

Kingdom of Tonga

Medium-Term Debt Strategy

Fiscal Years 2021 - 2025

Prepared by the Debt Management Section,
Financial Framework Division,
Ministry of Finance

May 2021

CONTENTS

Abbreviations and acronyms	2
Foreword	3
Executive summary	4
I. Introduction	6
II. Objectives and scope of the debt management strategy	8
III. Characteristics of the existing debt portfolio	9
A. Composition at the end of FY 2020	9
B. Evolution of the debt portfolio in recent years and key development in 2020	11
C. Cost and risk indicators	12
IV. Macroeconomic assumptions and main risk factors	15
A. Macroeconomic developments and baseline assumptions	15
B. Key macroeconomic risks	16
V. Sources of potential financing	17
A. External financing	17
B. Domestic financing	18
VI. Strategy for the period 2021-2025	19
A. Government borrowing requirements for the FY 2021	19
B. Description of the debt strategy for the period 2021-2025	19
C. Rationale for the choice of the strategy for the period 2021 - 2025	21
D. Implementation of the strategy	23
VII. Conclusions	24

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
ADF	Asian Development Fund
ATM	Average term (time) to maturity
ATR	Average term (time) to refixing
AUD	Australian dollar
NRBT	National Reserve Bank of Tonga
CNY	Chinese renminbi (yuan)
DMU	Debt Management Unit
DSA	Debt Sustainability Analysis
DSSI	Debt Service Suspension Initiative
EUR	Euro
GDP	Gross Domestic Product
GoT	Government of Tonga
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IFI	International Financial Institutions
IMF	International Monetary Fund
MoF	Ministry of Finance
MTDS	Medium-term debt management strategy
MDB	Multilateral Development Banks
TOP	Tongan Pa'anga
SDG	Sustainable Development Goals
XDR	Special Drawing Rights
USD	United States dollar
WB	The World Bank

FOREWORD

Policymakers in the Government of Tonga (GoT) face some particularly significant challenges in increasing our growth potential. This is due to Tonga being exposed to severe shocks, such as natural disasters, the COVID-19 pandemic, the effects of climate change, and the very narrow production and export bases. As such, the prudent management of public finances, in particular, government debt, is essential to increasing Tonga's growth potential and ability to not only withstand, but to grow stronger from, external shocks.

The GoT is pleased to release this Medium-Term Debt Strategy (MTDS) as a core element of its policy commitments to ensure continued strong, resilient, and inclusive growth within the context of sustainable public finances. The MTDS is a framework to guide the debt management decisions and operations of the government, through: linking borrowing with macroeconomic policy; helping maintain sustainable levels of debt; and facilitating domestic debt market development. The MTDS is a key tool in ensuring the GoT's will meet its debt management objectives, which are: to meet government financing needs at the lowest possible cost over the medium to long term consistent with a prudent degree of risk; to maintain sovereign debt within levels that are sustainable over time; and to support the early stage of development of the government securities market.

Furthermore, the MTDS forms a key policy pillar in the management of financing risks Tonga faces. The GoT is mindful of the significant level of external debt that it currently holds, especially from the People's Republic of China (PRC), and the attendant exchange rate risk. Added to this is Tonga's classification as a high debt distress country, limiting the ability to take on new external loans.

This MTDS is in line with the 2020/21 Budget theme "God is my refuge and fortress", emphasizing that in facing the current hardship and challenges, in particular the COVID-19 pandemic, our only hope and protection is the Almighty God. As referred to in the Budget Statement 2020/21, with continued vigor and great enthusiasm, by God's guidance and grace, our nation will get through difficult times and overcome any challenges ahead and focus to promote growth, enhance economic diversification, and create job opportunities, all of which are necessary in improving the standard of living of Tongans.

I would like to thank our development partners for their support during these difficult times, in particular to the World Bank, which provided technical assistance in preparing the MTDS. Our development partners will continue to play a key role in assisting us in implementing the MTDS over the next 5 years. This MTDS provides the best option for the Government to follow, and I would like to emphasise the GoT's commitment to promoting transparency and accountability in public financial management. The publication of this second MTDS (2021-2025), which will be continuously reviewed in line with fiscal and macroeconomic developments, provides a critical tool for: informing policy decisions by all stakeholders; reducing the debt burden and other fiscal vulnerabilities; and improving relations with external and domestic financiers, including development partners.



Hon. Tevita Lavemaau

Minister for Finance

Date: 6th May 2021.

EXECUTIVE SUMMARY

The Medium-Term Debt Strategy (MTDS) is a policy document that guides borrowing and public debt management of the Government of Tonga (GoT). This document describes the strategy that the government wants to implement during the period FY 2021-2025. It contains guidelines in respect of the composition of external and domestic debt and is guided by two overarching strategic policy directions to be pursued by the end of the FY 2025: (i) reduce the share of public debt denominated in foreign currencies; (ii) extend the average time to maturity (ATM) of public debt portfolio.

In addition to assessing the current cost and risk profile of Tonga's existing debt composition, the report examines the costs and risks that could arise from the implementation of the MTDS over the period 2021-2025. This analysis considers macroeconomic and financial market conditions, the availability of financing from different creditors, and vulnerabilities that may have an impact on future borrowing requirements and debt-service costs.

Tonga's public debt level remained stable in recent years and reached 42.8% of GDP as of 30 June 2020. Government fiscal consolidation and prudent debt management, avoiding non-concessional external borrowing, explains the decrease of the Debt/GDP ratio since 2016. However, Tonga is still rated at high risk of debt distress under the joint IMF-World Bank Debt Sustainability Analysis (DSA) framework because GDP growth is hindered by remoteness, a narrow production base and low economies of scale, and subject to a high exposure to natural disasters with large economic costs. All these factors are limiting Tonga's capacity to service debt.

Current debt portfolio has a low cost, but it is exposed to refinancing risk and exchange rate risk. The share of debt denominated in foreign currencies was 85.7% of total debt as of 30 June 2020. The portfolio has a large exposure to the Chinese renminbi (CNY) which represents 50.3% of the total outstanding debt. Refinancing risk mainly arises from the principal repayments, scheduled from 2024 to 2029, of two large loans provided by the Export-Import Bank of China (Eximbank China). Although the outstanding amount of domestic debt represents only 14.3% of total outstanding debt, the refinancing risk is elevated considering 21.5% of the domestic debt portfolio is maturing with 1 year and the ATM is low (2.6 years). The large proportion of external debt in the portfolio, entirely comprised of concessional and semi-concessional loans, maintains the cost of debt at a low level.

