

Tonga—IMF Assessment Letter for the World Bank April 2, 2020

This letter provides IMF staff's current assessment of Tonga's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to the World Bank's Resilience Development Policy Operation.

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, and marine exports. The post-Gita recovery was expected to gather speed due to continued improvements in exports and reconstruction. However, growth is expected to drop sharply due to spillovers from a major Covid-19-induced contraction in economic activity in remitting countries. 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 current expectations of a global recovery. 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, 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 2023, well below desirable coverage (6¾ months of imports) for disaster-prone countries. Inflation is forecast to remain low due to weaker global food and fuel prices.
- 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, natural disaster risks, and loss of correspondent banking relationships due to AML/CFT-related weaknesses. A prolonged and synchronized global slowdown, larger-than-expected impact of the Covid-19 pandemic, and large oil price volatility are also likely to weigh on growth.
- 3. Prudent economic management has delivered strong macro-financial outcomes.** A series of budget surpluses based on generally sound underlying policies, low inflation, a strong and stable financial system, and improving financial supervision and inclusion bear testament to a strong commitment to reforms. Nevertheless, the policy challenges of navigating the pandemic in the near term, while addressing medium-term concerns, is significant because of Tonga's modest economic prospects and elevated risks.

Fiscal Policy

4. **The government has demonstrated a commendable commitment to fiscal consolidation.** The budget surplus for FY2019 reflects 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 have shown some weaknesses, namely cost overruns particularly on the wage bill, compensated by delays in maintenance spending.

5. **Tonga's overall risk of public and external debt distress remains high.** Debt repayments 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 (although debt service indicators remain below the relevant ratios). Without new grant financing commitments and/or additional fiscal adjustment, the already low fiscal buffers and international reserves will need to be run down and additional debt incurred to service existing debt obligations, leading to an exploding medium-term debt path. Long-term debt sustainability would hinge on continued donor grants inflows to finance substantial fiscal and external gaps, and fiscal adjustment.

6. **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. Instead of planned surpluses, fiscal balances are projected to be in deficit in FY2020–21 to accommodate costs of containment and healthcare, and targeted support to those affected. Fiscal adjustment of the order of 3½–4 percent of GDP per year on average is required during FY2022–24 to allow a buildup of adequate fiscal buffers for debt, emergencies and 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 cross-governmental coordination, and more effective use of procurement. Donor grant financing will be essential to fill the gap, as maybe asset sales. Fiscal anchors on the wage bill and public debt to GDP ratios remain appropriate, but improvements in the debt management strategy are warranted.

Private Sector Development

7. **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 and processes for resolving insolvency. There also remains scope to improve governance, particularly regarding regulatory quality and enforcement, government effectiveness, and control of corruption.

8. **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 TVET programs and facilitating the integration of SWP 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, boosting official capacity can all help raise productivity by attracting investors.

Monetary Policy

9. **The monetary stance should stay supportive through the economic fallout of the pandemic.** Monetary policy has been appropriately accommodative thus far, given low inflation and the slow recovery. The central bank 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

10. **Bank balance sheets are strong and financial inclusion has been improving.** Banks were able to withstand the economic devastation of the 2018 Cyclone Gita which caused damage of 38 percent of GDP. They are 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 National Reserve Bank of Tonga (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.

11. **Nevertheless, financial sector vulnerabilities need to be better understood, closely monitored, and continued improvements in supervision and 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 awaiting 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

12. 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

	FY2016	FY2017	FY2018	Est.	Projection			FY2023
				FY2019	FY2020	FY2021	FY2022	
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	45.1	38.9	39.5	43.2	37.7
Revenue (excluding grants)	23.9	24.2	24.9	24.4	23.9	23.9	24.5	24.8
Grants	16.2	19.5	17.9	20.7	15.0	15.7	18.7	13.0
Expenditure	38.6	40.0	39.9	42.3	39.6	43.5	42.3	39.1
Expense (current exp.)	31.6	29.6	31.5	33.1	32.5	36.2	31.6	29.9
Transactions in nonfinancial assets (net) (capital exp.)	6.9	10.4	8.4	9.2	7.1	7.4	10.7	9.2
Overall balance	1.5	3.6	2.9	2.7	-0.7	-4.0	0.9	-1.3
Net acquisition of financial assets	3.1	4.9	3.4	1.1	0.5	0.3	0.4	1.4
External financing (net)	0.2	1.0	0.6	-1.6	-1.6	-1.6	-1.6	2.5
Domestic financing (net)	1.4	0.3	-0.1	0.0	2.8	5.9	1.0	0.2
Debt								
Public debt (external and domestic)	51.2	45.6	44.3	40.9	41.6	45.7	42.5	43.2
External debt	43.5	39.1	36.8	33.7	31.6	29.9	26.6	27.8
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	30.8	29.9	12.6	9.8
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	189.4	155.4	155.3	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	51.8	39.0	41.6	46.5	27.7
Current account balance	-27.3	-29.5	-28.5	-26.0	-60.2	-82.5	-74.0	-100.0
(In percent of GDP)	-6.7	-6.5	-5.9	-5.3	-12.1	-16.5	-13.9	-17.8
Overall balance	23.9	25.8	22.7	-2.1	-13.3	-30.3	-2.0	-2.3
(In percent of GDP)	5.9	5.7	4.7	-0.4	-2.7	-6.1	-0.4	-0.4
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	199.5	169.2	167.3	165.0
(In months of next year's goods and services imports)	6.6	7.2	7.5	7.6	7.2	5.5	5.1	4.8
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.