housing Sector<sup>1</sup>

*Housing credit continues to rise supported by lower interest rates and economic growth.*

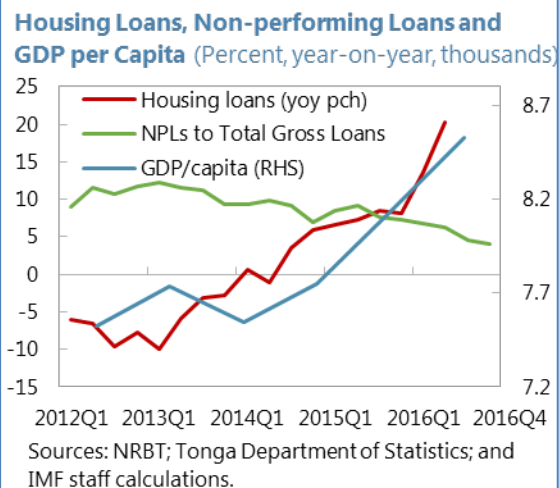
**A housing bubble is unlikely to develop.** Tonga has a rigid land tenure system with lengthy land registration. The secondary market for housing is very small and slow, with approximately 10 house sale transactions per each year. Most bank credit finances construction of owner-occupied dwellings and housing for personal use rather than for investment. The lending to households is collateralized, where land is the only asset that is qualified as collateral by banks. The limited time of land use<sup>2</sup> depreciates its value as collateral over time.

**Housing credit continues to rise** supported by (i) low lending rates for housing loans; (ii) revision of the Land Act; and (iii) other initiatives.<sup>3</sup> Higher payments for import of construction materials driven partially by removal of custom duty on construction materials also contributed to the increase of housing credit.

**The household credit quality is not a clear concern.** Although housing credit is growing rapidly, there are no signs of weakening ability of households to service the debt. All loans are salary-based, where loan payments are deducted directly from the salaries. The remittances continue to increase, and consumer confidence and demand are also on the rise. On the supply side, the ratio NPLs continue to decline. In FY2017, the value of collateral held against the delinquent loans reported by banks was at T\$40.5 million compared to total NPLs of T\$16.9 million, which indicates that banks hold sufficient collateral to cover any shortfall in loan-loss provisions.<sup>4</sup>

Total Remittances (In millions of Paanga)		
	FY2015	FY2016
Private Transfer	186.3	235.2
Compensation of Employees	14.8	17.5
Private Capital Transfers	0.9	1.6
Social Benefits	0.4	1.9
Total	202.4	256.2

Source: NRBT.



<sup>1</sup> Prepared by Olena Ftomova.

<sup>2</sup> According to the "Land Act" the lease term shall not exceed 50 years and shall be renewable upon such conditions as to rent.

<sup>3</sup> In August 2015 TDB introduced a new loan, which offers 5 percent interest rate for new home loans during the first 2 years. In July 2016, the Retirement Fund Board introduced a home improvement loan facility which contributed to the annual growth of personal loans from nonbank financial institutions.

<sup>4</sup> "Budget Statement 2018," MFNP, Tonga.

## Box 2. Tonga: External Sector Assessment<sup>1</sup>

*The external sector position is moderately weaker compared with fundamentals and desirable policies.*

### External balance assessment.<sup>2</sup>

The EBA-lite assessment, based on the CA and external sustainability (ES) approaches, estimates an adjusted current account gap of -1.5 percent (CA) and 2.1 percent (ES), respectively. Given Tonga's reliance on grants, the CA deficit is adjusted to reflect a significant share of imports (5.5 percent of GDP in 2016) financed by

capital grants, which are insensitive to changes in exchange rates. Therefore, after adjusting the CA for capital grant related imports and notwithstanding the inherent volatility of Tonga's BOP data, the external sector position is moderately weaker compared with fundamentals. The CA model is used for the assessment, because external sustainability is not at risk in the baseline and the ES model estimates are affected by large and volatile transactions related to transfers.

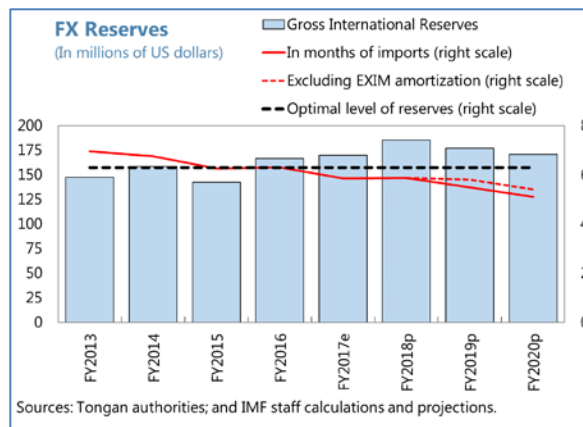
**FX reserves.** Tonga's gross FX reserves stood at US\$169.9 million in FY2017 boosted by grants and remittances inflows. Tonga's reserves coverage remained at a comfortable level of 6–7 months of prospective imports in FY2013–16, well above the NRBT's target of 3–4 months. However, coverage is projected to gradually decline, approaching around 5 months of prospective imports by FY2020, due to strong projected imports and large principal repayments of external debt starting in FY2018.

**Reserves adequacy.** When measured against its relatively high vulnerability to external shocks, Tonga's level of foreign exchange (FX) reserves should be maintained between 6 and 7 months of prospective imports. The reserves template estimates an optimal level of reserves, comparing costs and benefits of holding reserves. The

model for Tonga is calibrated using a higher-than-average risk of adverse external shock, to reflect both the vulnerability to natural disasters and the large current account deficit norm. Higher reconstruction spending or a shortfall in transfers could lead to a rapid decline in FX reserves and, therefore, a higher buffer is required to ensure external stability.

External Balance Assessment	CA model	ES model
<b>CA-Actual</b>	<b>-13.2%</b>	<b>-13.2%</b>
<b>CA (Adjusted)</b>	<b>-7.7%</b>	<b>-7.7%</b>
<b>CA-Norm</b>	<b>-6.2%</b>	<b>-9.8%</b>
Elasticity	-0.8	-0.8
CA-Gap (Adjusted)	-1.5%	2.1%
o/w policy gap	-0.1%	
REER Gap (Adjusted)	1.9%	-2.7%

Source: IMF Staff Estimates.



### FX Reserves adequacy metrics

**FY2017**

Actual Reserves (months of prospective imports)	5.9
Optimal level from reserves template	6.3
Broad Money coverage	136%

Source: IMF Staff Estimates.

<sup>1</sup> Prepared by Giovanni Ugazio.

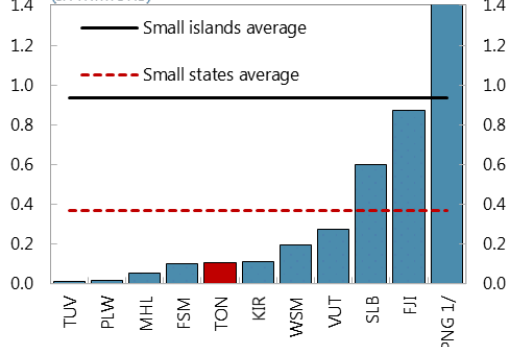
<sup>2</sup> See [Methodological Note on EBA-Lite](#). The EBA lite is calculated for 2016 due to data availability. The rest of the assessment refers to FY2017. Fiscal years in Tonga end in June. The EBA lite for Tonga cannot be calculated using the REER model due to data limitations.

Figure 1. Tonga: Stylized Facts

As a small Pacific island country, ...

**PICs: Population, 2016**

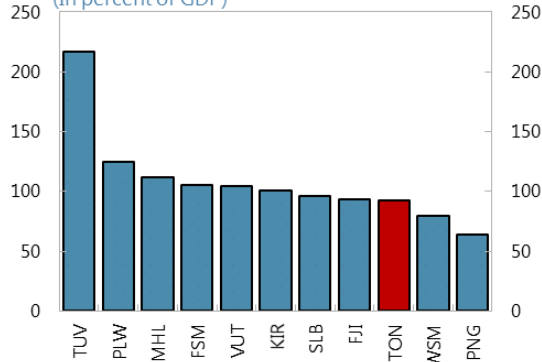
(In millions)



Though an open economy, Tonga has less trade activities compared to peer countries...

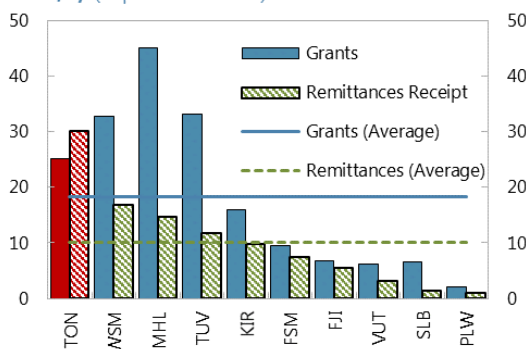
**PICs: Trade Activities, 2016 2/**

(In percent of GDP)



Tonga relies on private remittances and donor grants...

**Pacific Island Countries: Grants and Remittances, 2016, 3/** (In percent of GDP)



Sources: IMF WEO database; South Pacific Applied Geoscience Commission; World Bank Database; Tongan authorities; 2016 World Risk Report; and IMF staff estimates.

1/ PNG - is on right hand scale.

2/ Export and import of goods and services plus remittances.

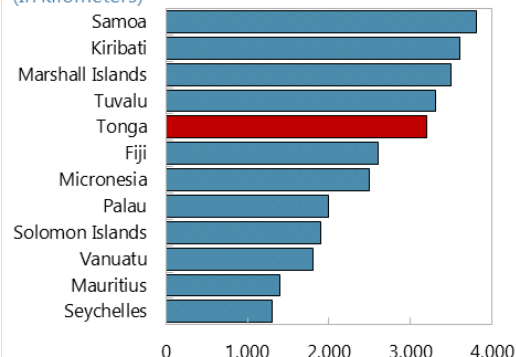
3/ Grants exclude allocations in kind.

