CONTEXT

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

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

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

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

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

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

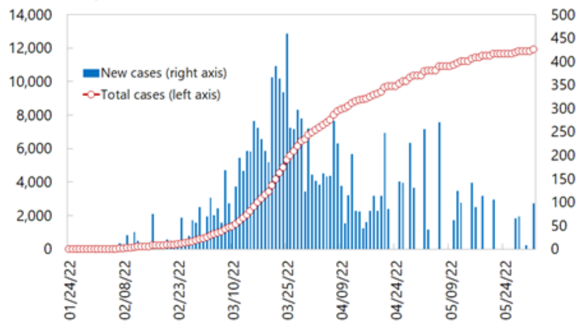
[2] https://www.worldbank.org/en/news/press-release/2022/02/14/tonga-volcanic-eruption-and-tsunami-world-bank-disaster-assessment-report-estimates-damages-at-us-90m

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

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

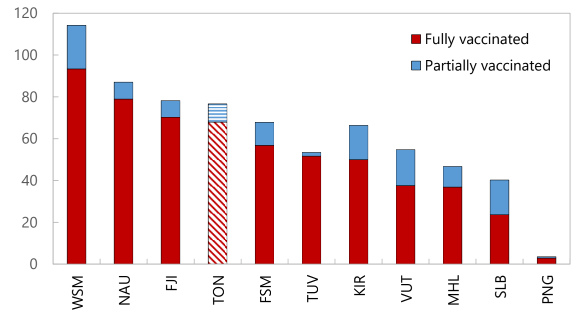
cases has steadily declined since late March, accompanied by a gradual easing of social distancing measures—including reopening of primary schools starting on June 6.

New COVID-19 Cases
(Number of persons)



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

Pacific Islands: Vaccines Administered
(Percent of population)

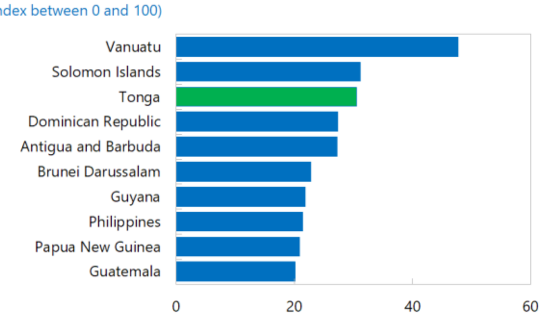


Sources: Our World in Data. Marshall Islands & Micronesia as of 6/01/2022; Fiji as of 5/30/2022; Samoa, Kiribati, Solomon Islands, and PNG as of 5/23/2022; Tonga as of 5/02/2022; Vanuatu as of 4/25/2022; Nauru as of 4/11/2022; Tuvalu as of 4/05/2022

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

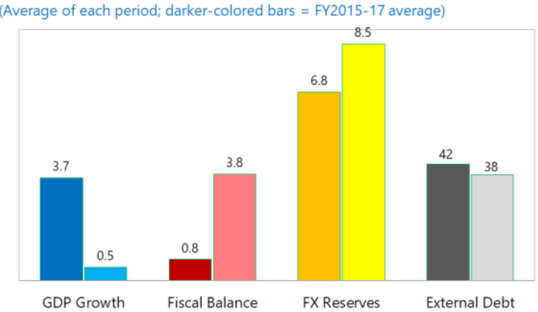
4. **The series of natural disasters underscore the urgency to implement reforms to enhance climate resilience and nurture the private sector**. Tonga is among the most vulnerable to natural disasters globally. While battered by two major tropical cyclones in early 2018 and 2020, Tonga nonetheless managed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

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



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

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



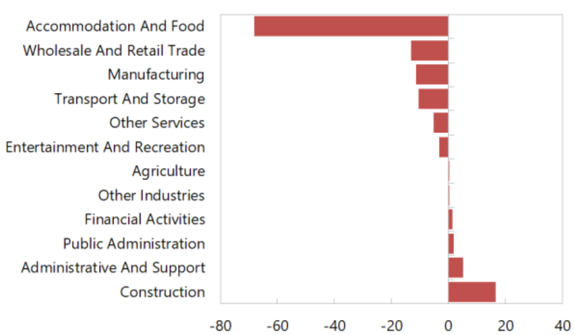
Sources: Tongan authorities; and IMF staff estimates.
Note: All variables expressed in percent (GDP Growth) or in percent of GDP (Fiscal balance, External Debt), except FX Reserves (in months of import cover).

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

RECENT ECONOMIC DEVELOPMENTS

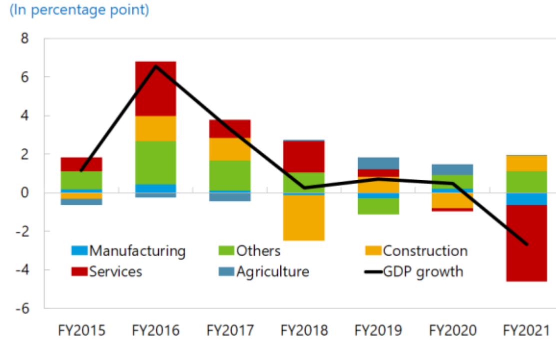
6. For FY2021 as a whole, Tonga's economy experienced the first contraction since FY2009, although some signs of recovery began to emerge during the second half of the year. Tonga sustained a double shock from Tropical Cyclone (TC) Harold (April 2020) and border closures in response to the pandemic overseas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

FY2021 Sectoral Output Growth
(In percent, year-on-year)



Sources: Tongan authorities; and IMF staff estimates

Contribution to Growth by Sector
(In percentage point)

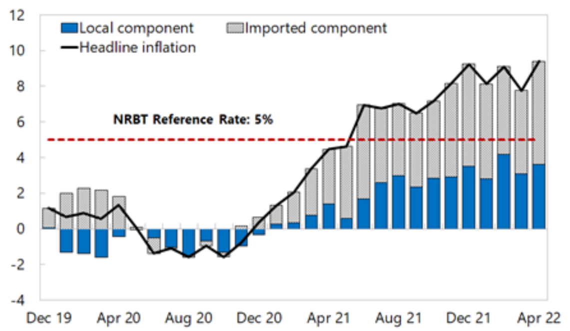


Sources: Tongan authorities; and IMF staff estimates.

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

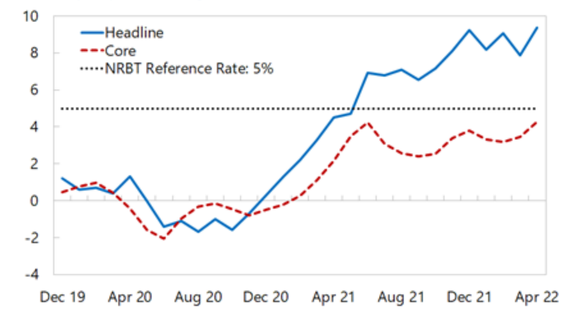
8. Inflation rose markedly since July 2021, largely reflecting higher import prices. Headline inflation averaged 7.9 percent (y/y) from July 2021 to April 2022, above the National Reserve Bank of Tonga's (NRBT's) reference rate of 5 percent. The rise in inflation was mostly driven by higher import prices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

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



Sources: Tonga Statistics Department; and IMF staff calculations.

