INTERNATIONAL MONETARY FUND

IMF Country Report No. 24/326

TONGA

November 2024

2024 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TONGA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2024 Article IV consultation with Tonga, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 6, 2024 consideration of the staff report that concluded the Article IV consultation with Tonga.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 6, 2024, following discussions that ended on August 23, 2024, with the officials of Tonga on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 10, 2024.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Tonga

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International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes 2024 Article IV Consultation with Tonga

FOR IMMEDIATE RELEASE

Washington, DC – November 25, 2024: On November 6, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tonga.

Tonga's economic activity has strengthened, bolstered by consistent remittance flows, continued tourism recovery, and robust construction activities. Despite a fall in agricultural output, GDP in FY2024 (July 2023 – June 2024) is estimated to have expanded at 1.8 percent. The potential for a stronger recovery has, however, been hindered by supply-side constraints including labor shortages.

Inflationary pressures have substantially eased. After peaking at 14.1 percent in September 2022, headline inflation has since been normalizing. Notwithstanding a spike in local food prices, headline inflation fell to 3 percent in July 2024, below the 5 percent reference rate of the National Reserve Bank of Tonga (NRBT), driven by a steady decline in core prices and a moderation of global goods and commodity prices.

The near-term baseline economic outlook remains favorable appropriately supported by expansionary fiscal and monetary policy. Real GDP growth is projected to accelerate to 2.4 percent in FY2025, mostly led by continued strength in domestic demand including large public investment projects and a rebound in agricultural output as the effects of El Nino dissipate. The medium-term growth prospects remain uneven, however. Tonga's long-term growth is projected at 1.2 percent, reflecting its exposure to increasingly frequent natural disasters, persistent loss of workers to emigration, and limited economies of scale due to geographical barriers. The balance of risks is, thus, tilted to the downside. A global slowdown could reduce tourism receipts and remittances while rising vulnerabilities in the banking sector, even though localized, pose a downside tail risk.

Executive Board Assessment[2]

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

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

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the Tongan authorities' ongoing efforts to support the economic recovery following the volcanic eruption and secure donor financing for substantive infrastructure projects. While noting the firming up of the economy and the favorable near-term outlook, Directors concurred that medium-term growth prospects remain weak, reflecting economic fragility and important downside risks. Against this backdrop, they underscored the importance of steadfast policy implementation and reforms to pave the way for continued macroeconomic stability and sustained growth. They also highlighted the need for sustained financial support from the international community as well as capacity development from the IMF.

Directors noted that the current fiscal stance is appropriately supporting reconstruction and building resilience. Given the high risk of debt distress and sizable financing needs, they stressed that over the medium term, a credible fiscal consolidation, additional grant financing, and refraining from new non-concessional borrowing are essential to place debt on a downward trajectory while achieving Tonga's development goals. Directors recommended efforts to mobilize revenue, including streamlining tax exemptions and strengthening tax administration. They also called for enhancing public financial management and spending efficiency, containing the public sector wage bill, and adhering to the fiscal rule.

Directors concurred that the current monetary policy stance is appropriate, as inflation has stabilized below the central bank's reference rate. They agreed that tightening would be warranted should inflation pressures resurface. Directors noted that the forthcoming amendments to the central bank act constitute an opportunity to further strengthen the monetary policy framework in line with IMF recommendations. Noting localized vulnerabilities in the banking system, Directors encouraged the authorities to closely monitor credit risks and ensure adequate provisioning for loan losses. They recommended expanding supervisory and regulatory frameworks to cover non-bank financial institutions.

Directors agreed that structural reforms are essential to enhance resilience to climate change and natural disasters and to promote private sector development. They stressed that enhancing anti-corruption and governance frameworks is crucial to meet Tonga's development goals. In this context, Directors welcomed the appointment of the first anti-corruption commissioner and the authorities' commitment to continue strengthening the AML/CFT framework, which is needed to help reduce the risk of losing correspondent banking relationships. They encouraged the authorities to advance digitalization, boost financial inclusion, address supply-side constraints and reduce gender inequalities, and further enhance the quality and timeliness of macroeconomic statistics.

Tonga: Selected Economic Indicators, FY2021 -FY2025 [1/ 2/]

Population (2021): 100 thousands
Major exports: root crops, vegetables, shellfish, fish

	FY2021	FY2022	Est. FY2023	Projections FY2024	FY2025
Output and prices					
Real GDP[2]	-1.3	0.0	2.0	1.8	2.4
Consumer prices (period average)[3]	1.4	8.5	10.2	4.6	3.2
Consumer prices (end of period)[3]	6.9	11.3	7.4	5.4	3.0
Central government finance					
Revenue	49.6	47.3	53.5	52.5	41.5
of which: Grants	23.0	19.9	27.6	26.7	15.8
Expenditure	50.6	48.1	47.4	49.0	49.5
Expense	42.9	42.0	39.6	37.2	38.6
Net acquisition of nonfinancial assets	7.7	6.1	7.8	11.8	10.9
Primary balance	-0.6	-0.2	6.7	3.9	-7.5
Overall balance	-1.0	-0.7	6.0	3.5	-8.0
Overall balance (excl. grants)	-24.0	-20.7	-21.5	-23.3	-23.7
Money and credit					
Broad money (M2)	25.0	13.4	-0.3	1.7	3.6
Domestic credit	-8.2	-3.3	-15.6	38.5	6.2
Of which: Private sector credit	1.0	-1.0	9.0	6.8	5.0
Balance of payments					
Current account balance	-31.2	-32.4	-34.6	-40.6	-44.1
(In percent of GDP)	-6.8	-6.8	-6.6	-7.4	-7.7
Exports of goods, f.o.b.	16.2	15.1	13.1	12.9	15.4
Imports of goods, f.o.b.	215.4	216.1	235.4	257.6	271.4
Tourism receipts	9.1	9.9	43.9	49.9	55.0
Total remittances	220.8	215.9	256.0	263.1	274.2
(In percent of GDP)	48.2	45.4	49.2	48.2	48.0
Compensation of overseas workers	41.3	35.3	55.3	59.2	62.3
Personal remittances	179.6	180.6	200.6	203.9	211.9
Official grants	10.5	24.6	22.9	29.1	27.6
Capital account balance	69.1	73.2	66.1	59.2	17.2
Financial account balance	0.9	29.5	17.6	-17.5	44.7
Gross official foreign reserves					
In millions of U.S. dollars	320.7	378.5	388.8	386.1	403.9
(In months of next year's total imports)	11.7	11.8	11.2	10.6	10.7
Debt					
Public debt (external and domestic)	48.8	47.5	43.3	37.8	44.0
Of which: External debt	42.3	41.3	37.8	32.3	38.0
External debt service ratio	0.8	1.5	2.2	3.8	3.6
Exchange rates					
Exchange rate (National currency per US dollar)	2.3	2.3	2.4	...	...
Real effective exchange rate (2010=100; +=appreciation)	107.1	115.7	125.4	...	...
Memorandum items:					
Nominal GDP (millions of US$)	458.6	475.4	520.3	545.4	571.1

Sources: Tonga authorities; and IMF staff estimates and projections.
[1]Fiscal year beginning July 1.
[2] The revisions to historical FY2021-22 data compared to the staff report for the 2023 Article IV consultation reflect recently released data from the authorities.
[3]CPI basket and methodology changed in September 2018.

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION

October 10, 2024

EXECUTIVE SUMMARY

Context. Tonga's economic activity has strengthened, bolstered by consistent remittance flows, continued tourism recovery, and robust construction activities, despite a fall in agricultural output. The potential for a stronger recovery has, however, been hindered by supply-side constraints including labor shortages. Inflationary pressures have eased, and headline inflation is falling below the 5 percent reference rate of the National Reserve Bank of Tonga (NRBT), mainly driven by the moderation of global goods and commodity prices. The elevated frequency of natural disasters, limited economies of scale, and geographical remoteness collectively temper medium-term growth. Localized risks are emerging in the banking sector.

Capacity Development (CD)–Surveillance Integration. Tonga is one of the largest recipients of IMF CD resources in the region, and the authorities have shown strong ownership. Recent IMF technical assistance, including on monetary policy operations, PFM, tax policy, revenue administration, macroeconomic and stress-testing frameworks, GDP nowcasting, and AML/CFT and financial stability frameworks, has informed staff's policy recommendations.

Policy Recommendations.

- The fiscal stance is appropriately focused on supporting reconstruction and building resilience, in the near term. The authorities, however, should consider normalizing non-reconstruction expenditures, including by limiting the increase in the public sector wage bill. Over the medium-term, a gradual and credible fiscal consolidation and additional grant financing commitments are both warranted to put debt on a firm downward path.

- The current monetary policy stance is appropriate, but a tightening will be warranted if demand-driven domestic inflation pressures resurface coupled with accelerating bank lending. The NRBT should continue to strengthen the monetary policy framework and its financial autonomy.

- Financial sector policies should aim at promoting financial deepening while safeguarding stability by expanding macroprudential toolkit, conducting regular bank stress tests, and strengthening prudential standards and governance.

- Structural reforms with a focus on bolstering disaster resilience, advancing digital transformation, and strengthening governance frameworks to foster a conducive business environment are essential to meet Tonga's developments goals.

Approved By
Lamin Leigh (APD) and Bergljot Bjornson Barkbu (SPR)

Discussions took place in Nuku'alofa, Tonga during August 12-23, 2024. The mission team comprised Andrea Pescatori (Head, RES), Xuehui Han, Ruifeng Zhang (both APD), and Krishal Prasad (Resident Representative Office, Fiji). Esala Masitabua (OED) and Ruth Nikijuluw (World Bank) participated in some of the meetings. Raja Anwar, Alternate Executive Director joined the concluding meetings. To-Nhu Dao, Reihana Paewai, and Shikha Atul Rao (all APD) provided excellent research and editorial assistance for the preparation of this report. The mission met with the Minister of Finance Tiofilusi Tiueti, the Governor of the National Reserve Bank of Tonga Tatafu Moeaki, other senior government officials, development partners, and private sector representatives. Data used in this report for staff analyses are as of October 8, 2024, unless otherwise noted.

CONTENTS

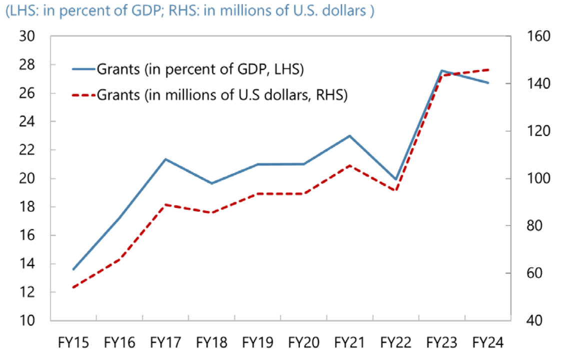
ANNEXES

CONTEXT: BOLSTERING THE RECOVERY AND ENHANCING LONG-TERM RESILIENCE

1. **The recovery of Tongan economy is firming up, bolstered by consistent remittance flows and deployment of emergency financing thanks to significant humanitarian and development aid**. Following the Hunga Tonga-Hunga Ha'apai (HTHH) volcanic eruption-tsunami in early 2022, Tonga's economy has benefitted from strong support from the international community (chart), including a second emergency financing under the IMF's Rapid Credit Facility (RCF) in July 2022 (bringing the total support to 100 percent of quota, equivalent to about US$18 million). While supporting economic activity, the reconstruction effort, coupled with global inflationary pressures, led to an initial burst of inflation which has now moderated falling below 5 percent reference rate of the National Reserve Bank of Tonga (NRBT). Risks are emerging in the banking sector.

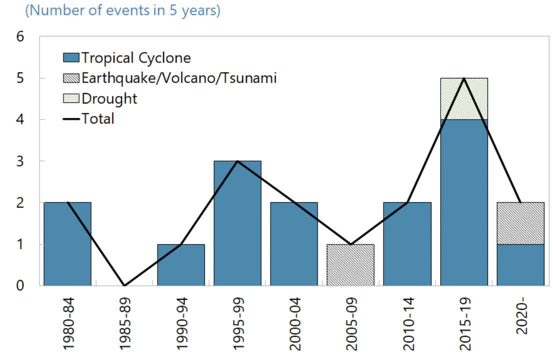
2. **In the long term, broad-based structural reforms are essential, given Tonga's high vulnerability to natural disasters, limited economies of scale due to geographical barriers, and high reliance on remittances**. Tonga has experienced three major natural disasters since 2018 (chart), which incurred substantial capital destruction (11 percent of GDP per year on average). This vulnerability discourages investment and, in turn, encourages emigration. Even though the authorities responded with bold policy support packages to the recent HTHH disaster and implemented several important reforms, including the passage of the Disaster Risk Management (DRM) bill in 2021, further advances on enhancing resilience to natural disasters are needed. Finally, reducing fossil fuel dependency with clean energy, thereby strengthening energy security and lowering the elevated energy costs, and fostering private sector development, accompanied by efforts to strengthen public finances, will be essential to meet Tonga's long-term development goals (Table 7).

International Grants Inflows
(LHS: in percent of GDP; RHS: in millions of U.S. dollars)



Sources: Tonga authorities and IMF staff estimates.

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

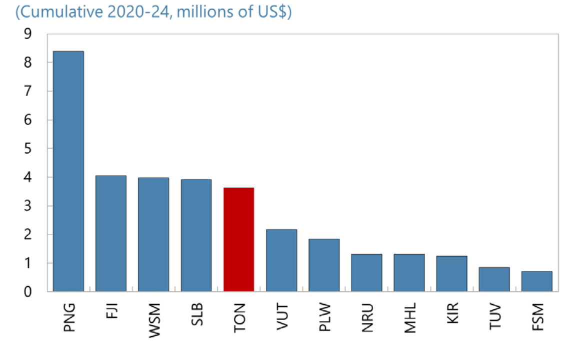


Sources: EM-DAT; and Staff calculations

3. **Tonga has benefitted from considerable capacity development (CD) assistance from the Fund, but more support is needed (Annex 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 (TA) on monetary policy operations, PFM, tax policy, revenue administration, macroeconomic and stress-testing frameworks, GDP nowcasting, and AML/CFT and financial stability frameworks has informed staff's policy recommendations. Addressing governance challenges and data shortcomings, particularly in external, fiscal, national accounts and monetary and financial statistics, remains a high priority. While the Fund's technical assistance has been instrumental in mitigating the authorities' capacity constraints, further improvements are needed. Finally, following the safeguards assessment in December 2021, and on the authorities' request, the Fund is providing TA on amending the central bank act.

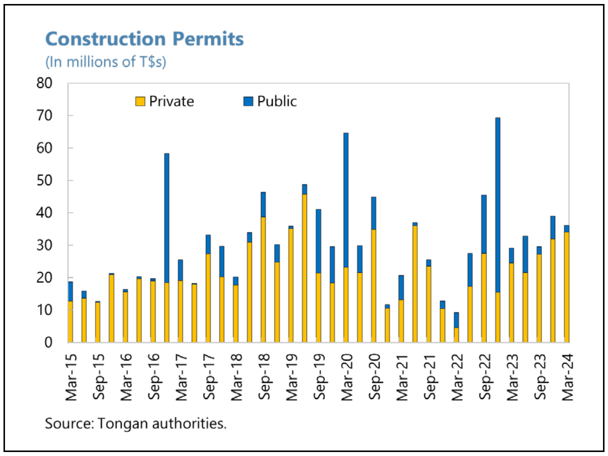
CD Delivery to Pacific Island Countries
(Cumulative 2020-24, millions of US$)

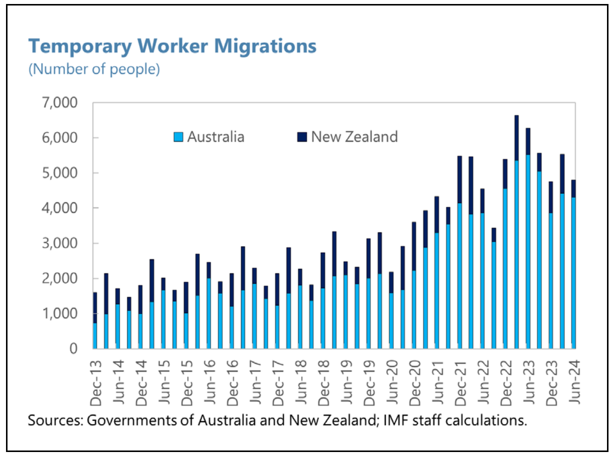


Sources: CDMAP database, and IMF staff calculations.

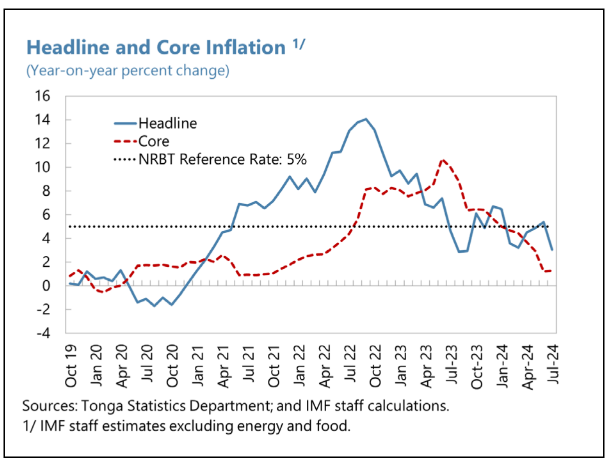
RECENT DEVELOPMENTS, OUTLOOK, AND RISKS; PRMOTING STABILITY AMID GLOBAL UNCERTAINTIES

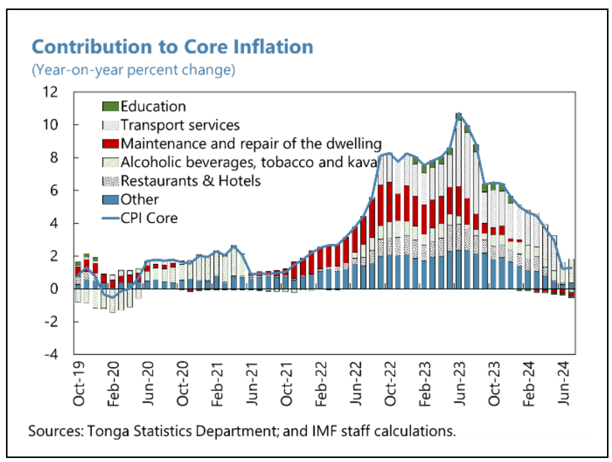
4. Economic activity has strengthened and become more broad-based driven by construction and wholesale trade, although some bottlenecks remain. Following a 2 percent growth in FY2023, GDP in FY2024 (July 2023 – June 2024) is estimated to have expanded at 1.8 percent, despite a ½ percentage point drag from agricultural production. The expansion was primarily driven by continued strength in domestic demand, including robust construction sector activity—as indicated by a rise in construction permits (chart)—and the recovery in tourist arrivals. The potential for a stronger recovery was, however, hindered by supply-side constraints. These include labor shortages, as evidenced by rising job vacancy posting (Figure 1), exacerbated by the increased demand from seasonal worker programs in Australia and New Zealand (chart).



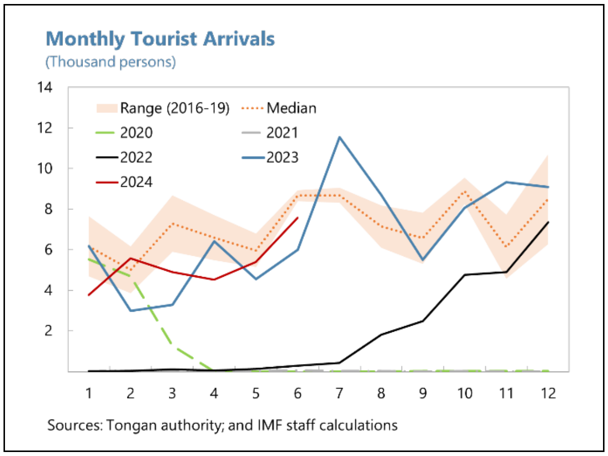


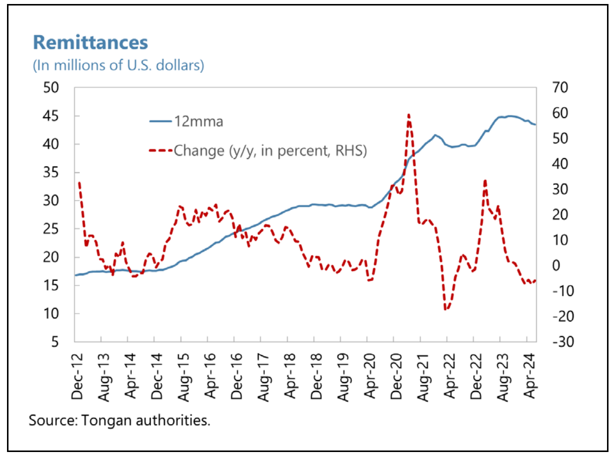
5. **Inflationary pressures have substantially eased.** After peaking at 14.1 percent in September 2022, headline inflation has since been normalizing, falling below the 5 percent reference rate of the NRBT, driven by a steady decline in core prices, a moderation of global goods and commodity prices, and some easing of local supply-side constraints. Headline inflation temporarily picked up again in June 2024 (reaching 5.4 percent), driven by a 24 percent surge in local food prices, which was attributed to reduced agricultural output from crop failures, partly due to El Niño, and strong food demand from festivities. Nonetheless, headline inflation once again fell to 3 percent in July 2024 as local food prices retrenched. Core inflation, as calculated by the IMF, has continued to fall, reaching 1.3 percent in the same period. This decrease has been supported by a slow increase in import prices, with the imported component of inflation rising by 0.8 percent.



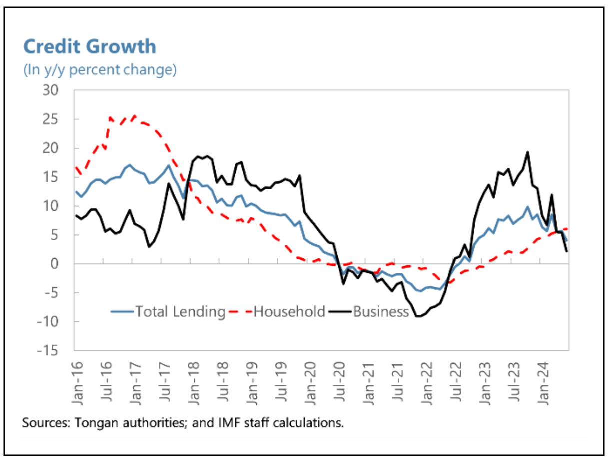


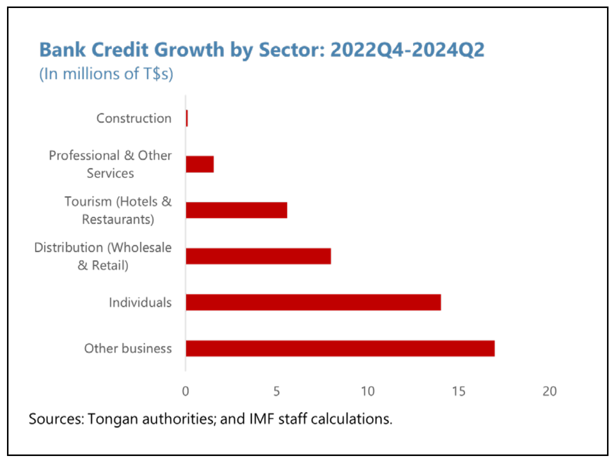
6. **The external position for FY2024 is assessed to be broadly in line with the level implied by medium-term fundamentals and desirable policies (Annex I).** Remittance inflows remained strong (chart), and tourist arrivals continued to recover in FY2024 (chart). However, higher imports due to continued economic recovery and construction activity led to a widening of the overall current account deficit from 6.6 percent of GDP in FY2023 to 7.4 percent in FY2024. Foreign exchange reserves remained adequate at the end of FY2024 covering 10.6 months of imports, supported by sizable capital transfers.



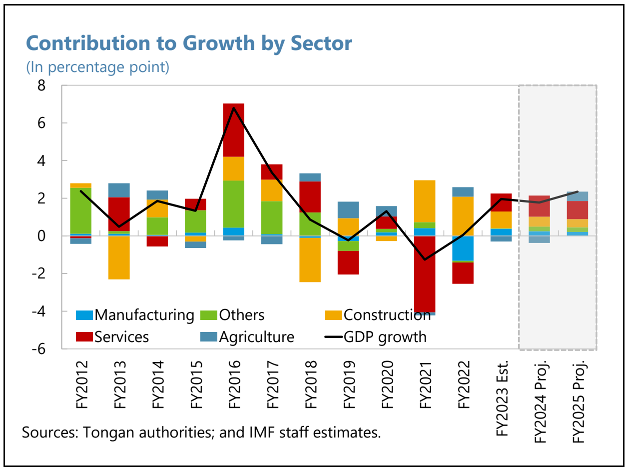


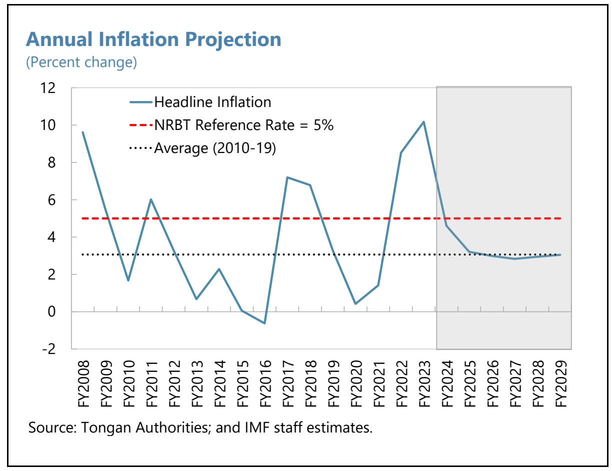
7. Credit continues to expand in line with recovery in the real sector. Total lending grew by 4.1 percent (y/y) at the end of June 2024 driven by lending to both households (6.0 percent) and business (2.2 percent) sectors. Demand for business credit mostly stemmed from professional services, distribution, and tourism consistent with the rebound in activity in these sectors. Credit to individuals has supported reconstruction. Due to the ample liquidity in the system, credit supply proved to be elastic—thus, interest rates have remained flat.





8. The near-term baseline economic outlook remains favorable. Real GDP growth is projected to increase to 2.4 percent in FY2025, mostly led by continued strength in domestic demand including large public investment projects (such as the Funga'uta Lagoon Bridge and the Nuku'alofa port upgrade) and a rebound in agricultural output as the effects of El Nino dissipate. While the tourism industry remains on a recovery path, tourism earnings as a percentage of GDP are not expected to cross above pre-pandemic levels before 2030. Headline inflation is expected to remain below the 5 percent reference rate in FY2025 and onward, supported by the retrenchment in local food prices from their recent highs and low import prices inflation (chart).





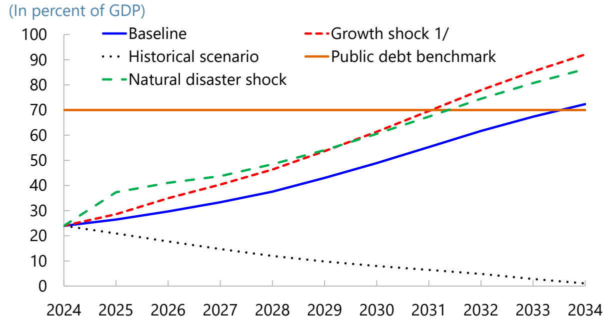
9. Medium-term growth prospects remain uneven. Tonga's long-term growth is projected at 1.2 percent, reflecting its exposure to increasingly frequent natural disasters, persistent loss of workers to emigration, and limited economies of scale due to geographical barriers. The current account deficit is expected to narrow only slowly over the medium-term, reflecting the continued recovery of tourism notwithstanding the normalization of remittances, heavy import dependence, and substantial infrastructure needs. FX reserve coverage is projected to remain adequate at about 10¾ -11 months of imports, above the NRBT's target of 7½ months, supported by external financing.