Against this background, the Ministry of Finance (MoF) performed a cost-risk analysis of the public debt portfolio, with the technical support of the World Bank, to select the MTDS presented in this report. The MTDS analysis shows that the borrowing strategies available to Tonga are limited. Indeed, financing from the World Bank and the Asian Development Bank (ADB) will be made on a grant-only basis during the strategy period, which means Tonga will not borrow from these two institutions. The IMF Rapid Credit Facility will be available until 2021 and the GoT decided to avoid any new non-concessional borrowing from external creditors. Furthermore, the domestic market for government securities is still in an early stage of development with a limited absorption capacity. Consequently, the GoT intends to prioritize

the pursuit of additional grants from the donors' community to finance the national budget, which will help maintaining public and external borrowing at prudent levels.

Based on the assumption that government financing needs will be significantly reduced by additional grants funding in the upcoming years (beyond grants already incorporated in the projections of the fiscal balance), the MTDS envisages government gross borrowing will come on average, over the period 2021-2025, at 92% from domestic sources and 8% from existing external loans still disbursing. This borrowing mix will contribute to decrease the share of debt denominated in foreign currencies at the end of FY 2025 and, therefore, reduce the exchange rate risk of the current debt portfolio. The strategy also envisages an extension of Treasury bonds maturities to lengthen the ATM of the debt portfolio and reduce thereby the refinancing risk of domestic debt.

Thus, grants financing will cover a major part of the Chinese loans' reimbursements in 2024 and 2025, the remaining financing gap being covered by Treasury bonds issuance focused on 5-years and 6-years tenors.

The MoF is confident this MTDS will maintain public debt at prudent levels but realizes that the implementation of the strategy might be challenging because government needs to secure sufficient grants funding and the domestic debt market is expected to preserve sufficient liquidity to absorb Treasury bonds issuance.

Facing these financing challenges, which could be further exacerbated by the occurrence of another natural disaster, the GoT is committed to continue to pursue debt relief from its main bilateral creditor. Indeed, the cancellation of the Chinese debt would ensure Tonga's debt sustainability and allow the country to implement the necessary spending aimed at reaching sustainable development goals.

In the absence of debt relief, the GoT plans to seek grant-only financing to the full extent possible, and only after grants are exhausted, carefully consider whether to take on highly concessional (over 35 percent grant element) new external debt in line with recommendations of MDBs sustainable development finance policies.

The MoF will monitor the implementation of the MTDS and might decide to review this strategy as circumstances evolve. Indeed, uncertainties about the outcome of the negotiation with the main bilateral creditor, the volumes of grants made available to Tonga, the absorptive capacity of the domestic market, and the future level of debt distress can substantially change the baseline scenario on which this MTDS analysis was performed. These uncertainties also highlight the need for continued fiscal consolidation to reduce the risk of debt distress.

I. INTRODUCTION

In recent years, the Government of Tonga (GoT) has managed to maintain public debt under control through fiscal discipline and avoiding non-concessional external borrowing. However, Tonga is still rated at high risk of debt distress under the joint IMF-World Bank Debt Sustainability Analysis (DSA) framework¹ because GDP growth is hindered by remoteness, a narrow production base and low economies of scale, and subject to a high exposure to natural disasters with large economic costs. All these factors are limiting Tonga's capacity to service debt and resulted in the GoT adopting prudent debt management practices.

The GoT has decided to publish a formal and explicit debt management strategy, as part of its commitment to improve public debt management. This report describes the Medium-Term Debt Strategy (MTDS) selected by the Ministry of Finance (MoF) for the period 2021-2025, started on the 1st of July 2020 and ending on 30 June 2025. The MTDS is a plan that the Government intends to implement over the medium term in order to achieve a desired composition of the public debt portfolio that captures government's preferences with regard to the tradeoff between cost and risk. The MTDS operationalizes the debt management objectives set by the GoT.

The MTDS provides guidance for government borrowing and sets benchmarks to manage the public debt. The MoF will monitor these benchmarks (called strategic targets) to evaluate government performance in implementing the debt strategy. The MoF could decide to revise the MTDS if the financing and macroeconomic conditions underlying the strategy change considerably.

This MTDS is the outcome of a cost-risk analysis performed by the Debt Management Section (DMS) of the MoF, with the support of the World Bank. This analysis follows the guidance of the MTDS framework, jointly developed by the IMF and the World Bank, and is based on the MTDS Analytical Tool (AT) provided by these two institutions. This report examines the costs and risks of the current debt portfolio and the costs and risks that could arise from the implementation of the MTDS over the period 2021-2025, in light of factors such as the macroeconomic and financial market environment, the availability of financing from different creditors and markets, and vulnerabilities that may impact future borrowing requirements and debt-service costs.

The MoF selected a time horizon of 5 years for the debt strategy. This choice was made to have a better view of the medium-term horizon and include in the analysis the impact of increasing debt amortization in 2024 and 2025.

¹ See Tonga IMF Country Report n. 18/12, December 2017.

In the framework of this MTDS analysis, domestic debt is defined as the debt denominated in Tongan Pa'anga (TOP). Thus, external debt is the debt denominated in foreign currencies. Indeed, the elaboration of the debt strategy is based on the analysis of the costs and risks of the debt portfolio, among which the exchange rate risk is one of the major risks. For this reason, the denomination of the debt currency, rather than residence of the holders of the debt, is the preeminent criteria for this cost-risk analysis to determine if the debt is external or not.

The MTDS sets operational targets for market risks. In order to achieve the desired composition of the debt portfolio in 2025, the GoT will manage the market risks associated with the public debt portfolio, namely the refinancing risk, the interest rate risk and the exchange rate risk. Therefore, the MoF has set quantitative targets on two market risk indicators to steer the debt strategy. These targets are discussed and defined in this report and will be used to regularly monitor the implementation of the strategy.

II. OBJECTIVES AND SCOPE OF THE DEBT MANAGEMENT STRATEGY

The GoT has set two main objectives for debt management:

- First objective is to meet government financing needs at the lowest possible cost over the medium to long term consistent with a prudent degree of risk.
- Second objective is to contribute to maintain sovereign debt within levels that are sustainable over time, where such levels are regularly monitored against commonly accepted debt targets or thresholds and taking into account the unique aspects of the Tongan economy.