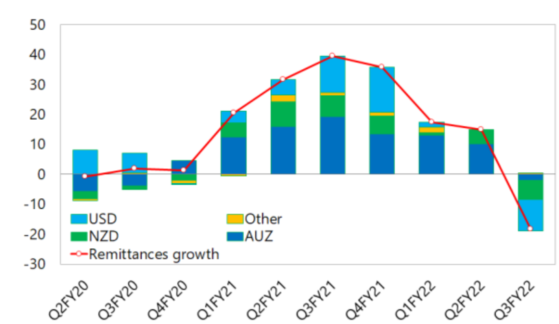
Headline and Core Inflation1/
(Year-on-year percent change)



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

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

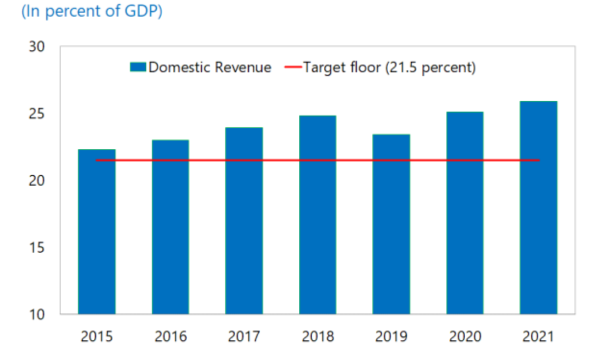
Contribution to Remittance Growth By Currency
(Year-on-year, percent changes)



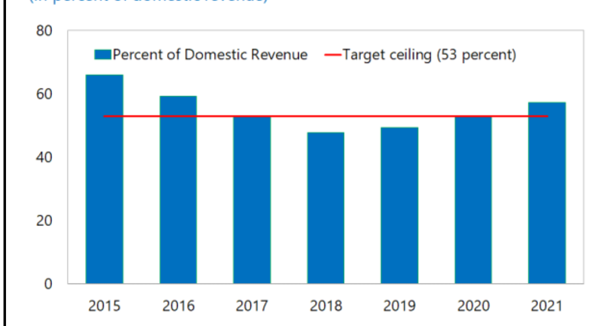
Sources: Tongan authorities; and IMF staff calculations.

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

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



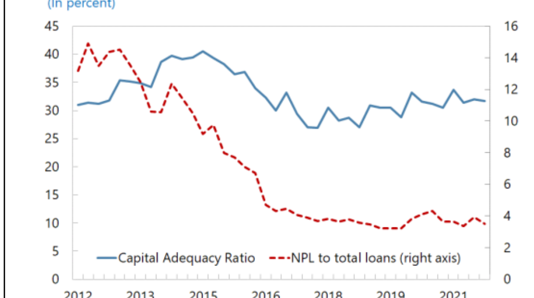
Sources: Tongan authorities; and IMF staff estimates.



Sources: Tongan authorities; and IMF staff estimates.

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

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



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

OUTLOOK AND RISKS

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

- While the authorities plan to gradually reopen international borders over FY2023, a meaningful recovery in tourism is expected be delayed to FY2024 given the time required for repairs and reconstruction of severely damaged tourism facilities.

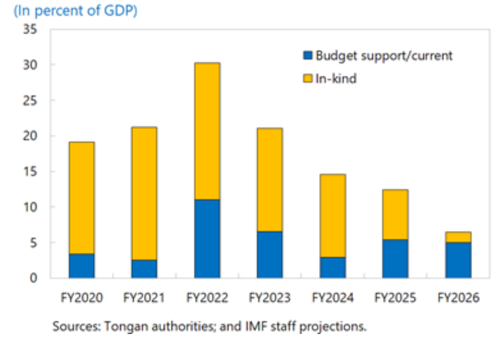
- The reconstruction of flagship infrastructure projects is expected to accelerate in FY2023 after the border reopens in July, which would allow entries of foreign engineers.

- Crop production is expected to gradually recover over FY2023–FY2024 as the soil contamination caused by the tsunami and volcanic ash dissipates.

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

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

External Grants
(In percent of GDP)



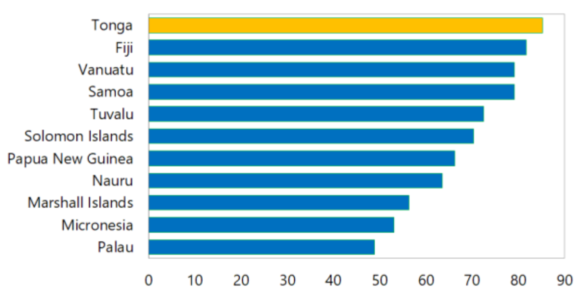
Sources: Tongan authorities; and IMF staff projections.

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

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

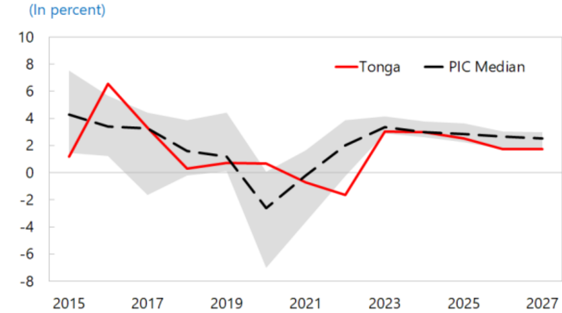
16. The medium-term outlook is weak. Tonga's growth potential is low due to its exposure to natural disasters, geographical remoteness, and a limited production base. Without bold structural reforms to boost climate resilience and private sector development, growth is expected to converge to its long-term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

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



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

PIC: Real GDP Growth 1/
(In percent)



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

Authorities' Views

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

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

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

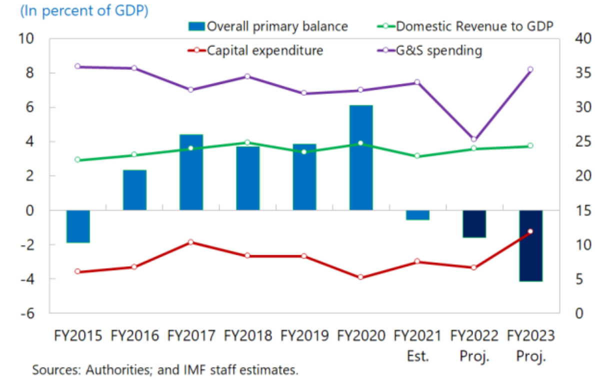
POLICIES TO REBUILD AND RECOVER STRONGER

A. Fiscal Policy

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

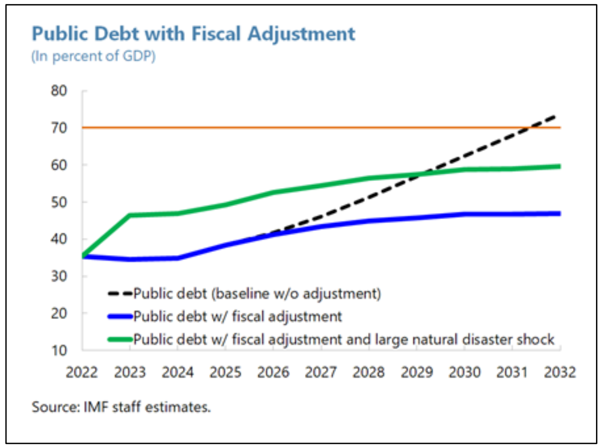
19. The envisaged expansionary fiscal stance in FY2023 is appropriate considering the urgent spending needs for reconstruction and recovery. The authorities are targeting a larger budget envelope in FY2023, which is expected to lead to an increase in the fiscal deficit from FY2022 despite higher domestic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

Primary Balance
(In percent of GDP)



Sources: Authorities; and IMF staff estimates.

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



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

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

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

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

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

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

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

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

Authorities' Views

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

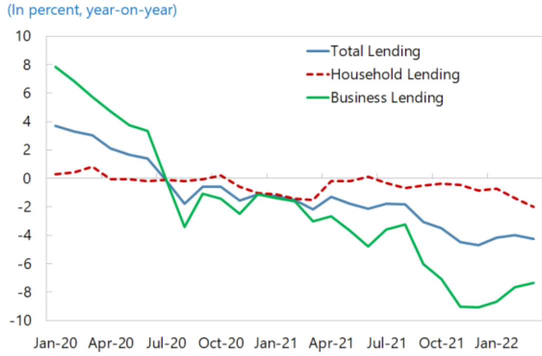
[7] As of FY2020, the amount of collectable tax arrears is estimated at 2.4 percent of GDP.

