CONCLUDING STATEMENT

Tonga: Staff Concluding Statement of the 2023 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Nuku'alofa, Tonga–August 2, 2023:

1. **The Tongan economy is rebounding strongly from a major double shock in early 2022**. After an estimated contraction of 2 percent in FY2022, real GDP is estimated to have expanded by 2.6 percent in FY2023 (July 2022-June 2023). The bold policy support measures deployed in response to the Hunga Tonga–Hunga Ha'apai (HTHH) volcanic eruption-tsunami and the local COVID-19 outbreak in January-February 2022, together with aid from the international community, were instrumental in mitigating the socioeconomic fallouts. The post-HTHH recovery in FY2023 has been driven by strong domestic demand and a pickup in tourist arrivals following the border reopening in August 2022.

2. **The recovery, however, has been accompanied by emerging supply-side bottlenecks and inflation pressures**. Tonga is experiencing significant labor shortages resulting from increased demand from seasonal worker programs in Australia and New Zealand. Combined with slow progress in rebuilding damaged tourism facilities (e.g., hotels and resorts) and buoyant domestic demand supported by remittances, underlying inflationary pressures remain elevated, with core inflation showing no signs of easing since September 2022. Headline inflation peaked at 14.1 percent in September 2022 and has since moderated to 6.6 percent in May 2023, driven by the decline in global energy prices and monetary policy tightening in trading partner economies.

3. **Credit has started to expand**. Bank credit growth has turned positive since September 2022 and reached 5.9 percent (y/y) in May 2023. Bank lending to businesses has been relatively strong at 12.5 percent, especially in the professional and other services, distribution, and construction sectors, consistent with the rebound in activity in these sectors. Household lending has remained weaker at 1.2 percent, with around 80 percent directed towards housing. The authorities have also supported lending to small businesses and low-income households by providing subsidized interest rate loans under the Government Development Loan (GDL) scheme.

4. **The economic outlook is uncertain in the short term**. Growth in FY2024 is projected at 2.5 percent, underpinned by public investment. Although tourism-related services are expected to continue their recovery, tourism receipts as share of GDP are anticipated to remain below pre-pandemic levels until FY2026 due to slow reconstruction of damaged facilities. The recovery in agricultural production is expected to proceed slowly, reflecting labor shortages and soil contamination due to the HTHH tsunami. Remittance inflows are expected to decline from an estimated 44.2 percent of GDP in FY2023 to 39.7 percent in FY2024. Average inflation is projected at 5.8 percent in FY2024—above the National Reserve Bank of Tonga's (NRBT's) reference rate of 5 percent.

5. **The medium-to-long-term growth prospects are weak**. 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. While remittances are expected to remain significant, the current account deficit (CAD) is expected to gradually widen relative to its pre-pandemic levels, reflecting heavy import dependence, weak competitiveness, and substantial infrastructure needs. Foreign exchange (FX) reserve coverage is projected to stabilize over the medium term at about 11 months of imports, above the NRBT's target of 7½ months, supported by external financing.

6. **Risks are tilted to the downside**. Tonga's limited productive capacity and strong foreign demand for Tongan workers have significantly increased inflation risks. A sharp increase in global commodity prices could further intensify inflation pressures, deteriorating households' real purchasing power and the CAD. 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. On the upside, tourism could recover faster due to stronger-than-expected pent-up demand.

7. **Tonga is assessed as being at high risk of debt distress**. Without additional grant commitments to IMF staff's baseline projection, the present value (PV) of public debt-to-GDP ratio is projected to rise and remain above the 70 percent debt-distress benchmark starting in FY2033. This mainly reflects significant development spending needs over the long term to achieve its climate resilience and Sustainable Development Goals (SDGs). Debt obligations are largely external, with over half to China Exim Bank. Debt repayments are expected to surge in FY2024, mainly to China Exim Bank, and stay elevated at over 3 percent of GDP until FY2027.

8. **The external position for FY2023 is preliminarily assessed to be broadly in line with the level implied by medium-term fundamentals and desirable policies**. Tonga continued to receive sizable remittances and donors' budget support in FY2023 and saw a rebound in tourist arrivals. However, imports have simultaneously increased, driven by higher demand for reconstruction-related capital goods. While the CAD is estimated to have widened from 6.3 percent of GDP in FY2022 to 7.9 percent in FY2023, FX reserves have increased further in FY2023 and import cover strengthened to about 11 months, supported by official capital transfers and the IMF's Rapid Credit Facility (RCF) disbursement in July 2022.