4/ Risk combines exposure to natural hazards, coping, and adaptive capacities, ranges 0 to 100 with higher number indicating higher risk.

...Tonga faces geographical challenges.

**PICs: Distance to the Closest Continent**

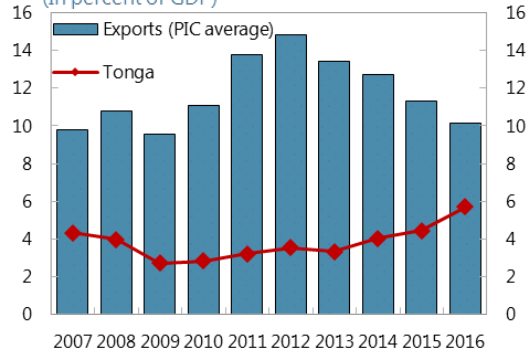
(In kilometers)



...and is constrained by a narrow export base.

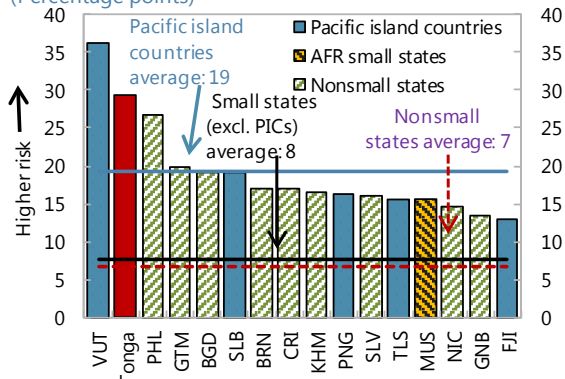
**PICs: Exports**

(In percent of GDP)



...and is vulnerable to large natural disasters.

**Natural Disaster Risks: World Risk Index, 2016 4/** (Percentage points)

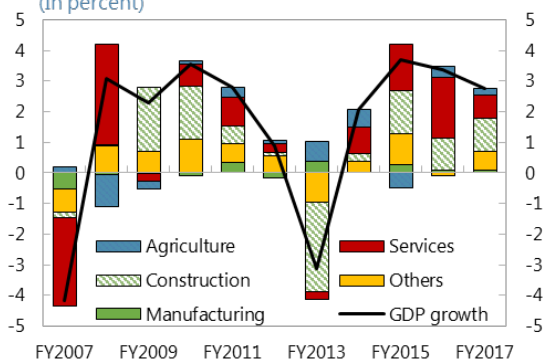


**Figure 2. Tonga: Recent Economic Developments**

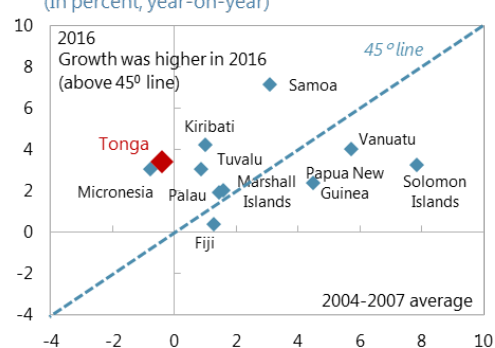
GDP growth was robust in recent years...

...stronger than many peer countries.

**Tonga: Contribution to Growth by Sector**  
(In percent)



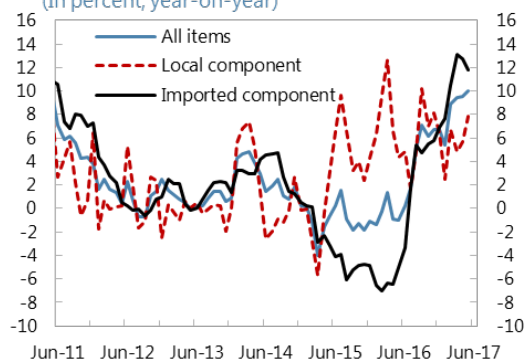
**PICs: Real GDP Growth**  
(In percent, year-on-year)



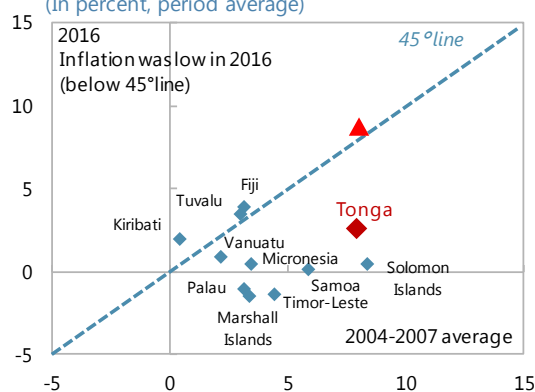
Headline inflation spiked in FY2017, due to the dry weather and the introduction of import taxes on unhealthy goods...

...well above regional trends.

**Tonga: Inflation**  
(In percent, year-on-year)



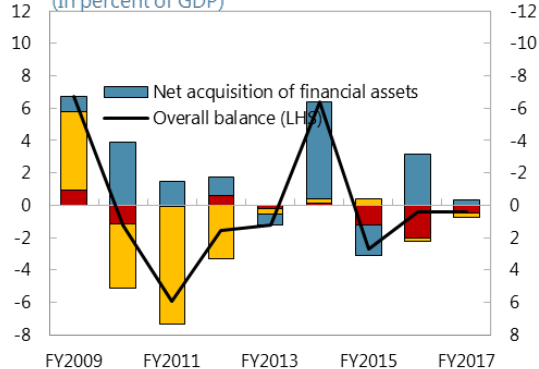
**PICs: Inflation**  
(In percent, period average)



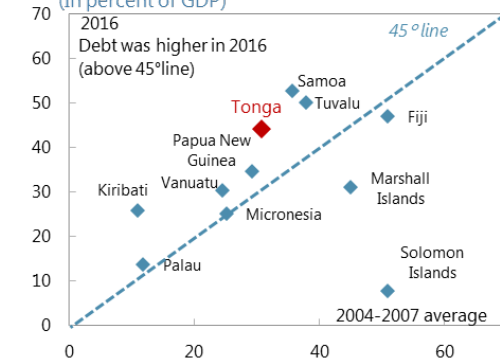
The fiscal balance has been volatile in the past few years...

...and total government debt remains high.

**Tonga: Fiscal Balance**  
(In percent of GDP)



**PICs: Government Debt**  
(In percent of GDP)

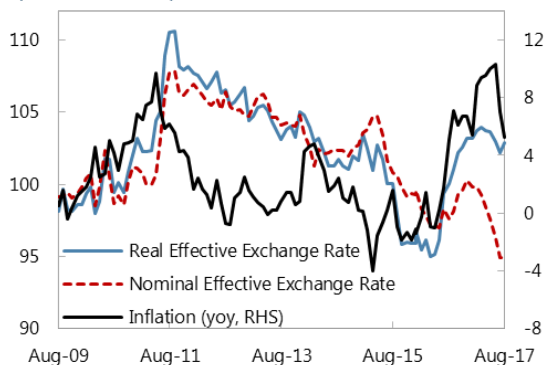


Sources: Tongan authorities; and IMF staff estimates.

**Figure 3. Tonga: External and Monetary Developments**

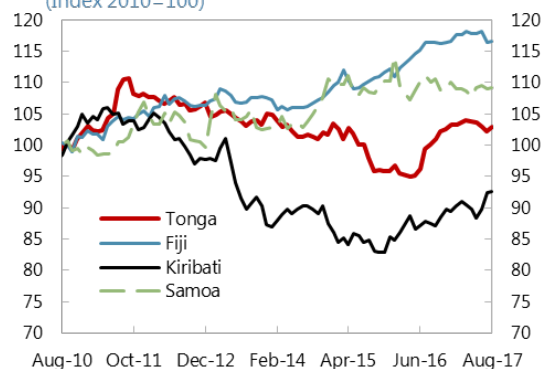
*Real effective exchange rate has recently appreciated...*

**Tonga: Effective Exchange Rates**  
(Index 2010=100)



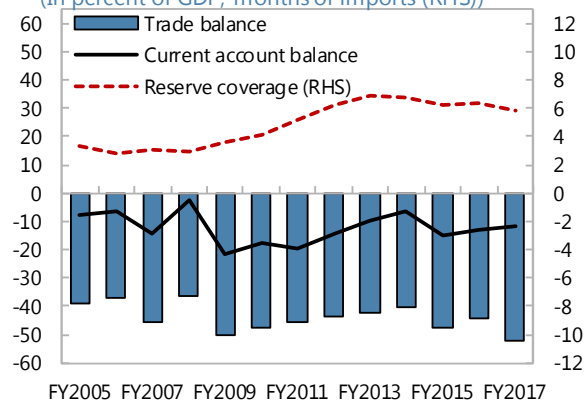
*...but remained less volatile than in peer countries.*

**PICs: Real Effective Exchange Rates**  
(Index 2010=100)



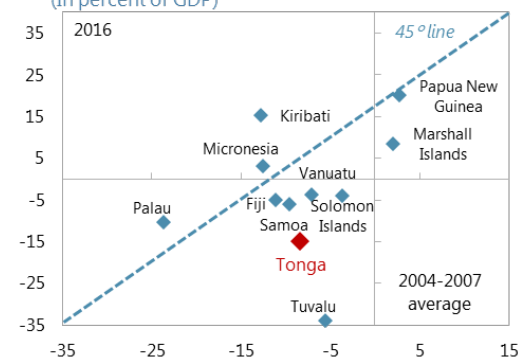
*Reserves coverage remained high, despite the large current account deficit...*