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

B. Monetary and Exchange Rate Policies

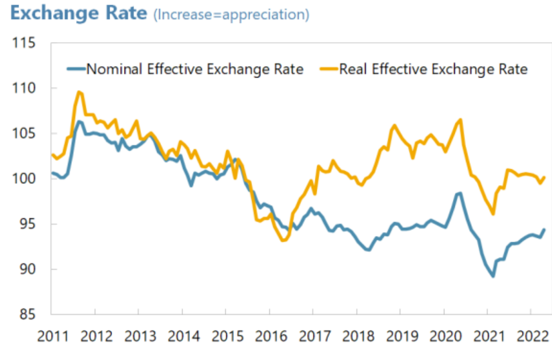
24. The current monetary policy stance is appropriate, but the NRBT should stand ready to tighten given significant risks to inflation. The NRBT has stayed on hold, maintaining the policy rate at zero percent, the statutory reserve deposit (SRD) ratio at 10 percent, and the inflation reference rate at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

Bank Lending Growth
(In percent, year-on-year)



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

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



Sources: Tongan authorities; and IMF staff estimates.

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

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

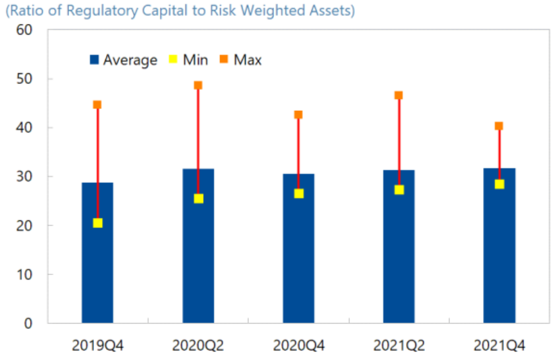
Authorities' Views

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

C. Financial Sector Policies

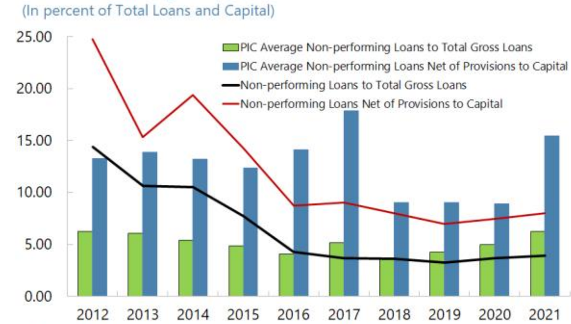
27. The NRBT should encourage banks to actively provision for potential loan losses and monitor credit risks closely. While banks are well capitalized, economic disruptions caused by the volcanic eruption would worsen bank balance sheets. NPLs could pick up significantly and impair banks' ability to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

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



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

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



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

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

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

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

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

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

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

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

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

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

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

Authorities' Views

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

D. Structural Reforms

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

[12] See IMF Report on the Pacific Roundtables: Actions to Address Correspondent Banking and Remittance Pressure, 2019, for more details on the voucher system and the regional efforts needed in this area.

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

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

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

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

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

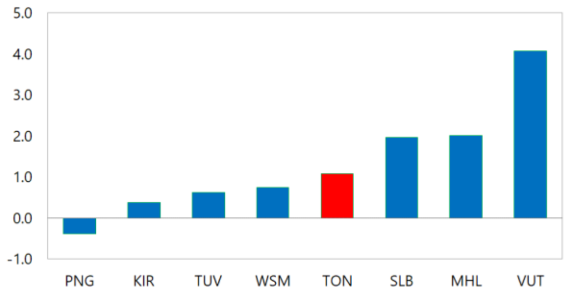
(ii) Increasing government spending on health, education, and social protection. Based on an earlier study by IMF staff,[17] additional annual spending of 5 percent of FY2030 GDP would be needed to meet select SDGs, particularly in the areas of health and education. In this context, staff support the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

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

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

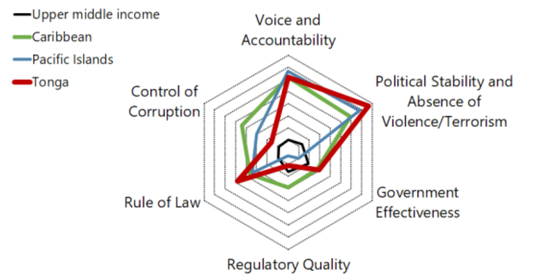
[17] See IMF Country Report No. 21/26, Annex IV.

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



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

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



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

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

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

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

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

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

Authorities' Views

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

E. Strengthening Statistical Capacity

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

RCF—FINANCING NEEDS AND CAPACITY TO REPAY

38. Staff assess the RCF to be the most appropriate financing instrument to meet Tonga's urgent BOP need. The estimated BOP need amounts to about US$134 million or 25 percent of FY2023 GDP (Table 7), largely due to higher import demand for food and reconstruction-related materials, combined with a surge in global energy and food prices following the war in Ukraine (¶14). If left unaddressed, Tonga would face a severe economic fallout, with disproportionately large adverse socioeconomic impacts on the poor, due to Tonga's high reliance on imports for the supply of essential goods. In this context, the authorities requested emergency financing under the RCF worth 50 percent of quota to meet the urgent BOP need (Appendix I). Although an upper credit tranche (UCT) quality Fund-supported program could help facilitate Tonga's reform efforts beyond the short term, the double blow of volcanic

eruption and COVID-19 have substantially stretched Tonga's already weak administrative capacity at this juncture. Furthermore, the slow and unreliable internet connection in the midst of border closures poses another important challenge for conducting intensive discussions to reach an agreement on a multi-year program.

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

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

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

42. A first-time safeguards assessment of the NRBT, following the RCF-1, was completed in December 2021. The NRBT has maintained basic controls in key safeguards areas, but faces several challenges, mainly owing to the lack of capacity. Governance weaknesses such

as the lack of independent oversight, coupled with an incipient internal audit function, could potentially undermine the effectiveness of safeguards at the NRBT. Outstanding safeguards recommendations include drafting amendments to the NRBT Act to strengthen the autonomy of the NRBT, filling its Board vacancies, and outsourcing audits of high-risk areas. Although the authorities have committed to implement these recommendations, to date, little progress has been made. Further efforts are needed to strengthen the safeguards framework in the NRBT.

STAFF APPRAISAL

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

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

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

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

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

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

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

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

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

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

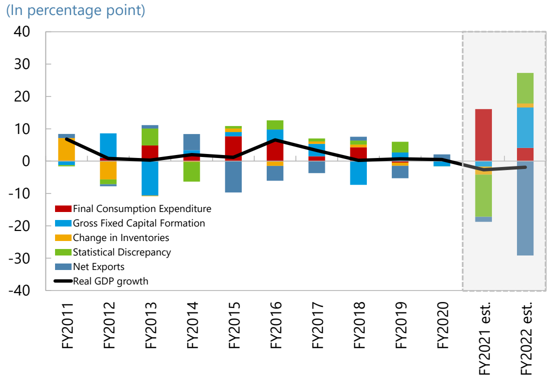
53. Staff support the authorities' request for emergency financial assistance under the RCF. The IMF's assistance through the RCF equivalent to 50 percent of quote (SDR 6.9 million), together with additional aids expected from other donors, will help Tonga meet urgent BOP and budgetary needs and could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

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

Figure 1. Tonga: Real Sector Development

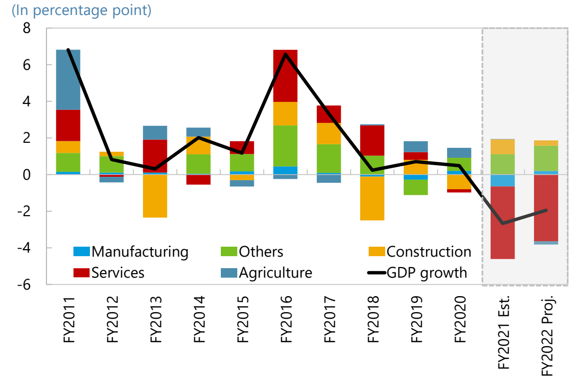
Net exports contracted due to the pandemic and the effect of the volcano eruption.