The GoT also considers the additional objective of supporting the early stage of development of the local government securities market. This objective aims at diversifying the source of budget financing and allow in the future a greater mobilization of national savings towards Tonga's development goals.

The MTDS focuses on the public and publicly guaranteed debt of Tonga. It encompasses both domestic and external borrowing. The GoT borrows funds which are on-lent to other public entities. The original borrowing is included in the government debt portfolio as a direct government debt and, therefore, part of this MTDS analysis.

III. CHARACTERISTICS OF THE EXISTING DEBT PORTFOLIO

A. Composition at the end of FY 2020

Public debt outstanding amounted to 488.4 million TOP as of 30 June 2020, or 42.8% of the GDP. There was no debt guaranteed by the government, but loans on-lent by the government to public entities amounted to 51.7 million TOP. The Government also provides loans to the private sector, under the Agriculture and Fisheries Market Funds. The disbursed outstanding amount of these loans reached 1.2 million TOP at the end of FY 2020, as shown in the table 1 below. It is worth underlining that on-lent loans and government funds are assets of the State, not liabilities. However, a fiscal risk is associated to these loans in case the government is not able to recover the whole amount provided to the entities.

Table 1. Public debt outstanding at the end of FY 2020

(in millions TOP)	as of 30 June 2020	
	Outstanding	% GDP
Total Public Debt	488.4	42.8%
External Debt	418.4	36.7%
Domestic Debt	70.0	6.1%
Government loans	52.9	4.6%
On-lent loans	51.7	4.5%
Funds to the private sector	1.2	0.1%

Source: Debt Management Section, MoF

External debt represents 85.7% of the portfolio, while Treasury bonds outstanding amount makes up the remaining 14.3%. The main creditor of the GoT is the Eximbank China with two loans that represent 50.3% of the total debt portfolio and 58.7% of the external debt outstanding amount. The rest of the external debt portfolio is concessional and composed by loans from the Asian Development Bank (ADB), the International Development Association (IDA) and the International Fund for Agricultural Development (IFAD), which represent respectively 15.4%, 23.7% and 2.2% of the external debt stock. Table 2 shows the creditor composition of the total debt outstanding and disbursed.

Table 2. Creditor composition of debt outstanding at the end of FY 2020

(in millions TOP)	as of 30 June 2020		
	Outstanding	% total	% GDP
External Debt	418.4	85.7%	36.7%
ADB	64.3	13.2%	5.6%
IDA	99.3	20.3%	8.7%
IFAD	9.4	1.9%	0.8%
EximBank China	245.4	50.3%	21.5%
Domestic Debt	70.0	14.3%	6.1%
Bondholders	70.0	14.3%	6.1%
Total	488.4	100%	42.8%

Source: Debt Management Section, MoF

Domestic Debt is composed of Treasury bonds with tenors ranging from 2 years to 6 years. Government has mainly issued bonds with a maturity of 5 years. The table 3 shows the outstanding amounts by tenor as of 30 June 2020. Issuance is authorized and capped by the Minister of Finance while the National Reserve Bank of Tonga (NRBT) act as the registrar of domestic bonds issuance.

Table 3. Domestic Debt Outstanding by tenors

Tenors	as of 30 June 2020	
	Outstanding (in TOP)	% total
2 Years	5 000 000	7.1%
3 Years	13 765 000	19.7%
4 Years	6 000 000	8.6%
5 Years	32 389 000	46.3%
6 Years	12 832 000	18.3%
Total	69 986 000	100.0%

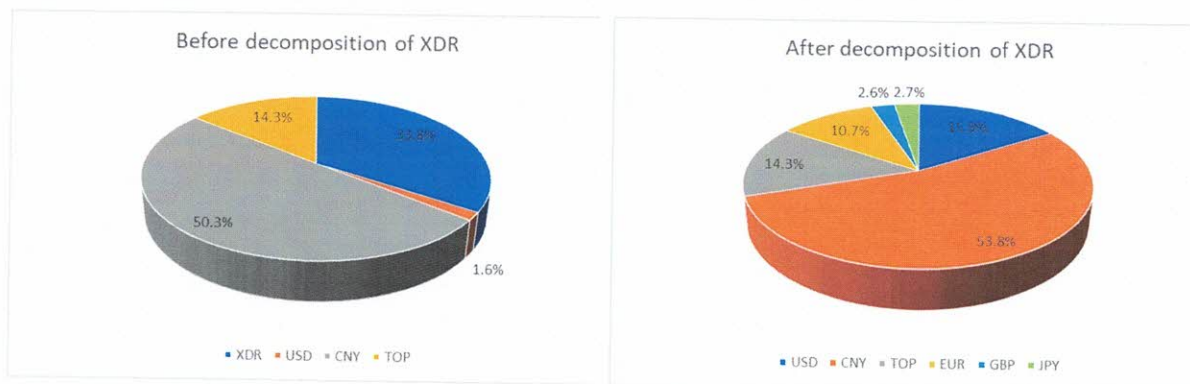
Source: NRBT

Holdings of domestic government securities are highly concentrated in a few financial institutions. Commercial banks and two Pensions funds are the main holders of government securities and take most of the volume auctioned. However, there is no restriction on potential bondholders because government boards, private companies and individuals can also apply to the volumes offered by the government.

Consistent with the large share external debt in the total portfolio, Chinese renminbi (yuan) and US dollars dominate the debt portfolio. Half of the public debt is denominated in CNY, while XDR represents 34% of the total portfolio (reflecting loans on concessional terms

from ADB, IDA and IFAD). However, after decomposition of the XDR into its constituent currencies, the portfolio contains 16% of debt exposed to fluctuations of the US dollar exchange rate against TOP. Figure 1 shows the foreign currencies to which the debt portfolio is exposed.

