

**FOR
INFORMATION**

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To: Members of the Executive Board

From: The Secretary

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Tonga—Assessment Letter for the Asian Development Bank May 26, 2020

This letter provides IMF staff's assessment of Tonga's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to the Asian Development Bank's "Strengthening Macroeconomic Resilience Program" for Tonga.

Recent Developments, Outlook and Risks

1. **Tonga's modest recovery from Cyclone Gita will be interrupted by the Covid-19 pandemic.** Following a sharp drop in FY2018 due to Cyclone Gita, economic activity began normalizing in FY2019, largely due to reconstruction activities supported by remittances. The post-Gita recovery was expected to gather speed due to continued improvements in exports and reconstruction. However, FY2020 real GDP growth is now expected to drop sharply due to Covid-19 related domestic containment measures and spillovers from major contraction in economic activity in remitting countries.¹ In line with current (albeit highly uncertain) expectations about the trajectory and global impact of the pandemic, these effects are likely to persist through at least the first half of FY2021. Beyond this period, growth is expected to recover to 3–4 percent in FY2022–23 in line with the most recent IMF global forecasts.² These forecasts are subject to considerable uncertainty regarding the evolution and impact of the pandemic. While reserves are likely to remain comfortable in the remainder of FY2020, mainly due to import compression, slow post-pandemic recovery in tourism, weak competitiveness, lower remittances, heavy debt repayments, and large import needs are likely to widen current account deficits over time, reducing reserve coverage to 3–4 months of imports by end-FY2023, well below desirable coverage (6¾ months of imports) for disaster-prone countries. Inflation is forecast to remain low due to weak global food and fuel prices, although domestic inflation is likely to rise due to constrained supply.

2. **The economic outlook is modest and fragile.** Tonga's growth potential is low due to its exposure to natural disasters, loss of workers to emigration and seasonal worker programs, and socioeconomic limitations on female labor force participation. Without a concerted effort to boost private sector development, medium-term growth is expected to trend down to 1.8 percent. There are significant downside risks to growth, stemming from difficult external debt dynamics, persistent and high natural disaster risks, and loss of correspondent banking relationships due to AML/CFT-related weaknesses. A prolonged and synchronized global economic slowdown, larger-than-expected impact of the Covid-19 pandemic, and large oil price volatility are also likely to weigh on growth. While the authorities' commitment to prudent economic management remains

¹ Damage from Tropical Cyclone Harold, which caused major destruction in the agriculture sector, infrastructure and tourism-related structures in Tonga in April 2020, is being assessed. The economic impact of TC Harold will be incorporated in future IMF forecasts once these assessments and associated reconstruction plans have been finalized.

² IMF World Economic Outlook (April 2020) <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>.

strong, nevertheless, the policy challenges of navigating the pandemic in the near term, while addressing medium-term concerns, are significant because of Tonga's modest economic prospects and elevated risks.

Fiscal Policy

3. **After four consecutive years of budget surpluses, the pandemic will result in large fiscal deficits in FY2020–21.** The FY2020 budget was on track to record a surplus on the basis of continued strength in revenue collection and generally effective controls on current spending in line with the fiscal anchors adopted in 2017. However, underlying spending policies showed some weaknesses, such as overruns on the wage bill, which were compensated by delays in maintenance spending. Instead of planned surpluses, fiscal balances are now projected to be in deficit in FY2020–21 due to the economic impact of containment measures and targeted policy support measures announced by the government.³ The fiscal deficits are likely to be financed by new donor budget support commitments in the form of grants, new domestic debt issuance and a drawdown of government reserves and national emergency funds.

4. **Tonga's overall risk of public and external debt distress remains high.** Debt repayments (especially those to China Exim Bank) are expected to spike starting in 2024, and the present value of public debt-to-GDP ratio is expected to rise above the 70 percent debt-distress threshold in 2028–29 under current policies and financing commitments. Without new grant financing commitments and/or additional fiscal adjustment, Tonga's already low fiscal buffers and international reserves will need to be further run down and additional debt incurred to service existing debt obligations, leading to an exploding medium-term debt path. Long-term debt sustainability hinges on continued donor grants inflows to finance substantial fiscal and external gaps, and ongoing fiscal adjustment.