Policies to Promote Sustainable and Inclusive Growth

Macroeconomic policy settings should be aimed at simultaneously supporting reconstruction and tackling inflation in the near term. Both delays in reconstruction and persistently high inflation would incur substantial welfare costs, especially for low-income households and small businesses. Achieving this dual objective requires an all-government effort, with monetary policy focused on safeguarding price stability and fiscal policy on providing ample financial support to the vulnerable while postponing non-urgent spending.

Fiscal Policy

9. **The fiscal balance continued to improve in FY2023**. Despite the HTHH disaster, the primary deficit declined from 0.6 percent of GDP in FY2021 to 0.2 percent in FY2022, reflecting lower-than-targeted reconstruction expenditures due to capacity constraints and COVID-19-related mobility restrictions. The primary fiscal balance is expected to have shifted to a surplus of 1.0 percent in FY2023, as a pickup in HTHH-related external grants more than offset increased reconstruction-related expenditures.

10. **The expanded budget envelope for FY2024 is appropriate, given the need to support reconstruction and strengthen social protection**. Based on both the authorities' FY2024 budget and IMF staff's forecasts, the primary balance is expected to revert to a deficit of 6.3 percent of GDP as HTHH-related external grants unwind and implementation of public reconstruction projects gathers momentum. Concurrently, the authorities have phased out most pandemic- and HTHH-related tax exemptions and plan to gradually normalize current spending, including by limiting the public sector wage bill. The government should also prioritize on the execution of budgets related to reconstruction and social protection. The planned top-up of the GDL fund under the current budget would help the vulnerable to maintain access to credit at affordable costs, even under a tighter monetary policy.

11. **Beyond the near term, a combination of domestic fiscal measures and additional donor support is required to meet Tonga's development spending needs while minimizing the risk of debt distress**. The primary fiscal deficit is projected to widen further in the long term under the baseline, primarily reflecting a decline in committed grants and sizable spending needed to achieve Tonga's SDGs and climate resilience. The fiscal adjustments to address the accompanying deterioration in debt dynamics should include gradual increases in tax revenues and further reductions in the public wage bill and other current expenditures. Securing new grants in line with the historical trends is critical to fund capital investment projects. The government's plan to refrain from new non-concessional borrowing would further help reduce Tonga's risk of debt distress.

12. **To achieve the necessary fiscal adjustments, reforms to improve revenue administration, spending efficiency, and transparency are essential**. The authorities have already initiated several reforms in these areas, consistent with IMF Technical Assistance (TA). The ongoing rollout of the Electronic Sales Register System has the potential to improve revenue compliance and reduce administrative burden. The planned amendments to the PFM Act would improve fiscal transparency, budget allocation aligned with the national economic objectives, and the medium-term budget processes. Reducing tax exemptions and strengthening the governance for granting new exemptions, including by setting clear eligibility criteria and limited timeframes, as well as allowing the Minister of Finance to have the ultimate authority to grant exemptions in the government, would help deliver significant additional revenues and ensure that exemptions are adequately aligned with national strategic objectives. Fully delivering on the authorities' commitment under the IMF's RCF to publish

pandemic-related procurement contracts with information on the beneficial ownership would also be important.

Monetary and Exchange Rate Policies

13. **The NRBT has recently taken measures to tighten its monetary policy stance**. The NRBT increased the statutory reserve deposit (SRD) ratio from 10 to 15 percent in February 2023, the first time since July 2017, while maintaining the policy rate (the rate on excess bank reserves) at zero percent. This move, together with the NRBT's newly established deposit facility for retirement funds in February 2023, has helped absorb sizable banking system liquidity, leading to more active liquidity management by some banks. However, the measures have yet to have meaningful impacts on aggregate demand, including through the bank lending channel, due to the still abundant banking system liquidity.

14. **Further actions are needed to contain underlying inflation pressures**. Under staff's baseline projection predicated on current monetary policy settings, inflation would remain above the reference rate until end-FY2024 due to persistent domestic inflation pressures. To prevent high inflation expectations from becoming entrenched, a further tightening of the monetary policy stance is warranted. This could be achieved by increasing the policy rate from the current zero percent level, possibly combined with a further hike in the SRD ratio to mop up more liquidity. This adjustment in the policy rate under the current favorable economic environment would also create room to lower the rate in case important downside risks materialize (e.g., a major natural disaster).