Figure 1. Currency exposure of debt outstanding as of 30 June 2020

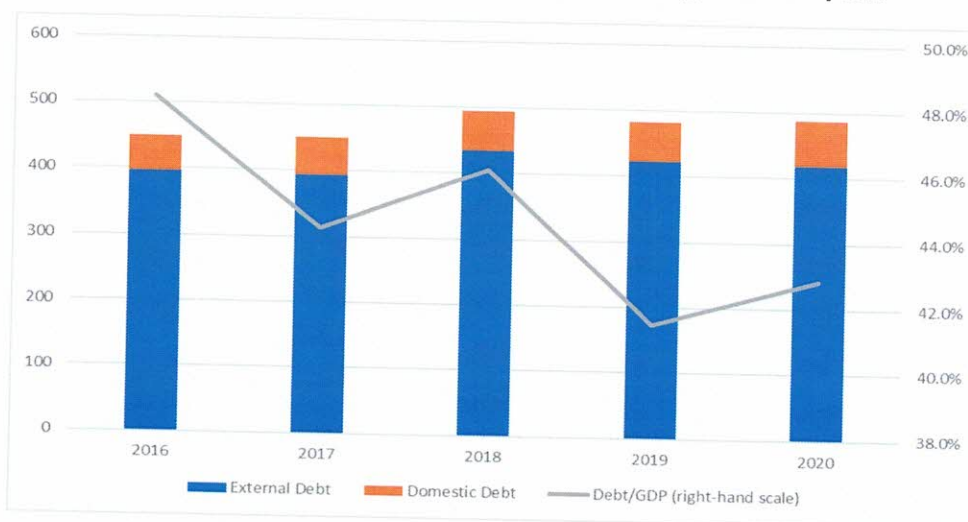


Source: Debt Management Section, MoF

B. Evolution of the debt portfolio in recent years and key development in 2020

The GoT prudent debt management in recent years has stabilized debt levels. In fact, the Debt/GDP ratio has even decreased since 2016 as shown in the figure 2 below. The GoT has successfully avoided new non-concessional external borrowing since 2016 and Tonga’s total and external public debt is on a downward trend since 2018. By contrast, domestic debt has steadily increased in the last 5 years, but the outstanding amount remains relatively small compared to the external debt.

Figure 2. Evolution of the Debt/GDP ratio during the last 5 years



Source: NRBT Quarterly bulletin June 2020 and IMF Article IV February 2021 for the GDP figures

On the external debt side, the GoT agreed with Eximbank China to postpone loans principal repayments to 2024. As a result, refinancing pressures were alleviated, and more fiscal space was created. However, the total reimbursements of the two Chinese loans are now condensed from 2024 to 2029. The GoT's adherence to the rule of no new non-concessional external borrowing was at the heart of government liability decisions in the last five years to avoid putting further pressure on Tonga's debt service.

On the domestic debt side, the GoT has issued Treasury bonds essentially to refinance maturing bonds, although net issuance has increased in recent years. Unexpectedly, the Covid-19 pandemic seems to have generated higher liquidity in the banking system because commercial banks preferred to slow down their investments abroad. Consequently, the conditions were favorable to domestic issuance in the FY 2020 and the outstanding amount of Treasury bonds increased to help financing the GoT's fiscal and economic response package.

In 2017, Tonga was downgraded from moderate to high risk of debt distress under the IMF-WB DSA framework. Consequently, the GoT introduced in 2017 a limit on external debt level set at 50% of GDP. Despite several years of fiscal consolidation and this new fiscal anchor, debt dynamics remained unfavorable underlining the need to rely only on grants for budget financing. Thus, Multilateral development banks (MDBs) assigned to Tonga a 100% grants financing status.

Under the Debt Service Suspension Initiative (DSSI), the GoT has benefited from a temporary suspension of debt service payments to the Eximbank China. This suspension is continuing during the FY 2021; Interest payments scheduled for March 2021 will be postponed. The following section describes how the DSSI impacts Tonga's public debt redemption profile.

C. Cost and risk indicators

The cost of the existing debt portfolio is relatively low and driven by the large share of external debt. At the end of FY 2020, the present value of total debt represented 33.8% of GDP² compared to the nominal debt which stood at 42.8% of GDP. This shows that total debt as an important share of concessional external borrowing. Under the DSSI, interest payments scheduled in FY 2021 for the two largest loans of the portfolio have been suspended which is driving down the other cost indicators in the table 4 below. Indeed, total interest payments projected for the FY 2021 represent 0.3% of GDP but without the DSSI this ratio would have

² Present Value as percent of GDP is calculated based on projected debt service payments where discount rate of 5% is applied to those instruments on concessional or semi-concessional terms.

been at 0.9% of GDP³. The same is true for the weighted average implied interest rate of the portfolio which is 0.8%⁴, instead of 2.0% without the DSSI. The cost of domestic debt is higher than the cost of external debt with a weighted average implied interest rate of respectively 3% and 0.4%. The latest issuances of Treasury bonds were achieved at similar interest rates.

Table 4. Cost and risk indicators of debt outstanding at the end of FY 2020

Risk Indicators		External debt	Domestic debt	Total debt
Amount (in millions of TOP)		418.4	70.0	488.4
Amount (in millions of USD)		182.5	30.5	213.0
Nominal debt as percent of GDP		36.7	6.1	42.8
PV as percent of GDP		27.7	6.1	33.8
Cost of debt	Interest payment as percent of GDP	0.1	0.2	0.3
	Weighted Average IR (percent)	0.4	3.0	0.8
Refinancing risk	ATM (years)	8.8	2.6	8.0
	Debt maturing in 1yr (% of total)	1.5	21.5	4.3
	Debt maturing in 1yr (% of GDP)	0.5	1.3	1.9
Interest rate risk	ATR (years)	8.8	2.6	8.0
	Debt refixing in 1yr (percent of total)	1.5	21.5	4.3
	Fixed rate debt incl T-bills (% of total)	100.0	100.0	100.0
	T-bills (percent of total)	0.0	0.0	0.0
FX risk	FX debt (percent of total debt)			85.7
	ST FX debt (percent of reserves)			1.1