**Tonga: Balance of Payments**  
(In percent of GDP; months of imports (RHS))



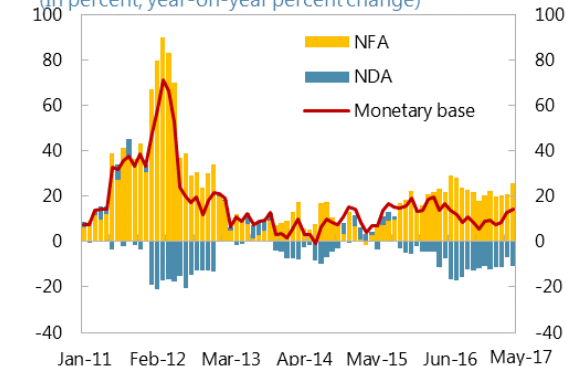
*...that are among the largest in the region.*

**PICs: Current Account Balance**  
(In percent of GDP)



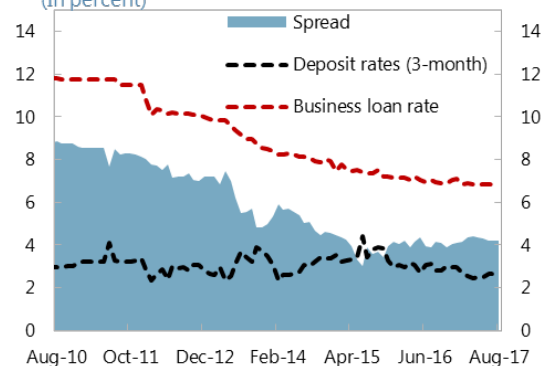
*Monetary policy stance remained accommodative...*

**Tonga: Monetary Base**  
(In percent, year-on-year percent change)



*...stimulating credit growth and leading to narrower interest margins.*

**Tonga: Interest Rates**  
(In percent)

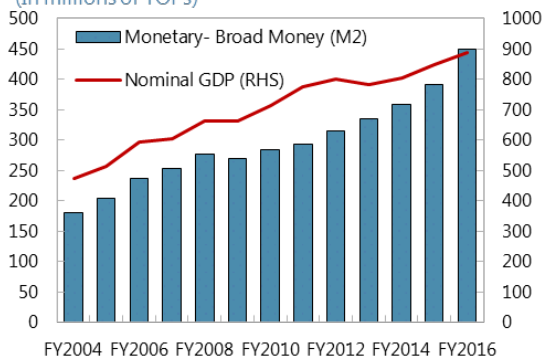


Sources: Tongan authorities; IMF Information Notice System; IMF Integrated Monetary Database; and IMF staff estimates.

**Figure 4. Tonga: Financial Intermediation**

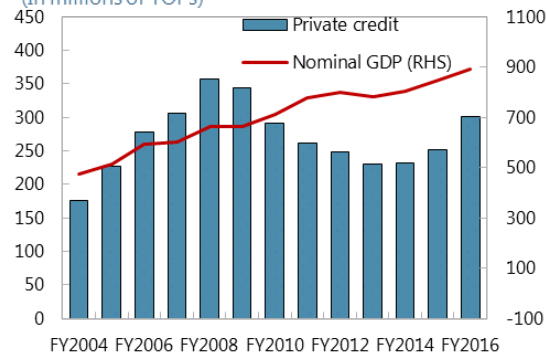
Domestic liquidity has grown in tandem with nominal GDP...

**Domestic Liquidity**  
(In millions of TOPs)



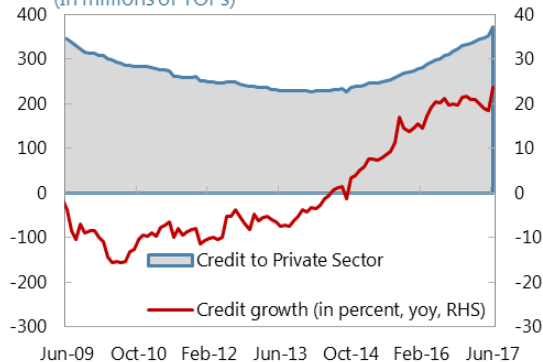
...while credit to private sector started growing faster only recently.

**Credit to Private Sector**  
(In millions of TOPs)



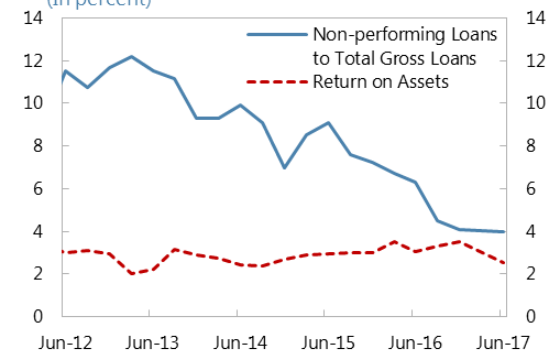
Credit has been expanding in the last few years, ...

**Bank Lending**  
(In millions of TOPs)



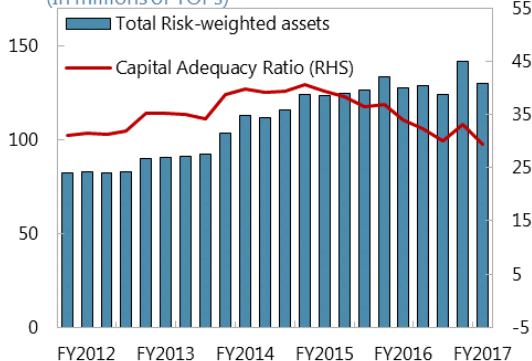
...asset quality indicators improved substantially, ...

**Non-performing Loans and Return on Assets**  
(In percent)



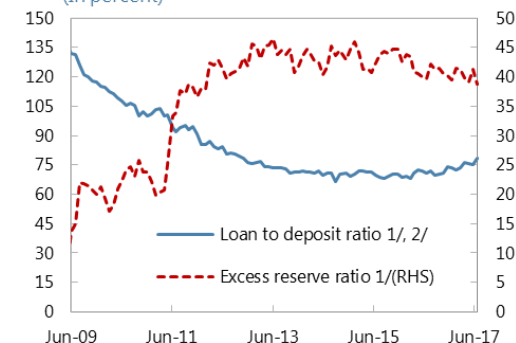
...bank capital ratios remain high, ...

**Capital Buildup**  
(In millions of TOPs)



...suggesting some space for banks to expand credit.

**Loan-to-Deposit and Excess Reserve Ratio**  
(In percent)



Source: Tongan authorities, IMF Integrated Monetary Database; and IMF staff estimates.

1/ Ratio to non-government deposits.

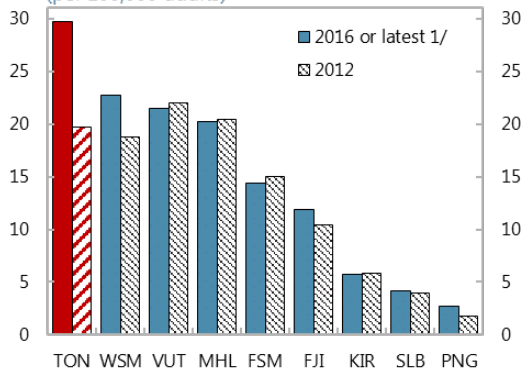
2/ Credit to private sector by the banks.



**Figure 5. Tonga: Financial Access**

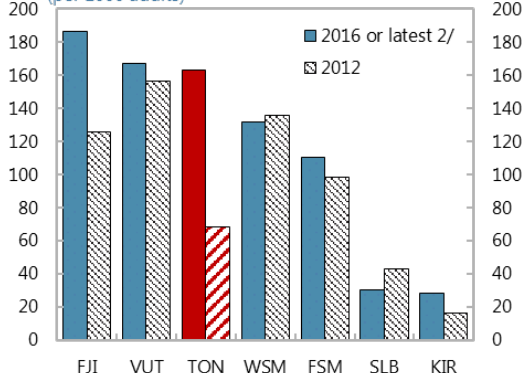
Financial access is high compared with other PICs. Number of bank branches is large....

**Commercial Bank Branches**  
(per 100,000 adults)



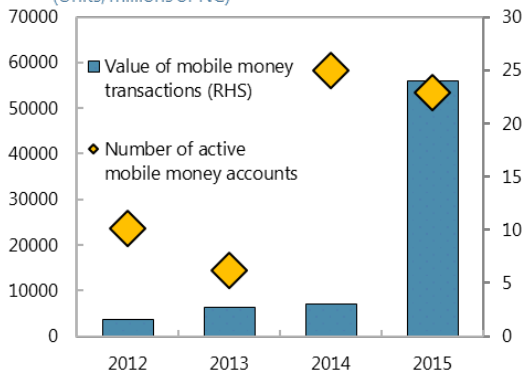
...so is the number of bank loan accounts, ...

**Commercial Bank Loan Accounts**  
(per 1000 adults)



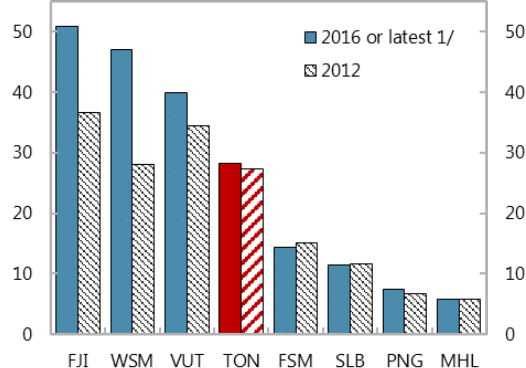
Tonga is experiencing high growth of mobile money transactions...