10. The balance of risks is tilted to the downside (Annex II). Frequent natural disasters could place additional demands on scarce public resources and decrease asset quality in the banking sector, while a further loss of correspondent banking relationships (CBRs) in the region due to AML/CFT-related weaknesses could disrupt transfers and remittance flows. The risk of a faster outflows of Tonga worker contribute to tilt GDP growth risks to the downside and domestic inflation risks to the upside. A global slowdown would reduce tourism receipts and remittances. [1] Rising vulnerabilities in the banking sector pose a downside tail risk. On the upside, tourism could recover faster due to a stronger-than-expected pent-up demand, and grants could come stronger than expected.

[1] Tonga's remittances are somewhat insensitive to business cycle fluctuations in remitting countries (SR2010, Box I). Such a slowdown in remittances would, thus, be mild and possibly associated with a slower worker emigration outflow, balancing the overall GDP impact. In general, remittances volatility is mostly explained by natural disasters which lead to a surge and a subsequent normalization of the remittances flow.

11. Tonga is assessed as being at high risk of debt distress (DSA Annex). Without additional grant commitments to staff's baseline projection, the present value (PV) of the external and public debt-to-GDP ratios are projected to keep rising and both cross the 55 percent threshold and the 70 percent benchmark in FY2034, largely and persistently. This reflects significant development spending needs over the long term to achieve its climate resilience goals and SDGs. Debt obligations are largely external, with over half of the external debt to China Exim Bank. Debt repayments surged to 3.5 percent of GDP in FY2024, mainly to Exim Bank, and remain elevated at over 3.0 percent of GDP until FY2027. The government's plan to refrain from new non-concessional borrowing would further help reduce Tonga's risk of debt distress.

High Risk of Public Debt Distress
Present Value of Debt-to-GDP Ratio
(In percent of GDP)



Source: IMF staff estimates.
1/ The most extreme shock scenario is the growth shock (one standard deviation below the baseline for two years starting from FY2024).

Authorities' Views

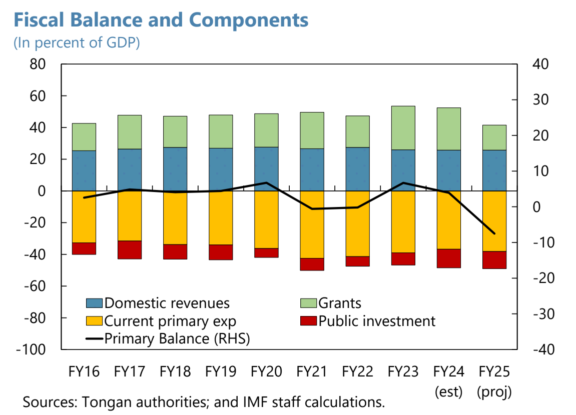
12. The authorities broadly agreed with staff's assessment and showed relatively more optimism about the near-term economic outlook, while concerns remained over long-term growth prospects. The authorities' GDP growth projections for this and next fiscal year range between 2.5 and 3 percent, slightly higher than staff. Growth is expected to be mostly led by continued strength in domestic demand, thanks to large upcoming public investment projects, and a stronger contribution from the tertiary sector (in part related to the hosting of the 53rd Pacific Islands Forum Leaders Meeting in August 2024). The NRBT projects inflation to be below 5 percent by FY2025, with headline inflation expected between 2 to 4 percent. However, potential spikes in domestic food prices remain a concern, not only for inflation but also in relation to the cost of living, particularly affecting the most vulnerable segments of the population. The authorities considered the loss of workers due to emigration and recurrent natural disasters as major risks to their outlook, posing a significant drag to medium- and long-term growth.

POLICY DISCUSSIONS: REBUILDING THE BUFFERS AND BOOSTING RESILIANCE

Macroeconomic policies should capitalize on the favorable economic environment to accelerate reconstruction, strengthen Tonga's resilience to shocks, and promote private sector development. The current expansionary fiscal stance is deemed appropriate in the short term. Over the medium-term, however, a gradual and credible fiscal consolidation and additional grant financing commitments are warranted to put debt on a firm downward path and build fiscal buffers. Monetary policy can stay accommodative as inflation remains contained, but authorities should be prepared to tighten, including through policy rate hikes, if domestic demand-driven inflation pressures resurface. The forthcoming *amendments to the NRBT Act should be used as an opportunity to strengthen the monetary policy framework. Financial sector policies should aim at safeguarding financial stability while promoting financial deepening. Broad-based structural reforms (including reforms to address governance issues) are needed to facilitate Tonga's transition to a more resilient and private sector-led economy.*

A. Fiscal Policy

13. The fiscal balance remains in surplus in FY2024 notwithstanding sustained high rebuilding-related expenditures. Despite increased reconstruction-related expenditures, the overall fiscal balance is expected to remain in surplus in FY2024 at 3.5 percent of GDP, thanks to continued record-high grant inflows and stronger-than-expected consumption tax and income tax revenues due to strong remittance and a rebound in construction-related business activities. IMF staff projects the fiscal balance to revert to a deficit, of 8.0 percent of GDP in FY2025, assuming external grants to return to their historical trend while public reconstruction expenditures remain strong.



Sources: Tongan authorities; and IMF staff calculations.

14. The current fiscal stance is appropriately supporting reconstruction and building resilience, in the near term. Excluding grants, the FY2024 fiscal impulse is expansionary, about 2.0 percent of GDP, appropriately supporting the ongoing reconstruction, and it is expected to moderate to mildly expansionary in FY2025, about 0.5 percent of GDP. [2] The fiscal easing in FY2025 is driven by wage increases for cost-of-living adjustments and talent retention, enhancements to social protection, and higher-than-expected spending for hosting the Pacific Islands Forum Leaders Meeting. Even though the current fiscal stance is broadly appropriate, the authorities should consider normalizing spending unrelated to reconstruction, including by limiting the public sector wage bill which is expected to cross the 53 percent limit as share of domestic revenues. This is driven by a 15 percent anticipated increase in public sector wage bill in FY2025, resulting from a 5 percent cost of living adjustment and filling existing vacancies.

15. Over the medium-term, a gradual and credible medium-term fiscal consolidation and additional grant financing are warranted to put debt on a firm downward path. This should be partly through boosting domestic revenue mobilization, limiting spending, and securing additional grants, which are required to meet Tonga's development spending needs while minimizing the risk of debt distress. In the absence of adjustment efforts and additional grant financing relative to current commitments, the fiscal deficit is projected to widen substantially in the long term under the

[2] The fiscal impulse is calculated as the difference in the primary balance excluding grants between the current and previous year. Given data limitations, a cyclical adjustment of the fiscal balance is not available.

baseline scenario, primarily due to sizable spending needs to achieve Tonga's Sustainable Development Goals (SDGs) and climate resilience objectives.

16. The fiscal adjustments should have a three-prong approach: domestic revenue mobilization (including a gradual increase in tax revenues), enhancing spending efficiency, and securing additional grants. It includes removing tax-inefficient exemptions (estimated at 13 percent of GDP, Liu and others 2019)[3] without increasing the statutory rates,[4] improving tax administration, restraining the public wage bill (by adhering to the fiscal rule, Annex VII), rationalizing other low-priority current expenditures, and securing additional grants from development partners. The fiscal consolidation envisaged for FY2026 is 1.3 percent of GDP, increasing to 4.5 percent by FY2034. The government's plan to refrain from new non-concessional borrowing will further help reduce Tonga's risk of debt distress.

17. Reforms will be needed, guided by Fund TA. The authorities have already initiated several reforms in these areas, consistent with IMF TA. The initiation of the Medium-term Fiscal Framework is poised to strengthen fiscal planning and discipline, mitigate fiscal risks, and bolster debt sustainability. The ongoing operation of the Electronic Sales Register System has improved revenue compliance and alleviate administrative burdens. The passage and implementation of the Public Financial Management (PFM) Act, which is expected to be presented to parliament before year-end , are expected to further enhance fiscal transparency, ensure budget allocation is in line with national economic objectives, and improve medium-term budget processes. As the authorities have drafted a tax policy proposal focused on reforming tax exemptions for tourism and agriculture sectors in consultation with the Fund and World Bank. The authorities' committed under the IMF's RCF to publish pandemic-related procurement contracts with information on the awardees' beneficial ownership. Currently, the information on procurement contract awards by Ministry of Health is published for FY 2020-2021, with the exception of beneficial ownership information. Going forward, developing structural mechanisms for the publication of public procurement contract award information, including on awardees' beneficial owners, can ensure sustainable implementation of these measures.

18. An illustrative fiscal adjustment scenario shows that Tonga's debt can remain well below the benchmark even with the natural disaster or the most extreme shock. Under this scenario, Tonga implements a set of domestic fiscal measures over FY2026–FY2034, including a modest improvement in consumption tax collection compliance and reductions in tax exemptions, reductions in current spending, and modest additional grants (Text Table 1). [5] The PV of the public debt-to-GDP ratio would then stabilize below the 70 percent benchmark with a buffer over the long term, even with a natural disaster or a multi-year growth shock. The PV of the external debt-to-GDP

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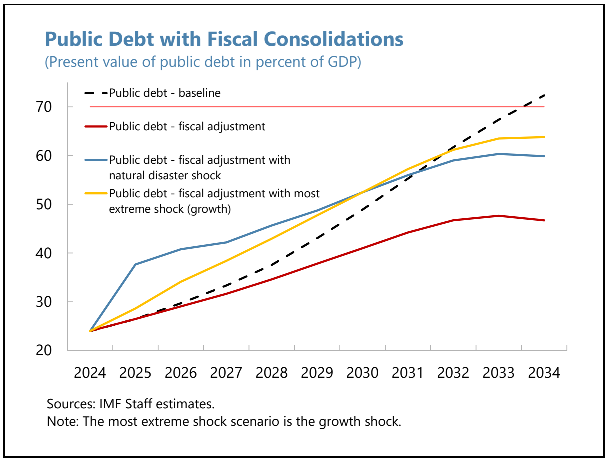
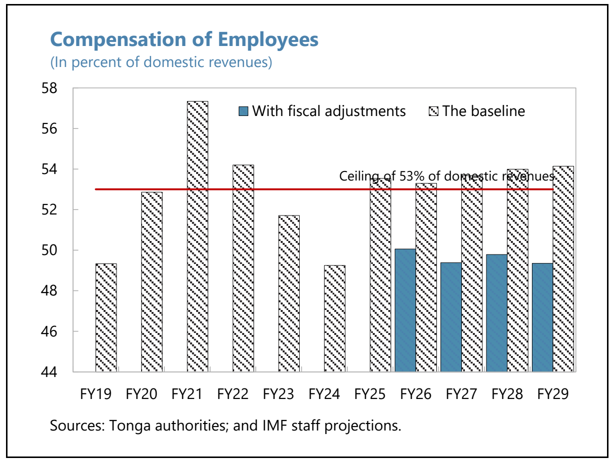
[3] Reducing tax exemptions and strengthening governance for granting new exemptions—including setting clear eligibility criteria and limited timeframes, as well as allowing the Minister of Finance to have the ultimate authority to grant exemptions—would help deliver significant additional revenues (see also Liu and others 2019).

[4] The consumption tax rate is 15 percent in Tonga, one of the highest in PICs.

[5] In the baseline projection, only firmly committed grants are included, leading to a long-term decline to 4 percent of GDP. The additional grants aim to maintain the level above 8.5 percent of GDP, close to the historical average.

ratio would also stabilize below the 55 percent threshold under this scenario. Furthermore, contrary to the baseline scenario, the ratio of employee compensation to domestic revenues is projected to fall below the 53 percent threshold starting from 2026.





Text Table 1. Costing of Fiscal Adjustments

(In percentage points of GDP)

	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2034
Baseline primary balance	-9.1	-9.4	-9.9	-11.3	-11.1	-11.6	-11.8	-11.0	-9.4
Proposed primary balance	-7.8	-7.5	-7.7	-7.5	-6.5	-6.2	-5.2	-2.7	0.6
Domestic Consolidation needed	1.3	1.9	2.2	2.5	2.6	2.6	3.1	3.8	4.5
Contribution from tax revenue	0.8	0.8	0.8	1.1	1.2	1.2	1.7	2.3	2.7
Improved consumption tax 1/	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.5	0.6
Less tax exemptions 2/	0.5	0.5	0.5	0.8	0.8	0.8	1.3	1.8	2.1
Contribution from current spending	-0.5	-1.1	-1.4	-1.4	-1.4	-1.4	-1.4	-1.5	-1.8
Lower G&S	0.0	-0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.7	-0.8
Lower public sector wage bill	-0.5	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-1.0
Additional Grants 3/	0.0	0.0	0.0	1.3	2.0	2.8	3.5	4.5	5.5

1/ For reference IMF (SR, 2023) estimates that the potential revenue impact from such reform for Tonga at about 6.2 percent of GDP.
2/ For reference IMF (SR, 2021) estimates that an additional 2.5 percent of GDP in tax revenues could be collected by removing various tax exemptions.
3/ The additional grants are to maintain the grants above 10 percent of GDP.

Authorities' Views

19. The authorities intend to continue prioritizing reconstruction and social protection in the near term while advancing fiscal reforms to strengthen the public finances in the long term. They expect robust post-disaster reconstruction and renewable energy projects to continue in FY2025 with support from development partners. The FY2025 budget includes new initiatives to enhance social protection, such as increasing allowances for the elderly by lowering the coverage age from 70 to 67 years, intending to further protect vulnerable segments of the population. In terms of fiscal reforms, the authorities have seen positive results from rationalizing overtime pay and plan to introduce performance-based assessments in FY2025 to further improve efficiency. They are also committed to revenue mobilization measures, including improving revenue services administration through the continued rollout of the electronic sales register system and upgrading the revenue management system, streamlining tax exemptions for the tourism and agriculture sectors, improving the efficiency of current spending, and adhering to the fiscal rule. Additionally, they remain committed to securing new grant financing from development partners to ensure that debt remains on a sustainable path while meeting climate resilience and development goals.

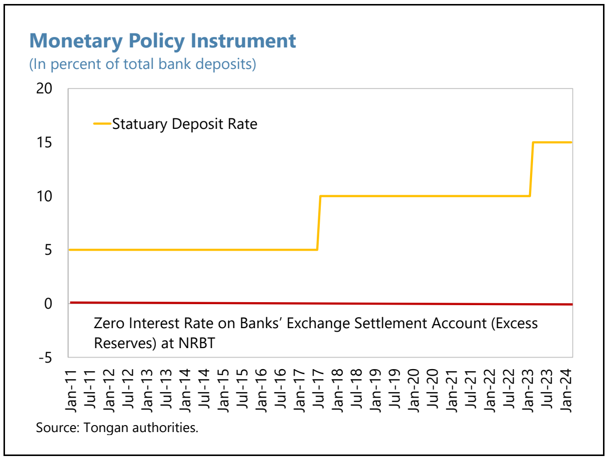
B. Monetary and Exchange Rate Policies

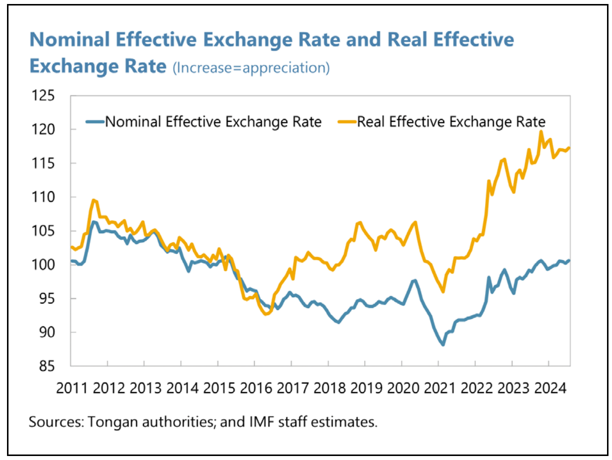
20. The current monetary policy stance is appropriately accommodative as inflation has stabilized below the 5 percent reference rate. The NRBT took measures last year to signal tightening. In February 2023, the NRBT increased the statutory reserve deposit (SRD) ratio from 10 percent to 15 percent, the first adjustment since July 2017, while keeping the policy rate (i.e., the rate on excess bank reserves) unchanged at zero percent. The impact on aggregate demand and bank lending, however, has been limited due to the banking system's abundant excess liquidity (Annex VI). However, if demand-driven domestic inflation pressures resurface (possibly driven by the expanding construction activity), coupled with signs of accelerating bank lending, a monetary policy tightening would be warranted, including by raising the policy rate (i.e., the floor interest rate paid on excess reserves). This adjustment in the policy rate would also help move monetary policy towards a neutral stance over the medium term and also create room to lower the rate in case important downside risks materialize (e.g., a major natural disaster).

21. With the forthcoming amendments to the NRBT Act, there is an opportunity to strengthen the monetary policy framework in several key areas with support from the ongoing IMF TA. The reserve bank could redefine its preferred inflation measure by focusing on a core measure, that excludes volatile energy and food prices which are largely beyond monetary policy's control. A more proactive use of the policy rate would aid in stabilizing domestic prices. This approach should be supported by enhancing the NRBT's communication strategy, such as publishing regular board meeting dates to improve transparency and market expectations (Annes IV). Furthermore, to ensure that increases in sterilization costs resulting from a policy rate hike do not lead to concerns about the NRBT's operational independence, the NRBT and the government could consider further clarifying the operational guidelines for transfer of profits, coverage of losses, and recapitalization, consistent with the 2021 IMF safeguards assessment and TA recommendations. The safeguards assessment also highlighted the need to develop a business continuity plan and a cybersecurity policy.[6] Finally, staff advised against potential amendments to the NRBT Act that could

[6] Some progress has been observed in implementing the recommendations from the 2021 safeguards assessment. While the assessment found basic operational controls in key safeguards areas, it had also identified governance weaknesses, such as vacancies at the NRBT Board and the absence of an internal audit function. Since then, the Board has been fully constituted, but less progress has been noted in establishing an internal audit department or, alternatively, outsourcing the audits of high-risk areas. Efforts to implement outstanding recommendations should continue.

potentially normalize open-ended quasi-fiscal operations, undermine central bank operational independence, and impair the financial autonomy of the NRBT.





22. Exchange rate stability has been maintained under the current currency basket. During July 2023 to June 2024, the nominal effective exchange rate (NEER) has seen a 2.2 percent increase compared to the previous year following the USD appreciation, leading the Tongan Pa'anga (TOP) to appreciate against the currencies of Tonga's major trading partners (AUD, NZD, FJD, JPY, and CNY), partially offsetting the impact of higher import prices denominated in trading-partner currencies on domestic inflation. Additionally, REER also increased over the year by 2.8 percent during the same period.

Authorities' Views

23. Like staff, the authorities view the current monetary stance as appropriately accommodative. They continue to emphasize the importance of nurturing the ongoing post-pandemic recovery, with the NRBT planning to maintain its accommodative monetary policy stance. The NRBT will, however, tighten policy if excess-demand driven inflationary pressures re-emerge. However, given the limited effectiveness of the monetary tools available, in the event of a significant inflation surge, the NRBT advocates complementing monetary tightening with fiscal tightening. The NRBT plans to continue improving the effectiveness of monetary policy transmission, including through improved liquidity management and communication. Although banking sector liquidity levels remain elevated so far, the NRBT will consider lowering the SRD rate in case liquidity needs arise. Finally, the authorities noted that foreign currency reserves remain at adequate levels owing to continued inflows of grants and remittances, which is crucial given Tonga's vulnerability to natural disasters, external shocks, high import dependence, and external debt repayments.

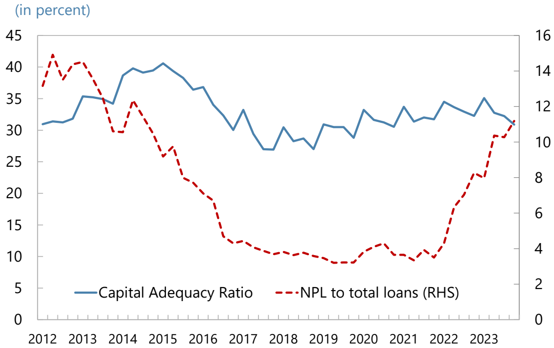
24. The authorities see the need to support bank lending in underserved sectors. The NRBT Act's amendments proposed by the authorities aim to introduce two NRBT facilities to subsidize bank lending in sectors deemed relevant for Tonga's economic growth, such as education and tourism. The authorities broadly concurred with staff on the introduction of the potential amendments to the NRBT act (even though reiterated the need to support some key sectors in the economy) and are open to incorporate some recommendations from the ongoing IMF TA that could address these proposed amendments.

C. Financial Sector Policies

25. The overall banking sector maintains strong capitalization and ample liquidity. As of June 2024, the banking sector's capital adequacy remained strong at 32.1 percent, above the 15 percent regulatory requirement supported by banking sectors' solid profitability. The banking system's liquidity position continues to remain high, with a Liquid Asset Ratio (LAR) of 46.9 percent, underpinned by healthy deposit growth. Banks' excess reserves stand at around 30 percent of GDP as of June 2024.

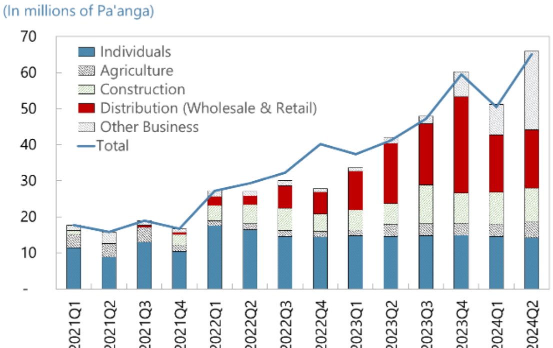
26. Risks to asset quality have increased as localized vulnerabilities persist. The banking system NPL ratio increased from 7.4 percent in 2023Q1 to 11.2 percent at the end of June 2024, mostly driven by business loans in the transport sector. Some NPL might still reflect the lingering effects of the HT-HH disaster and COVID–19. Meanwhile, the NPL coverage ratio declined from around 36.3 percent at end-2022 to 11.4 percent by the end of 2023. Systemic risk has, thus, increased, however it remains largely contained as the major banks operating in Tonga are well capitalized and represent the subsidiaries of relatively sizeable foreign financial institutions.

Capital Adequacy and NPL Ratio
(in percent)



Sources: NRBT

Non-Performing Loans by Sector
(In millions of Pa'anga)



Sources: Tongan authorities; and IMF staff calculations.

27. Reforms aimed at promoting financial deepening and stability should continue. The NRBT should also continue to conduct regular stress tests to ensure that banks maintain sufficient capital to absorb any potential losses. Strengthening prudential standards and regulations (e.g., for credit unions and those related to provisioning), avoiding frequent staff turnover, and expanding the scope and increasing the frequency of relevant data collection, will help enhance Tonga's capacity to conduct risk-based supervision and further mitigate asset quality risks in the financial sector. Given that data gaps on Non-Bank Financial Institutions (NBFIs) impede effective risk oversight and management of the broader financial system, the NRBT's regulatory and supervisory remit should be broadened to cover NBFIs, including the retirement funds.[7] Issuing domestic government bonds to promote domestic interbank markets and, thus, financial deepening should continue.

28. Various initiatives have been promoted to boost financial inclusion. The Private Sector Development Initiative (PSDI) has proposed its support to undertake a feasibility study aimed at evaluating the establishment of a Credit Registry. This initiative seeks to improve the credit landscape and facilitate more effective monitoring of business and household debt levels within the Tongan economy. Additionally, to advance financial inclusion in Tonga, the NRBT unveiled the National Financial Inclusion Strategy (NFIS) for 2023-2027 in November 2023, and, as part of its rollout, conducted the inaugural in-country training in March 2024 in collaboration with the AFI, concentrating on enhancing Responsible Digital Financial Services, Product Innovation and Delivery, and promoting Inclusive Green Finance, with working groups and their terms of reference (TORs) currently being established.

29. The authorities continue to work towards strengthening the AML/CFT framework. The forthcoming Money Laundering and Proceeds of Crime Act (MLPCA) and Regulations amendments Bill 2024, aimed at addressing deficiencies identified in the APG's assessment report, is currently undergoing stakeholder consultations, and is slated for parliamentary submission by the end of this year. Risk-based supervisory tools are also being developed through IMF's technical assistance, marking significant steps towards strengthening the AML/CFT framework. Measures are being taken to ensure supervision of banks and non-banks, and to increase resource allocation for Designated Non-Financial Businesses and professions (DNFBP) supervision. In addition, the FIU's capacity is being increased through the adoption of an IT system with support from AUSTRAC. Finally, in relation to CBR the authorities should consider the region's CBR Roadmap and related World Bank regional project.

Authorities' Views

30. The authorities aligned with the staff's assessment and recommendations aimed at safeguarding financial stability and agreed to closely monitor and address the risks in the financial sector. The authorities stressed that the recent increase in banking system NPL ratio was a localized vulnerability. They believe, however, that systemic risk remains largely contained as the major banks operating in Tonga are well capitalized and represent subsidiaries of sizeable foreign financial institutions. In acknowledgment of the necessity for preemptive actions to secure financial stability, they have initiated several strategies to address elevated NPLs, such as enhanced monitoring, collateral reassessment mandates for banks, directives to mitigate exposure risks, and sensitivity analyses to evaluate the repercussions of high NPLs on capital adequacy. Furthermore, the NRBT is advancing reforms to augment its regulatory and oversight mechanisms, including updating prudential standards on credit risk, adopting International Financial Reporting Standard 9 (IFRS 9) with assistance from the Pacific Financial Technical Assistance Centre (PFTAC), and extending its regulatory cover to encompass pension funds and insurance companies, supported by technical

[7] NBFIs are estimated to account for about 20 percent of total private credit.

assistance from the World Bank and the Asian Development Bank (ADB). Finally, even though not perceived as an imminent risk, the authorities are concerned about a potential loss of CBR, especially for USD-denominated accounts, and appreciate the region CBR's Roadman project led by the World Bank.

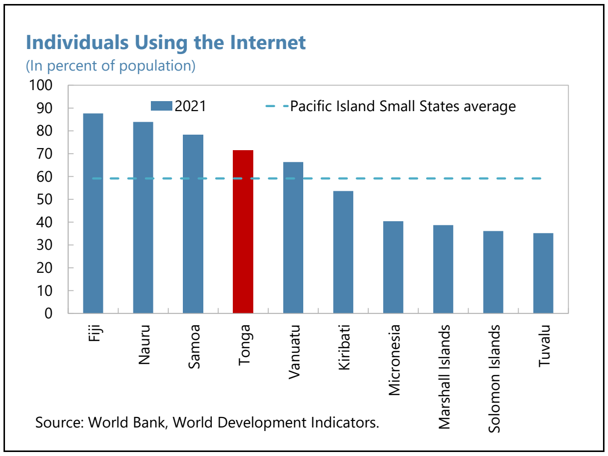
D. Structural Reforms

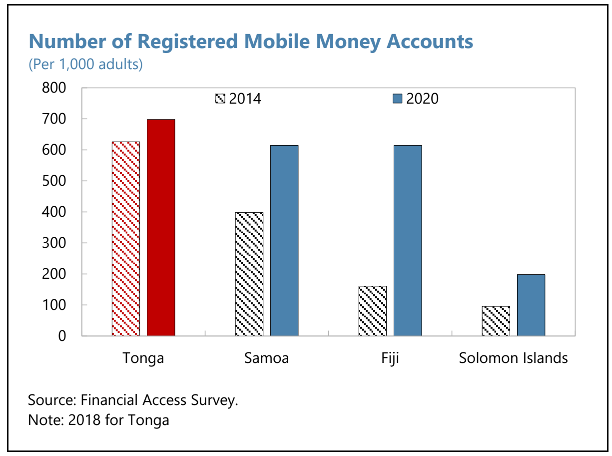
31. Enhancing resilience to natural disasters and climate change is a top reform priority. The DRM bill that passed the Parliament in August 2021 marks an important step forward in this regard. It aims to pivot the focus of Tonga's disaster management frameworks from ex-post responses to proactive ex-ante risk mitigation and preparedness (IMF/WB 2021 CCPA Report). Expanding the classification of climate change-related spending and strengthening the social protection system are other priorities.