Source: Debt Management Section with the MTDS Analytical Tool

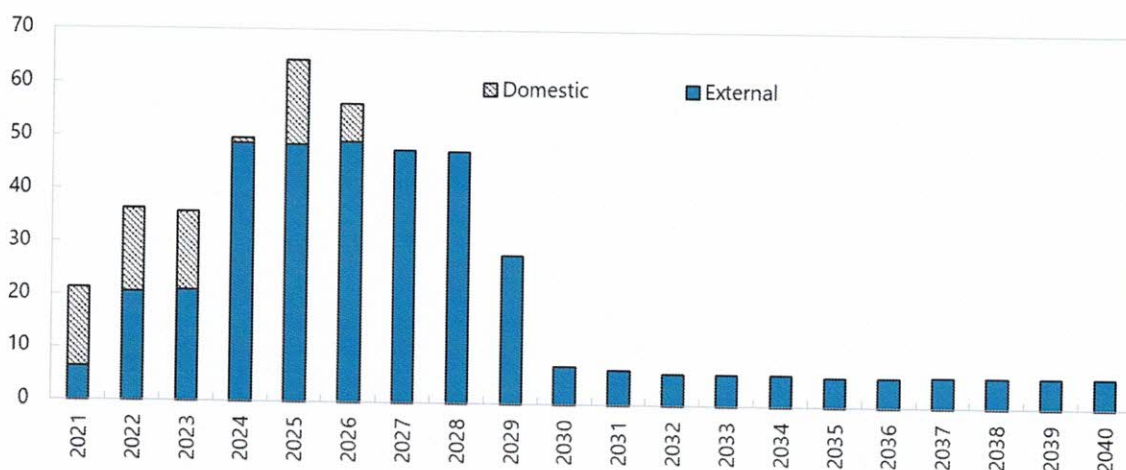
Refinancing risk is the main risk of the existing debt portfolio. The domestic debt portfolio is exposed to refinancing risk with 21.5% of the government securities due for redemption within 1 year and an average time to maturity of only 2.6 years. Refinancing risk is also large for the external debt portfolio. Indeed, even if the share of debt maturing within 1 year is low (only 1.5% of external debt outstanding amount), the redemption profile of the external debt is not lengthy and smooth, as one could expect from multilateral loans with long maturities

³ Interest payment as percent of GDP is calculated by dividing the sum of interest payments in the FY 2021 by the GDP 2020.

⁴ The implied interest rate is calculated by dividing interest payments in the FY 2021 by the outstanding amount of the debt instrument as of 30 June 2020.

and amortizing structure, but rather concentrated between 2024 and 2029 (due to the amortization of the two Chinese loans) as shown by the figure 3 below. This explains why the average time to maturity of the external debt portfolio is less high (8.8 years) than if concessional borrowing was predominant.

Figure 3. Redemption profile of debt outstanding as of 30 June 2020 (in million TOP)



Source: Debt Management Section with the MTDS Analytical Tool

With no variable interest rate debt and no Treasury Bills issued, the interest rate risk is driven exclusively by the redemption profile of the debt portfolio. For this reason, refinancing risk and interest rate risk indicators are the same.

With 85.7% of the debt denominated in foreign currencies, the exchange rate risk of the portfolio is high. The exposure to the Chinese renminbi fluctuations is particularly strong with loans denominated in CNY representing 53.8% of the total debt portfolio (after decomposition of the XDR in its constituent currencies). For the FY 2021, exchange rate risk is limited considering foreign currency debt due for repayment within 1 year is equal to 1.5% of total external debt, which represents only 1.1% of the stock of international reserves amounting to USD 242 million (as of 30 June 2020). The exchange rate risk might not present major challenges for the current budget, but it might generate serious consequences from 2024 onwards.

IV. MACROECONOMIC ASSUMPTIONS AND MAIN RISK FACTORS

A. Macroeconomic developments and baseline assumptions

The baseline scenario selected for this MTDS analysis is based on the latest IMF macro-fiscal forecasts⁵. This choice was made because IMF forecasts are recent (February 2021) and available for a long period of 5 years. The MoF is finalizing its own forecasts for the budget statement FY 2021/2022, which will be used to update the MTDS in the mid-year review. Table 5 presents the baseline scenario used in this MTDS analysis.

Table 5. Baseline macro-fiscal projections

(in million TOP)	2020	2021	2022	2023	2024	2025
(A) Total Revenue including grants	521	498	486	539	439	427
(B) Primary Expenditures (non-interest)	463	543	482	520	533	549
(C) Total Expenditures	471	552	489	527	542	559
(D) Primary Balance (A-B)	58	-45	3	19	-94	-122
(E) Overall Balance (A-C)	50	-53	-3	12	-103	-132
Primary Balance as % of GDP	5,1	-4,1	0,3	1,6	-7,4	-9,2
Nominal GDP	1140	1090	1157	1215	1269	1322
International Reserves (in million USD)	242	192	169	148	149	150

Source: IMF Country Report n. 21/26 (Tonga Article IV), February 2021

Tonga faced a double exogenous shock in 2020: the Covid-19 pandemic and Cyclone Harold. This shock slowed down the recovery process from the devastating Tropical Cyclone Gita in 2018. The impact on economic activity was negative with the tourism industry severely hit. The IMF forecasts for the period FY 2021-2025 anticipates a contraction of GDP in FY 2020 and FY 2021 of respectively 2.5% and 3.5%, before GDP starts increasing again in FY 2022.

Led by emergency grants and imports compression resulting from delayed aid spending, NRBT international reserves increased considerably in 2020. However, reserves could decrease in 2021 due to pressure on current account deficit which could arise from the continued effects of the pandemic and increasing reconstruction imports. This situation could eventually lead to a decrease of the international reserves from 2021 to 2023.

Donors support, through grants, and delays in investment expenditures generated further fiscal consolidation in 2020. Consequently, the primary and overall balance in FY

⁵ IMF Country Report n. 21/26 (Tonga Article IV), February 2021.

2020 are expected to reach respectively 5.2% and 4.4% of GDP. However, a fiscal deficit could be generated in FY 2021 led by government healthcare and stimulus spending related to the pandemic and reconstruction spending in the aftermath of cyclone Harold. Fiscal deficit is projected to decrease in FY 2022 and a slight surplus is forecasted for the FY 2023, before an expected decline of grants from the donors' community in FY 2024 and 2025 could lead to reduction in government total revenues and generate fiscal deficits.

B. Key macroeconomic risks

The baseline assumptions are exposed to risks to the economic outlook for Tonga which are tilted toward the downside. A weaker global recovery of the Covid-19 pandemic could worsen tourism, and international aid, provoking a lower than anticipated economic growth compared to the baseline scenario. Economic recovery could also be hampered by a local outbreak of the pandemic or the occurrence of another natural disaster. Such a broad-based negative impact could spill over to the fiscal outcome and inflationary expectations, and also balance of payments deterioration with pressure on the exchange rate. Delays in enacting tax reforms could jeopardize government revenues.

