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INTERNATIONAL DEVELOPMENT ASSOCIATION

SUPPLEMENTAL FINANCING DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY GRANT OF SDR 14.5 MILLION (EQUIVALENT TO US$20 MILLION)
FROM THE IDA CRISIS RESPONSE WINDOW RESOURCES

TO

KINGDOM OF TONGA

FOR THE

TONGA SECOND RESILIENCE DEVELOPMENT POLICY FINANCING: SUPPLEMENTAL FINANCING

MAY 10, 2022

Macroeconomics, Trade And Investment Global Practice
Urban, Disaster Risk Management, Resilience and Land Global Practice
East Asia And Pacific Region

Kingdom of Tonga

GOVERNMENT FISCAL YEAR

July 1 – June 30

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of March 31, 2022)

Currency Unit	Tongan Pa'anga
US$1.00	TOP$2.25
SDR1.00	US$1.3824

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
Cat-DDO	Disaster Risk Management Catastrophe-Deferred Drawdown Option
CEO	Chief Executive Officer
CRW	Crisis Response Window
DPO	Development Policy Operation
DRFS	Disaster risk financing strategy
DRM	Disaster Risk Management
DSA	Debt Sustainability Analysis
DSSI	Debt Service Suspension Initiative
EIA	Environmental Impact Assessment
FY	Fiscal Year
GDP	Gross Domestic Product
GoT	Government of Tonga
GRADE	Global RApid post-disaster Damage Estimation
GRID	Green, Resilient and Inclusive Development
GRS	Grievance Redress Service
HSRO	Housing Sector Resilience Office
HT-HH	Hunga Tonga-Hunga Ha'apai (volcano)
IDA	International Development Association
IMF	International Monetary Fund
MIA	Ministry of Internal Affairs
MoF	Ministry of Finance
MTDS	Medium-Term Debt Management Strategy
NDVP	National Deployment and Vaccination Plan for COVID-19 Vaccines 2021–2023
NEF	National Emergency Fund
NRBT	National Reserve Bank of Tonga
NZ	New Zealand
PA	Prior Action
PDO	Program Development Objective
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PREP	WB Pacific Resilience Project
PSC	Public Service Commission
PV	Present Value
RCF	Rapid Credit Facility
RPF	Regional Partnership Framework
SDR	Special Drawing Rights
TC	Tropical Cyclone
TOP	Tongan Pa'anga
TVET	Technical and vocational education and training
WB	World Bank
WBG	World Bank Group

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KINGDOM OF TONGA

TONGA SECOND RESILIENCE DPO WITH A CAT-DDO: SUPPLEMENTAL FINANCING

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Parent Project
P178698	P172742

Proposed Development Objective(s)

The proposed Development Policy Operation supports the Government of Tonga to: (i) strengthen public finances; (ii) enhance resilience to climate change, natural disasters, and health-related risks; and (iii) support economic recovery and improved labor market outcomes.

Organizations

Borrower:	KINGDOM OF TONGA
Implementing Agency:	Ministry of Finance

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**20.00**

DETAILS

International Development Association (IDA)	20.00
IDA Grant	20.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial

Results

Indicator Name	Baseline	Current Value	Target
1. Domestic revenue as a share of GDP	24 percent (average FY16-FY18)	24.6 percent (average FY20-FY21)	25 percent or higher (FY25)
2. Cash balance as a share of recurrent expenditure (months)	3.5 months (average during FY19)	2.5 months (FY21)	1 – 2 months (average FY22-FY24)
3. Percent of new external debt that is concessional	100 percent (FY16-FY18)	100 percent (FY20-FY21)	100 percent (FY21-FY24)
4. Public-sector wage bill as a share of domestic revenue	54 percent (average of FY16-FY18)	55.4 percent (average FY20-FY21)	53 percent or lower (average FY24-FY25)
5. The Housing Sector Resilience Office (HSRO) is established, and its work plan is submitted to the National Emergency Management Committee on an annual basis	No dedicated unit for housing-sector recovery and risk reduction exists (FY19)	The HSRO is established. Its annual work plan for FY22 was submitted and approved (FY21)	The HSRO is established, and its annual work plan is submitted to the National Emergency Management Committee (FY23)
6. Annual report submitted to the National Disaster Risk Management Committee on the implementation of disaster risk reduction initiatives under the national disaster risk management policy	N/A	No report (FY21)	Report submitted (FY24)
7. Establishment of national registries of public schools and health facilities that include asset vulnerability information, and are used for policy and operational decisions to enhance resilience of public assets	No registries exist (FY19)	No registries exist (FY21)	Registries finalized (FY23)
8. Proportion of the eligible population (aged 15 years and over) that have received the COVID-19 vaccine, disaggregated by sex	N/A	86.8 percent (female) and 94.3 percent (male) (March 15, 2022)	75 percent (female) and 75 percent (male) (FY23)
9. Increased number of Tongans in Ministry of Internal Affairs (MIA) worker pools, with increased female participation	511 Tongans in the MIA worker pools, of which 32 percent are female (Dec 2019)	1984 Tongans in the MIA worker pools, of which 45 percent are female (December 2021)	2000 Tongans in the MIA worker pools, of which 37 percent are female (June 2023)
10. Improved reporting on credit union sector regulatory and supervisory activities	N/A	No annual reporting (FY21)	Annual reporting submitted to NRBT Board (FY24)
11. Confidential data is collected and maintained annually on: (i) sexual harassment complaints and how they were dealt with, disaggregated by ministry, procedure followed (formal or informal) and gender; and (ii) officials' experiences of sexual harassment, and knowledge and satisfaction of the policy	N/A	No data available on either indicator (FY21)	Data is collected annually on both indicators (FY23)