32. Addressing key macro-critical corruption and governance vulnerabilities is essential for Tonga's economic development. Evidence of pervasive corruption, coupled with governance weaknesses in several state functions, highlight the urgent need for action in several areas, including fiscal governance (revenue institutions, procurement, fiscal transparency, and public financial management controls); regulatory frameworks (product market regulation, rule-making processes, and trade facilitation); central bank governance and operations; and AML/CFT related issues (preventive measures, entity transparency, and criminal justice). In this respect, the recent appointment of Tonga's first anti-corruption commissioner is a welcome and promising development.[8] Empowering the commissioner to effectively fulfill the office's mandate, as envisaged by the Authorities, is also critical to the anti-corruption agenda.

33. Developing the private sector is critical to boosting Tonga's growth potential. Notably, digitalization can be an effective way to overcome geographical limitations and widen economic opportunities. The authorities' ongoing efforts to launch a national digital ID system are a significant measure in this regard and could create synergies with other reforms, like facilitating timely delivery of social assistance and enhancing access to credit by facilitating banks' customer due diligence process, leveraging Tonga's active use of mobile money. In addition, Tonga's development goal would gain from: (1) better allocating the now increased government spending on education and training, (2) reducing gender inequality in the labor market and access to credit, and (3) and tackling regulatory restrictions to attract FDI. Finally, policies aimed at talent retention may help mitigate the negative effect of emigration dynamics on the labor supply.

[8] The Anti-Corruption Commissioner for Tonga was appointed by the King in Privy Council on 28 March 2024 and the Office of the Anti-Corruption Commissioner commenced operations on 1 July 2024.





Authorities' Views

34. The authorities broadly agree with the need of structural reforms to achieve Tonga's development goals. To foster economic and inclusive growth, the authorities plan to provide affordable, quality transport infrastructure and enhance public utilities and social protection services aiming at reducing multi-dimensional poverty (at about 24 0 percent). In addition, to combating labor shortage in key sectors, the authorities plan to foster youth training and capacity building. The authorities also stressed the ambitious renewable power generation goal (70 percent by 2027) and the environmentally responsible policies that are being incorporated to promote sustainability through aquaculture, fisheries development, and circular economy practices—with support from NRBT for finance mobilization. The authorities view enhancing resilience to future natural disasters and economic crises as a priority, learning lessons by drawing from the recent experience of HTHH volcanic eruption and Covid pandemic. In relation to natural disasters, the authorities agree that the effective implementation of the Disaster Risk Management Act is crucial.

E. Improve Economic Data

35. Further efforts are needed to address significant remaining data gaps (Annex V). The data provided to the Fund has some shortcomings that somewhat hamper surveillance. The authorities made some progress in improving the data quality and timeliness. The coverage for data across real, fiscal, external, and monetary sectors is adequate to some extent, however issues with consistency, frequency, and timeliness persist. Addressing these gaps, particularly through the provision of labor market data and a measure of core inflation, could significantly enhance monetary policy advice. Additionally, the introduction of more frequent GDP releases, including expenditure components, and a reconciliation between grants in the Balance of Payments (BoP) and government finance statistics, would bolster the assessment and projection of the real and external sector. To support these efforts, data sharing by relevant ministries should be strictly enforced, and the Statistical Department needs to be adequately resourced.

36. In response to these gaps, ongoing and planned Fund capacity development (CD) initiatives are underway. Support provided to Tonga has already facilitated the resumption of national accounts compilation and recommended steps for enhancing the resilience of the national accounts system, accompanied by extensive desk-based support from PFTAC. National accounts publication has resumed and is expected to return to its former schedule by FY 2025. Future assistance will focus on ensuring the timely publication of a FY 2023 estimate and the implementation of efficiency measures developed in FY 2024. Planned activities for FY 2025 include real sector and external sector statistics, macroeconomic programming and analysis, macroeconomic frameworks, public financial management, and revenue administration, aiming to strengthen Tonga's capacity in economic data management, among other objectives.

Authorities' Views

37. The authorities remain committed to addressing data gaps and improving data quality. They acknowledged IMF staff's Data Adequacy Assessment and highlighted their ongoing efforts including increasing staffing to enhance the capacity of the Statistical Department and strengthen the collaboration with other ministries. They noted the recent progress in enhancing the timeliness for BoP statistics. They expect to continue enhancing economic statistics including reducing the lag in the statistics of International Investment Position (IIP), with ongoing support from IMF TA.

STAFF APPRAISAL

38. Tonga's economic recovery has continued, although medium-term growth prospects remain weak. Economic activity has rebounded post the HTHH disaster, driven by reconstruction efforts, sustained remittances, and a partial recovery in tourism. GDP is projected to accelerate further, largely supported by robust domestic demand, including large public investment projects and a rebound in agricultural output as the effects of El Nino subside. However, frequent natural disasters and the risk of faster emigration of Tongan workers pose challenges to medium-term growth, posing challenges for long-term growth prospects. Rising vulnerabilities in the banking sector pose a downside tail risk.

39. The external position in FY2024 was broadly in line with the level implied by fundamentals and desirable policy settings. Despite sizable remittances and continued recovery in tourist arrivals, the current account deficit is estimated to have widened in FY2024 due to higher import needs for reconstruction-related capital goods. Nevertheless, FX reserves remained adequate, and the overall external position remains strong, supported by official capital transfers.

40. In the near term, an expansionary fiscal stance is deemed appropriate, given the need to expedite reconstruction and protect the most vulnerable. The FY2024 fiscal impulse is expansionary, appropriately supporting the ongoing reconstruction, and it is expected to moderate to mildly expansionary in FY2025. Despite increased reconstruction-related expenditures, the overall fiscal balance is estimated to have remained in surplus in FY2024 at 3.5 percent of GDP, thanks mostly to continued record-high grant inflows. The authorities should consider normalizing spending unrelated to reconstruction, including by limiting the public sector wage bill which is expected to cross the 53 percent limit as share of domestic revenues in FY2025.

41. Over the medium-term, a gradual and credible medium-term fiscal consolidation and additional grant financing commitments are warranted to put debt on a firm downward path. Tonga is assessed as being at high risk of debt distress without additional grant commitments, and sizeable external debt repayments in the coming years would further strain its public finances. Gradual fiscal adjustments over the medium term involving additional revenue mobilization, such as removing tax-inefficient exemptions without increasing the statutory rates and strengthening tax administration. This should be combined with normalizing current expenditures, through restraining the public wage bill and rationalizing other low-priority current expenditures. These efforts are crucial to achieve Tonga's development objectives in a fiscally sustainable manner, together with securing grants in line with historical levels. Enhancing spending efficiency and adhering to the fiscal rule can help guide the much-needed fiscal adjustments while mitigating the impact on growth.

42. The current monetary policy stance is appropriately accommodative as consumer price inflation is expected to stabilize below the 5 percent reference rate. With inflation currently below the NRBT reference rate, the current monetary policy stance is appropriate but if demand-driven domestic inflation pressures resurface coupled with signs of accelerating bank lending, a tightening stance would be warranted by raising the policy rate (i.e., the interest on excess reserves). The forthcoming amendments to the NRBT Act are an opportunity to strengthen NRBT's operational independence and improve the monetary policy framework. The current currency basket-weight system has served Tonga well.

43. The overall banking sector maintains strong capitalization and ample liquidity, however, pockets of vulnerabilities persist. More proactive measures are required to tackle banks' asset quality risks. Given the recent increase in NPLs, the authorities should consider requiring banks to adopt a more conservative provisioning approach and to submit concrete plans for NPL reduction. Overall, systemic risk remains largely contained as the major banks operating in Tonga are well capitalized and represent the subsidiaries of relatively sizeable foreign financial institutions. The NRBT should also enhance its risk-based supervision and broaden its regulatory and supervisory remit to cover NBFIs such as pension funds.

44. Comprehensive structural reforms aimed at enhancing climate resilience and nurturing the private sector are essential to boost Tonga's low growth potential. Stricter enforcement of Building Codes and facilitating relocation of properties to safer grounds would enhance Tonga's disaster-resilience. Reducing gender inequality and augmenting public investment in training and education, will help tackle labor shortages. A strong government-wide drive to accelerate the adoption of digital technologies, notably in public administration, as well as continued efforts to cut red tape, strengthen the AML/CFT framework are also important in this regard. Addressing key macro-critical corruption and governance vulnerabilities is also essential for Tonga's economic development. In this respect, staff welcome the recent appointment of Tonga's first anti-corruption commissioner. Ample resources should be allocated to ensuring production of timely and more reliable macroeconomic statistics for both timely policymaking and strengthened surveillance.

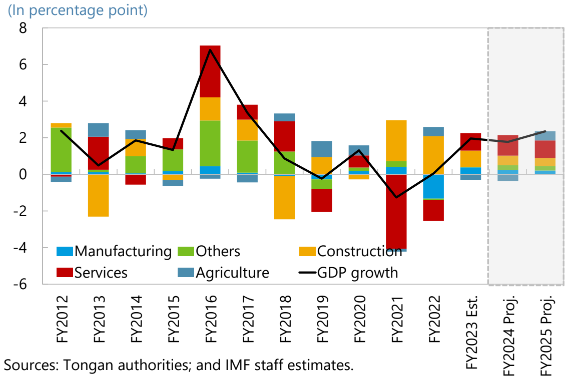
45. It is recommended that the next Article IV consultation for Tonga take place on a standard 12-month cycle.

Figure 1. Tonga: Real Sector Developments

Construction and tourism-related services are leading the recovery.

Contribution to Growth by Sector

(In percentage point)

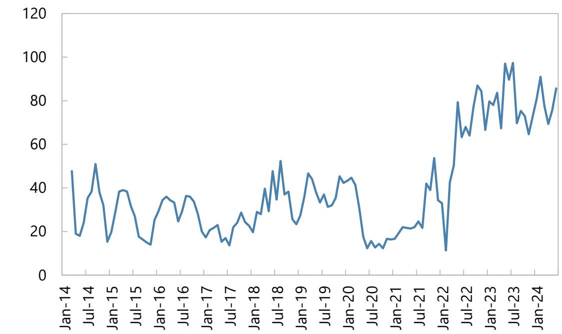


Sources: Tongan authorities; and IMF staff estimates.

The labor market has tightened significantly.

Monthly New Job Vacancy Posting

(Persons, 3-month MA)

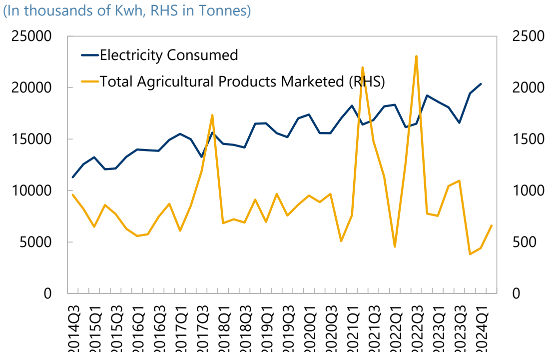


Source: Tongan authorities.

Electricity consumption has been strong, while agricultural production was affected by El Nino.

Agricultural Production and Electricity Consumption

(In thousands of Kwh, RHS in Tonnes)

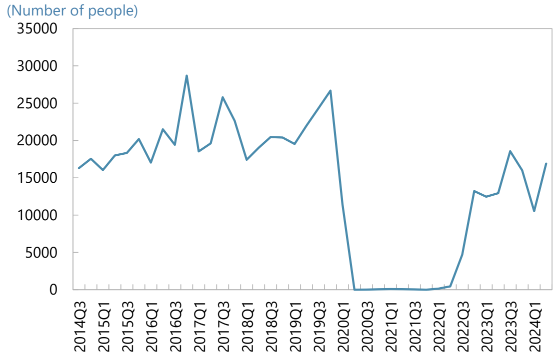


Source: Tongan authorities.

Tourists are returning after border reopening in August 2022.

Tourist Arrival

(Number of people)

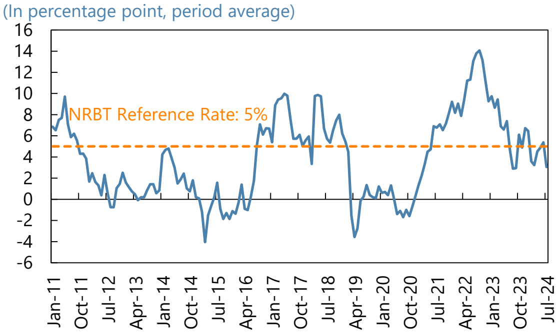


Source: Tongan authorities.

Headline inflation has declined below the NRBT's reference rate…

Consumer Price Index

(In percentage point, period average)

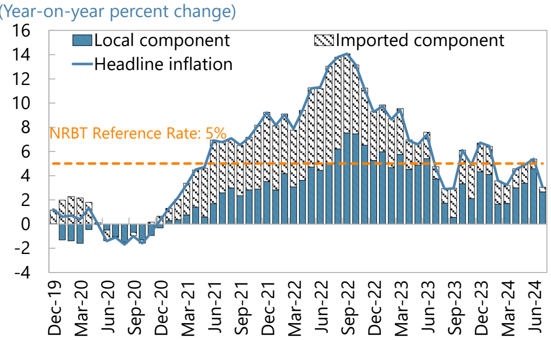


Source: Tongan authorities.

…helped by a decline in import prices.

Contribution to Headline Inflation

(Year-on-year percent change)

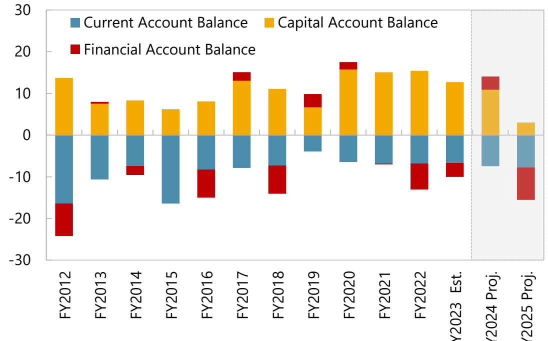


Sources: Tonga authorities; and IMF staff calculations.

Figure 2. Tonga: External Sector Developments

Donors' aids are expected to moderate after FY24.

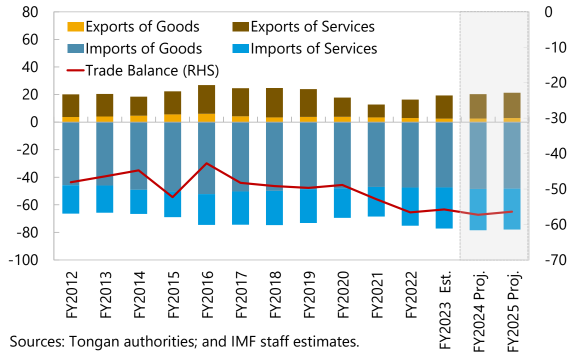
Balance of Payments Forecast
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

Trade deficits remain structurally large driven by imports.

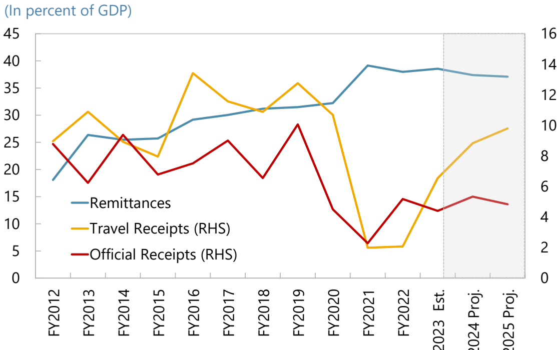
Trade Balance
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

The increase in travel receipts is expected to be partially offset by the moderation in official receipts …

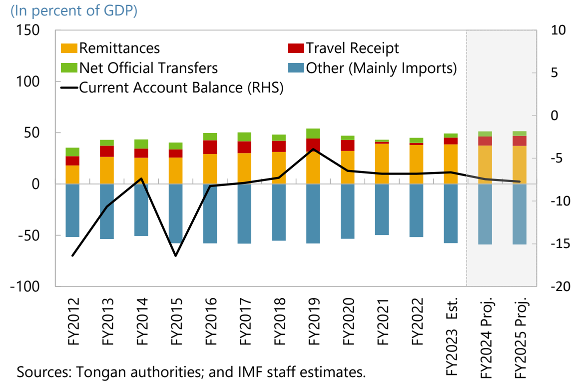
Remittances and Travel Receipts
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

…contributing to a slow narrowing of current account deficits.

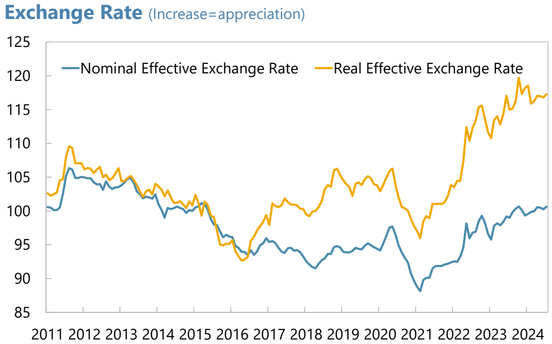
Contributions to Current Account Balance
(In percent of GDP)



Sources: Tongan authorities; and IMF staff estimates.

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

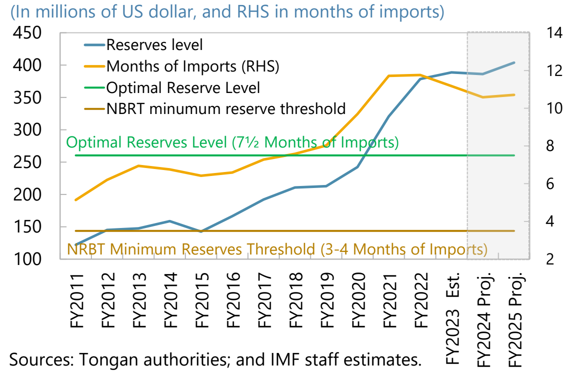
Nominal Effective Exchange Rate and Real Effective Exchange Rate (Increase=appreciation)



Sources: Tongan authorities; and IMF staff estimates.

Reserves are expected to remain more than adequate.

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



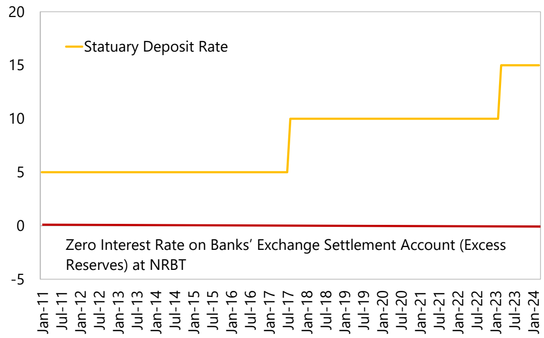
Sources: Tongan authorities; and IMF staff estimates.

Figure 3. Tonga: Monetary Sector Developments

Monetary policy was tightened in February 2023 …

Monetary Policy Instrument

(In percent of total bank deposits)

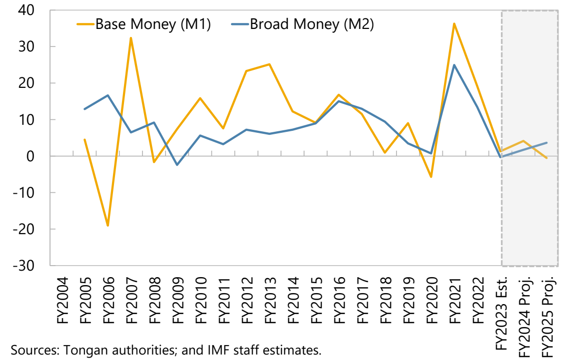


Source: Tongan authorities.

… but the stock of broad money is expected to remain largely unchanged…

Domestic Liquidity

(Year-on-year percent change)

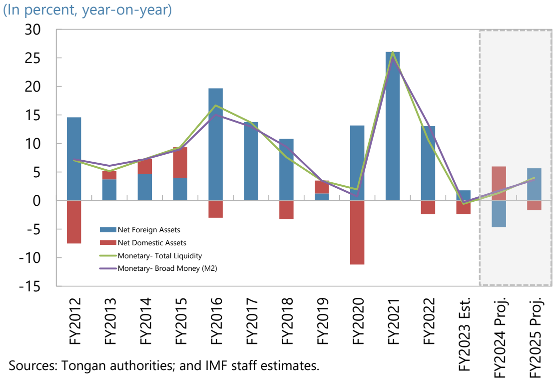


Sources: Tongan authorities; and IMF staff estimates.

…with the expected increase in net domestic assets offsetting the decrease in net foreign assets.

Contribution to Total Liquidity: M3

(In percent, year-on-year)

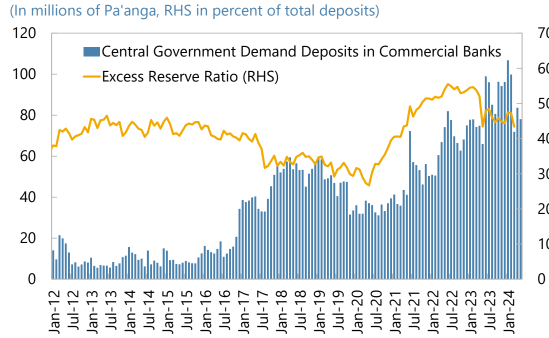


Sources: Tongan authorities; and IMF staff estimates.

The liquidity in the banking system remains high.

Excess Reserve Ratio and Central Government Demand Deposits in Commerical Banks

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

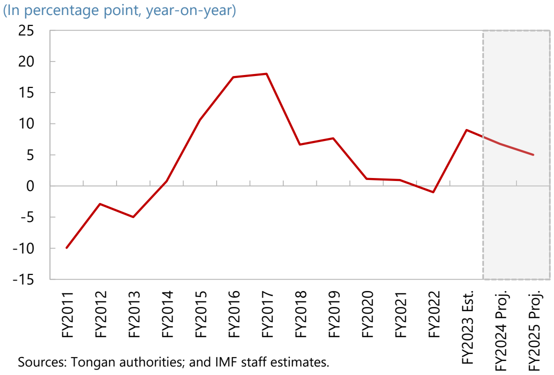


Sources: Tongan authorities; and IMF staff estimates.

Credit to the private sector is picking up.

Credit to Private Sector

(In percentage point, year-on-year)

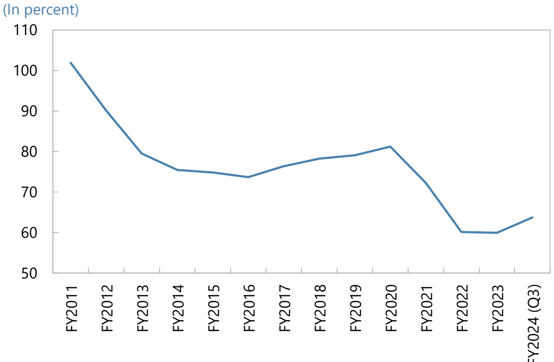


Sources: Tongan authorities; and IMF staff estimates.

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

Loan to Deposit Ratio

(In percent)



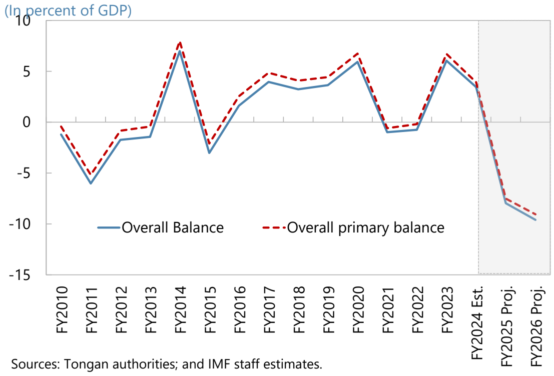
Sources: Tongan authorities; and IMF staff estimates.

Figure 4. Tonga: Fiscal Sector Developments

The primary fiscal balance is expected to deteriorate in FY24 and turn into deficit in FY25.

Overall and Primary Balance

(In percent of GDP)

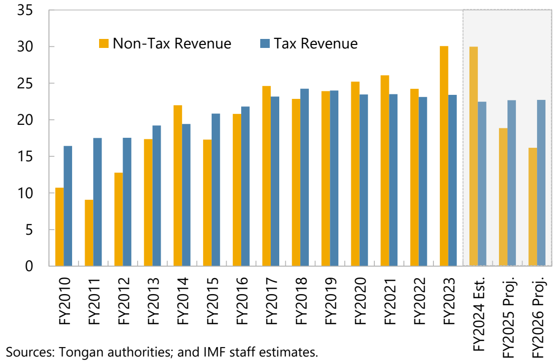


Sources: Tongan authorities; and IMF staff estimates.

Tax revenues are expected to remain stable after a small uptick thanks to tax on international trade…

Tax Revenue

(In percent of GDP)

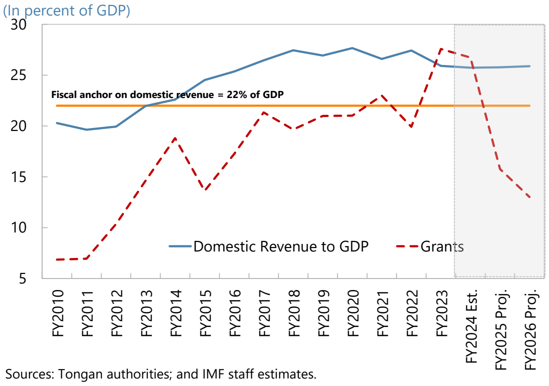


Sources: Tongan authorities; and IMF staff estimates.

… while development partners have stepped up their grant support after the natural disaster, but temporarily.

Revenues and Grants

(In percent of GDP)

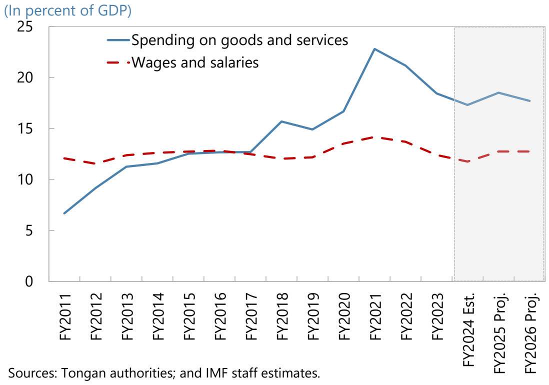


Sources: Tongan authorities; and IMF staff estimates.

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

Current Expenditure

(In percent of GDP)

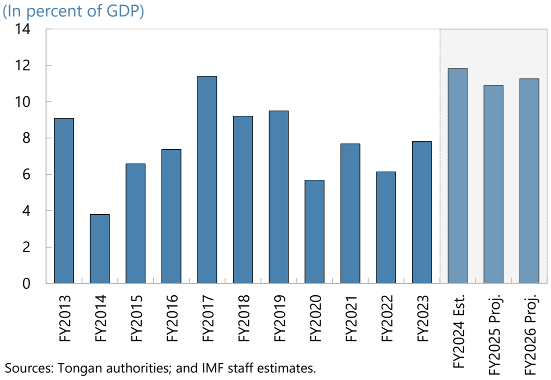


Sources: Tongan authorities; and IMF staff estimates.

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

Capital Expenditure

(In percent of GDP)

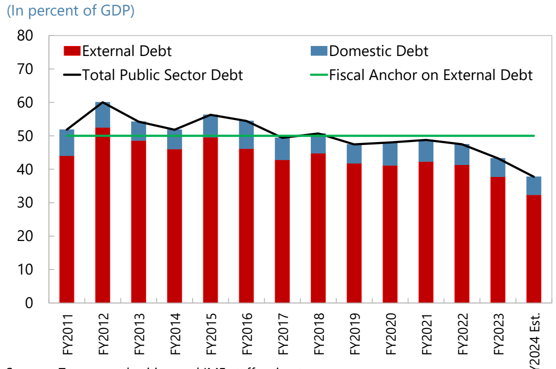


Sources: Tongan authorities; and IMF staff estimates.