5. **In addition to new grant financing, higher and better-quality budget surpluses are needed to stabilize debt dynamics while improving climate-resilience.** The impact of the pandemic will make it difficult to build buffers in the near term. Fiscal adjustment of the order of at least 4½ percent of GDP per year on average is required during FY2022–24 to allow a buildup of adequate fiscal buffers for debt servicing, emergencies and infrastructure maintenance. This will require continuing planned revenue administration reforms, broadening the tax base, updating excise rates, and expediting climate- and development-related spending. It will also require curbing and reorienting current spending toward improving capacity by rationalizing civil service functions and staffing critical positions while gradually aligning compensation with market pay levels to reduce turnover. Faster implementation of investments requires consistent prioritization, improved

³ IMF projections are based on the preliminary budget outturns and forecasts under discussion in the Parliament, which incorporate the Economic and Social Stimulus Package of 60 million Tongan pa'anga (5.3 percent of GDP) that was announced by the Government of Tonga for FY2020 on April 2, 2020 (<https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>). The forecasts incorporate IMF staff judgments on implementation capacity and the timing of the disbursement of budget support.

cross-governmental coordination, and more effective use of procurement. Donor grant financing will be essential to fill the budget deficit, as will asset sales. Fiscal anchors on the wage bill and public debt-to-GDP ratios remain appropriate, but improvements in Tonga's debt management strategy are warranted.

Private Sector Development

6. **A lasting solution to Tonga's fiscal and development challenges is to grow the small private sector.** Despite important progress, structural constraints continue to impede private sector development. Tonga performs well relative to comparators across many aspects of the business environment, but lags in terms of registering property and the legal framework/processes for resolving insolvency. There also remains scope to improve governance, particularly regarding regulatory quality and enforcement, government effectiveness, and control of corruption.

7. **Policies need to go further to address the main deterrents to private sector and foreign investment.** Reforms are needed to increase access to skilled labor by improving Technical and Vocational Education and Training programs and facilitating the integration of Seasonal Worker Programs workers into higher value-added activities and female workers (who are more skilled) into the labor force. Improving the transparency and predictability of, and clarifying ownership rights in, the land-lease market can boost investment and expand access to credit. Strengthening climate-resilience, improving regulations (such as the 2018 Foreign Exchange Control Act and insolvency laws), deregulating protected sectors, and boosting official capacity can all help raise productivity, and thereby help attract investors.

Monetary Policy

8. **The monetary stance should stay supportive through the duration of the economic fallout of the pandemic.** Monetary policy has been appropriately accommodative thus far, given low inflation and the slow recovery. The National Reserve Bank of Tonga (NRBT) stayed on hold, maintaining the monetary policy rate at zero percent and the statutory reserve deposit rate at 10 percent. The supportive stance should be continued, since inflation is likely to remain low due to Tonga's heavy import-reliance and current expectations of low global prices of food and fuel (the dominant components of the CPI basket). The NRBT's recent announcement of its readiness to provide liquidity to banks if needed, is appropriate.

Financial Stability

9. **Bank balance sheets have remained resilient thus far.** Banks were able to withstand the economic devastation of the 2018 Cyclone Gita which caused damage of 38 percent of GDP. Pre-pandemic, banks were profitable and well-capitalized, with declining non-performing loans (NPLs) due to loan write-offs and settlements. After several years of large increases, credit growth has moderated due to delays and cancellation of projects and lower household demand due to stretched debt-servicing capacity. Lending continues to be concentrated in the housing sector.

According to the NRBT, bank balance sheets should be resilient to the impact of the pandemic. The NRBT's willingness to ease liquidity and exchange restrictions if necessary, should also assist banks in navigating the pandemic.

10. Nevertheless, financial sector vulnerabilities need to be better understood, closely monitored, and continued improvements in supervision and financial inclusion are needed.

The NRBT is strengthening risk-based offsite supervision to complement its onsite efforts. New regulations came into effect in 2019 and others are being drafted or await Cabinet decisions. Financial supervision should continue to be upgraded and deepened to incorporate stress testing and closer monitoring of household leverage. As the pandemic unfolds, continued vigilance regarding its impact and that of the announced restructuring of loans on bank capital and liquidity buffers is warranted. Improving financial literacy and awareness and strengthening institutions such as credit bureaus will help improve financial inclusion. Given the importance of remittances for the economy and the financial system, the AML/CFT framework should be strengthened.

Fund Relations

11. Tonga is a large recipient of IMF technical assistance, including from the Pacific Financial Technical Assistance Center (PFTAC). Tonga is on a 24-month consultation cycle. The last Article IV consultation was concluded by the Executive Board on January 17, 2018. The most recent Article IV consultation mission took place between February 10–20, 2020.