15. **The monetary policy framework could be enhanced in a few areas**. The NRBT could consider resuming issuance of the NRBT notes, which has been suspended since 2009. This would provide the NRBT with a market-based policy instrument to absorb excess liquidity, which can facilitate the development of financial markets in the long run. 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, based on the existing provisions in the NRBT Act and consistent with IMF TA recommendations on Tonga's monetary policy framework.

16. **The current currency-basket regime has served Tonga well, helping preserve exchange rate stability**. The nominal effective exchange rate appreciated by 1.7 percent (y/y) in June 2023, helping partially offset the impact of higher import prices denominated in trading-partner currencies on domestic inflation. Meanwhile, the appreciation of the real effective exchange rate over the same period appears to have had relatively limited impacts on Tonga's exports due to the HTHH-induced disruption to crop production and border closures.

Financial Sector Policies

17. **Systemic risks appear modest overall, with the banking sector remaining well capitalized and liquid**. The system-wide capital adequacy ratio was around 35 percent in 2023Q1, well above the regulatory requirement (15 percent). Banks also remain profitable, although the average return on assets is below pre-pandemic levels and others in the region as of end-FY2022. The system-wide liquidity is ample, with excess reserves standing at a sizable 30.2 percent of GDP as of April 2023 despite the NRBT's recent mop-up measures.

18. **Risks to asset quality have increased, however, reflecting the impacts of HTHH and COVID-19**. The banking system's non-performing loan (NPL) ratio increased from 3.6 percent at end-2021 to 7.4 percent in 2023Q1. While both business and household NPLs climbed, business NPLs grew more rapidly, led by distribution and construction. The share of household NPLs in total NPLs declined, with housing loans accounting for over 75 percent of household NPLs. Meanwhile, the NPL coverage ratio declined from 141.3 percent at end-2021 to 99.3 percent in 2023Q1. While the current level of banks' NPLs appears manageable given the existing financial buffers, the capacity to sustain another severe shock to the economy in the near term without disrupting bank credit has likely weakened.

19. **The authorities should consider more proactive measures to tackle NPLs and asset quality risks**. These could include: (1) conducting more intrusive oversight for banks with relatively higher NPLs, possibly through more frequent and detailed regulatory reporting, intensified on-site supervision, and restrictions on dividend payments if needed; (2) requiring banks to adopt a more conservative approach to provisioning, including for secured loans (at least partly) and overdue non-NPL loans; and (3) requesting banks to prepare and submit their plans to address NPLs, which could include concrete operational targets (e.g., reducing NPLs to a target level over a certain time window and maintaining the provisioning level above a certain minimum threshold). Streamlining existing prudential standards and enhancing relevant data collection, with support from the ongoing IMF TA in this area, will help Tonga's capacity to conduct risk-based supervision and further mitigate asset quality risks facing banks. The NRBT's regulatory and supervisory remit should be broadened to cover non-bank financial institutions (NBFIs).

20. **Reforms aimed at promoting financial deepening and stability should continue**. The NRBT's initiative to set up a local credit registry is welcome, which should eventually be expanded to include NBFIs to capture all loans extended to individual borrowers. The authorities could also strengthen their efforts to tackle low financial literacy to enhance individuals' use of financial products and services, including through financial education in schools and engagement with local communities.

Structural Reform

21. **Enhancing resilience to natural disasters and climate change is a top reform priority**. The Disaster Risk Management Act of 2023 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, including by improving coordination across relevant ministries and management of scarce resources (IMF-World Bank 2021 Climate Change Policy Assessment Report). Expanding the classification of climate change-related spending and strengthening the social protection system are other priorities. The ongoing PFM reform, as well as the initiative to establish a national database of households eligible for social protection benefits, are important in this regard. Stricter enforcement of the Building Code, especially for residential properties, and facilitating relocation to safer grounds would significantly contribute to enhancing disaster resilience, which should be supported by allocation of adequate fiscal resources.