**Tonga: Mobile Money Transactions**  
(Units, millions of NC)



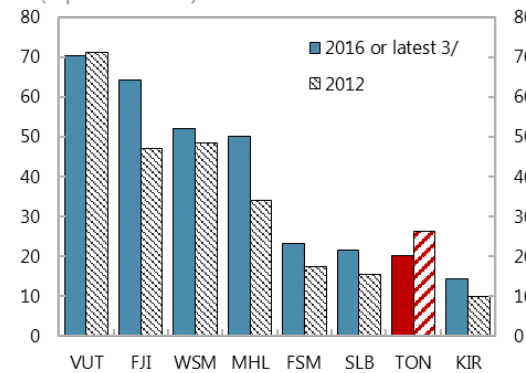
...but ratio of ATM to adults is average, ...

**Number of ATM**  
(per 1000 adults)



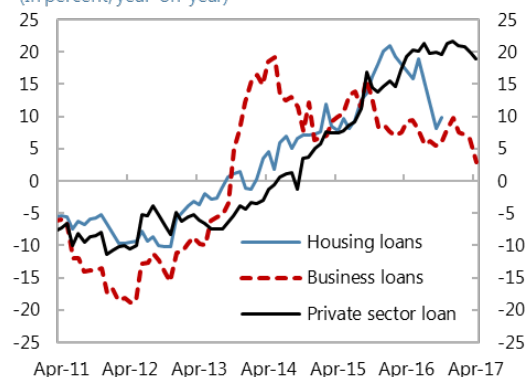
...while the value of loans is quite low.

**Commercial Bank Loans**  
(In percent of GDP)



...and of housing loans.

**Tonga: Commercial Bank Loans Growth**  
(In percent, year-on-year)



Sources: IMF FAS database; Tongan authorities, and IMF staff estimates.

1/ TON, VUT, PNG - 2015 data, KIR - 2013 data.

2/ TON - 2015 data, KIR - 2013 data, VUT - 2014-2015 data.

3/ TON, VUT, MHL - 2015 data, KIR - 2013 data.

**Table 1. Tonga: Selected Economic Indicators, FY2013–19 1/**

Nominal GDP FY2016: US\$422.3 million  
 Population (2014): 103.9 thousands  
 GDP per capita FY2016: US\$4059  
 Major exports: root crops, vanilla, squash, fish  
 Quota: SDR 13.8 million

	FY2013	FY2014	FY2015	FY2016	Estimates FY2017	Projections FY2018	FY2019
<b>(Annual percent change)</b>							
<b>Output and prices</b>							
Real GDP 2/	-3.1	2.1	3.7	3.4	2.7	3.4	3.0
Consumer prices (period average)	0.7	2.3	0.1	-0.6	7.2	5.3	2.5
Consumer prices (end of period)	0.2	1.5	0.2	0.2	10.3	2.5	2.5
GDP deflator	0.5	1.0	1.5	1.7	3.1	2.1	2.1
<b>(In percent of GDP)</b>							
<b>Central government finance</b>							
Total Revenue	33.2	37.7	34.9	40.9	44.5	53.5	52.6
Revenue (excluding grants in-kind)	25.1	28.8	28.1	30.6	30.5	32.1	30.3
Grants in-kind	8.1	8.9	6.8	10.3	14.0	21.5	22.3
Total Expenditure	34.5	31.3	37.6	41.3	44.9	55.8	54.5
Expense	26.2	27.8	31.6	32.0	34.1	41.1	39.7
Transactions in Nonfinancial Assets (Net)	8.2	3.4	6.0	9.4	10.8	14.8	14.8
Overall balance	-1.2	6.4	-2.7	-0.4	-0.4	-2.3	-1.9
Net Acquisition of Financial Assets	-0.7	6.0	-1.9	1.8	0.3	1.5	1.6
External financing (net)	0.4	-0.2	-0.4	0.2	0.3	3.6	3.5
Domestic financing (net)	0.2	-0.1	1.2	2.0	0.5	0.2	-0.1
<b>(Annual percent change)</b>							
<b>Money and credit</b>							
Total liquidity (M3)	5.2	7.3	9.3	16.7	18.8	11.7	11.3
Of which: Broad money (M2)	6.1	7.2	9.0	15.0	19.1	12.1	11.7
Domestic credit	2.5	7.8	15.4	8.8	5.8	16.6	14.1
Of which: Private sector credit	-2.7	0.7	10.6	18.0	18.9	13.0	12.0
Interest rates (end of period)							
Average deposit rate	2.0	1.9	2.0	2.1	2.3	...	...
Average lending rate	9.4	9.0	8.7	8.7	8.6	...	...
<b>(In millions of U.S. dollars)</b>							
<b>Balance of payments</b>							
Exports, f.o.b.	14.9	17.9	19.4	24.1	25.3	26.4	27.0
Imports, f.o.b.	-187.4	-187.6	-207.7	-202.8	-235.1	-258.4	-281.2
Services (net)	-17.9	-10.6	-19.4	-9.1	-14.4	-17.3	-21.7
Investment income (net)	11.3	3.2	4.5	2.5	6.8	8.7	11.6
Current transfers (net)	135.3	147.1	137.9	129.7	166.0	190.5	207.5
Of which: Remittances	107.4	102.7	102.2	112.2	117.4	124.3	130.4
Of which: Official grants	25.4	37.8	27.0	33.0	53.1	69.6	80.5
Current account balance	-43.7	-30.0	-65.3	-55.6	-51.3	-50.1	-56.7
(In percent of GDP)	-9.7	-6.8	-15.0	-13.2	-12.0	-11.8	-12.9
Overall balance	2.4	11.2	-16.2	23.9	3.5	15.4	-8.5
Terms of trade (annual percent change)	-2.7	1.5	-3.6	2.0	3.1	-1.8	-0.5
<b>Gross official foreign reserves</b>							
In millions of U.S. dollars	147.6	158.7	142.5	166.4	169.9	185.2	176.7
(In months of next year's goods and services imports)	6.9	6.8	6.3	6.3	5.9	5.9	5.5
<b>Debt (in percent of GDP)</b>							
Public debt (external and domestic)	49.2	47.1	51.4	51.8	48.0	49.2	50.3
External debt	44.0	41.9	45.2	44.0	41.8	43.2	44.6
Debt service ratio	1.4	1.5	1.6	1.6	1.6	1.5	3.8
<b>Exchange rates</b>							
Nominal effective exchange rate (2005=100)	105.4	103.3	103.0	98.8	99.1	...	...
Real effective exchange rate (2005=100)	105.5	103.4	101.7	96.4	101.8	...	...
<b>Memorandum items:</b>							
Remittances (in percent of GDP)	23.9	23.2	23.5	26.6	27.4	29.4	29.7
Tourism (in percent of GDP)	9.9	9.5	11.3	13.0	12.9	15.0	15.3
FDI (in percent of GDP)	1.4	1.7	2.4	2.6	2.7	2.8	2.8
Nominal GDP (millions of T\$)	779.3	803.7	846.1	889.4	941.8	993.8	1045.1
GDP per capita (thousands of T\$)	7.5	7.7	8.1	8.5	9.0	9.5	9.9
Population (thousands)	103.5	103.9	104.1	104.3	104.6	104.8	105.1

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

1/ Fiscal year beginning July.

2/ Including preliminary data.

Table 2a. Tonga: Summary of Government Operations, FY2013–19

	Estimates				Budget	Projections	
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019
(In millions of T\$)							
<b>Total Revenue</b>	258.9	303.0	295.0	363.8	418.7	541.0	550.1
<i>Memo: Revenue (excluding grants in-kind)</i>	195.5	231.2	237.4	272.5	287.0	327.6	317.0
Tax revenue	135.7	141.9	160.9	181.2	200.8	247.5	241.0
Taxes on income/profits	30.3	28.8	37.4	35.8	34.7	38.1	38.1
Taxes on property	0.7	0.1	0.2	0.3	0.3	0.9	0.9
Taxes on goods and services	89.9	97.9	105.7	124.3	139.4	171.9	170.0
Taxes on international trade and transactions	14.7	15.1	17.6	19.9	26.4	36.6	32.0
Other taxes	0.0	0.0	0.0	0.9	0.0	0.0	0.0
Grants	103.2	137.3	105.2	146.0	179.4	251.4	267.5
Current grants (cash)	12.6	32.1	14.5	24.1	27.6	34.4	34.4
Capital grants (cash)	27.2	33.4	33.1	30.5	20.1	3.6	0.0
Grants in-kind	63.4	71.8	57.6	91.4	131.7	213.4	233.1
Other Revenue	19.9	23.8	28.9	36.6	38.5	42.1	41.6
<b>Total Expenditure</b>	268.5	251.4	317.8	367.6	422.6	554.4	569.4
<i>Memo: Expenditure (excluding grants in-kind)</i>	205.1	179.6	260.2	276.2	290.9	341.0	336.3
Expense	204.4	223.7	267.0	284.4	320.7	407.8	414.4
Salaries and wages	87.5	92.2	98.4	108.5	123.6	135.9	136.2
Employers' social contribution	7.4	9.2	26.4	18.7	14.5	12.7	12.7
Interest	7.1	7.1	7.2	7.9	8.1	8.1	8.5
Of which: External	5.3	5.7	5.9	6.4	6.7	6.3	6.7
Use of goods and services	79.5	84.6	96.8	107.3	122.7	171.6	198.8
Subsidies	0.8	0.1	0.1	0.6	0.9	0.9	0.9
Grants	2.5	3.1	3.7	3.7	3.7	2.5	2.2
Social benefits	13.8	16.4	19.3	20.8	22.1	24.5	24.9
Other expense	5.6	10.9	15.1	16.9	25.1	51.6	30.2
Transactions in Nonfinancial Assets	64.1	27.7	50.8	83.2	101.9	146.6	155.0
Gross Operating Balance	54.5	79.3	28.0	79.5	98.0	133.2	135.6
<b>Overall balance</b>	-9.6	51.6	-22.8	-3.8	-3.9	-13.4	-19.4
Primary balance	-2.5	58.7	-15.6	4.1	4.2	-5.3	-10.8
Net acquisition of financial assets	-5.3	48.6	-15.7	16.0	3.2	15.1	16.5
External financing (loans)	2.9	-1.8	-3.2	1.6	2.4	26.6	35.9
Domestic financing (debt securities)	1.4	-1.2	10.3	18.2	4.7	1.9	-0.7
<b>Memorandum items:</b>							
Effective import duties rate (percent)	5%	4%	4%	4%	5%	6%	5%
Nominal GDP (in millions of T\$) 1/	779.3	803.7	846.1	889.4	941.8	993.8	1045.1
Compensation of employees							
(in percent of domestic revenue)	61.0	61.2	65.7	58.4	57.7	51.3	52.7
(in percent of current expense)	46.3	56.5	48.0	46.0	47.5	43.6	44.3
Total external public debt outstanding	343.2	336.5	382.8	390.9	393.3	419.9	465.7

Sources: Tongan authorities; and IMF staff estimates.

