

# **Tonga: 2022 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Tonga**



# TONGA

August 2022

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

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2022 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 15, 2022 consideration of the staff report that concluded the Article IV consultation with Tonga.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 15, 2022, following discussions that ended on May 10, 2022, with the officials of Tonga on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 29, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Statement by the Executive Director** for Tonga.

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**International Monetary Fund**  
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## IMF Executive Board Concludes 2022 Article IV Consultation with Tonga

FOR IMMEDIATE RELEASE

**Washington, DC – August 26, 2022:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Tonga.

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

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

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

### Executive Board Assessment<sup>2</sup>

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

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

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

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

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

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

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

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

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

Population (2020): 106 thousands

Major exports: root crops, vanilla, squash, fish Quota: SDR 13.2 million

Quota: SDR 13.2 million

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

<sup>1</sup>Fiscal year beginning July 1.<sup>2</sup>Including preliminary data.<sup>3</sup>CPI basket and methodology changed in September 2018.



# TONGA

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

July 29, 2022

### EXECUTIVE SUMMARY

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

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

#### **Policy recommendations.**

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

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

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

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