22. **Developing the private sector is critical to boost Tonga's growth potential**. Tonga is confronting important challenges to long-term growth posed by sustained worker

outflows and increasingly frequent natural disasters. In this context, digitalization can be an effective way to enhance economy-wide efficiency and overcome geographical limitations. 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. To reap the full benefits, however, this initiative should be reinforced by a government-wide drive to make public administration less paper-based and greater investment in information and communication infrastructure to improve the coverage and quality of internet connection. Other important reform priorities include:

(1) increasing government spending on education and training, especially to reduce the skill mismatch in the domestic labor market in the context of continuing worker outflows,
(2) reducing gender inequality in the labor market, including by enacting the Employment Relations Bill which would help better protect women in vulnerable work environments,
(3) cutting red tape hindering private sector investment, especially by improving the efficiency of land leasehold administration (e.g., adoption of necessary IT systems), and
(4) strengthening the AML/CFT framework, on which some progress has already been made. Continued efforts are needed to address the gaps identified by the Asia Pacific Group on Money Laundering (APG) in the Mutual Evaluation Report, however, including amendments to the AML Act. The IMF has been providing TA in this area.

23. **Tonga is facing severe capacity constraints in producing timely macroeconomic statistics, which needs to be urgently addressed**. Delays in publishing core macroeconomic data, like national accounts and external sector statistics, have become more prolonged and frequent in recent years. The requirements under the current law on data sharing and cooperation by relevant ministries need to be more strictly enforced. The IMF has provided extensive TA in several areas of statistics (e.g., national accounts, government finance, and balance of payments).

The IMF mission team would like to thank the Ministry of Finance, the National Reserve Bank of Tonga, other ministries and government agencies, and private sector interlocutors for their warm hospitality and constructive discussions.

Table 1. Tonga: Selected Economic Indicators

Population (2021): 100 thousands
Major exports: root crops, vanilla, squash, fish

		Est.	Projections		
	FY2021	FY2022	FY2023	FY2024	FY2025
Output and prices			(Annual percent change)		
Real GDP[2]	-2.7	-2.0	2.6	2.5	2.2
Consumer prices (period average)	1.4	8.5	10.0	5.8	4.1
Consumer prices (end of period)	6.9	11.3	6.1	6.2	3.2
Central government finance			(In percent of GDP)		
Revenue	48.3	45.2	47.7	41.6	37.6
of which: Grants	22.4	19.0	24.4	17.0	12.9
Expenditure	49.3	45.9	47.4	48.3	46.1
Expense	41.8	40.1	40.1	37.3	35.1
Net acquisition of nonfinancial assets	7.5	5.9	7.2	11.0	11.0
Primary balance	-0.6	-0.2	1.0	-6.3	-8.0
Overall balance	-1.0	-0.7	0.4	-6.8	-8.5
Overall balance (excl. grants)	-23.4	-19.7	-24.0	-23.8	-21.4
Money and credit			(Annual percent change)		
Broad money (M2)	25.0	13.4	-0.1	4.5	3.4
Domestic credit	-8.2	-3.3	3.9	16.1	8.8
Of which: Private sector credit	1.0	-1.0	6.4	5.9	4.3
Balance of payments			(In millions of U.S. dollars)		
Current account balance	-24.7	-31.5	-43.1	-41.1	-45.1
(In percent of GDP)	-5.2	-6.3	-7.9	-7.1	-7.4
Exports of goods, f.o.b.	16.2	15.1	16.3	18.4	19.6
Imports of goods, f.o.b.	214.5	214.9	295.7	285.7	295.4
Tourism receipts	9.1	9.6	35.6	50.9	58.5
Total remittances	220.6	218.5	242.1	230.9	227.9
(In percent of GDP)	46.9	43.9	44.2	39.7	37.5
Compensation of overseas workers	41.0	37.9	47.1	51.9	56.9
Personal remittances	179.6	180.6	195.0	179.0	171.0
Official grants	10.5	26.4	85.4	75.1	78.4
Capital account balance	69.1	84.6	53.1	29.0	5.4
Financial account balance	1.1	23.7	-6.6	25.3	47.4
Gross official foreign reserves					
In millions of U.S. dollars	317.9	375.5	388.1	401.4	409.1
(In months of next year's total imports)	11.7	10.3	10.9	10.9	10.8
Debt			(In percent of GDP)		
Public debt (external and domestic)	47.8	45.4	41.2	45.4	51.6
Of which: External debt	41.2	39.4	37.2	38.0	43.9
External debt service ratio	0.7	1.5	2.1	3.8	3.5
Exchange rates					
Exchange rate (National currency per US dollar)	2.3	2.3	...	...	...
Real effective exchange rate (2010=100; +=appreciation)	107.1	115.7	...	...	...
Memorandum items:					
Nominal GDP (millions of US$)	470.5	497.6	547.2	581.1	607.5

Sources: Tonga authorities; and IMF staff estimates and projections.
[1]Fiscal year beginning July 1.
[2]Including preliminary data.