1/ Nominal GDP for FY2018 based on staff estimates for both Budget and Projections.

Table 2b. Tonga: Summary of Government Operations, FY2013–19

	FY2013	FY2014	FY2015	FY2016	Estimates FY2017	Budget FY2018	Projections FY2018	FY2019
(In percent of GDP)								
<b>Total Revenue</b>	33.2	37.7	34.9	40.9	44.5	54.4	53.5	52.6
<i>Memo: Revenue (excluding grants in-kind)</i>	25.1	28.8	28.1	30.6	30.5	33.0	32.1	30.3
Tax revenue	17.4	17.6	19.0	20.4	21.3	24.9	24.0	23.1
Taxes on income/profits	3.9	3.6	4.4	4.0	3.7	3.8	3.8	3.6
Taxes on property	0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Taxes on goods and services	11.5	12.2	12.5	14.0	14.8	17.3	16.4	16.3
Taxes on international trade and transactions	1.9	1.9	2.1	2.2	2.8	3.7	3.7	3.1
Other taxes	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Grants	13.2	17.1	12.4	16.4	19.0	25.3	25.3	25.6
Current grants (cash)	1.6	4.0	1.7	2.7	2.9	3.5	3.5	3.3
Capital grants (cash)	3.5	4.2	3.9	3.4	2.1	0.4	0.4	0.0
Grants in-kind	8.1	8.9	6.8	10.3	14.0	21.5	21.5	22.3
Other Revenue	2.6	3.0	3.4	4.1	4.1	4.2	4.2	4.0
<b>Total Expenditure</b>	34.5	31.3	37.6	41.3	44.9	55.8	55.8	54.5
<i>Memo: Expenditure (excluding grants in-kind)</i>	26.3	22.3	30.8	31.1	30.9	34.3	34.3	32.2
Expense	26.2	27.8	31.6	32.0	34.1	41.0	41.1	39.7
Salaries and wages	11.2	11.5	11.6	12.2	13.1	13.7	13.7	13.0
Employers' social contribution	0.9	1.1	3.1	2.1	1.5	1.3	1.3	1.2
Interest	0.9	0.9	0.9	0.9	0.9	0.8	0.8	0.8
Of which: External	0.7	0.7	0.7	0.7	0.7	0.6	0.7	0.6
Use of goods and services	10.2	10.5	11.4	12.1	13.0	17.3	17.3	19.0
Subsidies	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Grants	0.3	0.4	0.4	0.4	0.4	0.3	0.3	0.2
Social benefits	1.8	2.0	2.3	2.3	2.3	2.5	2.5	2.4
Other expense	0.7	1.4	1.8	1.9	2.7	5.2	5.2	2.9
Transactions in Nonfinancial Assets	8.2	3.4	6.0	9.4	10.8	14.8	14.8	14.8
Gross Operating Balance	7.0	9.9	3.3	8.9	10.4	13.4	12.5	13.0
<b>Overall balance</b>	-1.2	6.4	-2.7	-0.4	-0.4	-1.3	-2.3	-1.9
Primary balance	-0.3	7.3	-1.8	0.5	0.4	-0.5	-1.4	-1.0
Net acquisition of financial assets	-0.7	6.0	-1.9	1.8	0.3	1.5	1.5	1.6
External financing (loans)	0.4	-0.2	-0.4	0.2	0.3	2.7	3.6	3.5
Domestic financing (debt securities)	0.2	-0.1	1.2	2.0	0.5	0.2	0.2	-0.1
<b>Memorandum items:</b>								
Effective import duties rate (percent)	5%	4%	4%	4%	5%	6%	6%	5%
Nominal GDP (in millions of T\$) 1/	779.3	803.7	846.1	889.4	941.8	993.8	993.8	1045.1
Compensation of employees								
(in percent of domestic revenue)	61.0	61.2	65.7	58.4	57.7	51.3	52.9	52.7
(in percent of current expense)	46.3	56.5	48.0	46.0	47.5	43.6	43.5	44.3
Total external public debt outstanding	44.0	41.9	45.2	44.0	41.8	42.3	43.2	44.6

Sources: Tongan authorities; and IMF staff estimates.

1/ Nominal GDP for FY2018 based on staff estimates for both Budget and Projections.

Table 3. Tonga: Depository Corporations Survey, FY2013–19 1/

	FY2013	FY2014	FY2015	FY2016	FY2017	Projections	
						FY2018	FY2019
(In millions of T\$, end of period)							
<b>Net foreign assets</b>	261.1	269.4	286.1	357.8	383.2	410.6	458.7
Claims on nonresidents	286.1	300.7	319.6	392.4	419.8	447.2	495.3
NRBT	268.5	284.0	300.0	366.4	393.8	421.3	469.3
Other depository corporations	17.6	16.7	19.6	26.0	26.0	26.0	26.0
Liabilities to Nonresidents	-25.1	-31.2	-33.5	-34.6	-36.6	-36.6	-36.6
NRBT	-18.0	-18.2	-19.5	-20.4	-20.7	-20.7	-20.7
Other depository corporations	-7.0	-13.0	-14.0	-14.2	-15.9	-15.9	-15.9
<b>Net domestic assets</b>	82.7	99.4	117.2	112.7	118.3	213.3	235.9
Net domestic credit	214.3	231.0	266.7	290.1	306.9	357.8	408.2
Net claims on government	-44.4	-54.4	-50.0	-74.3	-114.7	-112.8	-113.5
Claims on public nonfin. corps.	16.8	41.7	47.5	46.1	43.4	43.4	43.4
Claims on private sector	241.2	243.0	268.8	317.1	376.9	425.9	477.0
Other items, net	-131.6	-131.6	-149.5	-177.4	-188.6	-144.6	-172.3
<b>Total liquidity (M3)</b>	343.8	368.9	403.3	470.5	558.8	623.9	694.6
Broad money (M2)	334.1	358.3	390.4	449.1	534.9	599.6	669.9
Narrow money	149.4	167.7	182.1	210.8	263.6	268.2	272.8
Quasi money	184.7	190.7	208.3	238.3	271.2	331.4	397.1
FX Deposits	9.7	10.5	12.9	21.5	23.9	24.3	24.8
(Annual percentage change)							
<b>Net foreign assets</b>	8.6	3.2	6.2	25.1	7.1	7.2	11.7
<b>Net domestic assets</b>	-4.5	20.2	17.9	-3.9	5.0	80.2	10.6
Net domestic credit	2.5	7.8	15.4	8.8	5.8	16.6	14.1
Claims on private sector	-2.7	0.7	10.6	18.0	18.9	13.0	12.0
<b>Total liquidity</b>	5.2	7.3	9.3	16.7	18.8	11.7	11.3
Broad money (M2)	6.1	7.2	9.0	15.0	19.1	12.1	11.7
(In millions of U.S. dollars)							
<b>Net foreign assets</b>	143.5	150.6	135.9	162.5	165.3	...	...
Claims on nonresidents	157.2	168.1	151.9	178.2	181.1	...	...
NRBT	147.6	158.7	142.5	166.4	169.9	...	...
Other depository corporations	9.7	9.3	9.3	11.8	11.2	...	...
Liabilities to nonresidents	-13.8	-17.5	-15.9	-15.7	-15.8	...	...
NRBT	-9.9	-10.2	-9.3	-9.3	-8.9	...	...
Other depository corporations	-3.9	-7.3	-6.7	-6.5	-6.8	...	...
<b>Memorandum items:</b>							
Velocity (GDP/M2)	2.3	2.2	2.2	2.0	1.8	1.7	1.6
T\$ per U.S. dollar (end of period)	1.8	1.8	2.1	2.2	2.3	...	...

Sources: Tongan authorities; and IMF staff estimates.

1/ Comprises the National Reserve Bank of Tonga (NRBT) and other depository corporations (ODCs).