Contribution to Growth by Expenditure Category
(In percentage point)



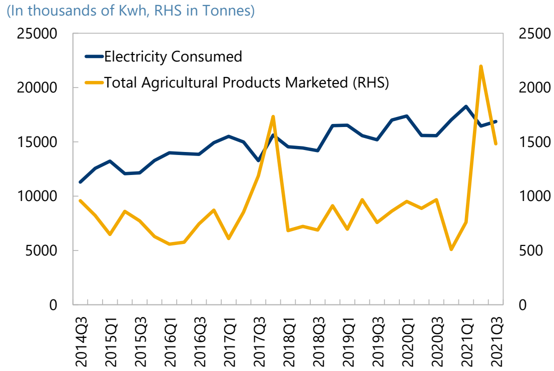
Construction activities are supporting growth.

Contribution to Growth by Sector
(In percentage point)



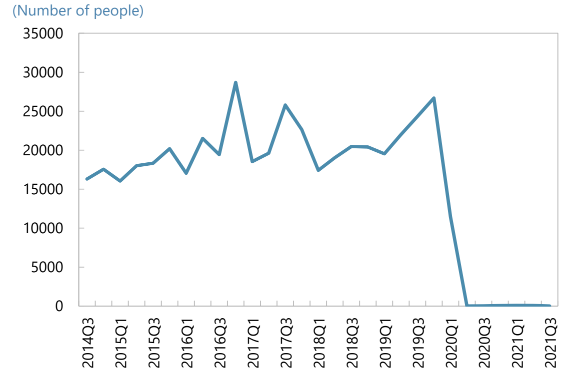
Agricultural production and electricity consumption remain strong.

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



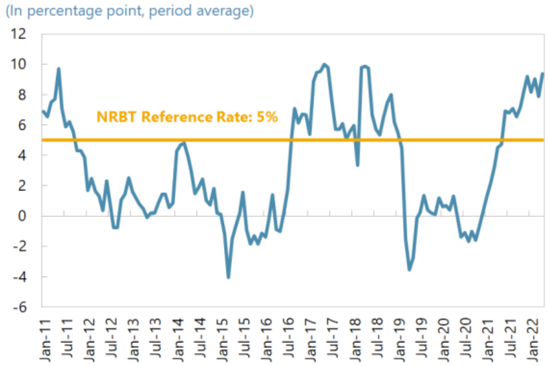
But tourist arrivals were reduced to zero due to the border closure.

Tourist Arrival
(Number of people)



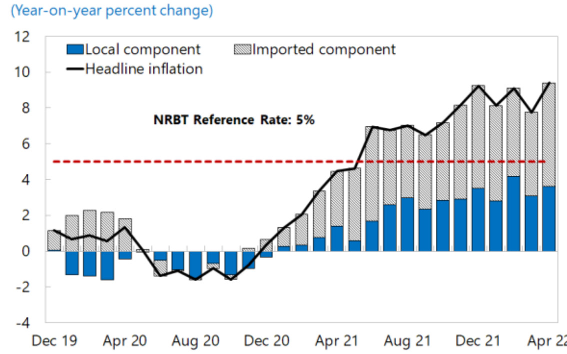
Headline inflation is above the NRBT's reference rate.

Consumer Price Index
(In percentage point, period average)



Headline inflation is mainly driven by import prices.

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

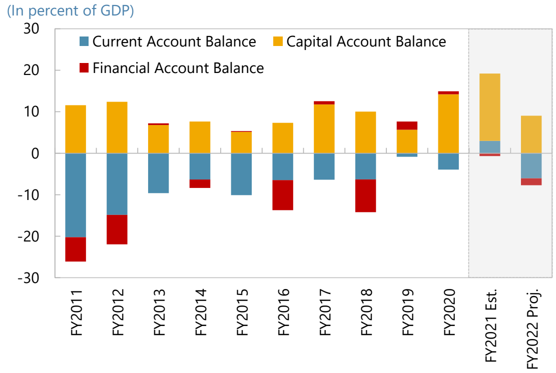


Sources: National Reserve Bank of Tonga; and IMF staff calculations.

Figure 2. Tonga: External Sector Development

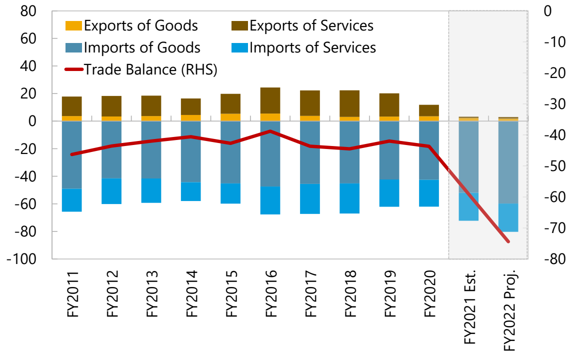
Donors' aids are boosting the capital account balance.

Balance of Payments Forecast
(In percent of GDP)



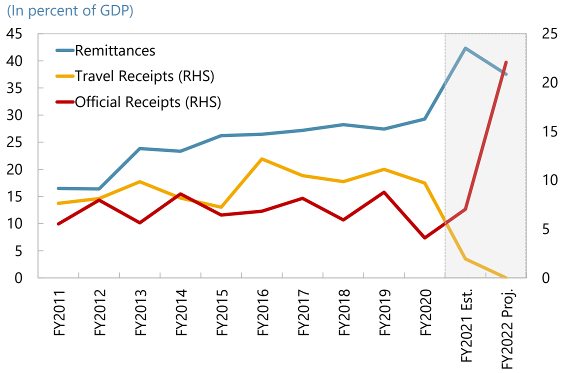
The pandemic and the volcano eruption are expected to affect the trade balance.

Trade Balance
(In percent of GDP)



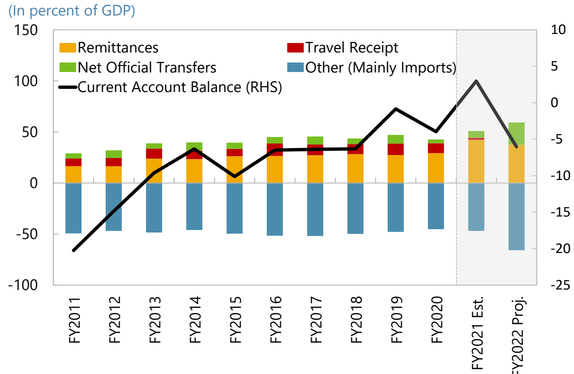
Remittances and grants are at record highs while travel receipts collapsed.

Remittances and Travel Receipts
(In percent of GDP)



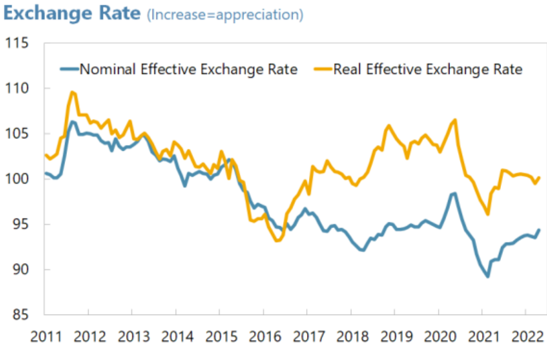
Thereby also supporting the current account balance.