The materialization of these risks could have significant implications for debt management. All these risks could result in higher borrowing requirements and increase debt levels over the medium term. Weaker-than-expected economic growth could reduce Tonga's capacity to repay public debt. Higher-than-expected inflation within the economy could depress demand for longer-dated government securities exacerbating refinancing risk of the domestic debt portfolio. Exchange rate depreciation, especially if sudden, could lead to higher debt service payments associated with foreign currency debt.

V. SOURCES OF POTENTIAL FINANCING

A. External financing

The GoT intends to continue seeking grants from bilateral donors and international financial institutions to keep public and external borrowing at prudent levels. Since 2018, external financing was restricted to grants and this situation will certainly continue in FY21 and FY22, except for the IMF Rapid Credit Facility, and beyond unless Tonga graduates from high to moderate risk of debt distress. Additional emergency grants related to the Covid-19 pandemic are still available for disbursements. These grants generated an increase in the foreign currency reserves of the NRBT which reached 242 million USD at the end of FY 2020.

The GoT expects budget support through the IMF Rapid Credit Facility (RCF) to catalyze additional grants from international financial institutions. For the FY 2021, the IMF RCF will provide support of approximately 9.7 million USD to the budget. This loan has a maturity of 10 years and a grace period of 5 years, with an interest rate of 0%. However, the donors' community could provide further grants for the FY 2021, in addition to the emergency grants related to the Covid-19 pandemic mentioned in the previous paragraph.

An extension of debt service suspension for FY 2021 was granted to Tonga by Exim Bank China under the DSSI. The amount suspended is equivalent to 5 million TOP. This will help government to free up budgetary resources to address country's urgent pandemic-related spending needs.

The GoT will continue to pursue debt relief from its main bilateral creditor, following the request made to the Chinese authorities in December 2019. Indeed, this debt relief is essential to create fiscal space to address challenges posed by tropical cyclones and ensure debt sustainability in the long run. The IMF considers "additional donor support, including approval of the 2019 request for debt relief from China Eximbank, could therefore be vital to keep investments on track"⁶.

If debt sustainability improves by 2023, the GoT could consider resuming concessional external borrowing. An upgrade to a moderate risk of debt distress under the DSA framework and a decrease of grants allocation in the medium-term could lead the MoF to restart borrowing from external creditors but only through loans with a minimum 35% grant element.

⁶ IMF Country Report n. 21/26 (Tonga Article IV), February 2021.

B. Domestic financing

The GoT issues Treasury bonds with maturities ranging from 2 to 6 years. These bonds have a bullet repayment structure⁷ and currently pay a coupon rate between 3% and 3.5%. The Ministry of Finance does not issue short-term instruments and does not use other source of domestic financing.

Tonga's domestic debt market is still at an early stage of development with limited absorption capacity. However, the GoT is committed to build up communication with investors for a better response to their needs and a smoother financing of the budget. The GoT is committed to continue issuing Treasury bonds to refinance maturing bonds. The intention is even to gradually increase new issuance as it has been the case in recent years⁸.

The MoF is deciding the terms and interest rates on Treasury bonds issued. The MoF sends to the NRBT the prospectus of the Treasury bond, which indicates the total amount to be issued and the fixed interest rate. Then, NRBT sends out the prospectus to market participants who must submit their offers within 1 month. There is no restriction on potential bondholders, anybody can apply. Successful bids terms and conditions are decided by the MoF before being applied by the NRBT to the individuals and institutions having submitted their offers. The MoF is responsible for the choice of the tenors to be issued and the interest rates to apply; the main practice consists in rolling over the maturing bonds keeping the same interest rate and trying to fill the gaps of the debt redemption profile.

The Covid-19 pandemic generated an excess of liquidity in the banking system favorable to the bonds issuance in FY 2020, but this situation could be temporary. Despite the accommodative monetary policy of the NRBT, who set reference interest rate to 0%, and the high level of foreign reserves which fostered liquidity into the system, the latest issuance in January 2021 was undersubscribed. This illustrates that the domestic market is characterized by a limited number of investors and when one of them does not participate to the offer, the volume of bids can decrease significantly. Furthermore, Pension funds did not participate to the latest issuance. Although the share of Treasury bonds hold by Pension funds has increased in recent years, the Retirement Fund Board have now new investment channels which may have reduced their appetite for government securities issued in January 2021⁹. It is not yet clear if this slowdown of demand was a one-off event or a structural concern of the investors, but the MoF intends to strengthen its channel of communication with domestic investors to reinforce its market intelligence.

⁷ A bullet repayment structure means the whole amount is repaid at the maturity date.

⁸ The volume of gross issuance increased from 9.1 million in FY 2016 to 31.6 million TOP in FY 2020. Net issuance was 13.6 million in FY 2020.

⁹ Since 2019, the Retirement Fund Board is authorized to invest offshore and lend money to their members.

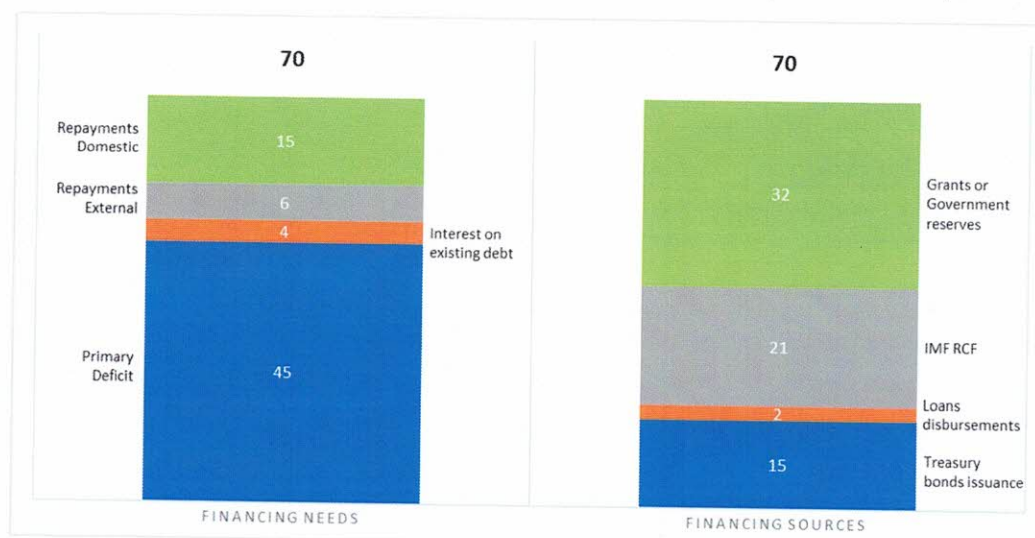
VI. STRATEGY FOR THE PERIOD 2021-2025

A. Government borrowing requirements for the FY 2021

For the FY 2021, Government financing need will roughly attain 70 million TOP. Government primary balance will show a deficit of 4% of the GDP equivalent to 45 million TOP. Interest payments on the existing debt will reach 4 million TOP and debt repayments 21 million TOP (respectively 15 and 6 million for domestic and external debt repayments)¹⁰.