Table 4. Tonga: Balance of Payments Summary, FY2013–19

	Estimates					Projections	
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019
(In millions of U.S. Dollars)							
Trade balance	-172.5	-169.7	-188.3	-178.7	-209.8	-232.0	-254.1
Exports, f.o.b.	14.9	17.9	19.4	24.1	25.3	26.4	27.0
Imports, f.o.b.	-187.4	-187.6	-207.7	-202.8	-235.1	-258.4	-281.2
Services balance	-17.9	-10.6	-19.4	-9.1	-14.4	-17.3	-21.7
Receipts	76.8	56.8	54.7	61.4	67.4	72.5	76.0
Payments	-94.6	-67.3	-74.1	-70.5	-81.7	-89.8	-97.7
Investment income balance	11.3	3.2	4.5	2.5	6.8	8.7	11.6
Receipts	25.0	21.8	23.4	23.2	27.7	29.8	32.9
Payments	-13.7	-18.7	-18.8	-20.7	-20.9	-21.1	-21.3
Transfers balance	135.3	147.1	137.9	129.7	166.0	190.5	207.5
Official transfers (net) 1/	23.3	36.1	26.4	30.7	50.9	67.4	78.2
Private transfers (net)	112.0	111.0	111.5	98.9	115.1	123.1	129.4
Current account balance	-43.7	-30.0	-65.3	-55.6	-51.3	-50.1	-56.7
(In percent of GDP)	-9.7	-6.8	-15.0	-13.2	-12.0	-11.8	-12.9
Capital account balance	30.6	33.6	24.0	29.6	36.1	44.9	39.5
Financial account balance	1.5	9.7	0.9	9.0	16.1	20.5	8.7
FDI (net)	6.2	7.7	10.6	10.9	11.3	11.8	12.2
Other investment (net)	-4.7	2.0	-9.6	-2.0	4.8	8.8	-3.5
Of which: EXIM loans	4.0	0.0	-0.7	-0.6	-0.4	0.0	-6.4
Errors and omissions	13.9	-2.1	24.2	40.8	2.6	0.0	0.0
Overall balance 2/	2.4	11.2	-16.2	23.9	3.5	15.4	-8.5
Memorandum items:							
Gross official foreign reserves	147.6	158.7	142.5	166.4	169.9	185.2	176.7
In months of next year's goods and services import	6.9	6.8	6.3	6.3	5.9	5.9	5.5
Exchange rate							
T\$ per U.S. dollar (period average)	1.7	1.8	1.9	2.2	2.2	...	...
T\$ per U.S. dollar (end of period)	1.8	1.8	2.1	2.2	2.3	...	...
Nominal GDP (in millions of US\$)	449.5	443.5	435.4	422.3	427.7	422.9	438.3
Commodity price indexes (2005 = 100)							
Food	176.8	173.8	155.5	142.3	146.4	...	...
Fuel	104.5	100.2	73.5	46.8	46.6	...	...
Sources: Tongan authorities; and IMF staff estimates.							
1/ Includes all official grants excluding project funds related to capital formation.							
2/ Change in gross official foreign reserves.							



Table 5. Tonga: Medium-Term Scenario, FY2013–23 1/

	Estimates					Projections					
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023 <sup>2</sup>
(Annual percentage change)											
Output and prices											
Real GDP	-3.1	2.1	3.7	3.4	2.7	3.4	3.0	2.9	1.9	1.9	1.1
Consumer prices (end of period)	0.2	1.5	0.2	0.2	10.3	2.5	2.5	2.5	2.5	2.5	2.5
Consumer prices (period average)	0.7	2.3	0.1	-0.6	7.2	5.3	2.5	2.5	2.5	2.5	2.5
GDP deflator	0.5	1.0	1.5	1.7	3.1	2.1	2.1	2.1	2.1	2.1	2.1
(In percent of GDP)											
Central government finance											
Total Revenue	33.2	37.7	34.9	40.9	44.5	53.5	52.6	51.6	49.0	49.5	49.5
Memo: Total Revenue (excluding grants in-kind)	25.1	28.8	28.1	30.6	30.5	32.1	30.3	31.0	30.8	30.8	30.8
Tax revenue	17.4	17.6	19.0	20.4	21.3	24.0	23.1	23.8	21.9	21.9	21.9
Grants	13.2	17.1	12.4	16.4	19.0	25.3	25.6	23.7	23.2	23.7	23.7
Other Revenue	2.6	3.0	3.4	4.1	4.1	4.2	4.0	4.1	3.9	3.9	3.9
Total Expenditure	34.5	31.3	37.6	41.3	44.9	55.8	54.5	56.0	51.0	50.9	51.9
Memo: Total Expenditure (excluding grants in-kind)	26.3	22.3	30.8	31.1	30.9	34.3	32.2	35.4	32.7	32.2	33.3
Expense	26.2	27.8	31.6	32.0	34.1	41.1	39.7	38.2	38.4	38.4	39.4
Salaries and wages	11.2	11.5	11.6	12.2	13.1	13.7	13.0	12.4	12.4	12.4	12.5
Employers' social contribution	0.9	1.1	3.1	2.1	1.5	1.3	1.2	1.1	1.2	1.2	1.2
Use of goods and services	10.2	10.5	11.4	12.1	13.0	17.3	19.0	18.2	18.5	18.5	19.5
Interest expense	0.9	0.9	0.9	0.9	0.9	0.8	0.8	0.7	0.7	0.7	0.6
Other expense	2.9	3.8	4.5	4.7	5.5	8.0	5.6	5.8	5.6	5.6	5.5
Transactions in Nonfinancial Assets	8.2	3.4	6.0	9.4	10.8	14.8	14.8	17.7	12.5	12.5	12.5
Gross Operating Balance	7.0	9.9	3.3	8.9	10.4	12.5	13.0	13.4	10.6	11.1	10.1
Overall Balance	-1.2	6.4	-2.7	-0.4	-0.4	-2.3	-1.9	-4.4	-1.9	-1.4	-2.4
Primary Balance	-0.3	7.3	-1.8	0.5	0.4	-1.4	-1.0	-3.6	-1.2	-0.8	-1.8
Net Acquisition of Financial Assets	-0.7	6.0	-1.9	1.8	0.3	1.5	1.6	-0.2	0.0	0.0	0.0
External financing (net)	0.4	-0.2	-0.4	0.2	0.3	3.6	3.5	4.0	1.9	1.4	2.4
Domestic financing (net)	0.2	-0.1	1.2	2.0	0.5	0.2	-0.1	0.2	0.0	0.0	0.0
(In millions of U.S. dollars)											
Balance of payments											
Trade balance	-172.5	-169.7	-188.3	-178.7	-209.8	-232.0	-254.1	-259.8	-270.8	-284.2	-299.2
Exports, f.o.b.	14.9	17.9	19.4	24.1	25.3	26.4	27.0	27.2	27.3	27.8	28.4
Imports, f.o.b.	-187.4	-187.6	-207.7	-202.8	-235.1	-258.4	-281.2	-287.0	-298.0	-312.1	-327.5
Services balance	-17.9	-10.6	-19.4	-9.1	-14.4	-17.3	-21.7	-20.2	-20.3	-20.3	-19.5
Investment income balance	11.3	3.2	4.5	2.5	6.8	8.7	11.6	13.0	13.6	14.1	9.3
Transfers balance	135.3	147.1	137.9	129.7	166.0	190.5	207.5	213.3	220.1	230.7	239.3
Of which: Remittances	107.4	102.7	102.2	112.2	117.4	124.3	130.4	136.0	141.5	147.2	153.1
(Annual percent change)	39.2	-4.4	-0.5	9.8	4.6	5.9	4.9	4.3	4.0	4.0	4.0
Current account balance	-43.7	-30.0	-65.3	-55.6	-51.3	-50.1	-56.7	-53.7	-57.3	-59.7	-70.0
(In percent of GDP)	-9.7	-6.8	-15.0	-13.2	-12.0	-11.8	-12.9	-11.7	-12.0	-12.0	-13.7
Capital account balance	30.6	33.6	24.0	29.6	36.1	44.9	39.5	36.4	37.3	38.9	40.0
Financial account balance	1.5	9.7	0.9	9.0	16.1	20.5	8.7	11.2	15.4	15.5	19.6
Overall balance	2.4	11.2	-16.2	23.9	3.5	15.4	-8.5	-6.1	-4.6	-5.3	-10.4
Terms of trade (percent change)	1.5	-3.6	2.0	3.1	-1.8	-0.5	-0.7	0.0	0.7	0.3	0.3
Gross international reserves (end of period)											
In millions of U.S. dollars	147.6	158.7	142.5	166.4	169.9	185.2	176.7	170.6	166.0	160.7	150.3
In months of next year's goods and services imports	6.9	6.8	6.3	6.3	5.9	5.9	5.5	5.1	4.7	4.4	4.0
External debt (in percent of GDP)											
Public sector external debt	44.0	41.9	45.2	44.0	41.8	43.2	44.6	46.4	46.5	46.1	47.1
Debt service ratio	1.4	1.5	1.6	1.6	1.6	1.5	3.8	3.6	3.4	3.3	3.1
Public sector total debt (in percent of GDP)	49.2	47.1	51.4	51.8	48.0	49.2	50.3	52.0	51.9	51.3	52.1
Memorandum items:											
Private transfers (net, in millions of U.S. dollars)	112.0	111.0	111.5	98.9	115.1	123.1	129.4	134.8	140.3	146.0	152.1
(In percent of imports of goods and services)	59.8	59.2	53.7	48.8	49.0	47.6	46.0	47.0	47.1	46.8	46.4
Commodity price indexes (2005 = 100)											
Food	176.8	173.8	155.5	142.3	146.4	...	...	...	...	...	...
Fuel	104.5	100.2	73.5	46.8	46.6	...	...	...	...	...	...
Nominal GDP (millions of T\$)	779.3	803.7	846.1	889.4	941.8	993.8	1045.1	1097.9	1142.5	1188.2	1226.4
Sources: Tongan authorities; and IMF staff estimates and projections.											
1/ Fiscal year beginning July.											
2/ FY2023 incorporates the average effect of natural disasters.											

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

1/ Fiscal year beginning July.

2/ FY2023 incorporates the average effect of natural disasters.