Contributions to Current Account Balance
(In percent of GDP)



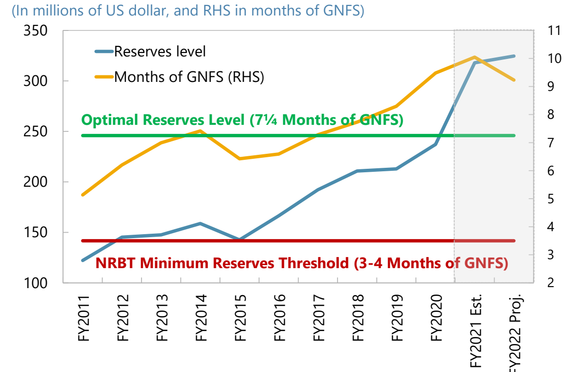
The REER has appreciated recently due to both nominal appreciation and high inflation.

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



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

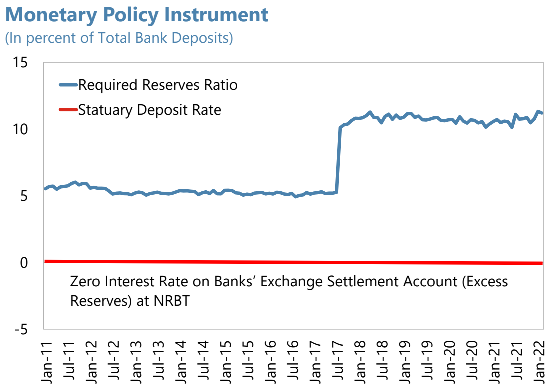
Reserves Level
(In millions of US dollar, and RHS in months of GNFS)



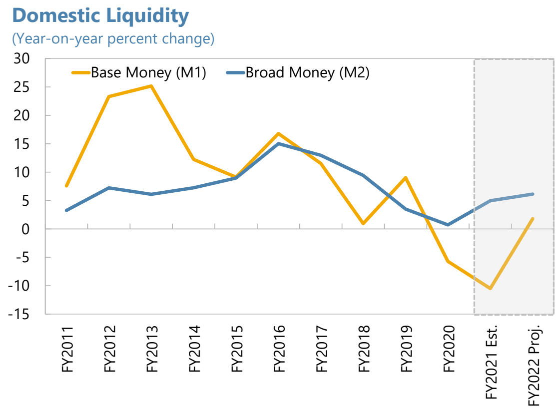
Sources: Tongan authorities; and IMF staff estimates.

Figure 3. Tonga: Monetary Sector Development

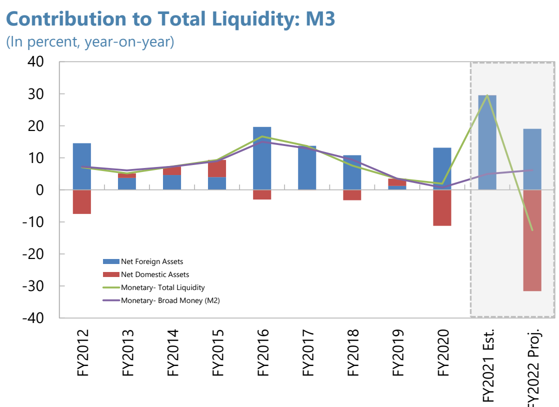
Monetary policy remains on hold.



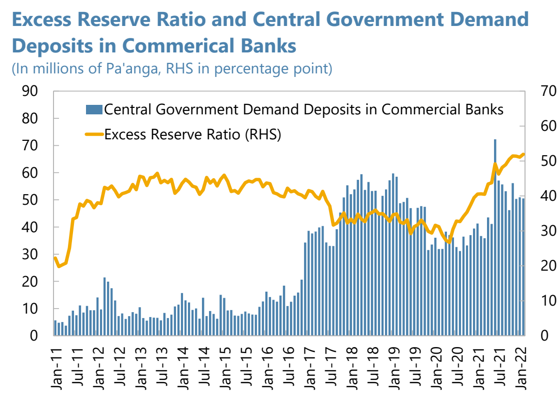
Broad money ticked up slightly.



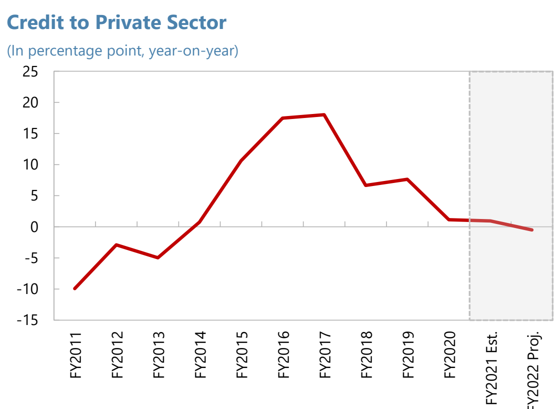
Unsterilized foreign inflows are the main drivers of liquidity.



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



Credit to the private sector remains subdued.



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

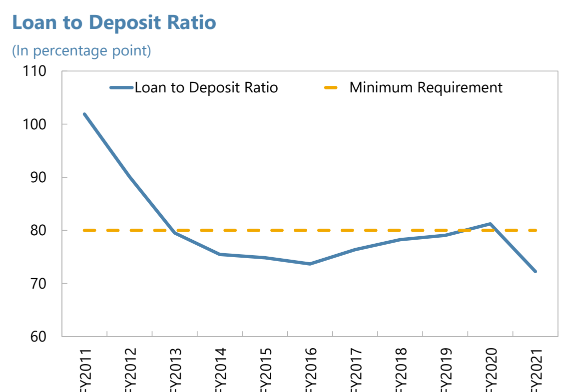
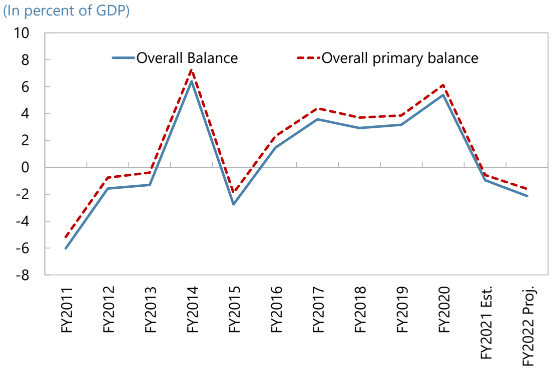


Figure 4. Tonga: Fiscal Sector Development

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

Overall and Primary Balance

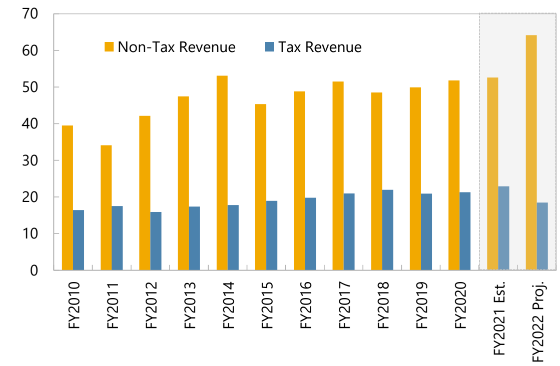
(In percent of GDP)



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

Tax Revenue

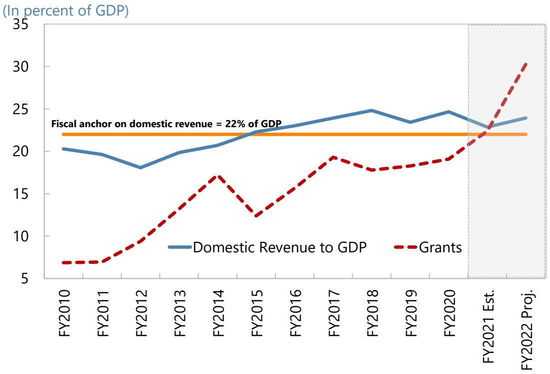
(In percent of GDP)