Table 1. Tonga: Selected Economic Indicators, FY2016–FY2023 1/

Population (2018): 101 thousands
 GDP per capita FY2018: US\$4815
 Major exports: fish, root crops, vanilla, squash
 Key export markets: Australia, Japan, New Zealand, United States
 Quota: SDR 13.8 million

	Est.				Projection			
	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Output and prices	(Annual percent change)							
Real GDP 1/	4.8	5.4	0.2	0.7	-1.0	-1.5	4.0	3.0
Consumer prices (period average) 2/	-0.6	7.2	7.0	3.2	0.9	1.5	2.0	1.8
Consumer prices (end of period) 2/	0.2	9.8	6.7	-0.1	1.9	1.1	2.9	0.7
GDP deflator	2.3	6.4	5.8	3.5	2.3	2.1	2.1	2.1
Central government finance	(In percent of GDP)							
Revenue and Grants	40.1	43.6	42.8	43.6	34.8	37.5	42.0	36.5
Revenue (excluding grants)	23.9	24.2	24.9	24.5	22.3	22.5	24.7	24.9
Grants	16.2	19.5	17.9	19.1	12.5	15.0	17.3	11.6
Expenditure	38.6	40.0	39.9	40.3	40.4	38.7	40.4	38.9
Expense (current exp.)	31.6	29.6	31.5	31.6	36.8	34.0	31.1	31.1
Transactions in nonfinancial assets (net) (capital exp.)	6.9	10.4	8.4	8.6	3.5	4.7	9.3	7.8
Overall balance	1.5	3.6	2.9	3.3	-5.5	-1.2	1.6	-2.4
Net acquisition of financial assets	3.1	4.9	3.4	2.1	-1.3	0.5	2.2	1.0
External financing (net)	0.2	1.0	0.6	-1.2	1.0	-1.6	-1.6	3.2
Domestic financing (net)	1.4	0.3	-0.1	0.0	3.3	3.3	2.1	0.3
Debt								
Public debt (external and domestic)	51.2	45.6	44.3	41.3	45.0	46.5	44.3	45.6
External debt	43.5	39.1	36.8	34.1	34.7	32.9	29.4	31.2
Debt service ratio	1.6	1.3	1.1	2.2	2.1	2.1	1.9	1.8
Money and credit	(Annual percent change)							
Total liquidity (M3)	16.7	13.7	7.6	4.3	2.1	1.7	6.4	5.8
Of which: Broad money (M2)	15.0	13.0	9.4	3.5	2.1	1.7	6.6	6.0
Domestic credit	8.3	4.8	-6.5	6.0	32.3	22.1	15.8	10.1
Of which: Private sector credit	17.5	18.0	6.7	7.6	8.1	8.5	8.1	8.1
Interest rates (end of period)								
Average deposit rate	2.1	2.3	2.3	2.3	...	...	...	...
Average lending rate	8.7	8.6	8.5	8.2	...	...	...	...
Balance of payments	(In millions of U.S. dollars)							
Exports, f.o.b.	25.2	20.8	14.2	14.4	13.2	12.4	15.4	16.8
Imports, f.o.b.	-192.7	-205.9	-216.2	-241.1	-234.1	-241.0	-267.1	-282.3
Services (net)	4.4	-15.7	-14.9	-13.6	-13.7	-14.7	-9.7	-11.0
Investment income (net)	8.8	18.3	29.6	25.0	19.1	5.6	11.0	10.6
Current transfers (net)	127.0	153.1	158.8	184.2	160.9	165.3	176.4	165.8
Of which: Remittances	111.3	125.1	141.6	141.6	123.7	127.8	143.9	152.9
Of which: Official grants	28.7	37.5	28.8	46.6	44.5	51.7	46.5	27.7
Current account balance	-27.3	-29.5	-28.5	-31.2	-54.7	-72.5	-74.0	-100.0
(In percent of GDP)	-6.7	-6.5	-5.9	-6.3	-11.0	-14.5	-13.9	-17.8
Overall balance	23.9	25.8	22.7	-2.1	-25.6	-33.6	-9.6	-6.4
(In percent of GDP)	5.9	5.7	4.7	-0.4	-5.2	-6.7	-1.8	-1.1
Terms of trade (annual percent change)	2.1	2.9	-1.8	-0.5	0.0	0.5	1.5	2.5
Gross official foreign reserves								
In millions of U.S. dollars	166.4	192.2	214.9	212.8	187.2	153.6	144.0	137.5
(In months of next year's goods and services imports)	6.6	7.2	7.5	7.6	6.7	5.0	4.4	4.0
Exchange rates								
Exchange Rate - US dollars per Tongan pa'ang (period av.)	0.5	0.5	0.5	0.4	...	...	...	...
Real effective exchange rate (2005=100)	95.3	99.3	101.8	102.4	...	...	...	...
Memorandum items:								
Remittances (in percent of GDP)	27.5	27.4	29.3	28.6	24.9	25.5	27.1	27.3
Tourism (in percent of GDP)	9.7	8.7	9.1	8.5	7.7	9.2	9.4	9.3
FDI (in percent of GDP)	1.4	-1.2	3.1	1.9	1.7	1.5	1.4	1.3
Nominal GDP (millions of US\$)	405.5	455.9	483.7	494.4	496.7	500.4	531.6	561.1

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

1/ Fiscal year beginning July. GDP growth for FY2019 reflects preliminary data released by Tonga Statistics Department.

2/ CPI basket and methodology changed in September 2018.