Public debt remains low, while external debt remains below the fiscal anchor.

Total Debt and Fiscal Anchor

(In percent of GDP)



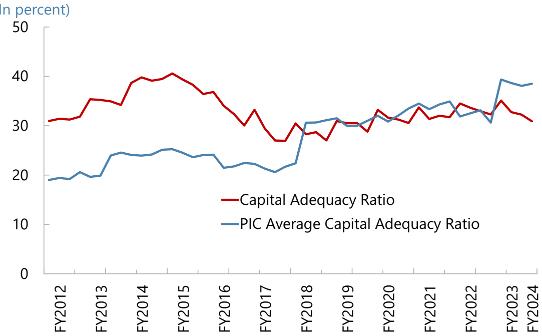
Sources: Tongan authorities; and IMF staff estimates.

Figure 5. Tonga: Financial Sector Developments

Capital buffers are similar to the PIC average.

Capital Adequacy Ratio

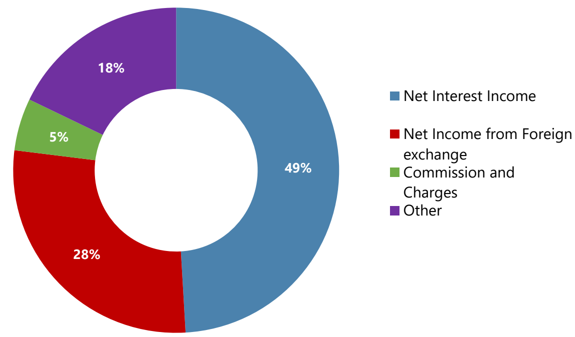
(In percent)



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

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

Financial Sector Operating Income Components in 2023

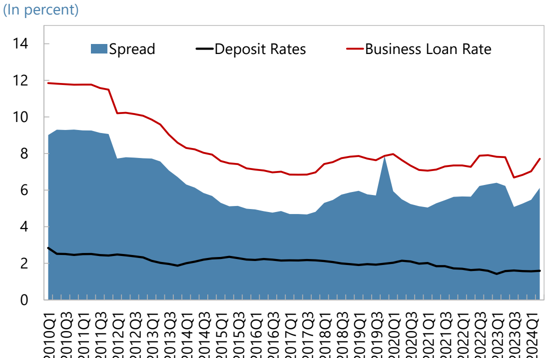


Source: Tongan authorities.

... as interest rate spreads remain wide.

Interest Rates

(In percent)

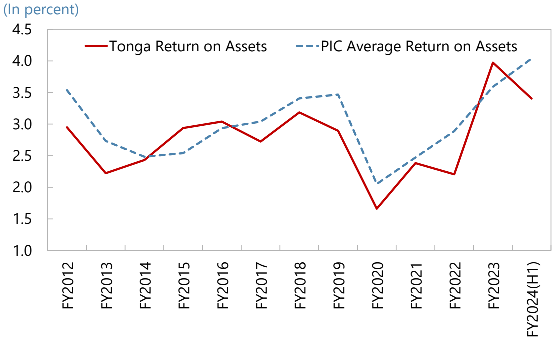


Source: Tongan authorities.

Banks remain profitable but ...

Return on Assets

(In percent)

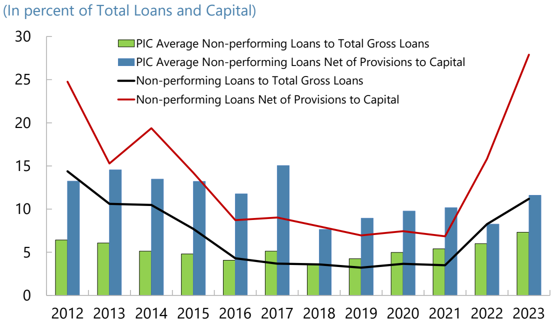


Note: PIC Countries includes Fiji, Micronesia, Papua New Guines, Samoa, Solomon Islands, and Vanuatu.

... NPLs have increased, recently ....

Non-Performing Loans

(In percent of Total Loans and Capital)



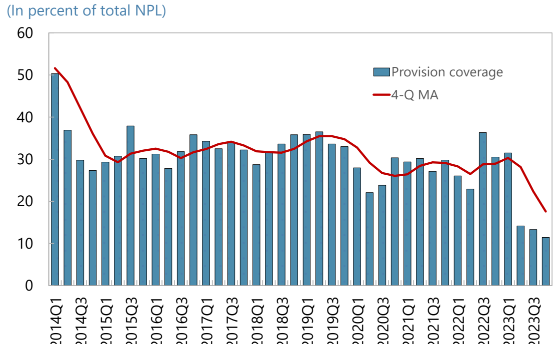
Sources: IMF Financial Soundness Indicators; and IMF staff estimates.

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

...followed by a decline in provision coverage.

NPL Provision Coverage

(In percent of total NPL)



Sources: Tonga authorities; and IMF staff calculations.

Table 1. Tonga: Selected Economic Indicators, FY2021–FY2025 1/ 2/

Population (2021): 100 thousands
Major exports: root crops, vegetables, shellfish, fish

	FY2021	FY2022	Est. FY2023	Projections FY2024	FY2025
Output and prices			(Annual percent change)		
Real GDP	-1.3	0.0	2.0	1.8	2.4
Consumer prices (period average)[3]	1.4	8.5	10.2	4.6	3.2
Consumer prices (end of period)[3]	6.9	11.3	7.4	5.4	3.0
Central government finance			(In percent of GDP)		
Revenue	49.6	47.3	53.5	52.5	41.5
of which: Grants	23.0	19.9	27.6	26.7	15.8
Expenditure	50.6	48.1	47.4	49.0	49.5
Expense	42.9	42.0	39.6	37.2	38.6
Net acquisition of nonfinancial assets	7.7	6.1	7.8	11.8	10.9
Primary balance	-0.6	-0.2	6.7	3.9	-7.5
Overall balance	-1.0	-0.7	6.0	3.5	-8.0
Overall balance (excl. grants)	-24.0	-20.7	-21.5	-23.3	-23.7
Money and credit			(Annual percent change)		
Broad money (M2)	25.0	13.4	-0.3	1.7	3.6
Domestic credit	-8.2	-3.3	-15.6	38.5	6.2
Of which: Private sector credit	1.0	-1.0	9.0	6.8	5.0
Balance of payments			(In millions of U.S. dollars)		
Current account balance	-31.2	-32.4	-34.6	-40.6	-44.1
(In percent of GDP)	-6.8	-6.8	-6.6	-7.4	-7.7
Exports of goods, f.o.b.	16.2	15.1	13.1	12.9	15.4
Imports of goods, f.o.b.	215.4	216.1	235.4	257.6	271.4
Tourism receipts	9.1	9.9	43.9	49.9	55.0
Total remittances	220.8	215.9	256.0	263.1	274.2
(In percent of GDP)	48.2	45.4	49.2	48.2	48.0
Compensation of overseas workers	41.3	35.3	55.3	59.2	62.3
Personal remittances	179.6	180.6	200.6	203.9	211.9
Official grants	10.5	24.6	22.9	29.1	27.6
Capital account balance	69.1	73.2	66.1	59.2	17.2
Financial account balance	0.9	29.5	17.6	-17.5	44.7
Gross official foreign reserves					
In millions of U.S. dollars	320.7	378.5	388.8	386.1	403.9
(In months of next year's total imports)	11.7	11.8	11.2	10.6	10.7
Debt			(In percent of GDP)		
Public debt (external and domestic)	48.8	47.5	43.3	37.8	44.0
Of which: External debt	42.3	41.3	37.8	32.3	38.0
External debt service ratio	0.8	1.5	2.2	3.8	3.6
Exchange rates					
Exchange rate (National currency per US dollar)	2.3	2.3	2.4	...	...
Real effective exchange rate (2010=100; +=appreciation)	107.1	115.7	125.4	...	...
Memorandum items:					
Nominal GDP (millions of US$)	458.6	475.4	520.3	545.4	571.1

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

[1]Fiscal year beginning July 1.

[2] The revisions to historical FY2021-22 data compared to the staff report for the 2023 Article IV consultation reflect recently released data from the authorities.

[3]CPI basket and methodology changed in September 2018.

Table 2. Tonga: Balance of Payments Summary, FY2021–FY2029 1/

			Est.	Projections					
	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029
				(In millions of U.S. Dollars)					
Current account balance	**-31.2**	**-32.4**	**-34.6**	**-40.6**	**-44.1**	**-46.4**	**-46.0**	**-46.4**	**-47.9**
Trade balance	-199.1	-201.0	-222.3	-244.7	-255.9	-261.3	-268.2	-275.8	-284.2
Exports, f.o.b.	16.2	15.1	13.1	12.9	15.4	18.6	20.6	21.7	22.6
Imports, f.o.b.	-215.4	-216.1	-235.4	-257.6	-271.4	-279.9	-288.9	-297.5	-306.8
Services balance	-43.2	-67.9	-67.8	-67.6	-66.0	-64.3	-62.4	-63.0	-63.7
Receipts	41.5	44.5	83.0	92.2	100.5	108.4	115.6	121.1	126.4
Payments	-84.7	-112.4	-150.8	-159.8	-166.6	-172.7	-178.0	-184.1	-190.1
Investment income balance	30.2	25.6	46.2	50.6	50.9	50.0	50.6	51.7	52.8
Receipts	43.8	40.5	64.3	69.7	69.0	69.2	71.1	73.4	75.9
Payments	-13.5	-15.0	-18.1	-19.1	-18.1	-19.3	-20.6	-21.7	-23.0
Transfers balance	180.9	211.0	209.4	221.1	226.9	229.1	234.1	240.7	247.1
Official transfers (net)[2]	8.8	23.5	21.2	27.3	25.7	21.8	22.6	23.4	24.2
Private transfers (net)	172.1	187.5	188.2	193.8	201.2	207.3	211.6	217.3	222.9
Capital account balance	**69.1**	**73.2**	**66.1**	**59.2**	**17.2**	**7.3**	**7.4**	**7.5**	**7.5**
Financial account balance	**0.9**	**29.5**	**17.6**	**-17.5**	**44.7**	**54.4**	**55.7**	**58.7**	**69.3**
FDI (net)	0.4	7.0	8.3	1.4	3.9	4.3	4.7	4.9	5.2
Other investment (net)	4.5	22.5	9.2	-19.1	40.7	49.9	50.9	53.6	64.0
Of which: Loan disbursements	6.6	3.1	9.6	0.0	59.8	68.5	69.0	70.9	75.7
Errors and omissions	29.8	-15.7	-38.9	-3.8	0.0	0.0	0.0	0.0	0.0
Overall balance	**62.2**	**54.8**	**10.3**	**-2.7**	**17.8**	**15.2**	**17.1**	**19.8**	**28.9**
Financing	**-62.2**	**-54.8**	**-10.3**	**2.7**	**-17.8**	**-15.2**	**-17.1**	**-19.8**	**-28.9**
Change in reserve assets (- decrease)	78.2	57.8	10.3	-2.7	17.8	15.2	15.1	15.7	24.8
Use of IMF credit (net)	9.7	0.0	0.0	0.0	0.0	0.0	-2.0	-4.1	-4.1
Disbursement (RCF)[3]	9.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0	2.0	4.1	4.1
Suspended debt service under G20 DSSI[4]	6.4	3.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(In percent of GDP)					
Current account balance	-6.8	-6.8	-6.6	-7.4	-7.7	-7.8	-7.5	-7.3	-7.3
Trade balance	-43.4	-42.3	-42.7	-44.9	-44.8	-43.9	-43.5	-43.2	-43.0
Exports, f.o.b.	3.5	3.2	2.5	2.4	2.7	3.1	3.3	3.4	3.4
Imports, f.o.b.	-47.0	-45.5	-45.2	-47.2	-47.5	-47.1	-46.9	-46.6	-46.5
Services balance	-9.4	-14.3	-13.0	-12.4	-11.6	-10.8	-10.1	-9.9	-9.6
Receipts	9.0	9.4	15.9	16.9	17.6	18.2	18.8	19.0	19.1
Payments	-18.5	-23.6	-29.0	-29.3	-29.2	-29.0	-28.9	-28.8	-28.8
Investment income balance	6.6	5.4	8.9	9.3	8.9	8.4	8.2	8.1	8.0
Receipts	9.5	8.5	12.4	12.8	12.1	11.6	11.5	11.5	11.5
Payments	-3.0	-3.2	-3.5	-3.5	-3.2	-3.2	-3.3	-3.4	-3.5
Transfers balance	39.4	44.4	40.2	40.5	39.7	38.5	38.0	37.7	37.4
Official transfers (net)[2]	1.9	4.9	4.1	5.0	4.5	3.7	3.7	3.7	3.7
Private transfers (net)	37.5	39.4	36.2	35.5	35.2	34.9	34.3	34.0	33.8
Capital account balance	15.1	15.4	12.7	10.9	3.0	1.2	1.2	1.2	1.1
Financial account balance	0.2	6.2	3.4	-3.2	7.8	9.1	9.0	9.2	10.5
FDI (net)	0.1	1.5	1.6	0.3	0.7	0.7	0.8	0.8	0.8
Other investment (net)	1.0	4.7	1.8	-3.5	7.1	8.4	8.3	8.4	9.7
of which : Loan disbursements	1.4	0.6	1.8	0.0	10.5	11.5	11.2	11.1	11.5
Overall balance	13.6	11.5	2.0	-0.5	3.1	2.6	2.8	3.1	4.4
Financing	-13.6	-11.5	-2.0	0.5	-3.1	-2.6	-2.8	-3.1	-4.4
Change in reserve assets (- decrease)	17.1	12.2	2.0	-0.5	3.1	2.6	2.5	2.5	3.8
Use of IMF credit (net)	2.1	0.0	0.0	0.0	0.0	0.0	-0.3	-0.6	-0.6
Disbursement (RCF)[3]	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.6	0.6
Suspended debt service under G20 DSSI[4]	1.4	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Gross official foreign reserves	320.7	378.5	388.8	386.1	403.9	419.1	434.2	449.9	449.9
In months of next year's total imports	11.7	11.8	11.2	*10.6*	*10.7*	*10.8*	*10.5*	*10.9*	*10.9*
Exchange rate									
T$ per U.S. dollar (period average)	2.3	2.3	2.3	…	…	…	…	…	…
T$ per U.S. dollar (end of period)	2.2	2.3	2.4	…	…	…	…	…	…
Nominal GDP (in millions of US$)	458.6	475.4	520.3	545.4	571.1	594.8	616.2	638.4	660.2
Commodity price indexes (2005 = 100)									
Food	114.7	137.9	142.4	133.8	127.3	124.5	124.8	124.9	124.9
Fuel	137.4	241.3	244.5	185.9	180.6	175.2	168.1	162.4	162.4

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

[1] The revisions to historical FY2021-22 data compared to the staff report for the 2023 Article IV consultation reflect recently released data from the authorities.

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

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

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

Table 3. Tonga: Depository Corporations Survey, FY2021-FY2025 1/

	FY2021	FY2022	Est. FY2023	Projections FY2024	FY2025
			(In millions of T$, end of period)		
Net foreign assets	728.6	828.4	843.5	804.3	852.6
Claims on nonresidents	782.0	922.8	988.5	944.6	996.0
NRBT	721.4	878.1	944.0	901.4	951.1
Other depository corporations	60.6	44.6	44.5	43.2	44.8
Liabilities to nonresidents	-53.4	-94.4	-145.0	-140.3	-143.4
NRBT	-43.3	-83.4	-131.2	-131.2	-131.2
Other depository corporations	-10.1	-11.0	-13.8	-9.2	-12.2
Net domestic assets	36.6	18.3	-1.7	48.7	34.3
Net domestic credit	231.3	223.6	188.6	261.3	277.4
Net claims on government	-257.6	-257.0	-325.4	-279.1	-288.2
Claims on public nonfin. corps.	50.3	46.0	35.9	29.3	29.3
Claims on private sector	436.9	432.5	471.3	503.2	528.3
Other items, net	-194.7	-205.3	-190.3	-212.6	-243.0
Total liquidity (M3)	765.2	846.7	841.8	856.9	887.0
Broad money (M2)	723.0	820.0	817.5	831.5	861.7
Narrow money	337.0	401.5	406.8	423.6	421.4
Quasi money	386.0	418.5	410.8	407.9	440.3
FX deposits	42.2	26.7	24.3	25.3	25.2
			(Annual percentage change)		
Net foreign assets	27.7	13.7	1.8	-4.7	6.0
Net domestic assets	0.1	-50.0	-109.2	-2999.9	-29.5
Net domestic credit	-8.2	-3.3	-15.6	38.5	6.2
Claims on private sector	1.0	-1.0	9.0	6.8	5.0
Total liquidity	26.1	10.6	-0.6	1.8	3.5
Broad money (M2)	25.0	13.4	-0.3	1.7	3.6
Memorandum items:					
Nominal GDP (in millions T$)	1041.7	1086.3	1220.3	1299.1	1372.3
Velocity (GDP/M2)	1.4	1.3	1.5	1.6	1.6
T$ per U.S. dollar (end of period)	2.2	2.3	2.3	...	...

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

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

Table 4. Tonga: Summary of Government Operations, FY2022-FY2029 1/

	FY2022	FY2023	Est. FY2024	Projections FY2025	FY2026	FY2027	FY2028	FY2029
				(In percent of GDP)				
Total Revenue	47.3	53.5	52.5	41.5	38.9	37.1	35.5	33.6
Memo: Revenue (excluding grants)	27.4	25.9	25.7	25.8	25.9	25.8	25.8	25.9
Tax revenue	23.1	23.4	22.5	22.7	22.7	22.7	22.7	22.8
Taxes on income/profits	5.1	4.8	4.9	4.9	4.9	4.9	4.9	5.0
Taxes on property	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on goods and services	16.1	16.0	15.1	15.1	15.1	15.1	15.1	15.1
Taxes on international trade and transactions	1.9	2.6	2.4	2.6	2.6	2.6	2.7	2.7
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants[1]	19.9	27.6	26.7	15.8	13.0	11.3	9.7	7.7
Budget support (cash)	6.0	4.4	5.3	4.8	4.0	4.0	4.0	4.0
Other grants	13.9	23.2	21.4	10.9	9.0	7.3	5.7	3.7
Other Revenue	4.3	2.5	3.3	3.1	3.2	3.1	3.1	3.1
Property income	1.1	0.9	0.8	1.0	1.0	1.0	1.0	1.0
Sales of goods and services	0.8	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Total Expenditure	48.1	47.4	49.0	49.5	48.5	47.2	46.2	45.8
Memo: Expenditure (excluding grants in-kind)	38.4	28.7	32.9	38.6	39.5	39.9	40.5	42.1
Expense	42.0	39.6	37.2	38.6	37.2	36.6	36.0	35.7
Salaries and wages	13.7	12.4	11.8	12.8	12.8	12.8	12.9	13.0
Employers' social contribution	1.2	1.0	0.9	1.0	1.0	1.0	1.1	1.1
Interest	0.6	0.7	0.5	0.5	0.5	0.7	0.8	0.9
Of which: External	0.4	0.5	0.3	0.3	0.3	0.4	0.5	0.6
Use of goods and services	21.2	18.4	17.3	18.5	17.7	16.9	16.2	15.7
Subsidies	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants	0.4	1.8	2.3	1.4	0.7	0.6	0.6	0.6
Social benefits	2.4	2.3	2.0	2.1	2.1	2.1	2.1	2.1
Other expense	2.5	2.9	2.3	2.3	2.4	2.4	2.3	2.3
Net investment in nonfinancial assets	6.1	7.8	11.8	10.9	11.3	10.6	10.2	10.0
Buildings and structures	3.9	3.9	8.3	7.8	7.7	7.3	7.0	6.8
Machinery and equipment	1.0	3.6	2.9	2.4	3.0	2.7	2.7	2.7
Other fixed assets and non-produced assets	1.2	0.3	0.6	0.6	0.6	0.6	0.5	0.5
Gross Operating Balance	5.4	13.8	15.3	2.9	1.7	0.5	-0.4	-2.1
Overall balance	-0.7	6.0	3.5	-8.0	-9.6	-10.0	-10.7	-12.2
Primary balance	-0.2	6.7	3.9	-7.5	-9.1	-9.4	-9.9	-11.3
Primary balance excluding grants	-20.1	-20.9	-22.8	-23.3	-22.1	-20.7	-19.7	-18.9
Net acquisition of financial assets	-1.3	6.3	0.2	0.0	0.0	0.0	0.0	0.0
External financing (loans)	-0.5	0.2	-3.5	7.2	8.4	8.6	9.1	10.4
New disbursement	0.7	1.9	0.0	10.5	11.6	11.6	11.8	12.1
Of which : IMF RCF[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which : G20 DSSI	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayment	1.2	1.7	3.5	3.3	3.1	3.0	2.7	1.8
Domestic financing (debt securities)	-0.1	0.0	0.3	0.8	1.2	1.4	1.6	1.8
Memorandum items:								
Nominal GDP (in millions of T$)[3]	1086.3	1220.3	1299.1	1372.3	1441.5	1506.3	1572.8	1640.8
Fiscal anchors[4]								
Compensation of employees								
(in percent of domestic revenue) **< 53**	54.2	51.7	49.2	53.6	53.3	53.7	54.0	54.1
(in percent of current expense) **< 45**	35.4	33.8	34.1	35.7	37.0	37.9	38.7	39.3
Domestic revenue (in percent of GDP) **> 22**	27.4	25.9	25.7	25.8	25.9	25.8	25.8	25.9
External debt (in percent of GDP) **< 50**	41.3	37.8	32.3	38.0	45.1	52.1	59.4	67.9

Sources: Tonga authorities; and IMF staff estimates and projectior

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

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

3 The revisions to historical FY2021-22 data compared to the staff report for the 2023 Article IV consultation reflect recently released GDP data from the authorities.

4 Numbers in bold indicate the thresholds in Tonga's fiscal anchors.

Table 5. Tonga: Medium-Term Baseline Scenario, FY2022–FY2029 1/

		Est.	Projections					
	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029
Output and prices				(Annual percentage change)				
Real GDP	0.0	2.0	1.8	2.4	2.0	1.6	1.4	1.2
Consumer prices (end of period)	11.3	7.4	5.4	3.0	2.9	2.8	3.0	3.0
Consumer prices (period average)	8.5	10.2	4.6	3.2	3.0	2.8	2.9	3.0
Central government finance[2]				(In percent of GDP)				
Total Revenue	47.3	53.5	52.5	41.5	38.9	37.1	35.5	33.6
Memo: Total Revenue (excluding grants)	27.4	25.9	25.7	25.8	25.9	25.8	25.8	25.9
Tax revenue	23.1	23.4	22.5	22.7	22.7	22.7	22.7	22.8
Grants	19.9	27.6	26.7	15.8	13.0	11.3	9.7	7.7
Other Revenue	4.3	2.5	3.3	3.1	3.2	3.1	3.1	3.1
Total Expenditure	48.1	47.4	49.0	49.5	48.5	47.2	46.2	45.8
Memo: Total Expenditure (excluding grants in-kind)	38.4	28.7	32.9	38.6	39.5	39.9	40.5	42.1
Expense	42.0	39.6	37.2	38.6	37.2	36.6	36.0	35.7
Salaries and wages	13.7	12.4	11.8	12.8	12.8	12.8	12.9	13.0
Employers' social contribution	1.2	1.0	0.9	1.0	1.0	1.0	1.1	1.1
Use of goods and services	21.2	18.4	17.3	18.5	17.7	16.9	16.2	15.7
Interest expense	0.6	0.7	0.5	0.5	0.5	0.7	0.8	0.9
Other expense	5.4	7.1	6.7	5.8	5.2	5.2	5.1	5.0
Transactions in Nonfinancial Assets	6.1	7.8	11.8	10.9	11.3	10.6	10.2	10.0
Gross Operating Balance	5.4	13.8	15.3	2.9	1.7	0.5	-0.4	-2.1
Overall Balance	-0.7	6.0	3.5	-8.0	-9.6	-10.0	-10.7	-12.2
Primary Balance	-0.2	6.7	3.9	-7.5	-9.1	-9.4	-9.9	-11.3
Net Acquisition of Financial Assets	-1.3	6.3	0.2	0.0	0.0	0.0	0.0	0.0
External financing (net)	-0.5	0.2	-3.5	7.2	8.4	8.6	9.1	10.4
Domestic financing (net)	-0.1	0.0	0.3	0.8	1.2	1.4	1.6	1.8
Balance of payments				(In percent of GDP)				
Trade balance	-42.3	-42.7	-44.9	-44.8	-43.9	-43.5	-43.2	-43.0
Exports, f.o.b.	3.2	2.5	2.4	2.7	3.1	3.3	3.4	3.4
Imports, f.o.b.	-45.5	-45.2	-47.2	-47.5	-47.1	-46.9	-46.6	-46.5
Services balance	-14.3	-13.0	-12.4	-11.6	-10.8	-10.1	-9.9	-9.6
Investment income balance	5.4	8.9	9.3	8.9	8.4	8.2	8.1	8.0
Transfers balance	44.4	40.2	40.5	39.7	38.5	38.0	37.7	37.4
Of which: Remittances	38.0	38.6	37.4	37.1	36.8	36.3	36.0	35.8
Of which: Official grants	5.2	4.4	5.3	4.8	4.0	4.0	4.0	4.0
Current account balance	-6.8	-6.6	-7.4	-7.7	-7.8	-7.5	-7.3	-7.3
Capital account balance	15.4	12.7	10.9	3.0	1.2	1.2	1.2	1.1
Financial account balance	-6.2	-3.4	3.2	-7.8	-9.1	-9.0	-9.2	-10.5
Gross international reserves (end of period)								
In millions of U.S. dollars	378.5	388.8	386.1	403.9	419.1	434.2	449.9	474.7
In months of next year's goods and services imports	11.8	11.2	10.6	10.7	10.8	10.8	10.9	11.1
External debt (in percent of GDP)								
Public sector external debt	41.3	37.8	32.3	38.0	45.1	52.1	59.4	67.9
Debt service ratio	1.5	2.2	3.8	3.6	3.5	3.4	3.2	2.4
Public sector total debt (in percent of GDP)	47.5	43.3	37.8	44.0	51.9	60.0	68.6	78.6
Memorandum items:								
Private transfers (net, in millions of U.S. dollars)	187.5	188.2	193.8	201.2	207.3	211.6	217.3	222.9
(In percent of imports of goods and services)	57.1	48.7	46.4	45.9	45.8	45.3	45.1	44.9
Commodity price indexes (2005 = 100)								
Food	137.9	142.4	133.8	127.3	124.5	124.8	124.9	124.9
Fuel	241.3	244.5	185.9	180.6	175.2	168.1	162.4	162.4
Nominal GDP (millions of T$)	1086.3	1220.3	1299.1	1372.3	1441.5	1506.3	1572.8	1640.8

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

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

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

Table 6. Tonga: Financial Soundness Indicators, FY2016-FY2023

	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Banks								
Net domestic credit				(Year-on-year percent change)				
Public non-financial corporations	-3.0	-5.9	20.5	15.2	2.4	-18.4	-8.7	-21.8
Private sector	17.5	18.0	6.7	7.6	1.1	1.0	-1.0	9.0
				(In percent of GDP)				
Credit/GDP	42.8	45.2	46.3	48.2	48.6	46.8	44.0	41.6
Private Sector Credit/GDP	37.3	40.5	40.9	42.3	42.6	41.9	39.8	38.6
Public Nonfinancial Corporations/GDP	5.4	4.7	5.4	5.9	6.1	4.8	4.2	2.9
				(In percent)				
Regulatory Capital to Risk-Weighted Assets	34.0	29.4	28.3	30.5	31.6	31.4	33.6	32.8
Return on Assets	3.6	2.7	3.2	2.9	1.7	2.4	2.2	4.0
Return on Equity	15.5	10.7	13.7	10.7	5.7	9.3	9.0	15.9
Non-performing Loans to Total Gross Loans	6.7	4.1	3.6	3.2	4.1	3.3	6.3	10.4
Non-performing Loans Net of Provisions to Capital	13.5	8.8	8.4	6.2	9.1	6.6	12.9	23.8
Liquid Assets to Total Assets	33.5	32.4	27.1	25.6	27.9	40.2	44.6	37.6
Liquid Assets to Short-term Liabilities	65.0	63.3	51.0	49.8	60.2	73.0	76.7	64.2
Large Exposures to Capital	44.6	56.9	49.4	48.0	60.1	55.7	53.7	40.7
Personnel Expenses to Non-interest Expenses	32.3	28.0	29.8	29.5	29.1	31.5	29.5	29.1
Foreign-Currency-Denominated Loans to Total Loans	0.3	1.0	1.4	2.3	0.7	0.7	0.7	0.6
Foreign-Currency-Denominated Liabilities to Total Liabilities	4.7	6.9	5.7	7.1	6.2	6.5	4.3	4.0
Residential Real Estate loans to Total Loans	35.9	41.1	42.4	41.3	41.6	42.6	42.3	38.8
Commercial Real Estate Loans to Total Loans	2.3	2.4	2.5	2.2	2.4	4.2	3.5	4.2
Memorandum Items:								
Nominal GDP (millions T$)	846.3	920.5	970.8	1,012.6	1,016.9	1,041.7	1,086.3	1,220.3

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

Table 7. Tonga: SDGs Mapped to Tonga's Strategic Development Framework (FY2015-2025)

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

Source: Tonga's Voluntary National Review 2019

Annex I. External Sector Assessment

Overall Assessment: Tonga's external position in FY2024 was broadly in line with the level implied by fundamentals and desirable policy settings, based on the results of the IMF's EBA-lite current account model.[1]

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

Foreign Assets and Liabilities: Position and Trajectory[2]

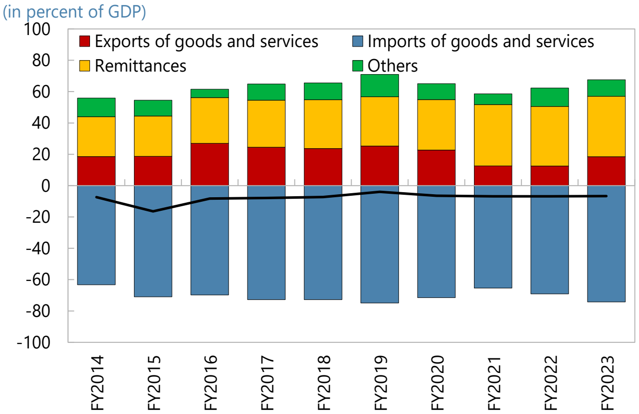
Background. Tonga's debt obligations are largely external, and over half of its external public debt is to China, with a sharp spike in debt repayments due from FY2024 onwards. Total public and publicly guaranteed (PPG) external debt stood at about 38 percent of GDP as of end FY 2023, accounting for 87 percent of total public debt. Outstanding debt to all multilateral creditors stood at about 18 percent of GDP, or about 46 percent of the total external debt stock (Also see Debt Sustainability Analysis).