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

Revenues and Grants

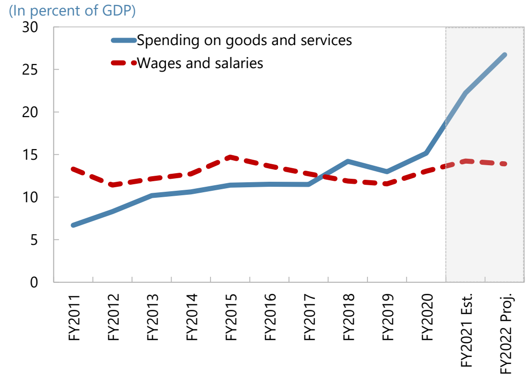
(In percent of GDP)



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

Current Expenditure

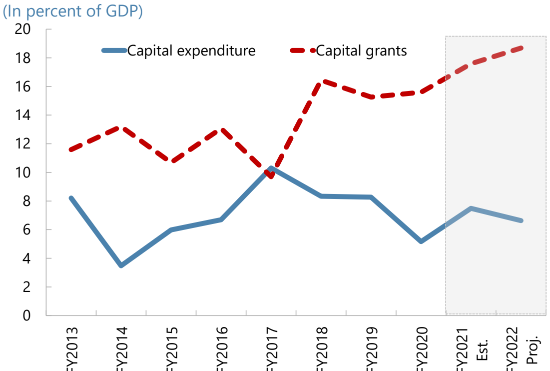
(In percent of GDP)



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

Capital Expenditure and Capital Grants

(In percent of GDP)



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

Total Debt and Fiscal Anchor

(In percent of GDP)

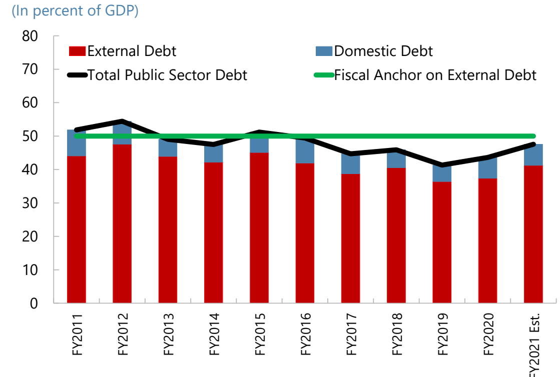
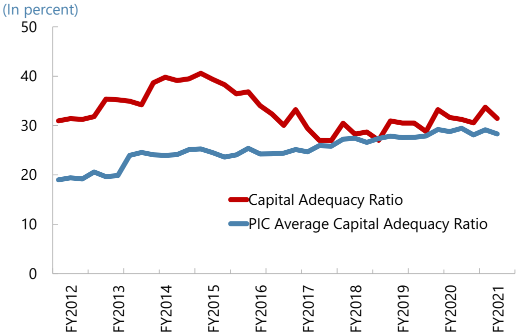


Figure 5. Tonga: Financial Sector Development

Capital buffers remain above the PIC average.

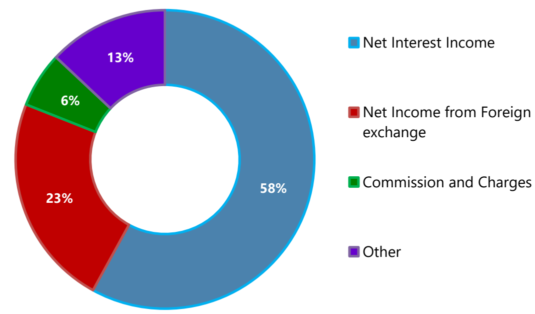
Capital Adequacy Ratio
(In percent)



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

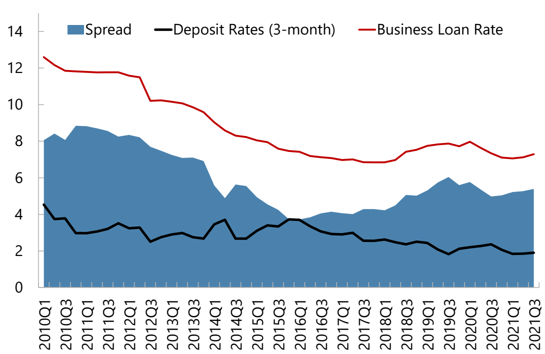
Bank income continues to rely on net interest income...

Financial Sector Operating Income Components in 2020



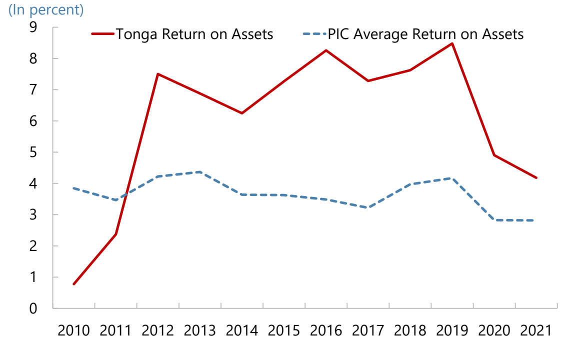
... as interest rate spreads remain wide.

Interest Rates
(In percent)



However, profitability has declined due to slow credit growth.

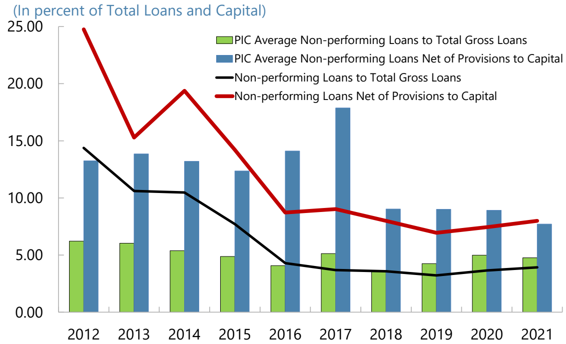
Return on Assets
(In percent)



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

NPLs ticked up slightly in FY2021.

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



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

Bank lending remains concentrated in residential loans.

Residential Real Estate Loans to Total Loans
(In percent)