**Table 6. Tonga: Financial Soundness Indicators, FY2011–16**

	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
<b>Banks</b>							
Net domestic credit		<b>(Year-on-year percent change)</b>					
Public non-financial corporations	-12.0	1.0	22.2	148.4	14.0	-3.0	-5.9
Private sector	-9.9	-5.2	-2.7	0.7	10.6	18.0	18.9
		<b>(In percent)</b>					
Credit/GDP	35.5	32.7	33.1	35.4	37.4	40.8	44.6
Regulatory Capital to Risk-Weighted Assets	...	31.4	35.2	39.8	39.4	34.0	29.4
Return on Assets	...	1.0	2.2	2.4	2.9	3.6	2.5
Return on Equity	...	4.8	9.7	10.0	11.8	15.5	11.9
Non-performing Loans to Total Gross Loans	...	14.9	13.6	12.4	9.8	6.7	4.0
Non-performing Loans Net of Provisions to Capital	...	28.7	19.3	19.7	17.3	13.5	8.6
Sources: National Reserve Bank of Tonga; and IMF, Financial Soundness Indicators.							

Table 7. Tonga: Baseline and Alternative Scenarios, FY2017–22

	Estimates	Projections				
	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
(In percent of GDP)						
<i>Baseline</i>						
<b>Central Government</b>						
Revenue and grants	44.5	53.5	52.6	51.6	49.0	49.5
Total Expenditure	44.9	55.8	54.5	56.0	51.0	50.9
Expense	34.1	41.1	39.7	38.2	38.4	38.4
Transactions in nonfinancial assets	10.8	14.8	14.8	17.7	12.5	12.5
Primary balance	0.4	-1.4	-1.0	-3.6	-1.2	-0.8
Fiscal balance	-0.4	-2.3	-1.9	-4.4	-1.9	-1.4
Total public debt	48.0	49.2	50.3	52.0	51.9	51.3
o/w External debt	41.8	43.2	44.6	46.4	46.5	46.1
<b>Memorandum items</b>						
Real GDP growth	2.7	3.4	3.0	2.9	1.9	1.9
Inflation (CPI average)	7.2	5.3	2.5	2.5	2.5	2.5
Current account balance	-12.0	-11.8	-12.9	-11.7	-12.0	-12.0
<i>Revenue and Current Expenditure</i>						
<b>Central Government</b>						
Revenue and grants	44.5	53.9	52.9	53.4	50.2	50.6
Total Expenditure	44.9	55.5	54.4	54.4	50.4	50.3
Expense	34.1	40.7	39.4	36.5	37.9	37.8
Transactions in nonfinancial assets	10.8	14.8	15.0	18.0	12.5	12.5
Primary balance	0.4	-0.8	-0.7	-0.3	0.5	1.0
Fiscal balance	-0.4	-1.7	-1.5	-1.1	-0.2	0.3
Total public debt	48.0	48.9	49.8	48.4	46.8	44.8
o/w External debt	41.8	42.8	44.0	42.7	41.4	39.5
<b>Memorandum items</b>						
Real GDP growth	2.7	2.8	2.6	2.5	1.7	1.7
Inflation (CPI average)	7.2	5.0	2.0	1.8	1.7	1.6
Current account balance	-12.0	-11.8	-12.9	-11.7	-12.0	-12.1
<i>Capital Expenditure Reduction</i>						
<b>Central Government</b>						
Revenue and grants	44.5	53.7	52.9	52.0	49.8	50.2
Total Expenditure	44.9	55.2	54.2	52.7	50.0	49.8
Expense	34.1	41.2	39.8	38.5	38.6	38.5
Transactions in nonfinancial assets	10.8	14.0	14.3	14.2	11.4	11.3
Primary balance	0.4	-0.7	-0.5	0.0	0.6	1.1
Fiscal balance	-0.4	-1.5	-1.3	-0.7	-0.2	0.4
Total public debt	48.0	48.6	49.2	47.5	45.8	43.7
o/w External debt	41.8	42.6	43.5	41.8	40.4	38.5
<b>Memorandum items</b>						
Real GDP growth	2.7	3.0	2.8	2.6	1.8	1.8
Inflation (CPI average)	7.2	5.0	2.0	1.8	1.7	1.6
Current account balance	-12.0	-11.8	-12.8	-11.4	-11.8	-11.8

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

## Appendix I. Risk Assessment Matrix<sup>1</sup>

Source	Likelihood	Impact	Policy Response
<b>EXTERNAL RISKS</b>			
<b>Structurally weak growth in key advanced economies</b> Weak global growth could have a large adverse impact on Tonga via reduced remittances, donor funds and tourism. The impact may be more severe if it is compound with the implementation of inward looking policies.	High	Medium/High	Preserve fiscal and external buffers to cope with adverse shocks in the short term. In the longer term, boost public investment, and pursue structural reforms to improve potential growth and reduce dependence on aid and remittances.
<b>Significant China slowdown and spillovers</b> China is a key development partner for Tonga, providing direct financing of several infrastructure projects.	Low/Medium	Medium/High	
<b>Reduced financial services by correspondent banks (“de-risking”)</b> De-risking could have a significant impact on money transfer operators (MTOs) and banks, potentially increasing the cost of inward remittances.	High	Medium	Maintain regulatory and supervisory up to date with international AML/CFT standards.
<b>DOMESTIC RISKS</b>			
<b>Financial stability risks from high credit growth</b> A prolonged period of high credit growth, especially if related to construction, may lead to lower lending standards, and/or excessive assets’ price increases.	Low	Medium	Remain vigilant and be ready to intervene should signs of overheating appear.
<b>Wage growth</b> Should the reform of public sector employment fail to contain wage growth in the coming years, there is a risk that the fiscal stance becomes unsustainable, possibly forcing the authorities to borrow externally.	Medium/High	High	Finalize the reform and keep wage growth in check.
<b>Natural disasters (regional)</b> Tonga remains vulnerable to large natural disasters, particularly cyclones, which have caused large damages to infrastructure and production base.	High	High	Maintain fiscal buffers of 4-5 months of recurrent expenditure. Invest in infrastructure that is resilient to disasters.

<sup>1</sup> The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff’s subjective assessment of the risks surrounding the baseline (“low” is meant to indicate a probability below 10 percent, “medium” a probability between 10 and 30 percent, and “high” a probability of 30 percent or more). 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.

## Appendix II. Recent Tax Reforms

*The Tongan authorities have initiated comprehensive tax reforms to mobilize revenue, tackle inequality, and address the excessive consumption of unhealthy food, drinks, and tobacco products. This appendix discusses reforms to the Pay-As-You-Earn (PAYE) income tax, excise and import taxes, the consumption tax, and the small business tax.*

**PAYE reform.** The government's proposal to change the PAYE system consists of an increase of the minimum taxable income from T\$7400 to T\$10000 and the introduction of a higher maximum rate of 25 percent for top earners. With the combination of these two measures, the government expects a broadly neutral effect on PAYE revenue. However, the increase in the minimum taxable income narrows significantly the tax base, leaving 60 percent of tax payers below the minimum threshold. The policy, while positive from the point of view of protecting the lower income tax payers and streamlining the administrative burden for

Reform to PAYE			
Gross Income Range	Percentage of Tax Payers	Rate	Percent of Tax Collected (in percent)
<i>Old System</i>			
T\$0-T\$7400	47	0	0
T\$7401-T\$30000	45	10	45
T\$30001 and above	8	20	55
<i>New System</i>			
T\$0-T\$10000	60	0	0
T\$10000-T\$30000	32	10	42
T\$30001-T\$60000	6	20	30
T\$60001 and above	2	25	28

Source: Tongan authorities.

tax collection, risks pushing more people into the informal sector and exposes revenue collection to tax-base shocks (such as tax evasion). Given the corporate tax rate is 25 percent, future increases of PAYE tax rates may also not be feasible as they would create incentive for top earners to setup self-employment relationships and declare income as profits (taxed at 25 percent).

**Excise and import duties reform.** The government's strategy for boosting revenue while addressing the non-communicable diseases (NDCs) is at the base of the reforms covering food, drinks, and tobacco products taxation. Overall, the government has lowered import duties for imported healthy products, while it converted import duties into excise taxes for widely consumed products that are considered unhealthy, such as sugary drinks, fatty meat, and tobacco. This is a welcome step, which is expected to significantly

Reform to Import Duties and Excise Taxes for Food, Drinks and Tobacco Products		
Product affected	Old measure	New measure
Tobacco concession for inbound travellers	500 cigarettes	250 cigarettes
Fresh fish	0.20 duty	0.10 duty
Tinned fish	0.20 duty	0.05 duty
Lard		\$1 per kg
Fruit juice drinks with sugar < 5g/100ml		0.15 duty
Fruit juice drinks with sugar 5g/100ml-20g/100ml		\$1.5 per litre
Fruit juice drinks with sugar > 20g/100ml		\$4 per litre
Imported flavoured in powder and in ready to drink form		\$4 per kg
Sugar and sweetened beverages < 5g/100ml		\$1 per litre to 0.15 ad valorem
Sugar and sweetened beverages 5g/100ml-20g/100ml		\$1 per litre to \$1.5 per litre
Sugar and sweetened beverages > 20g/100ml		\$1 per litre to \$4 per litre
Imported sweet biscuit	0.15 duty	\$1.5 per kg
Imported chocolate	0.15 duty	\$1.5 per kg
Imported sugar confectionaries without cocoa	0.20 duty	\$5 per kg
Imported lamb flap and lamb breast	0.15 duty	\$1.15 per kg
Locally manufactured instant noodle		50 senti per kg
Imported liquor	\$25 per lal	\$30 per lal + 0.15 duty
Locally manufactured tobacco/cigarettes		\$350 per 1000
Imported manufactured tobacco/cigarettes		\$450 per 1000, ad valorem of 0.15

Source: Tongan authorities

boost revenue and that the authorities hope will help in modifying in the long term the consumption habits of Tongan consumers, thus improving the overall population's health.