Assessment. In the near term, the external debt-to-GDP ratio is expected to decline from 37.8 percent in FY2023 to 32.3 percent in FY2024, reflecting large repayments to China Exim Bank. From FY2025 onwards, Tonga will need to incur new external debt to help finance its large spending needs to achieve SDGs and climate resilience. (Also see Debt Sustainability Analysis).

Current Account

Background. From FY2014 to FY2023, Tonga's current account (CA) deficit averaged about 7.8 percent of GDP. For FY2024, private remittance remained strong, and tourist arrivals continue to recover following the border reopening in August 2022. However, imports increased due to continued economic recovery and strong construction activity. Overall, the current account deficit is estimated to have widened from 6.6 percent of GDP in FY2023 to 7.4 percent of GDP in FY2024. The CA deficit is projected to continue to continue to increase in FY2025, reflecting strong imports and the decline in grants and private remittance that are partially offset by the continued tourism recovery.

Current Account Developments
(in percent of GDP)



Sources: Tonga authorities; and IMF staff estimates.

Assessment. The EBA-lite CA model estimates the adjusted CA balance at -8.0 percent of GDP and the adjusted CA norm at -8.0 percent of GDP. With a gap close to 0 percent of GDP, the external position in FY2024 is assessed to be broadly in line with medium-term fundamentals and desirable policies (text table). The policy gap (4.2 percent of GDP) primarily reflects the relatively looser fiscal policy in the rest of the world.

Tonga: EBA-lite Estimates for FY2024 (in percent of GDP)

	CA model 1/ (in percent of GDP)
CA-Actual	**-7.4**
Cyclical contributions (from model) (-)	-0.1
Additional temporary/statistical factors (-)	
Natural disasters and conflicts (-)	0.7
Adjusted CA	**-8.0**
CA Norm (from model) 2/	**-8.0**
Adjustments to the norm (+)	0.0
Adjusted CA Norm	**-8.0**
CA Gap	**0.0**
o/w Relative policy gap	4.2
Elasticity	-0.3
REER Gap (in percent)	**-0.1**

1/ Based on the EBA-lite 3.0 methodology
2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The Tonga pa'anga exchange rate is determined by a weighted-basket of currencies comprising the US dollar, New Zealand dollar, Fijian dollar, Australian dollar, British pound, Japanese yen, and the euro. 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 September 2023. The real effective exchange rate (REER) appreciated by about 2.8 percent on average in July 2023-April 2024, reflecting the appreciation of the nominal effective exchange rate (NEER) by about 2.2 percent and Tonga's higher inflation compared with its major trading partners.

Assessment. The CA gap model implied that the REER gap is close to -0.1 percent (applying an estimated elasticity of the trade balance with respect to changes in the REER of -0.25). However, there is a large uncertainty surrounding our assessment given that: (i) the official BOP data for FY2024 are yet to be published; (ii) the expected changes in grants, tourism receipts, and remittances are unusually large; and (iii) the recent inflation developments are affecting both the current account and the REER.

Capital and Financial Accounts: Flows and Policy Measures

Background. Tonga's recent current account deficits have been largely financed by large capital account credits in the form 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, including longstanding restrictions that prohibit non-residents' ownership in certain sectors. Recent external borrowings have been limited and exclusively on concessional terms, including the IMF's RCF disbursed in FY2021 and FY2023.

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

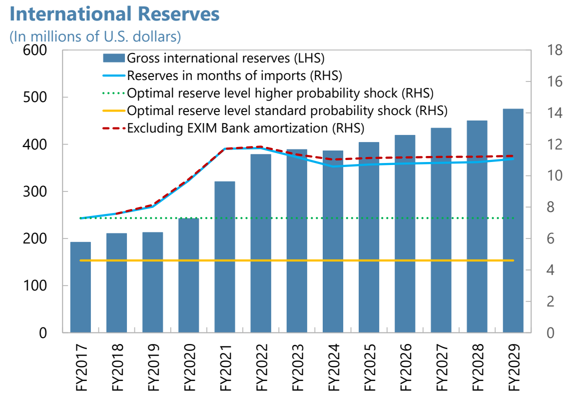
FX Intervention and Reserves Level

Background. Gross official reserves were US$386 million (about 10.6 months of the following year's imports) in FY2024, compared to US$389 million (11.2 months of imports) in FY2023. Reserves remained at a comfortable level due to inflows of foreign grants to help Tonga cope with rebuilding needs, continued remittances inflows, and the tourism recovery. Over the medium term, the pressures to reserve coverage come from moderation in remittances to pre-pandemic levels, lower grants after current commitments are met, and rising debt repayments, while external government borrowings are expected to support reserves. Overall, reserve coverage is projected to remain stable in FY2024 and over the medium term.

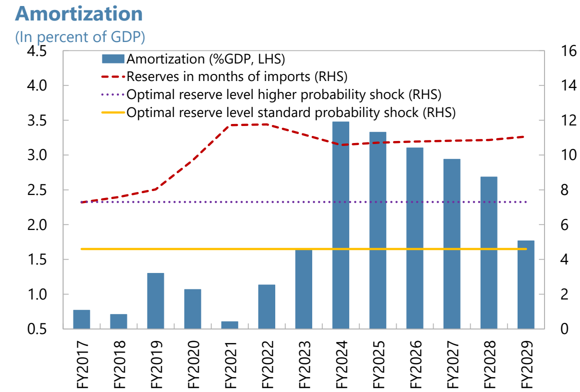
International Reserve Adequacy Metric	FY2024
Actual Reserves (months of prospective imports)	10.6
Optimal level with standard shock probability	4.6
Optimal level with higher shock probability	7.3
Optimal level taking into account debt repayment	8.0
Broad Money coverage	113%

Source: IMF staff estimates.

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



Sources: Tongan authorities; and IMF staff calculations.



Sources: Tongan authorities; and IMF staff estimates.

[1] The external sector assessment is based on staff's estimates.

[2] Data limitations do not allow an analysis of the net foreign asset position (with the latest IIP as of 2021). The assessment in this section is based on Debt Sustainability Analysis.

Annex II. Risk Assessment Matrix[1]

	Source of Risks	Likelihood	Expected Impact	Policy Recommendation
Global	**Commodity price volatility** 1/	High	Medium-High. If prices increase, a larger import bill and current account deficit, leading to lower FX reserves; higher inflation and weaker private consumption due to lower real income; delays in reconstruction or investment projects if wage inflation pressures or construction	Provide targeted fiscal support to the vulnerable. Monetary policy should be tightened using the NRBT's usual monetary policy instruments if strong second-round effects materialize. Prioritize public investment in the most necessary projects. In the long-term, increase public investment to expand the productive capacity.
	Global growth surprises 2/	Medium	Medium. Growth slowdown in major economies could lead to weaker remittance and grant inflows; slower recovery in tourism; lower foreign demand for agricultural products; and lower fiscal revenue. Acceleration in global growth would improve the external conditions of Tonga's economy.	Provide targeted fiscal support to the vulnerable. Improve the private sector business climate and diversify the economy. In the long-term, increase public investment to expand the productive capacity. Accelerate the reforms aimed at broadening the tax base and improving spending efficiency.
Domestic	**Extreme climate events** 3/	High	High. Disruptions in economic activity; lower GDP growth; amplifying inflationary pressures; damages to properties and infrastructure, resulting in lower growth potential; larger fiscal burden and public debts.	Prioritize ex-ante adaptation investment and ex-post expenditure to support the affected households. Strengthen the monitoring of potential asset quality problems in the banking sector. Strengthen fiscal buffers by accelerating reforms to mobilize additional revenues.
	Acceleration of outward migration	High	Medium. Higher inflation pressures owing to tighter domestic labor market; lower long-term growth due to increased difficulties in expanding the narrow domestic production base. Higher	Create economic opportunities by developing the small private sector, attracting FDI, and diversifying the economy. Enhance education and skill development.
	Higher or more persistent inflation	Medium	Medium-High. Loss in real purchasing power as wages adjust with lags, lower consumption; wage-price spiral accompanied with de-anchored inflation expectations, social unrest.	NRBT should stand ready to tighten monetary policy stance using the usual monetary policy instruments. Provide targeted fiscal support to the low-income households.
	Partial withdrawal of CBRs, including due to gaps in the AML/CFT framework	Medium	High. Lower remittance inflows, leading to weaker private consumption and a larger current account deficit.	Strengthen the AML/CFT framework and enhance its implementation, including by implementing a risk-based approach supervision and improving enforcement in line with the Asia-Pacific Group assessment. Pass the MLPCA and Regulation amendments Bill. Consider the region's CBR Roadmap and related World Bank regional project.
	Further increase in non-performing loans (NPLs)	Medium	Medium-high. Lower lending activities or tighter lending conditions, resulting in lower GDP growth.	NRBT should closely monitor the asset quality and strengthen oversight of banks, particularly with high NPL ratios. Consider requesting banks to prepare a comprehensive plan to tackle NPLs, including with a minimum target provisioning level.

1/ Supply and demand fluctuations (e.g., due to conflicts, export restrictions, OPEC+ decisions, and green energy transition) cause recurrent commodity price volatility, external and fiscal pressures in EMDEs, cross-border spillovers, and social and economic instability.
2/ **Slowdown.** Growth slowdown in major economies, including due to supply disruptions, tight monetary policy, or the real estate sector contraction (especially in China), with adverse spillovers through trade and financial channels, and market fragmentation triggering sudden stops in EMDEs. **Acceleration.** Positive supply-side surprises, retreat from protectionism and sanctions, monetary policy easing, productivity gains from AI, and/or stronger performance of large EMDEs increase global demand, promote trade, and ease global financing conditions.
3/ Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.

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

Annex III. Integration Matrix of Surveillance Issues and Capacity Building

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

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

Annex IV. Recommendations from 2023 Article IV Consultation

Sector	Main Recommendations	Actions Since 2023 Article IV Consultation
Fiscal Policies	A combination of domestic fiscal measures and additional donor support is needed to meet large development spending needs while reducing the risk of debt distress.	The authorities pursued additional grants from development partners such as the World Bank, ADB and the government of Australia, reaching record-high levels in FY24.
	The authorities should continue reform efforts to broaden the tax base and improve spending efficiency.	The Electronic Sales Register System regulations were gazetted in June 2022. By March 2023, 54 business across 163 outlets (particularly wholesale and retail outlets) in the two major islands (Tongatapu and Vava'u) have been registered onto the system.
	Manage the scheduled pickup in debt repayment in FY2024.	The government has set up a Debt Repayment Sinking Fund to facilitate timely repayments, including to its largest creditor—China EXIM Bank.
Monetary Policy	Tighten monetary policy stance if inflation is expected to stay above the reference rate for longer.	The NRBT increased the statutory reserve deposit (SRD) ratio from 10 to 15 percent in February 2023, given the more intense and persistent inflation pressures than anticipated in the 2022 Article IV consultation.
Financial Sector Policies	Improve financial supervision and develop macroprudential policy framework	With assistance from the PFTAC, the NBRT is working on developing/reviewing regulatory and supervisory frameworks for non-banking credit institutions and foreign exchange dealers.
	Support credit and promote financial deepening and inclusion	The authorities continue to support lending to micro-, small-, and medium-sized enterprises (MSMEs) and low-income households, including by providing subsidized interest rate loans under the Government Development Loan scheme. Additional schemes are studied in the amendments to the NRBT's Act.
Structural Policies	Enhancing resilience to natural disasters and climate change.	The authorities are implementing reconstruction projects under a comprehensive plan, with 8 out of 20 high-priority projects already completed.
	Developing the private sector to boost Tonga's long-term growth potential.	The authorities are working on promoting digitalization including through ongoing efforts to launch a national digital ID system.
	Continue to reinforce the AML/CFT framework	Tonga has advanced further on updating AML/CFT legislation with LEG technical assistance, which is aimed to address deficiencies identified in the Asia-Pacific Group's Mutual Evaluation Report. The draft amendments to the legal framework and implementing regulations are expected to be submitted to Parliament by the end of the year

Annex V. Data Issues

Table 1. Tonga: Data Adequacy Assessment for Surveillance

Data Adequacy Assessment Rating 1/

C

Questionnaire Results 2/

Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	C	B	C	C	C	D	C

Detailed Questionnaire Results

Data Quality Characteristics						
Coverage	C	B	C	B	C	
Granularity 3/	C		C	C	C	
			C		C	
Consistency			C	C		D
Frequency and Timeliness	C	B	C	C	C	

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.
2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF *Review of the Framework for Data Adequacy Assessment for Surveillance* , January 2024, Appendix I).
3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.

A	The data provided to the Fund is adequate for surveillance.
B	The data provided to the Fund has some shortcomings but is broadly adequate for surveillance.
C	The data provided to the Fund has some shortcomings that somewhat hamper surveillance.
D	The data provided to the Fund has serious shortcomings that significantly hamper surveillance.

Rationale for staff assessment. Overall data provided to the Fund has some shortcomings that somewhat hamper surveillance, partially reflecting the capacity issues for a small island country. Labor market data, however, will help the monetary policy advice complementing the inflation data, coupled with the publication by the authorities of a measure of core inflation. There are significant delays in releasing data on the External Sector, particularly IIP. More frequent GDP releases, including the expenditure components, as well as timely publication of the BOP and IIP, would help assess the current economic conditions. Finally, significant inconsistency in grants exists between the BoP and GFS, and a reconciliation between BoP and in government finance statistics is relevant to improve the external sector assessment and projections. For MFS, there is good bank level data available, but improvements could be made with NBFI data.

Changes since the last Article IV consultation. Tonga Statistical Department has made progress in enhancing the timeliness of the statistics in GDP and BoP.

Corrective actions and capacity development priorities. The authorities should continue their efforts to enhance their statistical capacity, including by enhancing training and ensuring adequate staffing. CD priorities include strengthening statistics on GDP, GFS, the external sector including BOP and IIP, and the monetary and financial sectors.

Use of data and/or estimates different from official statistics in the Article IV consultation. Staff do not use data and/or estimates different from official statistics.

Other data gaps. Labor Market & Gender data (unemployment, employment, labor force participation data by gender, by age), Housing market data, SOE balance sheet data, Excess Reserves at the NRBT.

Table 2. Tonga: Data Standards Initiatives

Tonga participates in the Enhanced General Data Dissemination System (e-GDDS) and first posted its metadata in May 2006 but is yet to disseminate the data recommended under the e-GDDS.

Table 3. Tonga: Table of Common Indicators Required for Surveillance

As of September 12, 2024

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Expected Frequency[6,7]	Tonga[8]	Expected Timeliness[6,7]	Tonga[8]
Exchange Rates	6/2024	8/2024	M	M	D	Q	...	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/2024	7/2024	M	M	M	M	1M	2W
Reserve/Base Money	6/2024	9/2024	M	M	M	Q	2M	6W
Broad Money	6/2024	8/2024	M	M	M	Q	1Q	6W
Central Bank Balance Sheet	6/2024	9/2024	M	M	M	Q	2M	6W
Consolidated Balance Sheet of the Banking System	6/2024	9/2024	M	M	M	Q	1Q	6W
Interest Rates[2]	7/2024	9/2024	M	M	M	M	...	6W
Consumer Price Index	7/2024	9/2024	M	M	M	M	2M	2W
Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4]	2022/23	5/2024	A	A	A	...	3Q	...
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	2022/23	5/2024	A	A	Q	SA	1Q	9-10M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	03/2024	4/2024	Q	Q	Q	A	2Q	1Y
External Current Account Balance	Q4/2023	8/2024	Q	Q	Q	A/Q	1Q	8W/4M
Exports and Imports of Goods and Services	Q4/2023	8/2024	Q	Q	M	Q	12W	4W
GDP/GNP	2022/23	4/2024	A	A	Q	A	1Q	4M
Gross External Debt	2022/23	5/2024	A	A	Q	A	2Q	9-12M
International Investment Position	2021	4/2023	A	A	A	...	3Q	...

[1] Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual.; ("SA") semiannual; ("I") irregular; ("NA") not available or not applicable; and ("NLT") not later than.

[7] Encouraged frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected. For those countries that do not participate in the IMF Data Standards Initiatives, the required frequency and timeliness under the SDDS are shown for New Zealand, and the encouraged frequency and timeliness under the e-GDDS are shown for Eritrea, Nauru, South Sudan, and Turkmenistan.

[8] Based on the information from the Summary of Observance for SDDS and SDDS Plus participants, and the Summary of Dissemination Practices for e-GDDS participants, available from the IMF Dissemination Standards Bulletin Board (https://dsbb.imf.org/). For those countries that do not participate in the Data Standards Initiatives, as well as those that do have a National Data Summary Page, the entries are shown as "..."

Annex VI. Monetary Policy Transmission Mechanism in Tonga[1]

As in many small island nations, in Tonga the transmission of the monetary policy impulse to the economy is weak, hampering the conduct of monetary policy. Filling a gap in the economic literature, this annex investigates the main channels through which monetary policy operates in Tonga and their limitations, quantifies the impact of a change in the preferred National Reserve Bank of Tonga's monetary policy instrument on lending rates, credit volumes, and inflation, and provides implementable policy recommendations to improve the conduct of monetary policy.

Monetary Policy Frameworks' Principles

1. A monetary policy framework encompasses a set of objectives, instruments, and targets that function within an established (either de facto or de jure) decision-making process and are communicated effectively between policymakers and the public. Essentially, such a framework can be viewed as the structural foundation that enables and guides the implementation of monetary policy (Unsal and Papageorgiou, 2023).

2. Central to the efficacy of a monetary policy framework are the instruments used, which must be capable of influencing the target variables directly and predictably. The relation between instruments and targets is, in turn, fundamentally interlinked to the transmission channel of monetary policy, which dictates how changes in policy tools affect the broader economy (e.g., inflation and output). In Pacific Island countries (PICs), monetary policy transmission has unique features that differentiate them from larger, more diversified economies. In particular, given the relatively small size of these economies, their openness to international trade (and, thus, exposure to international goods prices), the relevance of remittances,[2] and the limited development of local financial markets the transmission of monetary policy can have a reduced impact on inflation and economic activity.

Overview of the Monetary Policy Framework in Tonga

3. The stated objectives of the National Reserve Bank of Tonga (NRBT) are maintaining internal and external price stability while supporting economic growth and promoting financial stability.[3] The price stability's objective, in practice, aims at keeping inflation (as measured

[1] Prepared by Krishal Prasad (APD) and Wenchuan Dong (RES) with inputs from Tu-Nhu Dao (APD) for data and analysis.

[2] Consumption is about 120 percent of GDP and 3 times as big as investment in Tonga, thanks to the high flow of remittances.

[3] The National Reserve Bank of Tonga was established in 1989. The NRBT Act 2020 (Revised Edition), states that the principal objectives of the Reserve Bank are to maintain internal and external monetary stability, promote financial stability and promote a sound and efficient financial system. The Reserve Bank should conduct its activities in a manner that supports macroeconomic stability and economic growth.

by the 12-month rate of change in the consumer price index) below a reference rate, which is currently set at 5 percent.[4]

4. External price stability is defined in terms of the stability of Tonga's currency, the Pa'anga (TOP), in the international markets. The current exchange rate arrangement has served as another nominal anchor, while providing a certain degree of flexibility. The de jure and de facto exchange rate arrangement in Tonga is a pegged exchange rate within horizontal bands. The Tongan pa'anga is pegged to a basket of currencies (comprising the US dollar, New Zealand dollar, Fijian dollar, Australian dollar, British pound, Japanese yen, and the euro) with ±5 percent monthly adjustment limit**,** with the US dollars used as intervention currency. There is no limit on how much the Tongan pa'anga can fluctuate against the US dollar. This arrangement has provided a certain degree of flexibility against global events that have affected the value of the US dollar.

5. In the context of Tonga's monetary policy framework, the NRBT operates without a defined operational target for monetary policy, instead anchoring its strategy on the maintenance of the exchange rate regime. This approach places the exchange rate as the nominal anchor, with monetary policy actions being subordinate to the overarching objective of exchange rate stability.

6. In addition to the external nominal anchor, given the relatively underdeveloped interbank market in Tonga, to effectively achieve its objectives within the constraints of this framework, the NRBT predominantly influences domestic monetary conditions through adjustments in reserve requirements (SRD). For instance, in February 2023, the NRBT adopted a tighter monetary policy stance by increasing the SRD from 10 percent to 15 percent.[5] Additionally, since the adoption of a floor system in 2016, an interest rate on excess reserves has functioned as a de facto policy rate, which has remained at zero percent since 2012, however. By adjusting its policy rate, in principle, the NRBT would have the capability to modulate liquidity in the banking system more effectively than by adjusting the reserve requirement rate. However, paying interest on reserves can also entail potential costs to the NRBT, raising pertinent questions regarding its financial sustainability and operational autonomy.

[4] The NRBT lowered the indicative reference rate to 5 percent per annum from 6–8 percent in 2016 to be more consistent with historic inflation rates and better aligned to the medium-term outlook following the recommendation by the Article IV mission.

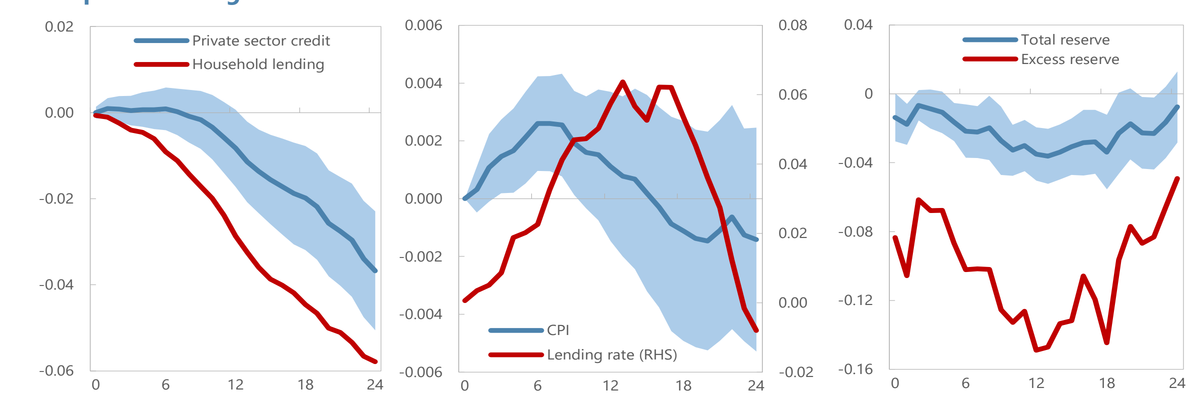
[5] SRD movements historically is as follows: Pre – 2006 the SRD was 15%, SRD reduced to 12.5% effective 3 March 2006, SRD reduced to 10% effective 2 April 2007, SRD reduced to 5% effective 4 August 2009, SRD increased to 10% effective July 2017, SRD increased to 15% effective April 2023.

Tonga's Monetary Policy Transmission Channels and the Effectiveness of the Current Policy Toolkit

7. This section delves into an empirical analysis of the mechanisms through which monetary policy influences the economic landscape in Tonga, focusing specifically on how adjustments in monetary policy parameters affect lending rates and the availability of credit within the country.

8. To assess the effectiveness of using the reservation ratio as tool, this Annex has performed an empirical analysis using Local Projection Methods (Jorda 2005) and monthly data (from 2006m1 to 2023m12), tracing the dynamic response of variable of interest after a 1 p.p. adjustment in the reserve requirement rate (SRD). In addition, a set of control variables, such as lags of CPI and of the dependent variables, remittances (up to 6 lags), the bilateral exchange rate with the US Dollar, international food and energy prices (up to 6 lags) are also used. The variables of interest are selected with the aim of investigating the transmission channel of monetary policy and include: excess reserves, total reserves (sum of required and excess reserves), private sector credit, household and business credit, a lending rate, and CPI. All variables are in logs except for the rates.

The Impact of Changes in the Reserve Ratio



Sources: International Financial Statistics, Natural Reserve Bank of Tonga; and IMF Staff estimations.

Note: the confident interval is 90%. Sample period is 2006 December to 2024 January.

9. Results suggest that after a 1 p.p. increase in the reserve ratio, excess reserves decline immediately and significantly to satisfy the tighter mandatory requirement. Possibly due to a signaling effect and a decline in deposit at commercial banks, total reserves slightly decline, surprisingly.

10. The impact on private credit volumes is, in fact, delayed. The decline in total price credit becomes significant only after 12 months, driven by a decline in lending to households (whose decline starts earlier, after about 6 months). Interestingly, the decline in credit does not appear to be driven by a significant increase in lending rates but by a curtailment of lending volumes. The response of the lending rate, in fact, is very modest (a few basis points), not very precisely estimated, and not very robust to changes in the empirical specification. Similarly, the impact on CPI inflation is mostly muted, even after controlling for international commodity prices. Consumer price inflation starts to recede only after 6 months (after the CPI peaks).[6] Since the regressions control for international commodity prices and for the exchange rate, the initial increase in consumer prices might be related to a lack of central bank credibility in fighting inflation effectively over the sample period selected or could simply be a short sample issue.

