

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

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

**Recent Macroeconomic Developments and Request for RCF-2**

1. Tonga has been hard hit by a double blow from the Hunga Tonga Hunga Ha‘apai (HTHH) volcanic eruption and the first local outbreak of COVID-19 in early 2022, disrupting a nascent economy recovery in the second half of FY2021 (July 2020–June 2021). Consequently, the economy is projected to contract by 2.5 percent in FY2022. Inflation is elevated over the year to 9.4 percent as of April 2022, above the 5 percent target by the National Reserve Bank of Tonga (NRBT). Risks are tilted to the downside, reflecting the adverse impacts of ongoing geopolitical tensions, and rising international commodity and energy prices globally, as well as supply-side disruptions caused by the volcanic eruption on domestic prices.
2. Against this backdrop, the Tongan authorities have requested emergency financing of SDR 6.9 million (50 percent of quota) under the exogenous shock window of the IMF's Rapid Credit Facility (RCF) to meet BOP needs and help with rebuilding efforts. Tonga's current account deficit is estimated to increase to about 6 percent of GDP in FY2022 and 22.5 percent in FY2023. The authorities expect that the Fund's financing program coupled with financing support from multilateral and bilateral development partners, as well as foreign exchange reserves will help address the country's urgent BOP issue (estimated at about US\$121 million). In this regard, the development partners have pledged additional budget support in grants worth about 7 percent of GDP for FY2022 and 4 percent for FY2023 to cover emergency spending, including on health care, social protection, and reconstruction.

**Policy Priorities and Outlook**

3. Near-term policy priorities will be on assisting the vulnerable and poor, supporting reconstruction, ensuring macroeconomic stability, and containing inflationary pressures. Our authorities underscore the importance of effective implementation of support measures to entrench the economic recovery and promote sustainable and inclusive growth in the long term.
4. A swift vaccination campaign<sup>1</sup> allowed the authorities to envisage a plan to open the border fully in October 2022. The authorities have issued the HTHH Recovery Plan, which outlines

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<sup>1</sup> Nearly 100 percent of population aged 18 and above received one vaccine shot, 91 percent two doses, and 56 percent with boosters as of end April 2022.

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

5. The authorities have also continued the accommodative fiscal and monetary policy mix to support firms and households to quickly restore production and businesses. The authorities forecast the economy to grow moderately at 3.2 percent in FY2023, mainly owing to the recovery in the construction and tourism sectors. Inflation is expected to remain elevated in the near term before easing to below the 5 percent reference rate in FY2023 supported by the rebound in domestic crop production and easing of global supply disruptions.
6. The authorities would remain vigilant to challenges that have been surfacing, including geopolitical tensions, higher global food and energy prices and the possibility of subsequent natural disasters, which could adversely affect domestic production and consumption. Upside risks include the FX reserves remaining at record high levels due to recent large inflows of grants, relief funds and remittances. Official foreign reserves increased substantially by US\$86.7 million yoy to US\$375 million as at end June, 2022, which is equivalent to 12.6 months of import cover. The reserves will help provide financing buffers to tackle possible natural disasters and external shocks.

### **Fiscal Policy**

7. Fiscal policy remains accommodative to entrench economic recovery in the near term. The authorities, in partnership with development partners, will continue to support recovery initiatives and build a more resilient economy through measures including providing relief assistance for businesses and employees, tax exemptions, and electricity price subsidy, among others. In this regard, the authorities have deferred and exempted some of the tax and non-tax revenue in FY2021/2022 in order to assist the affected citizens during the recovery stage. Exemptions include duty on goods imported by citizens in the affected areas until June 2022, and payment of school fees (Term 1) for all students in Tongatapu, Ha'apai and 'Eua.
8. The authorities aim to sustain macroeconomic stability through continuous monitoring of fiscal performance. Budget deficit is expected to narrow in FY2022 due to the significant drop in the estimated revenue by US\$17.1 million (7 percent), greater than the fall in total expenditure by US\$13.5 million (6.2 percent), along with the delays in ongoing project implementation caused by the COVID-19 pandemic. The authorities continue to observe prudence in fiscal management and prioritization of essential activities for FY2022.
9. The authorities are committed to maintaining fiscal sustainability and continuing to strengthen revenue collection. Some measures that have been implemented include the introduction of electronic sales register system to reduce fraudulent activities, and E-tax services in an effort to modernize the tax administration system. They are also reviewing the affordability and relevance of selected government fees and charges for education, electricity, water, waste, and communications (internet and telephone).
10. Over the medium term, the authorities recognize the need to strengthen public finances to reduce the risk of debt distress, while prioritizing financing plans drawing on additional