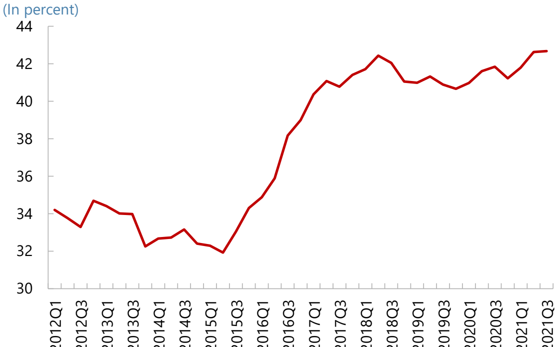


Table 1. Tonga: Selected Economic Indicators, FY2019–FY2024 1/

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

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

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

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

	FY2019	FY2020	Est. FY2021	Projections FY2022	FY2023	FY2024
			(In millions of U.S. Dollars)			
Current account balance	**-4.4**	**-19.4**	**14.0**	**-30.6**	**-123.8**	**-112.6**
Trade balance	-205.4	-193.5	-189.1	-279.7	-300.6	-299.5
Exports, f.o.b.	15.7	18.2	16.3	4.5	13.3	21.4
Imports, f.o.b.	-221.1	-211.6	-205.4	-284.2	-313.9	-321.0
Services balance	-9.3	-20.6	-88.9	-92.2	-100.4	-82.2
Receipts	96.7	75.6	5.8	3.7	8.5	44.7
Payments	-105.9	-96.3	-94.8	-95.9	-108.8	-126.9
Investment income balance	39.6	41.8	61.9	49.9	51.8	50.3
Receipts	55.2	57.5	78.5	67.6	69.1	68.1
Payments	-15.7	-15.7	-16.6	-17.8	-17.3	-17.8
Transfers balance	170.8	152.9	230.1	291.5	225.4	218.8
Official transfers (net)[1]	43.5	18.4	31.4	108.4	75.2	58.6
Private transfers (net)	127.2	134.6	198.7	183.1	150.1	160.2
Capital account balance	**29.0**	**69.6**	**76.3**	**45.2**	**37.1**	**27.3**
Financial account balance	**10.1**	**3.6**	**-3.2**	**-8.3**	**-15.1**	**-14.3**
FDI (net)	-0.3	-3.7	-7.1	-6.1	-6.6	-4.8
Other investment (net)	-6.7	-6.3	-3.9	2.2	8.5	9.5
Of which: Loan disbursements	0.0	2.8	6.6	3.1	0.0	11.2
Errors and omissions	-32.5	-29.4	-16.1	0.0	0.0	0.0
Overall balance	**2.1**	**24.3**	**64.7**	**6.2**	**-101.8**	**-99.6**
Financing	**-2.1**	**-24.3**	**-64.7**	**-3.1**	**101.8**	**99.6**
Change in reserve assets (- decrease)	2.1	24.3	80.8	6.2	-92.4	-99.6
Use of IMF credit (net)	0.0	0.0	9.7	0.0	9.4	0.0
Disbursement (RCF)[2]	0.0	0.0	9.7	0.0	9.4	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0
Suspended debt service under G20 DSSI[3]	0.0	0.0	6.4	3.1	0.0	0.0
			(In percent of GDP)			
Current account balance	-0.9	-4.0	3.0	-6.1	-23.1	-19.8
Trade balance	-40.2	-39.5	-40.2	-56.0	-56.2	-52.6
Exports, f.o.b.	3.1	3.7	3.5	0.9	2.5	3.8
Imports, f.o.b.	-43.2	-43.2	-43.7	-56.9	-58.7	-56.4
Services balance	-1.8	-4.2	-18.9	-18.5	-18.8	-14.4
Receipts	18.9	15.4	1.2	0.7	1.6	7.9
Payments	-20.7	-19.6	-20.1	-19.2	-20.3	-22.3
Investment income balance	7.7	8.5	13.2	10.0	9.7	8.8
Receipts	10.8	11.7	16.7	13.5	12.9	12.0
Payments	-3.1	-3.2	-3.5	-3.6	-3.2	-3.1
Transfers balance	33.4	31.2	48.9	58.3	42.1	38.4
Official transfers (net)[1]	8.5	3.7	6.7	21.7	14.1	10.3
Private transfers (net)	24.9	27.5	42.2	36.6	28.1	28.1
Capital account balance	5.7	14.2	16.2	9.0	6.9	4.8
Financial account balance	2.0	0.7	-0.7	-1.7	-2.8	-2.5
FDI (net)	-0.1	-0.7	-1.5	-1.2	-1.2	-0.8
Other investment (net)	-1.3	-1.3	-0.8	0.4	1.6	1.7
of which : Loan disbursements	0.0	0.6	1.4	0.6	0.0	2.0
Overall balance	0.4	5.0	13.7	1.2	-19.0	-17.5
Financing	-0.4	-5.0	-13.7	-0.6	19.0	17.5
Change in reserve assets (- decrease)	0.4	5.0	17.2	1.2	-17.3	-17.5
Use of IMF credit (net)	0.0	0.0	2.1	0.0	1.8	0.0
Disbursement (RCF)[2]	0.0	0.0	2.1	0.0	1.8	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0
Suspended debt service under G20 DSSI[3]	0.0	0.0	1.4	0.6	0.0	0.0
Memorandum items:						
Gross official foreign reserves	212.8	237.2	317.9	324.1	231.8	132.2
In months of next year's total imports	8.3	9.5	10.0	9.2	6.2	*3.8*
Exchange rate						
T$ per U.S. dollar (period average)	2.3	2.3	2.3	…	…	…
T$ per U.S. dollar (end of period)	2.3	2.3	2.2	…	…	…
Nominal GDP (in millions of US$)	511.3	490.2	470.5	499.7	534.9	569.5
Commodity price indexes (2005 = 100)						
Food	100.9	100.2	115.1	138.1	142.8	137.1
Fuel	144.1	110.9	137.9	265.5	304.4	243.2

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

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

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

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

Table 3. Tonga: Depository Corporations Survey, FY2019-FY2024 1/

	FY2019	FY2020	Est. FY2021	Projections FY2022	FY2023	FY2024
	(In millions of T$, end of period)					
Net foreign assets	492.3	570.6	749.8	899.6	942.3	731.9
Claims on nonresidents	531.3	601.9	782.0	937.2	972.8	766.1
NRBT	484.3	555.9	721.4	892.8	921.7	709.4
Other depository corporations	47.0	46.0	60.6	44.4	51.1	56.8
Liabilities to nonresidents	-39.0	-31.2	-32.2	-37.5	-30.5	-34.2
NRBT	-20.9	-20.8	-22.1	-20.7	-21.3	-21.8
Other depository corporations	-18.0	-10.4	-10.1	-16.8	-9.2	-12.5
Net domestic assets	86.1	36.5	36.6	-211.3	-200.9	55.2
Net domestic credit	300.1	251.9	231.3	269.7	281.7	328.2
Net claims on government	-190.9	-244.8	-257.6	-228.9	-213.7	-166.0
Claims on public nonfin. corps.	60.2	61.6	50.3	62.3	57.8	53.1
Claims on private sector	427.9	432.7	436.9	434.7	436.0	439.5
Other items, net	-214.0	-215.4	-194.7	-481.0	-482.6	-273.0
Total liquidity (M3)	600.1	607.1	649.5	688.3	741.4	787.1
Broad money (M2)	574.5	578.5	607.3	645.3	697.7	742.5
Narrow money	262.2	247.3	221.4	225.3	229.4	233.5
Quasi money	312.2	331.3	386.0	420.0	468.3	509.0
FX deposits	25.6	28.5	42.2	43.0	43.8	44.5
	(Annual percentage change)					
Net foreign assets	1.5	15.9	31.4	20.0	4.7	-22.3
Net domestic assets	-4.7	-57.6	0.1	-677.6	-4.9	-127.5
Net domestic credit	6.0	-16.1	-8.2	16.6	4.4	16.5
Claims on private sector	7.6	1.1	1.0	-0.5	0.3	0.8
Total liquidity	4.3	1.2	7.0	6.0	7.7	6.2
Broad money (M2)	3.5	0.7	5.0	6.3	8.1	6.4
Memorandum items:						
Nominal GDP (in millions T$)	1162.9	1119.7	1068.7	1135.6	1227.7	1306.6
Velocity (GDP/M2)	2.0	1.9	1.8	1.8	1.8	1.8
T$ per U.S. dollar (end of period)	2.3	2.3	2.2	…	…	…

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

[1]Comprises the balance sheets of the National Reserve Bank of Tonga (NRBT) and other depository corporations (ODCs).