11. Overall, results suggest that the use of the reserve requirement as monetary policy tools has various limitations: its impact on lending rate and inflation appear modest at best. Furthermore, the presence of sizeable excess reserves can significantly reduce the SDR effectiveness as banks would simply shift the excess reserves into the mandatory reserve category.

Policy Recommendations

12. Given the observed dynamics between reserve requirements, credit availability, and lending rates, the following policy recommendations are proposed to enhance the effectiveness of monetary policy and support economic stability and growth:

i. **Establish an interest rate corridor:** The NRBT should work towards using the already established interest rate corridor to guide market interest rates more effectively and align them with the NRBTs policy objectives. This strategic move will significantly enhance the NRBT's influence over price stability through critical financial channels, including credit, interest rates, and exchange rates, while simultaneously providing a structured approach for the macroeconomic supervision of Tonga's economy. Although the current structural liquidity surplus does not necessitate immediate absorption of excess reserves, given the lack of inflation or excessive credit growth indicators, implementing an interest rate corridor could preemptively mitigate potential future imbalances.

ii. **Review of the indicative reference rate:** The NRBT has taken a commendable step by adjusting the indicative inflation reference rate to 5% per annum, down from the prior 6-8%, aligning more closely with historical inflation rates and the medium-term economic outlook as highlighted in the Article IV missions. This move is a proactive measure towards anchoring inflationary expectations and enhancing monetary policy transparency. It is recommended that the NRBT implements a regular review process for the reference rate, ensuring it remains relevant against evolving economic conditions. The reserve bank could redefine its preferred inflation measure by focusing on a core measure, that excludes volatile energy and food prices which are largely beyond monetary policy's control. Additionally, clear communication regarding short-term deviations due to unforeseen shocks, along with a thorough public explanation of any future adjustments to the reference rate, is essential. These actions will support the NRBT in effectively managing inflationary pressures, maintaining the credibility of its monetary policy framework, and upholding public and market confidence.

[6] Similar results are obtained using domestic goods inflation which suggest that the initial increase in CPI is not driven by omitted variables such as import prices.

iii. **Enhanced and effective communication strategy:** To enhance the effectiveness of monetary policy transmission and foster greater economic stability in Tonga, it is recommended that the NRBT commits to a policy of transparent communication and forward guidance regarding its policy intentions. This commitment necessitates building credibility and trust through consistently delivering on the NRBT's promises, demonstrating accountability, and actively engaging with stakeholders to understand their feedback and concerns. Moreover, the publication of economic forecasts and thorough explanations of the NRBT's policy rationale will play a pivotal role in relying its operations and decisions for the broader public. It is also crucial for the NRBT to invest in public education about its role and mandate, ensuring that its objectives are clearly understood. Embracing modern communication tools, including social media and technology, will allow the NRBT to reach a wider audience and foster a more inclusive dialogue. Additionally, being attentive to market signals and willing to adjust policies in response are essential for maintaining policy relevance and effectiveness. To underscore its commitment to transparency, all policy decisions approved by the NRBT's Board should be promptly announced on its website following policy meetings. This approach to transparency and engagement is not merely procedural but fundamental to the successful implementation and public reception of the NRBT's monetary policy efforts.

Conclusion

13. **While adjusting the mandatory reserve ratio offers a basic mechanism for influencing inflation and economic activity, its effectiveness is hampered by sticky lending rates and the presence of sizeable excess reserves**. A more sound monetary policy instrument is a policy rate (at which reserves at the central bank are exchanged) which, however, typically requires the development of interbank market. Issuing domestic government debt that can be used as collateral in the interbank market (and is readily exchangeable with the central bank) would increase interbank liquidity. Even in absence of liquid interbank market, however, adjusting the interest rate floor on excess reserves would be a potent signaling device. Also, by influencing the relative attractiveness of lending versus idle reserves, it can more directly impact lending rates. Paying interest on reserves, however, can also entail potential monetary costs to the NRBT, raising pertinent questions regarding its financial sustainability and operational autonomy that should be firstly clarified in the NRBT Act.

Annex VII. Fiscal Rules in Tonga[1]

1. Since 2017, Tonga has implemented a fiscal rule enshrined within its Budget Statement to ensure medium-term fiscal sustainability. The fiscal rule comprises four key fiscal anchors (Table).[2] Two expenditure-related anchors specify that compensation for public employees (i.e., the public wage bill) should be less than 53 percent of domestic revenue and less than 45 percent of current expenses. The third anchor is a revenue rule, mandating that domestic revenue should exceed 22 percent of GDP. The final anchor is a debt rule, stipulating that external debt should remain below 50 percent of GDP. The compensation for public employees as a percentage of domestic revenue was initially set at 50 percent. However, following Tropical Cyclone Gita in 2018, the rule was eased to 53 percent.

Fiscal Rules in Tonga

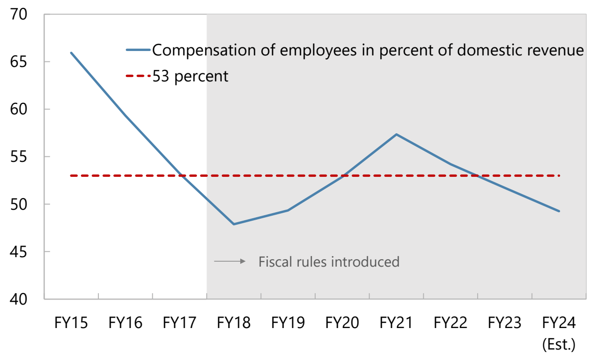
		Percent
Expenditure Rules		
Compensation of employees in percent of domestic revenue	<	53
Compensation of employees in percent of current expense	<	45
Revenue Rule		
Domestic revenue in percent of GDP	>	22
Debt Rule		
External debt in percent of GDP	<	50

2. Tonga has generally adhered to the fiscal rule's limitations despite recent shocks. Since its introduction, the public wage bill to current expense ratio and external debt as a percentage of GDP have remained below their respective thresholds, while domestic revenue has consistently surpassed the target (Text Chart). However, the fiscal rule was breached in FY 2021 and FY 2022, with the public wage bill exceeding 53 percent of domestic revenue. This deviation stemmed primarily from a 6.8 percent increase in nominal compensation coupled with a 1.5 percent decrease in nominal domestic revenue in FY 2021. While revenue recovery in FY 2022 partially rectified the breach, a further improvement is anticipated in FY 2024 due to a projected 0.7 percent increase in nominal compensation and a 5.7 percent increase in domestic revenue. However, as discussed in the main text report, the 15 percent increase in compensation of employees budgeted for FY 2025 would lead to a breach in FY 2025 and beyond.

[1] Prepared by Xuehui Han (APD) with helpful comments from Gemma Preston (FAD).

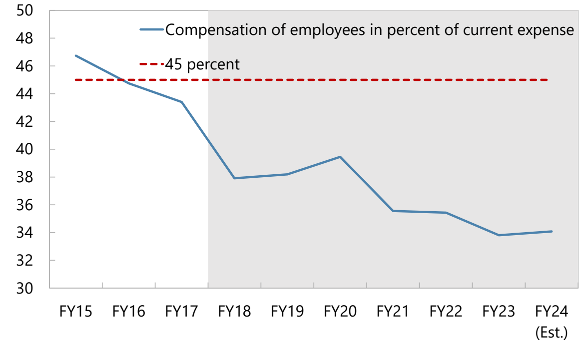
[2] The current set of fiscal rules on debt, domestic revenue, and the wage bill were formally established as part of a DPO Prior Action in 2017 (P159262). While the rule in maintaining remuneration costs lower than 45 percent of operating expenditure has always been stated by the government prior to 2017, the rule on wage bill as a share of domestic revenue was subsequently added in 2017. There is also a liquidity buffer that requires cash balances to be at least a month of recurrent expenditures.

Ratio of Compensation of Employees to Domestic Revenue
(Percent)



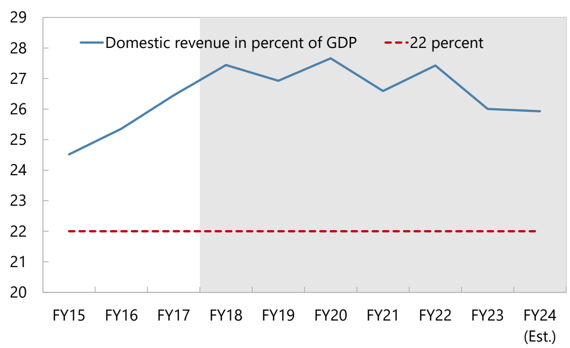
Sources: Tonga authoriteis, and IMF staff estimates.

Ratio of Compensation of Employees to Current Expense
(Percent)



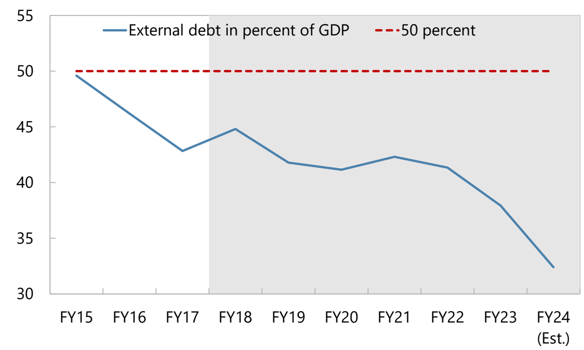
Sources: Tonga authoriteis, and IMF staff estimates

Domestic Revenue
(Percent of GDP)



Sources: Tonga authoriteis, and IMF staff estimates

External Debt
(Percent of GDP)



Sources: Tonga authoriteis, and IMF staff estimates

3. **The fiscal rules have helped maintain debt sustainability in Tonga**. Since its implementation, domestic revenues have consistently exceeded the 22 percent threshold (Figure) mitigating occasional breaches in the public sector wage bill target (remaining below the 53 percent threshold for 5 out of seven years). Overall, the fiscal rule has contributed to containing fiscal deficits and a steady decline of external debt as a percentage of GDP, ameliorating debt sustainability. The compensation of employees as a percentage of domestic revenue is the most effective anchor, as assessed by the outcomes of the past seven years, because the decline in external debt to GDP paused when the rule was breached. The government has been actively seeking further improvements to the fiscal rule framework with assistance from development partners such as the World Bank and IMF.

4. **Several areas offer opportunities to strengthen the effectiveness of Tonga's fiscal rule**. First, clearly articulate the rationale how the threshold of 53 percent for employee compensation as a percentage of domestic revenue was established.[3] Second, strengthen enforcement, by specifying

[3] Especially because the wage bill threshold was set at 50 percent of domestic revenues, initially, in 2017.

actions triggered by breaches of fiscal anchors. This could include automatic spending adjustments or revisions to future budgets. Additionally, explore the need for legal or policy safeguards to guarantee rule implementation. Third, improve institutional processes, focusing on strengthening revenue collection mechanisms and enhancing procurement processes with transparency and efficiency, and promote timely and accurate fiscal reporting and accountability mechanisms. Consider establishing a fiscal council to provide independent oversight and analysis. Fourth, introduce an escape clause that is automatically triggered with clearly defined expiration criteria. Finally, enhance credibility and transparency by leveraging the Medium-Term Fiscal Framework (MTFF) for setting wage limits based on projections of other variables and objectives related to deficit and debt reduction. Provisions for controlling the wage bill through Public Financial Management (PFM) reforms can be considered. This could involve implementing stricter hiring guidelines or performance-based compensation structures.

5. Beyond the current fiscal rule framework, future revisions should address the drawbacks of the current system. Specifically, the current wage rule does not incentivize savings from windfall revenues or promote revenue-increasing measures, which can lead to structural spending increases. To improve this, the framework should address its procyclical bias by trying to adjust for the business cycle and, especially, fluctuations in grants. Furthermore, a focus on total current expenditure (rather than just wages) would prevent the potential for circumventing the wage bill limit by offering alternative compensation schemes. Finally, given Tonga's vulnerability to natural disasters, consider incorporating provisions for building fiscal buffers to manage climate-related and disaster-related shocks in the medium to long term. By implementing these recommendations, Tonga can further strengthen its fiscal rule framework, enhance its effectiveness in ensuring long-term fiscal sustainability, and build resilience to external shocks.

INTERNATIONAL MONETARY FUND

TONGA

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 10, 2024

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

CONTENTS

FUND RELATIONS

(As of September 11, 2024)

Membership Status: Joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	13.80	100.00
Fund holdings of currency	10.36	75.1
Reserves tranche position	3.44	24.9

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	19.81	100.00
Holdings	18.86	95.23

Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
RCF Loans	13.80	100.00

Latest Financial Arrangements:

Outright Loans

Type	Date of Commitment	Date Drawn/Expired	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
RCF	Jul 15, 2022	Jul 19, 2022	6.90	6.90
RCF	Jan 25, 2021	Jan 27, 2021	6.90	6.90

Projected Payments to the Fund[1]

(SDR million; based on existing use of resources and presenting holdings of SDRs)

	Forthcoming				
	2024	2025	2026	2027	2028
Principal			0.69	1.38	2.76

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Charges/Interest	0.01	0.04	0.04	0.04	0.04
Total	0.01	0.04	0.73	1.42	2.80

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Catastrophe Containment and Relief: Not applicable

Exchange Arrangement

The currency of Tonga is the Tongan pa'anga. The de jure and de facto exchange rate arrangement is a pegged exchange rate within horizontal bands. The external value of the pa'anga is determined on the basis of a weighted currency basket comprising the U.S. dollar, New Zealand dollar, Fijian dollar, Australian dollar, British pound, Japanese yen, and the euro. The basket weights are determined based on the proportions of trade with trading partners. The exchange rate of the pa'anga in terms of the U.S. dollar, the intervention currency, is fixed daily by the National Reserve Bank of Tonga (NRBT) within a band of ±5 percent a month." Tonga has accepted the obligations of Article VIII, Sections 2(a), 3 and 4 of the IMF's Articles of Agreement, and maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

Safeguards Assessment

A first-time safeguards assessment of the NRBT completed in December 2021 found some key elements of the safeguards framework in place, including a tailored legal framework, external audits by an international firm, transparent financial statements, and basic operational controls. However, the prolonged absence of a functioning internal audit mechanism created a hiatus in the governance framework, exacerbated by vacancies at the Board-level. Since then, the Board has been fully reconstituted and reinstated their commitment to implement safeguards assessment recommendations, including through approving an audit committee charter and an external auditor selection policy. Oversight of external audit has also been strengthened. Going forward, the NRBT should continue to advance priority safeguards assessment recommendations, including drafting amendments to the NRBT Act to strengthen the autonomy of the NRBT (for which technical assistance was requested), outsourcing audits of high-risk areas, and establishing a business continuity plan.

Article IV Consultation

Tonga is on a 12–month consultation cycle. The previous Article IV consultation was concluded on October 23, 2023 (Country Report No. 23/361) reflecting discussions that took place during July 19-August 1, 2023.

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

Resident Representative: The IMF Regional Resident Representative Office based in Suva, Fiji covers 12 IMF member countries in the Pacific, including Tonga. Mr. Neil Saker is the current Resident Representative.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS AND PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER

Relations with other International Financial Institutions:

- Asian Development Bank:

https://www.adb.org/countries/tonga/main

- World Bank Group:

https://projects.worldbank.org/en/projects-operations/projects-summary?countrycode_exact=TO

Relations with Pacific Financial Technical Assistance Center (PFTAC):

- Pacific Financial Technical Assistance Center:

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

TONGA

October 10, 2024

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION —DEBT SUSTAINABILITY ANALYSIS

Approved By
Lamin Y.M. Leigh, Bergljot Bjornson Barkbu (IMF), and Manuela Francisco and Lalita Moorty (IDA)

Prepared by the staffs of the International Monetary Fund and the International Development Association

Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	High
Overall risk of debt distress	High
Granularity in the risk rating	Sustainable
Application of judgment	Yes. Considering the expected significant breach over the extended projection horizon from FY2034 until FY2044 and the impact of natural disasters on debt dynamics.

The risk of debt distress rating for Tonga remains high.[1] *Before the pandemic, Tonga's indebtedness had gradually declined from FY2015*[2] *to FY2019 owing to much-needed fiscal consolidation. Since 2020, however, the economy has been hit by multiple shocks. In response, the international community has stepped up financial support to Tonga through grants, concessional loans, and debt service suspensions. Thus, the debt increased and remained elevated until FY2023. The public debt-to-GDP ratio in FY2024 is expected to decline on the backdrop of increased repayment of external debt. The budget deficit is expected to rise sharply in the coming years due to a gradual decrease in grants based on current commitments and continued spending needs for sustainable development goals (SDG) and climate resilience. Debt service payments will remain elevated in FY2025 due to scheduled repayment to the China Exim Bank. Under the baseline scenario, the present value (PV) of the external debt-to-GDP ratio is expected to breach the high-risk threshold starting in FY2034, while the PV of the public debt-to-GDP ratio is also expected to exceed the benchmark in the same year. The breach will continue after FY2034 as both external and public debt continue to rise through the end of the projection horizon in 2044. A tailored, large one-time natural disaster shock would result in a significant deterioration in debt sustainability. To rebuild fiscal buffers and enhance resilience against shocks, measures for stronger revenue mobilization and expenditure rationalization will be essential, together with continued support from external donors consistent with the historical trends.*

[1] The Tonga Composite Indicator (CI) index, calculated based on the April 2024 World Economic Outlook (WEO) and the 2022 Country Policy and Institutional Assessment (CPIA), is at 3.06; hence, Tonga's debt carrying capacity classification remains "strong".

[2] All the figures are computed using fiscal year beginning in July, e.g., FY2023 runs from July 1, 2022, to June 30, 2023.

PUBLIC DEBT COVERAGE

1. **Tonga's public debt includes obligations of the central government and central bank**. The central bank's debt is borrowed on behalf of the government. Local governments do not incur debt, nor do other entities in the general government. As of end-June 2024, other government-guaranteed debt was small, about 1.2 percent of GDP. [3] Since the Debt Sustainability Analysis (DSA) coverage does not include debt of state-owned enterprises (guaranteed and non-guaranteed) due to data limitations, an additional 2 percent of GDP is added to the contingent liability test. Contingent liabilities also include a standard 5 percent of GDP cost to the government of a financial crisis, which is above the existing stock of financial sector NPLs.[4] The DSA is conducted on a residency basis. The coverage is appropriate for the DSA but would be enhanced if the debt of SOEs is available.[5]

Text Table 1. Tonga: Public Debt Coverage

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	X
3	Other elements in the general government	X
4	o/w: Social security fund	X
5	o/w: Extra budgetary funds (EBFs)	X
6	Guarantees (to other entities in the public and private sector, including to SOEs)	
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

1	**The country's coverage of public debt**	The general government, central bank			
		Default		Used for the analysis	Reasons for deviations from the default settings
2	Other elements of the general government not captured in 1.	0	percent of GDP	1.0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2	percent of GDP	2.0	
4	PPP	35	percent of PPP stock	0.0	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5	percent of GDP	5.0	
	Total (2+3+4+5) (in percent of GDP)			8.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

BACKGROUND ON DEBT

2. **After years of decline, public debt level has been rising modestly since 2019**. The public debt-to-GDP ratio declined from 55 percent at end-June 2016 to 48 percent of GDP at end-June 2019 (chart)

[3] The government has resumed the publication of the Quarterly Debt Bulletin, supported by the World Bank's FY24 Sustainable Development Finance Policy (SDFP), FY24 PPA1. The government-guaranteed debt is estimated to be about 1.2 percent of GDP at the end of June 2024.

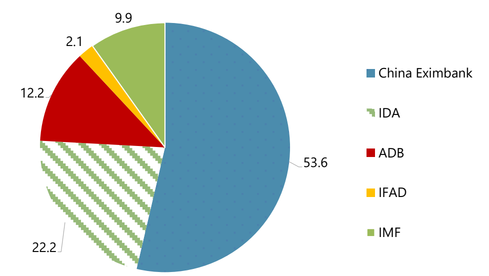
[4] Tonga does not have arrears to external creditors.

[5] The 1 percent other elements of the general government are to capture the $13.9 million government guarantee for private companies. With continued and reliable debt publications on government guarantees, the DSA would consider extending public debt coverage to include guarantees instead of treating it as other elements of the general government.

due to fiscal consolidation since FY2016.[6] The recent increase reflects new issuance of domestic debt and the two concessional emergency loans under the IMF Rapid Credit Facility (RCF) in 2021 and 2022. To contain unfavorable debt dynamics, the government's fiscal anchors (introduced in FY2018) limit total public external debt-to-GDP to a maximum of 50 percent. Tonga has not contracted any external non-concessional loans since FY2011, in line with their debt management strategy.

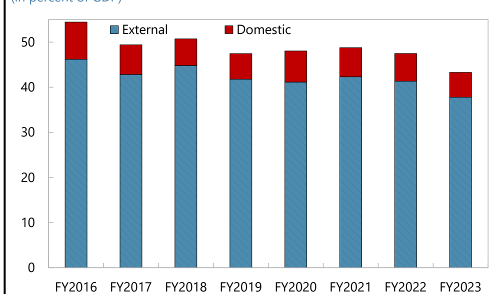
3. Tonga's debt obligations are largely external, and over half of its external public debt is to China, with a sharp spike in debt repayments due from FY2024 onwards. Total public and publicly guaranteed (PPG) external debt stood at USD189 million (about 38 percent of GDP) as of end-June 2023, accounting for 87 percent of total public debt. Outstanding debt to all multilateral creditors stood at USD88 million (about 18 percent of GDP), or about 46 percent of the total external debt stock. The single largest creditor remains the Export-Import Bank of China (China Exim Bank), which accounts for 54 percent of total external debt stock (chart).[7] Tonga started repayments to China Exim Bank in FY2019 with larger repayments coming due starting in FY2024. The spike reflects both the previously extended grace period and the DSSI rescheduling. Tonga's request for a temporary suspension of its calendar year 2020 and 2021 debt service to the China Exim Bank under the G20 Debt Service Suspension Initiative (DSSI) has been accepted and the rescheduled debt repayments are included in the baseline scenario (Text Table 2). Under the DSSI, debt deferral amounts to 1.4 percent of GDP in FY2021 and 0.7 percent of GDP in FY2022.

Outstanding External PPG Debt by Creditor, June 2023
(in percent of total external PPG debt)



Source: Ministry of Finance.

Total Public and Publically Guaranteed Debt
(in percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

4. Tonga's domestic debt obligations are relatively small. Public domestic debt stood at USD29 million (about 5.5 percent of GDP) at end-June 2023, accounting for 13 percent of total public debt. Domestic financial institutions hold about half of the total domestic debt with the rest held mainly by domestic pension funds. The authorities plan to issue new domestic debt in FY2024 and beyond, if necessary.

[6] Revisions to GDP by the Tonga statistical department do not allow full comparability with previous DSA.

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

Text Table 2. Tonga: Repayment Schedule for Existing External Debt, FY2024–34

	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2034
	(In percent of GDP)										
Total external debt	3.5	3.3	3.1	3.0	2.7	1.8	0.9	0.3	0.3	0.3	0.3
Multilateral	0.5	0.6	0.6	0.5	0.5	0.5	0.4	0.3	0.3	0.3	0.3
ADB	0.3	0.4	0.3	0.3	0.3	0.2	0.2	0.1	0.1	0.1	0.1
IDA/WB	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
IFAD 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.3	0.4	0.5	0.4	0.4	0.2	0.1	0.0
Bilateral	3.0	2.8	2.5	2.4	2.2	1.3	0.5	0.0	0.0	0.0	0.0
EXIM Bank of China	3.0	2.8	2.5	2.4	2.2	1.3	0.5	0.0	0.0	0.0	0.0

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

BACKGROUND ON MACROECONOMIC FORECASTS

5. **The assumptions in the baseline scenario are consistent with the macroeconomic framework presented in the Staff Report for the 2024 Article IV consultation.** The underlying structural factors have not meaningfully changed relative to the Staff Report for the 2023 Article IV consultation. The baseline projections reflect the authorities' commitments to undertake reforms to enhance growth and achieve Tonga's climate resilience and SDGs under its Strategic Development Framework (SDF) 2015–2025, which comprise: enhancing trade facilitation and access to credit; building more climate-resistant public infrastructure as envisaged in the National Infrastructure Plan; boosting domestic revenues, including through tax administration reforms and rationalization of tax exemptions; and containing the public sector wage bill within the fiscal target while strengthening social protection and targeted support for the vulnerable.

- **Real GDP growth** is projected at 1.5 percent on average during FY2024–34 (Text Table 3). The economy has resumed activities following the impacts of the double shock in form of COVID-19 and the HT-HH disaster, and recovery continues in FY2024 and FY2025 driven by tourist arrivals, construction projects, and sustained demand. However, the growth in FY2024 is lower than previous projection due to base effects combined with lower agricultural output and some delays in reconstruction. Over the medium to long term, GDP growth is projected to gradually converge to a potential rate of 1.2 percent, underpinned by continued remittances and sizable government development expenditures. Tonga's long-term growth reflects its remoteness and exposure to increasingly frequent natural disasters, persistent loss of workers to emigration, and limited economies of scale due to geographical barriers.

- **The risks to the growth projections are tilted to the downside.** Frequent natural disasters could place additional demands on scarce public resources and increase asset quality risks in the banking sector, while a further loss of correspondent banking relationships (CBRs) in the region due to AML/CFT-related weaknesses could disrupt transfers and remittance flows. The risk of a faster outflows of Tonga workers tilts domestic inflation risks to the upside while weighing on GDP growth. On the upside, tourism could recover faster due to a stronger-than-expected pent-up demand and grants could come stronger than expected.

- **Natural disaster**: The baseline scenario incorporates the effect of natural disasters and climate change mitigation and adaptation over the longer-term, as well as the recent progress in strengthening contingency planning through the ongoing implementation of the Tonga Disaster Risk Financing Strategy 2021 – 2025. Tonga developed an NDC Implementation Roadmap and Investment Plan in 2021 to achieve the targets of its Second NDC. This plan prioritizes mitigation and adaptation actions, specifically targeting the Agriculture, Forestry, and Other Land Use (AFOLU) sectors, waste sectors, Marine Protected Areas (MPAs), and Special Management Areas (SMAs). The plan is incorporated into the baseline and aligned with the Budget Statements. The years FY2024–FY2025 are assumed to be disaster-free to simplify the policy discussion of the near-term outlook. From FY2026 onwards, the baseline incorporates the average long-term effects of natural disasters by lowering annual GDP growth by 0.16 percentage points. These estimates are based on the findings of IMF staff analysis on the impact of natural disasters in Pacific Island countries.[8]

- **Inflation** is projected to average 3.1 percent during FY2024–34 (Text Table 3). Inflation is expected to continue declining in FY2024, reflecting dissipating of supply factors despite a crop failure induced by EL Niño. Afterwards, inflation is expected to gradually decline and converge to 3.0 percent.[9]

- The **non-interest current account deficit** is estimated to have reached 7.1 percent of GDP in FY2024, owing to lower current transfer. In the medium to long term, the non-interest current account deficit is projected to average 6.8 percent of GDP over FY2024–FY2034, reflecting persistent weakness in export competitiveness, continued heavy reliance on imports to support domestic demand, a return of remittances to pre-pandemic levels as share of GDP, and a reduction in official transfer inflows after current commitments are met (Text Table 3). Beyond FY2034, the export-to-GDP ratio is expected to gradually increase, reflecting enhanced competitiveness and productivity in the service sector including tourism due to continued investment in climate resilience and infrastructure and trading partners' growth rates being higher than Tonga's.

- **Net FDI inflows** are expected to stand at 0.7 percent of GDP over FY2024–34.

[8] Lee, D., H. Zhang and C. Nguyen, 2018, "The Economic Impact of Natural Disaster in Pacific Island Countries: Adaptation and Preparedness", the IMF Working Paper No. 18/108. The natural disaster scenario does not include sea level rise.