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

## **Monetary Policy**

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

## **Financial Sector Policies**

12. The financial system remains sound, supported by strong capital positions, high liquidity, and adequate profitability. However, non-performing loans (NPLs) increased to 4.8 percent of total loans reflecting the impact of the HTHH disaster and the COVID-19 lockdowns on both businesses and households. Ongoing close monitoring of affected sectors and customers including those customers taking up the relief packages, risk assessments and stress testing of banks' resilience to further shocks to the financial system continue. Banks' adherence to provisioning requirements are also scrutinised, as they continue to align with the IFRS9 provisioning requirements. The Financial Stability Unit has been established to develop and implement macroprudential policies, including better monitoring of household and corporate indebtedness, a factor that had also contributed to the more subdued credit growth trend. The IMF PFTAC is assisting in reviewing the banks' prudential standards to enhance the conduct of risk-based supervision, while establishing prudential standards for the newly regulated non-bank financial institutions.
13. The NRBT has also implemented a strategy to modernize and improve the resilience and the efficiency of the payments system, including by completing the rollout of the Domestic Electronic Payment System (DEPS) for increased automation of the clearing and settlement system.
14. The NRBT continues to improve the regulatory framework for non-bank financial institutions. Consultation on draft legislations for the licensing and supervision of pension funds and insurers are in progress while legislations are being drafted for the licensing and supervision of capital markets, credit information system, and payment systems including

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

## Structural Reforms

15. The authorities are committed to strengthening the AML/CFT framework to help alleviate de-risking and de-banking risks. In implementing the recommendations in the Asia-Pacific Group's mutual evaluation report, the IMF Legal Department is assisting in the review of the Money Laundering and Proceeds of Crime Act (MLPC Act) and the AML/CFT supervision capacity has been augmented to facilitate enhanced supervision and the extension of supervision to all financial institutions and cash dealers under the MLPC Act. Other measures adopted to enhance AML/CFT risk assessments include strengthening of the FIU's information database and analytical tools, the establishment of the NRBT's e-KYC database, and deepened collaboration with regional AML/CFT supervisors and FIUs for the exchanges of relevant intelligence and supervisory information.
16. The authorities are also committed to implementing the recommendations of the safeguards assessment. Some of the recommendations may take time to implement given the local context and priorities, however work is in progress to review the National Reserve Bank of Tonga Act and fully address the audit-related recommendations. Meanwhile, the Board vacancies have been filled and an internal audit function has been established.
17. Tonga is among the most vulnerable countries to climate change. The authorities developed and launched the Monitoring and Evaluation (M&E) System Guide, and its Standard Operating Procedure (SOP) in October 2019 to strengthen monitoring and evaluation of the 2<sup>nd</sup> Joint National Action Plan on Climate Change and Disaster Risk Management (JNAP2)<sup>2</sup> activities, as well as reporting on progress and achievements. These documents are intended to guide national processes for tracking and updating progress toward the 6 objectives and 22 targets outlined in the JNAP2. The authorities have also implemented recommendations in the 2020 IMF/WB Climate Change Policy Assessment to mainstream climate resilience into all sectoral plans and strengthen cooperation across ministries.
18. The authorities have made good progress to increase employment and reduce poverty. In this regard, the authorities have developed the Labor Mobility Policy framework aiming to maximize the ability of workers to move overseas to get jobs. Thousands of Tongans have been employed in labor mobility schemes in New Zealand and Australia. Accordingly, Australia has streamlined the Seasonal Workers' Program (SWP) and the Pacific Labor Scheme (PLS) to have only one process under the Pacific Australia Labor Mobility (PALM) scheme. This alignment allows transfer of workers that have accumulated skills over the years of work to be transferred from unskilled to low-skilled and then to semi-skilled, and

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

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

## **Conclusion**

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