Table 4. Tonga: Summary of Government Operations, FY2019-FY2027 1/

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

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

[1] Grant projections are based only on existing and highly likely commitments, consistent with the IMF's "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 8. Tonga: Indicators of Capacity to Repay the Fund, FY2020-FY2033

(In millions of SDRs, unless otherwise indicated; Reporting Year: July to June)

	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032
						(In millions of SDRs, unless otherwise indicated)							
IMF obligations based on existing credit (millions of SDR)													
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.4	1.4	1.4	1.4	0.0
Charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF Obligations based on prospective drawings (millions of SDRs)													
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7	1.4	1.4	1.4	1.4
Charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding IMF credit													
Millions of SDRs	0.0	6.9	6.9	13.8	13.8	13.8	13.8	12.4	10.4	7.6	4.8	2.1	0.7
Millions of T$	0.0	22.3	21.4	43.2	43.7	44.1	44.7	40.6	34.1	25.2	16.1	6.9	2.3
Percent of revenue	0.0	4.8	4.7	9.4	10.4	10.4	8.6	7.9	6.7	4.9	2.9	1.2	0.4
Percent of total exports	0.0	44.4	114.5	86.4	28.8	25.7	22.6	17.9	14.1	9.7	5.7	2.3	0.7
Percent of external debt service	0.0	284.0	132.3	169.8	82.2	84.2	83.9	75.9	63.6	55.3	44.4	18.7	5.0
Percent of net foreign assets	0.0	3.2	2.4	4.8	6.4	9.6	9.7	8.6	7.1	5.6	3.0	1.2	0.4
Percent of GDP	0.0	2.1	1.9	3.5	3.3	3.2	3.1	2.7	2.2	1.5	0.9	0.4	0.1
Percent of quota	0.0	50.0	50.0	100.0	100.0	100.0	100.0	90.0	75.0	55.0	35.0	15.0	5.0
Net use of IMF credit[1]	0.0	6.9	0.0	6.9	0.0	0.0	0.0	-1.4	-2.1	-2.8	-2.8	-2.8	-1.4
Disbursments	0.0	6.9	0.0	6.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	2.1	2.8	2.8	2.8	1.4
Memorandum items:													
Nominal GDP (millions of T$)	1,119.7	1,068.7	1,135.6	1,227.7	1,306.6	1,377.3	1,438.7	1,500.7	1,565.6	1,636.2	1,712.1	1,792.7	1,879.5
Exports of goods and services (millions of $T)	214.2	50.3	18.6	50.0	151.8	171.7	197.3	226.9	241.6	260.1	280.2	303.7	332.5
Government revenue (millions of T$)	420.8	468.6	458.7	459.1	420.5	425.7	519.5	515.4	510.8	514.9	546.4	570.3	584.0
External debt service (millions of T$)	17.2	7.9	16.1	25.4	53.2	52.4	53.2	53.5	53.7	45.5	36.2	36.9	46.0
Net Foreign Assets Central Bank (millions of T$)	535.0	699.3	872.1	900.4	687.6	460.2	460.6	470.4	479.6	452.7	529.3	577.9	625.1
Quota (millions of SDRs)	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8

Source: IMF staff estimates and projections.

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

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

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

Source: Tonga's Voluntary National Review 2019

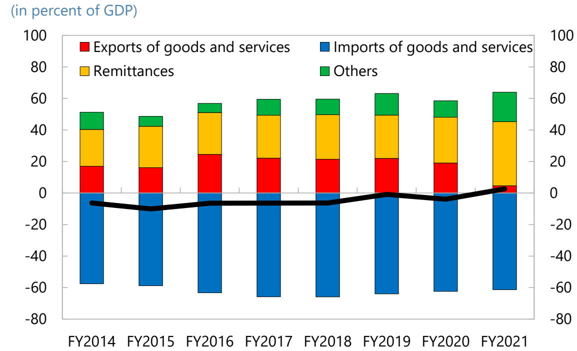
Annex I. External Sector Assessment

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

Current Account

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

Current Account Developments
(in percent of GDP)



Sources: Tonga authorities; and IMF staff estimates.

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

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

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

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

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

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

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

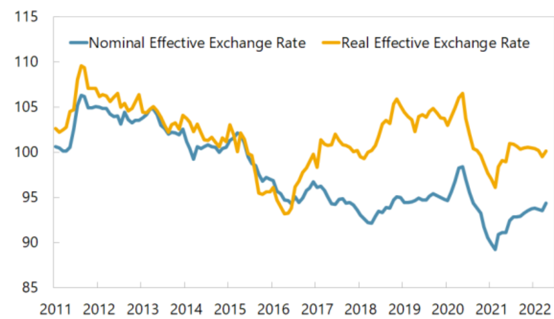
[2] The adjustment is calculated using the difference in the projected net remittances balance and net tourism balance pre-COVID-19 (January 2020) and current projections.

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

Real Exchange Rate

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

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



Sources: Tongan authorities; and IMF staff estimates.

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

Capital and Financial Accounts

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

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

International Reserves

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

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

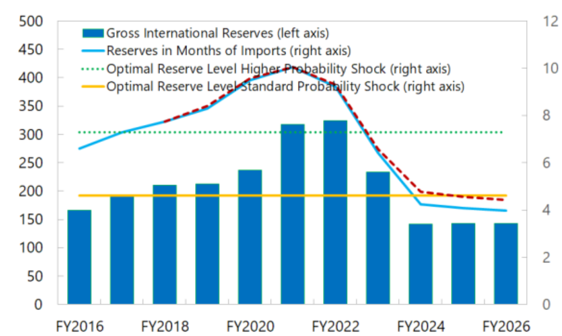
International Reserve Adequacy Metric	FY2021
Actual Reserves (months of prospective imports)	10.0
Optimal level with standard shock probability	4.6
Optimal level with higher shock probability	7.3
Broad Money coverage	256%

Source: IMF staff estimates.

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

International Reserves

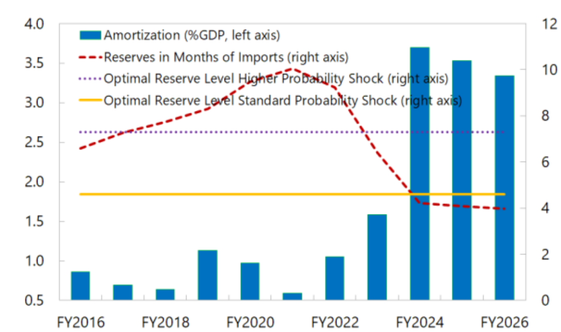
(In millions of U.S. dollars)



Sources: Tongan authorities; and IMF staff calculations.

Amortization

(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

Annex II. Risk Assessment Matrix[1]

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

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

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

Annex III. Integration Matrix of Surveillance Issues and Capacity Building

Surveillance Issues	International Monetary Fund			World Bank		Asian Development Bank	
	Past	2020-2021	Planned/ Ongoing	Past	Planned/ Ongoing	Past	Planned/ Ongoing
Fiscal Sector							
Public Financial Management	√	√	√	√	√	√	√
Expenditure framework		√	√	√	√	√	√
Revenue Framework	√	√	√	√	√		
Macroeconomic Frameworks							
Macroeconomic forecasting		√	√				
Macro-Financial Issues							
Financial supervision and regulation	√	√	√	√	√		
Financial market development	√	√	√	√	√		√
Correpondent Banking		√					√
Macro-Structural iIssues							
Infrastructure				√	√		√
Private sector development				√	√	√	√
Governance issues				√	√	√	√
Poverty/Gender/Inequality				√	√	√	
Climate change		√		√	√	√	√
Natural disaster management		√		√	√	√	√
Financial Inclusion						√	
Gender				√	√	√	√
Labor markets				√	√		
Land						√	
Business climate				√	√		
Statistics							
Data Enhancement	√	√	√				

Sources: IMF, World Bank, and Asian Development Bank (ADB).

Annex IV. Recommendations from 2021 Article IV Consultation

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

Appendix I. Letter of Intent

Ministry of Finance
Government of Tonga

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

Ms. Kristalina Georgieva

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

Dear Ms. Georgieva,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely yours,

MINISTER FOR FINANCE
TONGA

NATIONAL RESERVE BANK OF TONGA
GOVERNOR
Private Bag
No. 25, P.O.NUKU'ALOFA
TONGA

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

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