[9]The downward revision of the long-term inflation forecast from the 2023 DSA primarily reflects the faster-than-expected decline in inflation.

Text Table 3. Tonga: Baseline Macroeconomic Projections
(In percent of GDP, unless otherwise stated)

Current DSA	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2034	FY2013-23 Historical average	FY2024-34 average
Real GDP growth (in percent)	1.8	2.4	2.0	1.6	1.4	1.2	1.2	1.2	1.2	1.2	1.2	1.6	1.5
GDP deflator in US dollars (change in percent)	3.0	2.3	2.1	2.0	2.1	2.2	2.1	2.1	2.1	2.1	2.1	1.0	2.2
Inflation rate (GDP deflator, in percent)	4.6	3.2	3.0	2.8	2.9	3.0	3.0	3.0	3.0	3.0	3.0	4.0	3.1
Non-interest current account deficit	7.1	7.5	7.5	7.0	6.8	6.7	6.7	6.7	6.6	6.4	6.1	7.2	6.8
Net FDI (negative = inflow)	0.3	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	1.1	0.7
Primary deficit	-3.9	7.5	9.1	9.4	9.9	11.3	11.1	11.6	11.8	11.0	9.4	-3.4	8.9
Government revenues	52.5	41.5	38.9	37.1	35.5	33.6	33.1	31.9	31.3	30.8	31.2	46.4	36.1
Government primary expenditure	48.5	49.0	48.0	46.5	45.5	44.8	44.2	43.5	43.0	41.8	40.6	43.0	45.0
Grants	26.7	15.8	13.0	11.3	9.7	7.7	6.9	5.7	5.1	4.5	4.5	20.3	10.1

Previous DSA	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2034
Real GDP growth (in percent)	2.5	2.2	1.6	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
GDP deflator in US dollars (change in percent)	3.6	2.3	2.1	2.1	2.2	2.0	2.2	2.1	2.1	2.1	2.0
Inflation rate (GDP deflator, in percent)	5.8	4.1	3.4	3.2	3.4	3.2	3.4	3.5	3.5	3.5	3.3
Non-interest current account deficit	6.8	7.2	7.3	7.4	7.8	8.2	8.9	8.4	7.8	7.0	6.4
Net FDI (negative = inflow)	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Primary deficit	6.3	8.0	9.0	10.0	11.4	11.7	10.8	10.0	8.2	6.7	5.3
Government revenues	41.6	37.6	35.9	34.5	32.5	31.7	31.2	30.7	30.1	30.3	30.0
Government primary expenditure	47.9	45.7	44.9	44.5	44.0	43.4	42.1	40.6	38.4	36.9	35.3
Grants	17.0	12.9	11.1	9.5	7.5	6.5	5.1	4.5	4.0	4.0	4.0

- **External borrowing**: Except for the IMF's second RCF-supported financing (disbursed in July 2022), new external borrowing is expected to commence in FY2025 and to gradually increase over the medium term to refinance debt repayments coming due and the primary deficit that is expected to reach double digits over FY2029–2033. Even if the authorities were to rely on grants for their budget spending needs, under the baseline scenario, they would still need to borrow externally to meet their existing loan repayments while maintaining sufficient international reserves.[10] The level of international reserves, currently estimated at 10.6 months of next year's imports at end-FY2024, is expected to remain stable in the coming years despite the large repayments to China EXIM Bank that has started since FY2024 (annual payments of about 2.4 percent of GDP in FY2024–29 on average). The government is expected to be able to service the debt without facing a liquidity crunch, as debt repayment peaked in FY2024 and there is a higher-than-expected fiscal surplus in both FY2023 and FY2024. The authorities will continue to seek new concessional and grant financing commitments from bilateral donors and international financial institutions to contain external debt and to refrain from non-concessional borrowing

[10] All lending are assumed for all years in the projection period for which grant finance has not already been committed, consistent with "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf). Tonga, an IDA-only small island economy at high risk of debt distress, receives all IDA financing as grants. Tonga has an IDA20 indicative allocation of SDR 52.2 million (about US$70.0 million), with SDR 9.8 million (US$13.0 million) committed and a remaining balance of SDR 42.3 million (about US$57.0 million). Tonga is eligible to access the Regional Window, Crisis Response Window, and Private Sector Window from the World Bank. World Bank IDA financing will remain fully grants until FY2025, then a mix of grants and loans until FY2028, after which it is fully loans, and the loans remain at a similar level as in FY2026-FY2028. The IDA loans are assumed to be on regular concessional credit terms for small economies. For other multilateral donors, new commitments from 2025 onwards are assumed to be on concessional loan terms. The terms are 40-year maturity, 10-year grace period, 0.75 percent service charge. The discount rate used to calculate the net PV of external debt is the default value set at 5 percent.

(consistent with Tonga's compliance with a non-concessional external borrowing ceiling as part of the World Bank's Sustainable Development Finance Policy, SDFP). This commitment is reflected in the government's medium-term debt strategy, which is being used to guide fiscal policy and debt management decisions. The new public financial management (PFM) legislation, approved by the cabinet, is expected to further improve debt management. Both the debt strategy and PFM legislation are supported by the World Bank's SDFP.[11]

- **Fiscal outlook:** The primary fiscal balance is expected to shift from a surplus of 3.9 percent of GDP in FY2024 to a deficit of 7.5 percent of GDP in FY2025 and then double-digit deficits during FY2029-FY2033 (Table). The surplus in FY2024 was mainly driven by the record-high grant inflow and stronger-than-expected consumption tax and income tax revenues due to strong remittance and a rebound in construction-related business activities. The deficit in FY2025 reflects the normalization of grants from a record-high level. The long-term deterioration is primarily due to lower grant inflows after existing commitments are met (only firmly committed and highly likely grants are included in the projection, LIC DSF Guidance Note ¶37), as well as to sizable spending needs for covering infrastructure gaps and achieving climate resilience and SDGs. At the same time, domestic revenues are expected to improve over time, reflecting the authorities' ongoing efforts in revenue administration and tax arrears collection (see also Staff Report for further details). Public sector wage bills are projected to temporarily drop below the fiscal target of 53 percent of domestic revenue in FY2024 thanks to recovering domestic revenues. The fiscal deficit in percent of GDP is expected to decline after FY2033 as capital spending needs moderate following the completion of the authorities' multi-year reconstruction program and the accumulation of climate-resilient capital over the next decade.

6. **The realism tools indicate that the primary balance projections are reasonable** (Figure 4). The fiscal forecasts between FY2024 and FY2026 are not overly optimistic as the projected three-year adjustment lies in the left section of the distribution of past adjustments of the primary fiscal deficit (Figure 4). The adjustment on the far end of the left section is mainly driven by the elevated grants in FY2024. The real growth forecast for FY2024 reflects a modest growth. The realism of projections for public and private investment rates and their contribution to real GDP could not be calculated due to the unavailability of private investment data. The main driver for external debt changes is current account and FDI and that for public debt changes is primary balance.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

7. **Tonga's debt-carrying capacity applied in the 2024 DSA remains strong**. Tonga's Composite Indicator (CI) index, which has been calculated based on the April 2024 WEO and the 2022 CPIA is 3.06.

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

The current CI score implies "strong" debt-carrying capacity. [12]Thus, Tonga's debt-carrying capacity classification remains "strong".

8. Given the severity and frequency of natural disasters in Tonga, a tailored one-time stress test for natural disaster shocks was conducted.[13] As a small developing state prone to natural disasters, Tonga is automatically subject to the standard natural disaster shock in the DSA. The Emergency Events Database (EM-DAT) shows that the country's largest damage from natural disasters during 1980–2016 was 28.2 percent of GDP. Since only part of the economic damage is expected to be financed by external debt, the DSA assumes a one-off shock of 14 percentage points (ppts) to the debt to-GDP ratio in FY2025. Real GDP growth and exports are lowered by 3 and 7 ppts, respectively, in the year of the shock (Lee et al., 2018). The recently approved Catastrophe Deferred Drawdown Option by the World Bank can help mitigate the impacts of natural disaster shocks.

Text Table 4. Tonga: Composite Indicator and Threshold Tables

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.39	3.44	1.32	43%
Real growth rate (in percent)	2.72	0.79	0.02	1%
Import coverage of reserves (in percent)	4.05	57.96	2.35	77%
Import coverage of reserves^2 (in percent)	-3.99	33.60	-1.34	-44%
Remittances (in percent)	2.02	15.49	0.31	10%
World economic growth (in percent)	13.52	2.91	0.39	13%
CI Score			3.06	100%
CI rating			Strong	

Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintages
Strong	Strong 3.06	Strong 3.05	Strong 3.06

Applicable thresholds

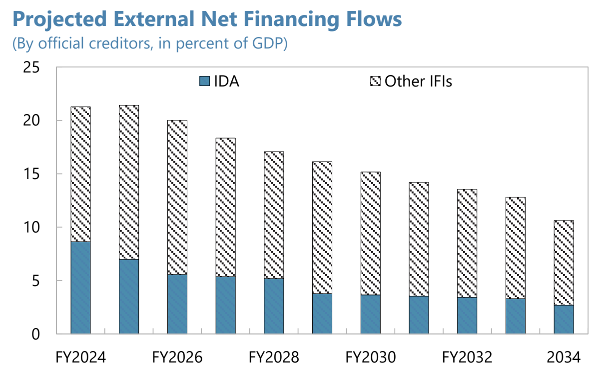
APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	240
GDP	55
Debt service in % of	
Exports	21
Revenue	23

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

[12] The CI must be greater than 3.05 to be assessed as strong.

[13] All the standardized stress tests (i.e., growth shock, export shock, combination shock, historical scenario) are described in Table 8 of the new "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf).

EXTERNAL DEBT SUSTAINABILITY ANALYSIS



Sources: IMF Staff Projections
Note: net financing flows are calculated as grants plus new debt disbursement minus repayment

9. Judgment has been applied to reflect long-run, climate-related risks. Threshold breaches beyond the ten-year horizon for the mechanical signal reflect Tonga's vulnerability to natural disasters and the effects of climate change on debt dynamics.

10. Under the baseline scenario, PV of external debt-to-GDP ratio will breach its threshold starting from FY2034 (Figure 1 and Table 3). In the near term, the external debt--to--GDP ratio is expected to decline from 37.8 percent in FY2023 to 32.3 percent in FY2024, reflecting large repayments to China Exim Bank. From FY2025 onwards, Tonga will need to incur new external debt to help finance its large spending needs to achieve SDGs and climate resilience. As a result, external debt-to-GDP ratio will breach the authorities' fiscal anchor of 50 percent in FY2027. The PV of the external debt-to-GDP ratio is expected to breach the threshold of 55 percent starting from FY2034. Grants surprised to the upside in FY24 remaining at record high levels following the HT-HH disaster. In absence of major shifts in underlying structural factors, this upside forecast revision in grants has shifted the breaching of the threshold by one year from FY2033 (as reported in the 2023 Staff Report) to FY2034. The breach is not a single one-off event as external debt will continue to rise substantially until the end of the projected horizon in FY2044, with high probability in absence of policy corrections (Table 1). Under an export shock, which is the most extreme scenario, the PV of external debt-to-GDP ratio would breach the threshold earlier in FY2032.

11. The tailored natural disaster shock would significantly worsen the external debt path (Table 3). The PV of external debt-to-GDP ratio would jump up in FY2025 when the one-off shock is assumed, breach the threshold two years earlier in FY2032. Given recent experience, there is a significant possibility that multiple severe natural disasters could occur within a ten-year timeframe. Multiple natural disasters could have a larger cumulative negative effect on external debt sustainability due to larger reconstruction needs (which may require additional debt financing) and also by lowering the long-term growth.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

12. Under the baseline scenario, the PV of the public debt-to-GDP ratio would breach 70 percent from FY2034 onwards (Figure 2). The public debt dynamic is driven by large primary fiscal deficit, as shown in Figure 3. Compared to the previous DSA, nominal public debt-to-GDP ratio is lower from FY2024 onward due to higher-than-expected grants committed in FY2024.

13. The standardized sensitivity analysis indicates an earlier breach of debt threshold (Figure 2, Table 4).[14] The most extreme shock scenario is the growth shock, where growth rate is one standard deviation below the baseline for two years starting from 2025. The breach is not a single one-off event as public debt will continue to rise until FY2044 (Table 2). The PV of the public debt-to-GDP ratio would cross 70 percent of GDP in FY2032 under a multi-year GDP growth shock and breach the threshold in FY2032 under an exports shock.

14. The tailored one-time natural disaster shock worsens public debt. The PV of the public debt-to-GDP ratio would cross 70 percent of GDP in FY2032, two years earlier than in the baseline scenario.

15. A tailored stress test for the combined contingent liability shock also causes a deterioration in public debt sustainability. The trajectory of the PV of the public debt-to-GDP ratio shifts upwards by 4 percentage points in FY2034 from the baseline.

RISK RATING AND VULNERABILITIES

16. Tonga's risk of external debt distress is assessed as high. The analysis using the LIC debt sustainability framework (DSF) indicates a "moderate" mechanical risk rating for external debt distress. However, under the baseline scenario, the PV of the external debt-to-GDP ratio is expected to breach its indicative threshold from FY2034 until the end of the projection horizon in FY2044, due to a sustained and persistent increase in the external debt ratio over this period because of high financing needs to address risks from climate change in the long term. As the breaches are expected to be large and persistent, resulting in significant differences relative to historical averages, and occur with a high probability in the absence of a major policy correction, staff applied judgement and assessed the risk rating of external debt distress as "high."

17. The overall risk of debt distress is also assessed as high. The analysis using the LIC DSF indicates a "moderate" mechanical rating. However, the PV of the public debt-to-GDP ratio is projected to breach its indicative benchmark from FY2034 until FY2044, reflecting both large investment needs and decreasing capital grant commitments over this period.[15] Considering the expected significant breach over this extended projection horizon, together with the average long-term effects of natural disasters on Tonga's growth and fiscal position, staff assess the risk rating of the overall debt distress as "high."

18. In the short term, fiscal policy should prioritize reconstruction and protecting vulnerable groups, while containing public sector wages. Fiscal policy should focus on rebuilding and repairs while supporting vulnerable households. On the other hand, current spending, especially the

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[14] Real GDP growth (in USD) is set to its historical average minus one standard deviation or the baseline projection minus one standard deviation, whichever is lower in the second and third years of the projection period.

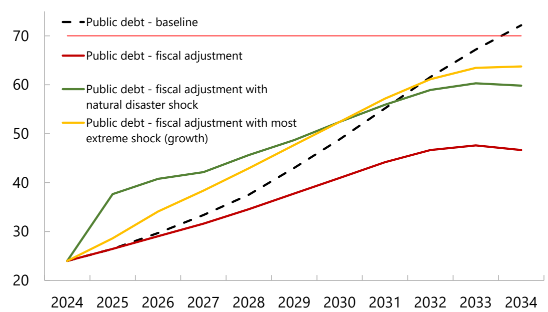
[15] Cash and in-kind grants averaged 16.0 percent of GDP annually over FY2011–2019. Under the baseline, staff assume continued budget support in line with historical levels and capital grants falling to zero from FY2036 onwards.

recurrent portions such as public sector wages and use of goods and services, should be contained to preserve fiscal buffers.

19. A medium-term credible fiscal consolidation and new grant commitments can put Tonga's debt on a sustainable path. Under an illustrative fiscal adjustment scenario, the PV of public debt-to-GDP ratio could stabilize below the 70 percent threshold over the long term, even with the natural disaster or the most extreme shock. The fiscal adjustments could include a modest improvement in consumption tax collection compliance, reductions in tax exemptions, and reductions in current spending. New grant commitments consistent with the historical trends are also essential under this fiscal path to fund capital investment projects for SDGs and climate resilience.[16] The government's strategy to further improve revenue administration, streamline tax exemptions, collect tax arrears, contain public wage bill within the fiscal target, and pursue additional grants from development partners[17] and avoid any new non-concessional borrowing from external creditors is aligned with this fiscal adjustment path and feasible considering Tonga's strong policy track record in the run up to the global pandemic.

Public Debt with Fiscal Consolidations

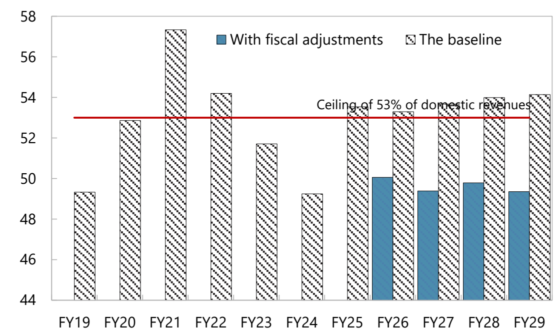
(Present value of public debt in percent of GDP)



Sources: IMF Staff estimates.
Note: The most extreme shock scenario is the growth shock.

Compensation of Employees

(In percent of domestic revenues)



Sources: Tonga authorities; and IMF staff projections.

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

[17] The additional grants are to maintain grants above 10 percent of GDP, with a high probability of materializing, as this is still well below the average of 16.0 percent of GDP annually over FY2011–2019.

Text Table 5. Tonga: Costing of Fiscal Adjustments
(In percentage points of GDP)

	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031	FY2032	FY2033	FY2034
Baseline primary balance	-9.1	-9.4	-9.9	-11.3	-11.1	-11.6	-11.8	-11.0	-9.4
Proposed primary balance	-7.8	-7.5	-7.7	-7.5	-6.5	-6.2	-5.2	-2.7	0.6
Domestic Consolidation needed	1.3	1.9	2.2	2.5	2.6	2.6	3.1	3.8	4.5
Contribution from tax revenue	0.8	0.8	0.8	1.1	1.2	1.2	1.7	2.3	2.7
Improved consumption tax 1/	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.5	0.6
Less tax exemptions 2/	0.5	0.5	0.5	0.8	0.8	0.8	1.3	1.8	2.1
Contribution from current spending	-0.5	-1.1	-1.4	-1.4	-1.4	-1.4	-1.4	-1.5	-1.8
Lower G&S	0.0	-0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.7	-0.8
Lower public sector wage bill	-0.5	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-1.0
Additional Grants 3/	0.0	0.0	0.0	1.3	2.0	2.8	3.5	4.5	5.5

1/ For reference IMF (SR, 2023) estimates that the potential revenue impact from such reform for Tonga at about 6.2 percent of GDP.
2/ For reference IMF (SR, 2021) estimates that an additional 2.5 percent of GDP in tax revenues could be collected by removing various tax exemptions.
3/ The additional grants are to maintain the grants above 10 percent of GDP.

AUTHORITIES' VIEWS

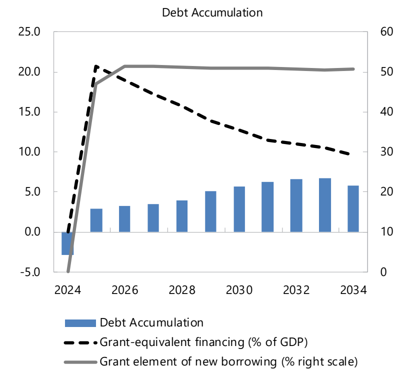
20. **The authorities agreed on the need for fiscal adjustment and emphasized the importance of sustained support from development partners.** They shared the staff's concern regarding the high public sector wage bill, particularly after the increase in FY2025, given the narrow domestic revenue base. However, growing pay differentials with New Zealand and Australia, combined with strong labor demand there, have made it challenging to retain civil servants, thereby putting upward pressure on public sector wages. To address this, they are taking necessary steps to improve consumption tax collections by continuing to roll out the Electronic Sales Register System, upgrading the tax revenue management system, and mitigating wage pressures—including by introducing performance-based assessments, continuing to limit overtime allowances, considering outsourcing some functions, and offering voluntary retirement. The authorities underscored their intention to seek new grant financing from development partners to meet climate resilience and development goals while ensuring that debt remains on a sustainable path.

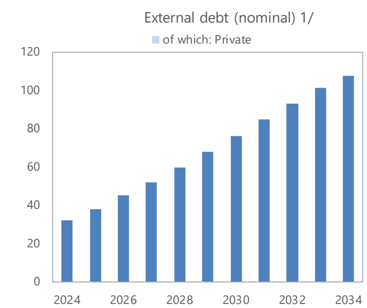
Table 1. Tonga: External Debt Sustainability Framework, Baseline Scenario, FY2021–2044

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2034	2044	Historical	Projections
External debt (nominal) 1/	42.3	41.3	37.8	32.3	38.0	45.1	52.1	59.4	67.9	107.5	139.6	43.4	68.9
of which: public and publicly guaranteed (PPG)	42.3	41.3	37.8	32.3	38.0	45.1	52.1	59.4	67.9	107.5	139.6	43.4	68.9
Change in external debt	1.2	-1.0	-3.5	-5.4	5.7	7.0	7.0	7.3	8.5	6.1	2.6		
Identified net debt-creating flows	5.7	6.8	4.7	7.1	7.7	7.8	7.5	7.3	7.3	6.8	5.9	8.0	7.3
Non-interest current account deficit	6.7	6.4	6.2	7.1	7.5	7.5	7.0	6.8	6.7	6.1	5.2	7.2	6.8
Deficit in balance of goods and services	52.8	56.6	55.8	57.3	56.4	54.7	53.7	53.1	52.7	51.0	48.6	50.1	53.4
Exports	12.6	12.5	18.5	19.3	20.3	21.4	22.1	22.4	22.6	24.1	26.1		
Imports	65.4	69.1	74.2	76.5	76.7	76.1	75.8	75.4	75.3	75.1	74.7		
Net current transfers (negative = inflow)	-39.4	-44.4	-40.2	-40.5	-39.7	-38.5	-38.0	-37.7	-37.4	-36.3	-34.9	-37.4	-37.8
of which: official	-2.3	-5.2	-4.4	-5.3	-4.8	-4.0	-4.0	-4.0	-4.0	-4.0	-4.0		
Other current account flows (negative = net inflow)	-6.7	-5.8	-9.4	-9.6	-9.2	-8.7	-8.6	-8.6	-8.6	-8.5	-8.6		
Net FDI (negative = inflow)	0.1	1.5	1.6	0.3	0.7	0.7	0.8	0.8	0.8	0.8	0.8	1.1	0.7
Endogenous debt dynamics 2/	-1.1	-1.1	-3.1	-0.3	-0.5	-0.4	-0.3	-0.2	-0.1	-0.1	-0.1		
Contribution from nominal interest rate	0.2	0.4	0.5	0.3	0.3	0.3	0.4	0.5	0.6	1.1	1.5		
Contribution from real GDP growth	0.5	0.0	-0.7	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-1.2	-1.7		
Contribution from price and exchange rate changes	-1.7	-1.5	-2.8	...	...	...	...	...	...	...	...		
Residual 3/	-4.5	-7.8	-8.2	-12.5	-2.0	-0.8	-0.5	0.0	1.1	-0.7	-3.2	-9.0	-1.0
of which: exceptional financing	-1.4	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	22.2	18.4	20.4	22.8	25.3	28.2	32.2	55.5	79.0		
PV of PPG external debt-to-exports ratio	...	...	120.3	95.6	100.6	106.6	114.5	126.2	142.9	230.6	302.7		
PPG debt service-to-exports ratio	6.0	12.2	11.7	19.8	17.8	16.2	15.3	14.3	10.5	7.6	15.8		
PPG debt service-to-revenue ratio	2.8	5.6	8.3	14.9	14.0	13.3	13.1	12.4	9.2	6.9	14.6		
Gross external financing need (Million of U.S. dollars)	34.4	44.9	51.5	61.1	67.1	69.3	68.9	68.6	64.8	68.4	110.1		
Key macroeconomic assumptions													
Real GDP growth (in percent)	-1.3	0.0	2.0	1.8	2.4	2.0	1.6	1.4	1.2	1.2	1.2	1.6	1.5
GDP deflator in US dollar terms (change in percent)	4.3	3.6	7.4	3.0	2.3	2.1	2.0	2.1	2.2	2.1	2.1	1.0	2.2
Effective interest rate (percent) 4/	0.4	0.9	1.3	0.9	0.9	0.9	1.0	1.0	1.0	1.1	1.1	1.4	1.0
Growth of exports of G&S (US dollar terms, in percent)	-42.8	3.2	61.3	9.4	10.3	9.5	7.3	4.8	4.3	4.7	3.5	4.0	6.3
Growth of imports of G&S (US dollar terms, in percent)	-5.8	9.5	17.6	8.1	4.9	3.3	3.2	3.1	3.2	3.1	3.4	3.6	3.9
Grant element of new public sector borrowing (in percent)			20.1	...	47.1	51.5	51.3	51.1	50.9	50.8	49.9	...	50.6
Government revenues (excluding grants, in percent of GDP)	26.6	27.4	25.9	25.7	25.8	25.9	25.8	25.8	25.9	26.7	28.3	26.1	26.0
Aid flows (in Million of US dollars) 5/	286.9	269.6	305.3	286.0	240.0	222.7	197.2	173.7	152.3	118.4	118.5	...	
Grant-equivalent financing (in percent of GDP) 6/	23.0	19.9	27.6	...	20.7	19.0	17.2	15.7	13.8	9.6	8.8	...	14.2
Grant-equivalent financing (in percent of external financing) 6/	100.0	100.0	100.0	...	78.8	77.2	75.4	73.2	69.9	65.9	64.5	...	70.7
Nominal GDP (Million of US dollars)	459	475	520	545	571	595	616	638	660	779	1,085		
Nominal dollar GDP growth	3.0	3.7	9.5	4.8	4.7	4.1	3.6	3.6	3.4	3.4	3.4	2.6	3.7
Memorandum items:													
PV of external debt 7/	...	...	22.2	18.4	20.4	22.8	25.3	28.2	32.2	55.5	79.0		
In percent of exports	...	...	120.3	95.6	100.6	106.6	114.5	126.2	142.9	230.6	302.7		
Total external debt service-to-exports ratio	6.0	12.2	11.7	19.8	17.8	16.2	15.3	14.3	10.5	7.6	15.8		
PV of PPG external debt (in Million of U.S. dollars)			115.6	100.5	116.7	135.3	155.9	180.1	212.8	432.5	857.9		
(PVt-PVt-1)/GDPt-1 (in percent)				-2.9	3.0	3.3	3.5	3.9	5.1	5.8	4.6		
Non-interest current account deficit that stabilizes debt ratio	5.5	7.4	9.7	12.6	1.8	0.4	0.0	-0.6	-1.8	0.0	2.5		

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





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g) + \mathcal{E}\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Current-year interest payments divided by previous period debt stock.

5/ Defined as grants, concessional loans, and debt relief.