The financing gap between borrowing sources and government needs will be closed by additional new grants from the international donors (i.e. beyond those already incorporated in the projected primary balance). Treasury bonds issuance will reach approximately 15 million TOP to rollover maturing bonds. From external sources, four loans are still disbursing and could draw around 2 million TOP in FY 2021. The IMF RCF will bring 9.7 million USD equivalent to roughly 21 million TOP. The remaining amount will come from grants (or government reserves) as shown by the figure 4.

Figure 4. Government financing need for the FY 2021 (in million TOP)



Source: Ministry of Finance

B. Description of the debt strategy for the period 2021-2025

¹⁰ Interest payments and principal repayments are extracted from the debt database managed by the Debt management section of the Ministry of Finance. Interest payments include the reduction granted by the Debt Service Suspension Initiative.

The MTDS was selected by performing a cost-risk analysis of the public debt portfolio. The results of this analysis show this strategy offers a good compromise by reducing exchange rate risk and refinancing risk of the portfolio without drastically increasing the cost of debt. This strategy is expressed in proportions allocated to each external and domestic instrument to finance government gross borrowing requirements for each year from 2021 to 2025.

Over the five-years' time-horizon, the strategy relies essentially on domestic sources of financing. On average over the strategy period, government gross borrowing will come at 8% from external loans and 92% from domestic issuances, as shown in the Table 6 below. The main source of financing will be the Treasury bonds 5-years and 6-years (64% of total borrowing), the other bonds represent 28% of the borrowing mix. The IMF RCF would represent only 6% of total borrowing needs during the five years, while the remaining disbursements from prior loans commitments play a marginal role in the borrowing mix (IDA loans would represent 2% of borrowing needs, ADB and IFAD close to 0%, and the two loans from Eximbank China already terminated their disbursement period). However, ADB and IDA are important sources of financing for Tonga, but through grants only.

Table 6. Average percentage of gross borrowing over the strategy period

Instrument	Strategy	Financial Conditions		
	Proportion of financing	Maturity	Grace	Interest Rate
ADB	0	40	10	1%
IDA	2	40	10	0.75%
IFAD	0	40	10	1%
IMF	6	10	5	0%
Eximbank China	0	20	5	2%
Treasury bonds 2-years	9	2	1	Market
Treasury bonds 3-years	11	3	2	Market
Treasury bonds 4-years	8	4	3	Market
Treasury bonds 5-years	32	5	4	Market
Treasury bonds 6-years	32	6	5	Market
External Sources	8			
Domestic Sources	92			

Source: Debt Management Section with the MTDS Analytical Tool

However, the strategy borrowing mix for FY 2021 is very different from the average one over the period. This is due to the large share of borrowing coming from the IMF RCF which will represent 54% of government borrowing needs for FY 2021 but will not provide any funds afterwards. For FY 2021, disbursements from prior loans commitments will represent approximately 6% of gross borrowing, the remaining 40% being covered by Treasury bonds issuances.

The MTDS aims at extending Treasury bonds maturities and increasing the use of grants to reduce the burden of Chinese loans reimbursements in FY 2024 and FY 2025. Since the

baseline scenario envisages a reduction of grants in FY 2024 and FY 2025, decreasing thereby government revenues and increasing primary deficit, the strategy softens this hypothesis by considering access to new grants amounting to 100 million TOP equally split between FY 2024 and FY 2025. New grants will reduce government borrowing requirements for these two years. For FY 2022, the remaining disbursements expected from external loans are estimated to 2.3 million TOP or approximately 13% of the borrowing needs of that year. Then, from FY 2023 to FY 2025, the MoF does not expect any loans disbursements because the financing from Tonga’s external partners would come only in form of grants. Therefore, the share of external sources in the borrowing mix would be zero. With this borrowing strategy, the GoT plans to continue avoiding non-concessional external debt and to seek grant-only financing to the full extent possible.

Treasury bonds issuance focuses on longer maturities. The 5-years and 6-years tenors represent each 35% of the domestic issuance for each year, while the other tenors (2-years, 3-years and 4-years) represent each 10% of domestic issuance.

The MoF sets 2 strategic targets on risk indicators which will be used to evaluate government performance in implementing the debt strategy. By the end of FY 2025, the MoF expects the ATM of the domestic debt portfolio to exceed 3 years and the share of debt denominated in foreign currencies to drop below 70% of total debt, as summarized in table 7 below. The GoT objective is to reduce the refinancing risk of the current domestic debt portfolio and decrease total debt exposure to exchange rate risk.

Table 7. Strategic targets to attain by the end of FY 2025.

Risk indicators	Strategic targets	Current level as of 30 June 2020
Average time to maturity (ATM) of the domestic debt portfolio	Minimum 3 years	2.6 years
Percentage of debt denominated in foreign currencies in total debt	Maximum 70%	86%

Source: Ministry of Finance

The Ministry of finance also set a fiscal anchor to the level of external debt compared to GDP, but this is a fiscal performance indicator and not a debt management one. Indeed, the fiscal anchor requires the external debt stock to remain below 50% of GDP. As of 30 June 2020, external debt reached the level of 36.7% of GDP.

C. Rationale for the choice of the strategy for the period 2021 - 2025

The MTDS addresses the refinancing risk associated with the current public debt portfolio. On the domestic front, the issuance focuses on the Treasury bonds with longer maturity and, therefore, will significantly reduce, by the end of FY 2025, the share of domestic

debt maturing within 1 year¹¹. This strategy will increase the average time to maturity of the domestic portfolio above the strategic target¹². Regarding external debt, the refinancing risk associated with the redemption of Chinese loans in FY 2024 and FY 2025 is partially covered by the assumption that the donors' community will provide new grants to Tonga.