**Consumption tax reform.** The authorities are planning to reform the consumption tax by (i) extending the consumption tax to International Telecommunications and (ii) reducing the tax rate from 15 percent to 12.5 percent. With the reduction of the consumption tax rate the authorities aim

at reducing final prices for consumers and boosting purchasing power of the lower income part of the population, but at the cost of considerably lowering revenue from a very broad-based source. The authorities count on the lower outturn from the decreased rate to be more-than-compensated by increased compliance with the tax, as well as strong GDP growth and consumption, boosted by remittances. The reform has not yet been adopted and is pending parliamentary review, probably occurring in the last quarter of FY2018.

**Construction Materials Import Tax.** In the FY2018 budget, the authorities prepared a proposal to temporarily remove import duties for construction materials, to provide a further boost for the sector. This proposal has been so far put aside by the parliament.

**Small Business Tax.** Although not a new proposal, the introduction of this tax in FY2015 has succeeded in bringing many small business into the formalized economy, by setting up a streamlined taxation system based on lump-sums. To offer further streamlining, the tax is based on the turnover of the businesses rather on the profit. Only sole proprietors with a turnover of T\$100000 or below can file using this process.

Small Business Tax	
Annual Turnover	Tax Payable
T\$0-T\$10000	T\$100
T\$10001-T\$30000	T\$250
T\$30001-T\$50000	T\$500
T\$50001-T\$100000	0.02 of turnover
Sources: Tongan Authorities.	



## Appendix III. Structural Reforms and Infrastructure Priorities<sup>1</sup>

**Tonga needs structural reforms to boost potential growth and reduce vulnerabilities.** Among these are continued improvements in financial inclusion, business climate, and private sector development support, particularly MSMEs focusing on expanding export market access and increasing the value added of agriculture and fishery production. Developing infrastructure plays a critical role in connecting and supporting growth in all sectors. Consequently, infrastructure projects should focus on inclusive growth, natural disaster resilience, and long term economic and social goals.

**Tonga has developed a National Infrastructure Investment Plan FY2013-23 (NIIP)** with the support of the Pacific Infrastructure Advisory Centre (PIAC). This plan outlines government priorities and plans for major infrastructure initiatives with national, regional, or local significance. The NIIP focuses on economic infrastructure facilities that support everyday life and business activity, such as energy supply systems (electricity, fuel); telecommunications (telephone, internet, and broadcasting); water and waste management (water supply, waste water, drainage, and solid waste); and transportation (airports, roads, and sea ports).

**For the development of economic infrastructure over FY2013-18,** the government set four priority themes: (i) connecting Tonga, (ii) infrastructure for communities, (iii) reliable and affordable energy, and (iv)

sustainability, safety, and resilience. Furthermore, the NIIP identified 74 future investment projects with capital requirements around T\$690 million.

Because of financial constraints, priority has been given to 13 projects (Table 1) aligned with TSDF II<sup>2</sup> objectives, expected to deliver the highest level of benefits to Tonga, and are consistent with available financial resources and implementation capacity. In addition, an estimated

Table 1: NIIP FY2013-23 Highest Priority Proposed Projects		
(T\$ million)		
Sector	Project	Cost Estim.
Energy	Additional 1-2MW of Solar PV on Tongatapu	24
	Outer Islands On-Grid Renewable Energy Project	9
Telecoms	Fibre-Optic Cable to Ha'apai and Vava'u	30
	Communications for Early Warning and Disaster Recovery	6
Water	Outer Islands water supply improvements	15
	Expand Nuku'alofa system to growth areas	11
Solid Waste	New Landfill or Transfer Station on Ha'apai	4
Roads	Outer Islands Roads Upgrading Program	10
Ports	Maritime Sector Safety and Resilience	20
Airports	Resurfacing Ha'apai Airport runway, apron, taxiway	9
	New Control Tower at Fua'amotu International Airport	7
Multi-sector	Coastal Protection - Eastern Tongatapu	15
	Disaster Response & Evacuation Infrastructure	12
Sub-total – High Priority proposed projects		172
Projects Underway and Committed Projects (FY2010-13)		173
Total		345
Source: Tonga NIIP FY2013-23.		

T\$300 million was invested in economic infrastructure projects during FY2010-13, including redevelopment of roads, electricity, telecommunications, the Nukualofa central business district infrastructure, and the Vuna Wharf cruise ship terminal.

<sup>1</sup> Prepared by Olena Ftomova.

<sup>2</sup> Tonga strategic development Framework FY2015-25 (TSDF II).

**The government has limited capacity to finance infrastructure development.** Main sources of infrastructure financing are grants from development partners, concessional loans from international financial institutions, self-financing by public enterprises, and limited financing by government from consolidated revenues. Financing is needed for capital investment in new or upgraded infrastructure; complementary initiatives that support the operation and

**Table 2: NIIP FY2013-23 Indicative Infrastructure Budget for FY2014-18 (T\$ million)**

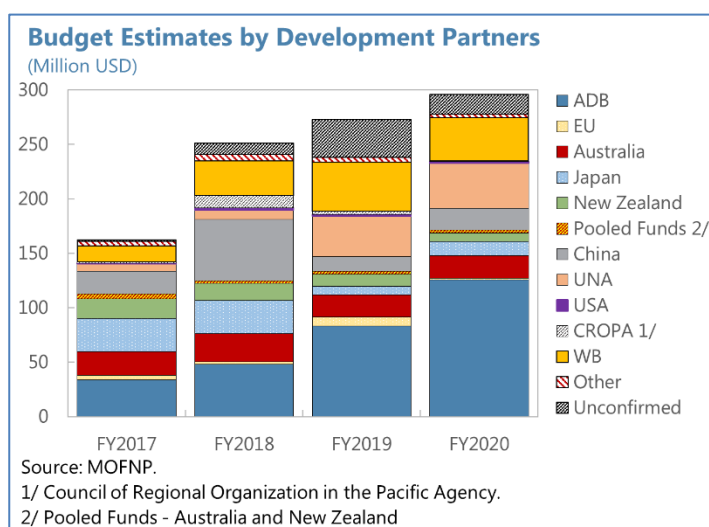
	Demand for Funding	Funding Source		
		Government	Public Enterprises	Development Partners
Capital Investment	385	5	80	300
Complementary Activities	15	-	-	15
Maintenance	70	35	35	-
<b>Total</b>	<b>470</b>	<b>40</b>	<b>115</b>	<b>315</b>

Source: Tonga NIIP 2013-23.

management of the infrastructure sector; and its ongoing maintenance (Table 2). Fiscal deficit and tight fiscal position has led to limited capacity of the Tongan government to finance economic infrastructure investment from domestic revenues or through borrowing. Currently most economic infrastructure, except roads and outer island ports in Tonga are managed and operated by public enterprises whose financial performance improved in recent years with respect to (i) recording profits, (ii) more paying dividends to the government, and (iii) more strong capacity to self-fund infrastructure maintenance and renewal and fund some of the capital investment projects.

**Development partners support plays a critical role in Tongan infrastructure development.**

Projects that are externally funded are based on the Government's priorities and focused areas of donor interest. Major projects that are currently financed by development partners include natural disaster resilience, energy, urban development, health, education, and transport projects. Projects in the pipeline include upgrading high school sports facilities, the Teufaiva stadium, coastal protection, energy, climate readiness, and youth life skill and employment projects.



**The government emphasizes maintenance and improvement of existing infrastructure as a priority,** including main roads, agriculture roads, government offices, hospitals, buildings, and major assets. Specifically, the FY2018 Budget allocates T\$10 million for road maintenance and sets as a top priority implementation of high impact construction projects. It is anticipated that significant infrastructure development will take place during FY2018. The following projects, including development-funded projects, are committed: the Tonga High School sports facilities funded by

People's Republic of China, the Teufaiva playground (rugby) funded by New Zealand, and a golf course funded by the government of Tonga. Despite the cancelation of PGs, the government has retained the development of sports among their priorities. In general, it is important to ensure that the spending of public resources is focused on economic and social infrastructure. Key priorities should also be given to raising efficiency of public investment and improving targeting and infrastructure investment process.

## Appendix IV. Strengthening Ex-Ante and Ex-Post Resilience to Natural Disasters

Ex-Ante risk mitigation	Category of risk management measure	Measures Taken and On-going
Risk Assessment	1. Assess vulnerability 2. Incorporate disaster costs into budget planning	-Enhance PFM systems
Self Insurance	3. Build buffers	-Maintain funding through contingency budget -Maintaining adequate international reserves and moderate public debt
Risk Reduction	4. Improve eco-system resilience of climate resilient infrastructure investments (The Ridge to Reef (R2R) Project)  5. Enhance preparedness and invest in smart infrastructure	-Increase ability of coral reefs to recover after climate related events -Improving management of mangroves for climate adaptation -Upgrading evacuation and post disaster access roads -Enhancing coastal protection -Upgrading schools -Rural electrification program to improve energy efficiency -Disaster risk management training and improving communication with districts and communities -Completion of specialized hazard maps and detailed analysis
Risk Transfer	6. Regional risk pooling	-Tonga is one of the five Pacific countries taking part in the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) regional insurance scheme which aims to provide coverage in times of natural disasters. -A Climate Change Trust Fund has been established under the ADB-CRSP (Climate Resilience Sector Projects) project funded by (Climate Investment Fund) CIF.
<b>Ex-Post response</b>		
Coping	7. Emergency response and reconstruction	-Maintaining financial tools and arrangements such as capital budget realignment, bilateral and multilateral donor assistance for relief and reconstruction, flash appeals. -The National Emergency Management Office (NEMO) has pursued to activate 8 out of the 10 coordinated clusters; Water and Sanitation; Food Security and Livelihood (FSL); Safety and Protection; Economic and Social Recovery; Communications; Logistics; Essential Services; Education; shelter; and transport.