6/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

7/ Assumes that PV of private sector debt is equivalent to its face value.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

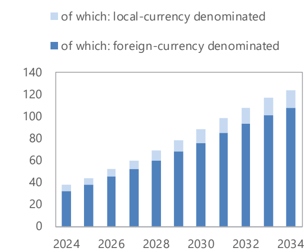
Table 2. Tonga: Public Sector Debt Sustainability Framework, Baseline Scenario, FY2021–2044

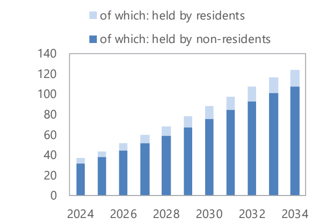
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 6/	
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2034	2044	Historical	Projections
Public sector debt 1/	48.8	47.5	43.3	37.8	44.0	51.9	60.0	68.6	78.6	124.1	161.0	49.5	79.7
of which: external debt	42.3	41.3	37.8	32.3	38.0	45.1	52.1	59.4	67.9	107.5	139.6	43.4	68.9
Change in public sector debt	0.7	-1.2	-4.2	-5.5	6.2	7.9	8.2	8.6	9.9	7.1	3.0		
Identified debt-creating flows	-1.0	0.0	-10.4	-5.0	6.4	8.0	8.3	8.8	10.2	7.6	5.8	-4.2	7.7
Primary deficit	0.6	0.2	-6.7	-3.9	7.5	9.1	9.4	9.9	11.3	9.4	6.1	-3.4	8.9
Revenue and grants	49.6	47.3	53.5	52.5	41.5	38.9	37.1	35.5	33.6	31.2	32.3	46.4	36.1
of which: grants	23.0	19.9	27.6	26.7	15.8	13.0	11.3	9.7	7.7	4.5	4.0		
Primary (noninterest) expenditure	50.2	47.5	46.8	48.5	49.0	48.0	46.5	45.5	44.8	40.6	38.4	43.0	45.0
Automatic debt dynamics	-1.6	-0.2	-3.7	-1.1	-1.1	-1.1	-1.0	-1.1	-1.1	-1.8	-0.3		
Contribution from interest rate/growth differential	0.0	-0.4	-1.4	-1.1	-1.1	-1.1	-1.0	-1.1	-1.1	-1.8	-0.3		
of which: contribution from average real interest rate	-0.6	-0.4	-0.4	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	1.7		
of which: contribution from real GDP growth	0.6	0.0	-0.9	-0.8	-0.9	-0.9	-0.8	-0.8	-0.8	-1.4	-1.9		
Contribution from real exchange rate depreciation	-1.6	0.2	-2.4	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	1.7	-1.3	6.2	-0.5	-0.2	-0.1	-0.2	-0.2	-0.3	-0.5	-2.8	2.8	-0.3
Sustainability indicators													
PV of public debt-to-GDP ratio 2/	...	...	28.0	24.0	26.5	29.7	33.3	37.5	43.0	72.3	100.8		
PV of public debt-to-revenue and grants ratio	...	...	52.3	45.7	63.7	76.3	89.8	105.6	128.2	231.9	312.1		
Debt service-to-revenue and grants ratio 3/	5.1	7.7	7.0	9.3	12.3	12.6	15.0	18.2	18.1	25.1	38.2		
Gross financing need 4/	3.1	3.8	-2.9	1.0	12.6	14.0	14.9	16.4	17.3	17.2	18.4		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	-1.3	0.0	2.0	1.8	2.4	2.0	1.6	1.4	1.2	1.2	1.2	1.6	1.5
Average nominal interest rate on external debt (in percent)	0.4	0.9	1.3	0.9	0.9	0.9	1.0	1.0	1.0	1.1	1.1	1.4	1.0
Average real interest rate on domestic debt (in percent)	-1.2	-1.3	-5.8	-1.7	0.3	0.6	0.9	0.5	0.7	0.6	0.5	-2.0	0.5
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.8	0.5	-5.8	...	...	...	...	...	...	...	...	0.3	...
Inflation rate (GDP deflator, in percent)	3.8	4.2	10.2	4.6	3.2	3.0	2.8	2.9	3.0	3.0	3.0	4.0	3.1
Growth of real primary spending (deflated by GDP deflator, in percent)	18.1	-5.2	0.3	5.6	3.4	-0.3	-1.5	-0.8	-0.2	-1.7	1.2	4.4	0.2
Primary deficit that stabilizes the debt-to-GDP ratio 5/	-0.2	1.4	-2.5	1.6	1.3	1.2	1.2	1.3	1.3	2.3	3.1	-0.4	1.6
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

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

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The general government, central bank . Definition of external debt is Residency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

"Other debt creating or reducing flow" is the net acquisition of financial assets.

Table 3. Tonga: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, FY2024–2034

(In percent)

	Projections 1/										
	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
PV of debt-to GDP ratio											
Baseline	18	20	23	25	28	32	37	42	47	52	**55.5**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	18	21	23	26	30	35	40	45	51	**57**	**62**
B. Bound Tests											
B1. Real GDP growth	18	21	25	28	31	35	40	45	51	**56**	**61**
B2. Primary balance	18	22	25	28	31	35	40	45	50	**55**	**59**
B3. Exports	18	25	34	37	40	44	49	54	**60**	**65**	**69**
B4. Other flows 3/	18	25	31	34	37	41	45	50	**55**	**60**	**64**
B5. Depreciation	18	26	20	23	27	32	38	44	50	**56**	**61**
B6. Combination of B1-B5	18	28	32	35	38	43	48	53	**59**	**64**	**68**
C. Tailored Tests											
C1. Combined contingent liabilities	18	23	25	29	32	36	41	46	51	**56**	**60**
C2. Natural disaster	18	26	29	33	36	41	46	52	**58**	**63**	**68**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	55	55	55	55	55	55	55	55	55	55	55
PV of debt-to-exports ratio											
Baseline	96	101	107	114	126	143	160	180	199	217	231
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	96	103	110	120	134	153	173	195	217	239	**257**
B. Bound Tests											
B1. Real GDP growth	96	101	107	114	126	143	160	180	199	217	231
B2. Primary balance	96	106	117	126	140	157	174	194	213	232	**245**
B3. Exports	96	171	**318**	**332**	**357**	**392**	**428**	**469**	**510**	**548**	**575**
B4. Other flows 3/	96	123	145	152	163	180	197	216	235	**253**	**265**
B5. Depreciation	96	101	75	84	96	113	130	150	169	188	201
B6. Combination of B1-B5	96	161	138	218	235	**260**	**285**	**314**	**343**	**370**	**389**
C. Tailored Tests											
C1. Combined contingent liabilities	96	113	119	130	142	160	177	197	216	234	**247**
C2. Natural disaster	96	132	139	155	169	190	210	233	**255**	**276**	**292**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	240	240	240	240	240	240	240	240	240	240	240
Debt service-to-exports ratio											
Baseline	20	18	16	15	14	11	7	5	6	7	8
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	20	18	17	16	15	11	8	6	7	8	8
B. Bound Tests											
B1. Real GDP growth	20	18	16	15	14	11	7	5	6	7	8
B2. Primary balance	20	18	16	16	15	11	7	6	7	7	8
B3. Exports	20	**26**	**35**	**35**	**32**	**24**	17	14	15	17	19
B4. Other flows 3/	20	18	17	16	15	11	8	6	7	8	9
B5. Depreciation	20	18	16	15	14	10	6	5	6	6	7
B6. Combination of B1-B5	20	**22**	**25**	**24**	**22**	17	12	9	10	11	14
C. Tailored Tests											
C1. Combined contingent liabilities	20	18	16	16	15	11	7	6	7	7	8
C2. Natural disaster	20	19	18	17	16	12	8	7	8	8	9
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	21	21	21	21	21	21	21	21	21	21	21
Debt service-to-revenue ratio											
Baseline	15	14	13	13	12	9	6	5	6	6	7
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	15	14	14	14	13	10	7	5	6	7	8
B. Bound Tests											
B1. Real GDP growth	15	15	15	14	14	10	7	5	6	7	8
B2. Primary balance	15	14	13	13	13	9	6	5	6	7	7
B3. Exports	15	15	15	15	14	11	7	6	7	7	9
B4. Other flows 3/	15	14	14	14	13	10	7	6	6	7	8
B5. Depreciation	15	18	17	16	15	11	7	5	6	7	8
B6. Combination of B1-B5	15	15	15	15	14	11	7	6	7	8	9
C. Tailored Tests											
C1. Combined contingent liabilities	15	14	14	13	13	9	7	5	6	7	7
C2. Natural disaster	15	14	14	14	13	10	7	6	6	7	8
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	23	23	23	23	23	23	23	23	23	23	23
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	49	49	49	49	49	49	49	49	49	49	**49**

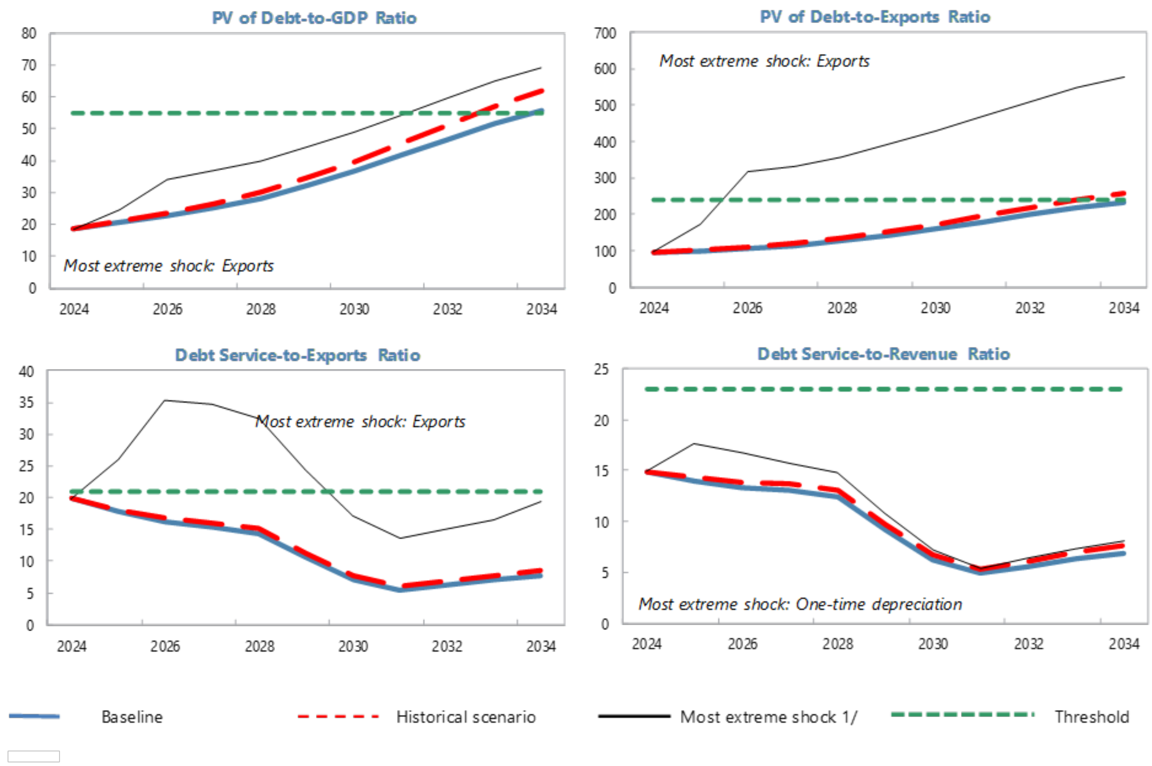
Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private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

Table 4. Tonga: Sensitivity Analysis for Key Indicators of Public Debt, FY2024–2034
(In percent)

	Projections 1/										
	2024	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**	**2032**	**2033**	**2034**
					PV of Debt-to-GDP Ratio						
Baseline	24.0	26.5	29.7	33.3	37.5	43.0	48.9	55.3	61.7	67.4	**72.3**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	24	21	18	15	12	10	8	6	5	3	1
B. Bound Tests											
B1. Real GDP growth	24	29	35	40	46	54	61	70	**78**	**85**	**92**
B2. Primary balance	24	29	34	38	41	47	53	59	65	**71**	**76**
B3. Exports	24	30	39	42	47	52	58	65	**71**	**77**	**82**
B4. Other flows 3/	24	31	38	42	46	51	57	64	**70**	**76**	**81**
B5. Depreciation	24	29	28	28	28	31	34	37	41	44	47
B6. Combination of B1-B5	24	28	31	33	37	42	48	55	61	66	**71**
C. Tailored Tests											
C1. Combined contingent liabilities	24	32	35	38	42	47	53	59	66	**72**	**77**
C2. Natural disaster	24	37	41	44	48	54	61	67	**74**	**81**	**86**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	70	70	70	70	70	70	70	70	70	70	70
					PV of Debt-to-Revenue Ratio						
Baseline	46	64	76	90	106	128	148	174	197	219	232
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	46	50	46	40	34	29	24	20	16	9	4
B. Bound Tests											
B1. Real GDP growth	46	68	87	106	127	157	182	215	246	273	291
B2. Primary balance	46	69	88	101	117	139	159	185	209	230	243
B3. Exports	46	72	100	114	131	155	176	203	227	249	262
B4. Other flows 3/	46	74	98	112	129	153	173	200	225	246	259
B5. Depreciation	46	71	73	76	82	93	103	119	133	146	154
B6. Combination of B1-B5	46	67	80	90	105	127	146	171	195	216	229
C. Tailored Tests											
C1. Combined contingent liabilities	46	77	90	102	118	141	161	187	211	232	245
C2. Natural disaster	46	89	105	117	135	160	182	210	237	261	276
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
					Debt Service-to-Revenue Ratio						
Baseline	9	12	13	15	18	18	16	19	22	23	25
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2024-2034 2/	9	12	12	14	17	16	13	15	17	17	18
B. Bound Tests											
B1. Real GDP growth	9	13	13	17	22	23	21	24	28	29	32
B2. Primary balance	9	12	13	18	22	20	18	19	22	23	26
B3. Exports	9	12	13	16	19	19	17	19	22	23	26
B4. Other flows 3/	9	12	13	16	19	19	17	19	22	23	26
B5. Depreciation	9	13	15	18	20	20	17	19	21	23	25
B6. Combination of B1-B5	9	12	13	15	19	18	16	18	21	22	25
C. Tailored Tests											
C1. Combined contingent liabilities	9	12	13	22	19	21	17	20	22	23	26
C2. Natural disaster	9	13	14	29	20	25	18	23	24	26	28
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the benchmark.
2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.
3/ Includes official and private transfers and FDI.

Figure 1. Tonga: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, FY2024–2034



Customization of Default Settings	Size	Interactions
Tailored Stress		
Combined CL	Yes	
Natural disaster	Yes	Yes
Commodity price 2/	n.a.	n.a.
Market financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.2%	1.2%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	38	38
Avg. grace period	8	8

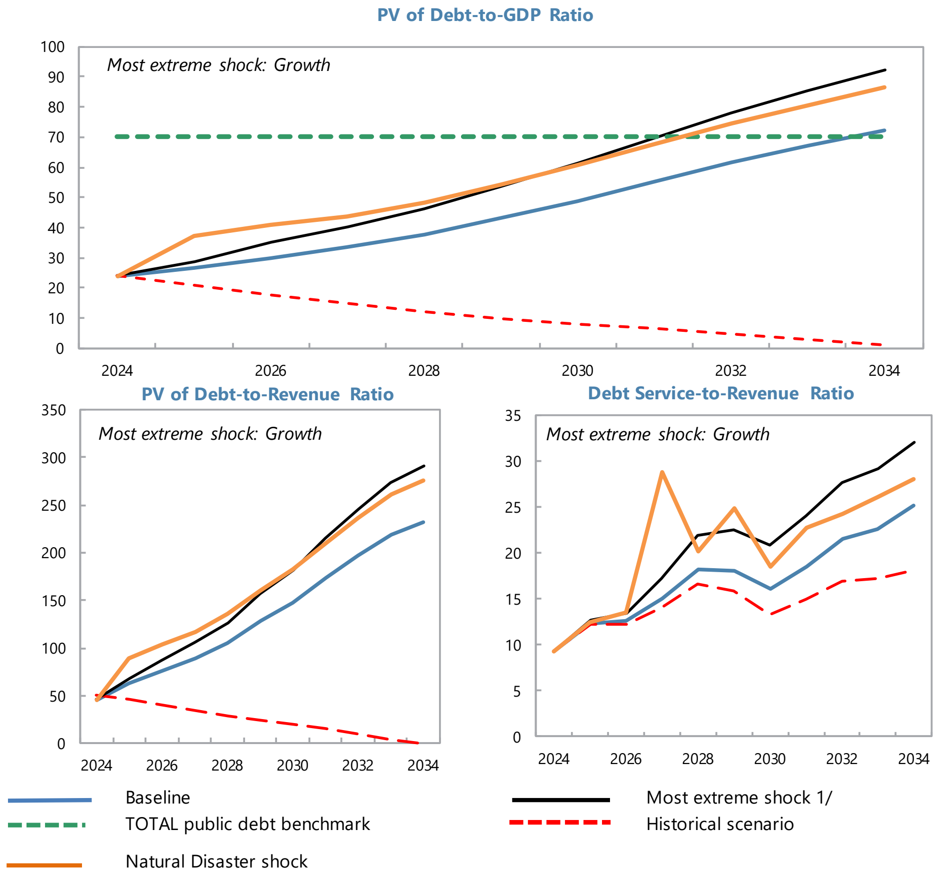
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2034. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Tonga: Indicators of Public Debt Under Alternative Scenarios, FY2024–2034



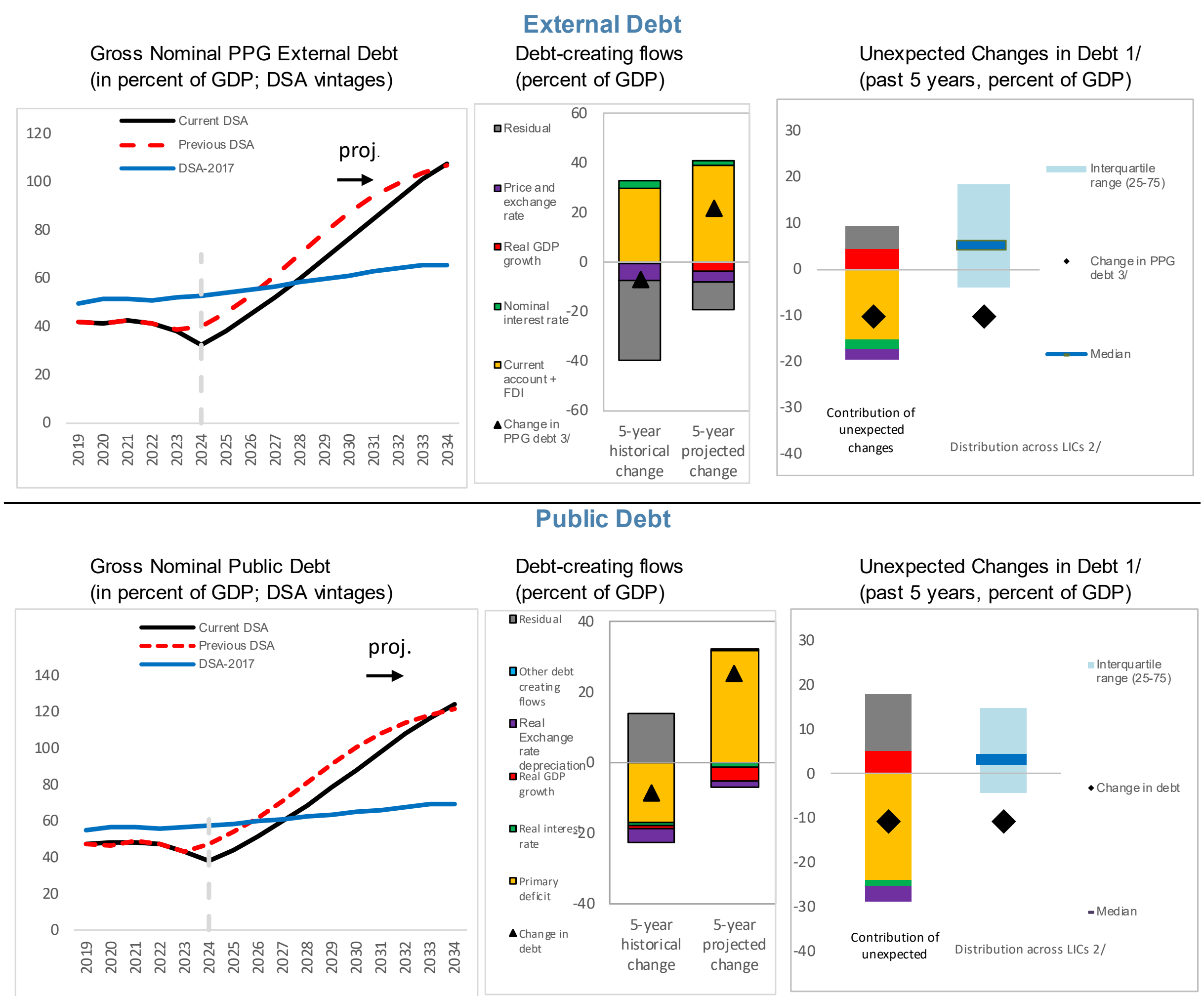
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	64%	64%
Domestic medium and long-term	36%	36%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.2%	1.2%
Avg. maturity (incl. grace period)	38	38
Avg. grace period	8	8
Domestic MLT debt		
Avg. real interest rate on new borrowing	0.3%	0.3%
Avg. maturity (incl. grace period)	2	2
Avg. grace period	1	1
Domestic short-term debt		
Avg. real interest rate	0.0%	0.0%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2034. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 3. Tonga: Drivers of Debt Dynamics—Baseline Scenario



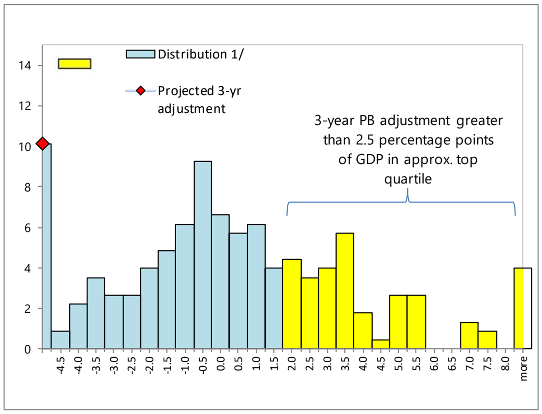
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

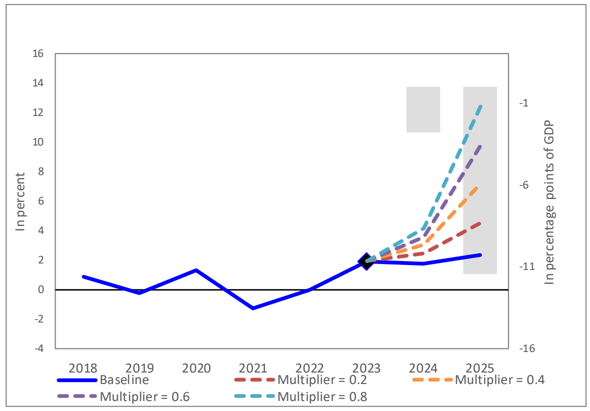
Figure 4. Tonga: Realism Tools

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Statement by Ms. Yati Kurniati, Executive Director for Tonga
And Mr. Raja Anwar, Alternative Executive Director and Mr. Esala Masitabua,
Advisor to the Executive Director
November 6, 2024

The Tonga authorities express their gratitude to the Mission Chief, Mr. Andrea Pescatori, and his team for their constructive and candid dialogue during the AIV mission. They also appreciate the thoughtful consideration underpinning staff's advice. The authorities broadly agree with the staff's assessment of the outlook and the thrust of the recommendations.

Tonga is a hereditary constitutional monarchy with a single legislative house. Geographically it has a population of just over 100,000, spread over around 40 of its 170 islands in the South Pacific. Economically, Tonga is a small developing state with a narrow base, heavily reliant on agriculture, tourism and remittance inflows from its diaspora dispersed due to historical and cultural links, predominantly in New Zealand, the United States, and Australia. Like other small and open Pacific Island countries, Tonga benefits from grants and concessional lending from multilateral development banks, and through long standing bilateral relationships with donor countries.

Recent economic development and outlook

Tonga's economy is continuing its gradual recovery following the devastating impact of the 2022 Hunga Tonga-Hunga Ha'apai volcanic eruption which derailed the incipient but encouraging post-pandemic economic growth. The authorities agree with staff that while the outlook is favorable, it is facing significant headwinds and dominant downside risks, particularly over the medium term. However, the authorities are more optimistic in the near term, projecting growth for FY2025 about 0.5 percent above staff projections. Tonga's economic activity is driven by construction activity and strong remittance flows. Inflation has retreated from its peak of 14.1 percent in September 2022 and is now persistently within the National Reserve Bank of Tonga's (NRBT) reference rate of 5 percent, averaging around 4 percent y.o.y, so far this year.

Despite Tonga's resilience and near-term optimism, the authorities share the concern that long- term growth prospects remain uneven with risks titled to the downside. Supply side constraints exacerbated by limited economies of scale and geographical remoteness, coupled with the persistent loss of workers to emigration are major headwinds to economic growth, impacting key sectors of agriculture, construction, and tourism. Meanwhile the risk of frequent natural disasters was evident when an overnight storm and gale force winds uprooted trees, damaged electrical infrastructure, and caused severe flooding, just a few weeks ago.

Fiscal policy

The authorities welcome the staff assessment of the appropriateness of the expansionary fiscal stance and remain committed to fiscal consolidation that carefully balances critical climate resilience needs, continuing social programs for the most vulnerable, and advancing broad development goals. The authorities are focused on entrenching recovery by accelerating post disaster construction and productivity-enhancing public investments, including inter-island ports, roads, bridges, and medical facilities.

Adherence to Tonga's fiscal rules adopted in 2017 has guided fiscal discipline well. However following the necessary financial responses to the recent shocks, the authorities broadly concur with the staff's debt sustainability assessment and the associated risks. Guided by Fund technical assistance, the authorities will continue its medium-term fiscal strategy to create fiscal buffers and improve debt dynamics by enhancing domestic revenue collection and rationalizing public expenditure. The authorities recognize that while these measures are important, they remain challenging particularly amid workforce retention and rising cost of living.

The World Bank is complementing the Fund in providing technical assistance on rationalizing tax exemptions. Meanwhile, given Tonga's well-established ties with donor partners, its proven commitment to prudent economic management, as evidenced by the progress made in addressing past Article VI recommendations, the authorities are optimistic of achieving the requisite levels of financial support over the medium term.

Monetary policy

The National Reserve Bank of Tonga (NRBT) tightened monetary policy in 2023 by increasing in Statutory Reserve Deposit (SRD) to reign in aggregate demand and tame inflationary pressures. While the immediate impact was limited due to significant excess liquidity, inflation have steadily receded in recent months, driven primarily by global factors, including eased supply bottlenecks and lower commodity prices.

With support from the Fund, the authorities will continue evaluating the effectiveness of NRBT's policy tools in alignment with the ongoing review of the NRBT Act. This review, informed by the 2021 Safeguards Assessment and ongoing TA, aimed to modernize, and enhance the NRBT's mandate, function, and effectiveness, while also safeguarding its autonomy and independence.

Financial sector

Tonga's financial sector remains strong, with high levels of capitalization and liquidity. Vulnerabilities are localized, and systemic risks are largely contained, as the major banks operating in Tonga are well-capitalized subsidiaries of large foreign financial institutions.

Work on strengthening the AML/CFT framework continues and the NRBT is augmenting its regulatory and oversight mechanisms with the assistance of the Pacific Financial Technical Centre (PFTAC).

Structural reforms

The authorities are fully aligned with the structural reform priorities identified by staff. As a small developing island state surrounded by the Pacific Ocean, Tonga's immediate structural reform priority is enhancing its resilience to natural disasters and adverse climate events. A single major climate event or the cumulative impact of frequent smaller events can unwind months or even years of development. Notwithstanding the financing and capacity constraints, the authorities seek to embed climate resilience in public infrastructure and invest in the broader society's adaptation to climate challenges.

The authorities are also addressing the challenge of persistently low private sector investment. To this end, the Government launched the FY2025 budget statement "Building the Foundations for Sector-Driven Economic Growth and Stability," which aims to revitalize investments through three key thematic areas in collaboration with the private sector. Additionally, the National Financial Inclusion Strategy 2023 – 2027 has been launched and is now in operation. The authorities recognize that broader consideration and review of impediments to investment, including land ownership, regulation and red tape, and legal reform will eventually be necessary.

The authorities will persevere with anti-corruption efforts and the strengthening of governance and institutions. They recognize these reforms as crucial for strengthening partnerships with donor countries and multilateral agencies. These efforts will also foster a fair environment that supports socio-economic development and lay the foundation for reforms to stimulate private sector investments.

Improving Economic Data

The authorities are committed to strengthening its statistical capacity, addressing the significant identified data gaps, and improving quality and timeliness to enhance surveillance, which in turn sharpens analysis and focuses policy recommendations. They welcome continued Fund CD support in this area.