The strategy also reduces the exchange rate risk arising from the large share of external debt in the current portfolio. The GoT intends to decrease substantially the share of debt denominated in foreign currencies in the public debt portfolio by the end of FY 2025¹³. Considering FX debt represent currently 86% of total debt and the strategic target is fixed at a share of 70%, this impressive drop can come only from a major reduction of the stock of external debt through the combination of several factors, namely the access to new grants, the fact that the GoT does not intend to sign new external loans during the upcoming years, and the reliance on domestic market to finance the remaining borrowing needs.

Interest rate risk is equivalent to refinancing risk because the debt portfolio does not have any variable-rate debt instruments and any T-bills. Consequently, the risk of refixing of the interest rate only arises from the maturing debt.

However, the strategy will increase the average cost of debt. Total interest payments will increase regularly during the strategy period. The GoT anticipates it might pay approximately 12 million TOP in interest on debt by 2025, or 0.9% of GDP, compared to annual payments of roughly 8 million on average in recent years.

At the end of FY 2025, Debt/GDP ratio will increase significantly compared to the current level of 42.8%¹⁴. However, the increase is not due to the debt strategy but to the repeated budget deficits expected during the strategy period driven by the reduction of grants in FY 2024 and FY 2025. In addition, although part of the Chinese loans would be reimbursed with new grants, the remaining gap is expected to be covered by Treasury bonds net issuance.

The GoT is committed to strengthen fiscal consolidation, including through tax policy reforms, considering the uncertainty related to the grants-only funding policy. To this end, the GoT intends to increase domestic revenue mobilization by broadening the tax base and increasing the efficiency of tax collection. Government is also committed to improve spending efficiency by strengthening controls and improving the prioritization of health and infrastructure spending. Continued efforts on fiscal consolidation are essential to avoid

¹¹ The share of domestic debt maturing within 1 year would decrease to 8.5% of total domestic compared to current share of 21.5%.

¹² ATM of the domestic debt portfolio would attain 3.4 years compared to the current ATM of 2.6 years.

¹³ FX debt is expected to drop to 48,4% of total debt from the current share of 85.7%.

¹⁴ By the end of 2025, Debt/GDP ratio is expected to reach 48.2%.

greater-than-expected deficits in the future, especially in the case where Tonga's access to international grants decrease over the medium-term following an upgrade to a rating of medium risk of debt distress.

The MTDS would lead to a substantial increase of domestic outstanding debt by the end of FY 2025 compared to the current amount of TOP 70 million. By the end of FY 2025, the domestic debt outstanding amount would reach TOP 330 million if the strategy is fully implemented as proposed. Indeed, the MTDS envisages an average annual gross issuance of Treasury bonds (including rollovers) of TOP 81 million from 2022 to 2025. The risk the domestic market cannot absorb such a high volume of issuance is important and, therefore, the GoT could decide, in that case, to borrow externally on concessional terms and amend the strategy during the period under review.

D. Implementation of the strategy

The MTDS requires government to secure additional grant funding in FY 2024 and FY 2025. Considering forecasts for the primary balance in FY 2024 and FY 2025, estimating a deficit of 94 and 122 million TOP, and Chinese loans amortization of respectively 41 and 40 million TOP, the GoT will have to build up reserves along the whole strategy period by seeking additional grant financing among the donors' community.

Domestic debt market absorption capacity needs to be strengthened to implement the strategy. Treasury bonds issuance suffers a major concentration risk of government securities holders. The GoT intends to diversify the investor base, improve the mobilization of domestic savings, and increase foreign investors' appetite for Tongan securities. This would require reforms to improve domestic market functioning and let the interest rates be determined by the market demand, which would certainly mean higher rates on Treasury bonds. The GoT will seek technical assistance from International financial institutions to develop domestic securities market and improve Treasury bonds issuance efficiency.

The Debt management section will be responsible for the monitoring of the implementation of the debt strategy. In particular, the unit will monitor the evolution of the ATM of the domestic debt portfolio and the share of debt denominated in foreign currencies in the total debt to see if it complies with the strategic targets set by the GoT. Actual levels of these two risk indicators will be reported against their strategic targets in the annual budget statement.

The strategy has a time-horizon of 5 years but the GoT will review the implementation of the strategy every year. The MoF will assess each year whether the targets set for FY 2025 can be achieved and whether the financing and macroeconomic conditions underlying the strategy are still valid. If, over the period of the strategy, underlying conditions change substantially, the Ministry of Finance might decide to elaborate and implement a new MTDS.

VII. CONCLUSIONS

The MTDS for the period FY 2021-2025 aims at reducing the refinancing risk and exchange rate risk associated with the current public debt portfolio. From one side, the strategy relies on additional grants from the donor community to reduce refinancing risk of the portfolio arising from the reimbursements of two Chinese loans starting in FY 2024 and, from the other side, it focuses on extending Treasury bond maturities to reduce the refinancing risk of the domestic debt portfolio. By reducing the external debt stock at the end of FY 2025, the strategy will also decrease the exchange rate risk of the portfolio.

The Ministry of Finance is confident this MTDS will maintain public debt at prudent levels. However, it realizes that the implementation of the strategy might be challenging because government needs to secure sufficient grants funding, especially to finance gross financing needs in FY 2024 and FY 2025, and the domestic debt market is expected to preserve sufficient liquidity to absorb Treasury bonds issuance. The MoF does not plan to resort to new external debt borrowing during the period of the strategy.

The GoT will continue to pursue debt relief from its main bilateral creditor. As requested to the Chinese authorities in December 2019, the debt cancellation of the two loans maturing in 2029 would create fiscal space. This will ensure Tonga's debt sustainability and allow the country to implement the necessary spending to reach sustainable development goals. In the absence of debt relief, the GoT plans to seek grant-only financing to the full extent possible, and only after grants are exhausted, carefully consider whether to take on highly concessional (over 35 percent grant element) new external debt in line with recommendations of MDBs sustainable development finance policies.

The MoF will monitor the implementation of the MTDS and might decide to review this strategy as circumstances evolve. Indeed, uncertainties about the outcome of the negotiation with the main bilateral creditor, the volumes of grants made available to Tonga, the absorptive capacity of the domestic market, and the future level of debt distress can substantially change the baseline scenario on which this MTDS analysis was performed. These uncertainties also highlight the need for continued fiscal consolidation to reduce the risk of debt distress.