IDA SUPPLEMENTAL FINANCING DOCUMENT FOR A PROPOSED GRANT TO KINGDOM OF TONGA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation provides US$20 million in supplemental financing from the IDA Crisis Response Window (CRW) for the Second Resilience Development Policy Operation with a Catastrophe-Deferred Drawdown Option (Parent DPO2/Cat-DDO, P172742).** The supplemental financing is to help the Government of Tonga (GoT) cover an unanticipated financing gap that has arisen due to the impact of the Hunga-Tonga-Hunga-Ha'apai (HT-HH) volcanic eruption and the subsequent tsunami.[1] The Parent DPO2/Cat-DDO, consisting of a US$11m DPO (Parent DPO) and a US$8m Disaster Risk Management (DRM) Development Policy Grant with a Cat-DDO (Parent Cat-DDO), was presented to the Board on November 22, 2021. The Program Development Objectives (PDOs) of the Parent DPO2/Cat-DDO are to: (i) strengthen public finances; (ii) enhance resilience to climate change, natural disasters, and health-related risks; and (iii) support economic recovery and improved labor market outcomes. However, the HT-HH disaster has created an unanticipated financing gap, putting at risk the satisfactory implementation of the reform program. The supplemental financing is proposed to be provided to the Parent DPO, not to the Parent Cat-DDO. The request for US$20m supplemental financing (182 percent of the parent DPO, 4.0 percent of Gross Domestic Product, GDP) is consistent with the World Bank (WB) policy on Development Policy Financing.

2. **On January 15, 2022, a volcanic eruption and a subsequent tsunami and ashfall caused damages and losses of at least US$182m (36.4 percent of GDP).**[2] The eruption—the most explosive volcanic event in the world in 30 years—created an ash plume at least 35 kilometers high and 260 kilometers wide. It also triggered tsunami waves that inundated several inhabited islands in the Tonga archipelago and reached countries across the Pacific Ocean. In Tonga, 167 houses were destroyed and a further 299 were damaged. The tsunami also caused widespread damage to buildings, schools, roads, power and water supply networks, tourism infrastructure, and agricultural crops, livestock, and fisheries. A thick layer of ash covered the islands of Tongatapu, Ha'apai, and 'Eua, damaging crops and disrupting air transport. The volcanic activity also severed submarine fiberoptic cables, cutting off both international and domestic communications. The disaster is estimated to have affected 85 percent (85,000 people) of the population directly, especially impacting poor households reliant on agriculture and tourism sectors, while the entire population (100,209 people) was affected by the disruption to telecommunications.

3. **Tonga is also managing its first outbreak of COVID-19 and is affected by rising global commodity prices due to the Russian invasion of Ukraine, compounding the impacts on the economy and public finances.** On April 13, 8,761 cases of COVID-19 had been recorded (8.7 percent of the population). The country's high vaccination rate (90 percent of the eligible population) and domestic lockdowns in February and March 2022 have helped to curb the spread. However, the lockdowns have hampered post-disaster response and recovery efforts. The pandemic has weakened Tonga's economic performance, as stringent border closures since March 2020 have resulted in significant negative impacts on the tourism and retail sectors, as well as government finances. Higher global commodity prices due to the Russian invasion of Ukraine are compounding the impacts on domestic prices, pushing up recovery costs and inflation, putting additional pressure on households, particularly the poor and vulnerable.

[1] In April 2022, the WB approved US$35m in IDA CRW support for recovery from the HT-HH disaster. The CRW funds will be channeled through three operations: (i) US$20m for this supplemental DPO financing; (ii) US$10m for additional financing to the Tonga Safe and Resilient Schools Project (P174434); and (iii) US$5m for additional financing to the Tonga: Pacific Resilience Project under the Pacific Resilience Program (P154840).

[2] A Global Rapid post-disaster Damage Estimation (GRADE) was completed on February 7, 2022, by the World Bank, in collaboration with the GoT. The GRADE estimated damages of US$90.4m (18.5 percent of GDP). The GoT revised up the estimate in late February to US$102.2m based on their Initial Damage Assessment. Detailed post-disaster needs assessments are ongoing. Based on past impacts of natural disasters in Tonga and preliminary estimates from the WB's GRADE team, economic losses could represent up to an additional US$80m.

4. **The HT-HH disaster caused a substantial unanticipated fiscal financing need of over 10 percent of GDP in FY22.** Preliminary GoT estimates indicate that the total public sector response and recovery costs are likely to be at least US$188m (37.5 percent of GDP). Combined with revenue shortfalls due to lower economic activity caused by the disaster, the unanticipated fiscal financing needs are estimated to be US$52.5m (10.5 percent of GDP) in FY22. Despite the mobilization of domestic resources, the drawdown of US$8m from the Parent Cat-DDO, and substantial commitments from other development partners, there remains an unmet financing gap of $20m in FY22 (Table 8).

5. **The proposed US$20m DPO Supplemental Financing will enable the GoT to close the FY22 unanticipated financing gap and keep the reform program on track.** While the government remains committed to the reform program and has made good progress in achieving results, the financing gap created by the disaster is hampering development outcomes and implementation of the policy agenda. Given the government's limited borrowing options and the low level of cash reserves (less than three months of recurrent spending), fast-disbursing financial support is needed to respond to the disaster. Moreover, the absence of supplemental financing poses two risks. First, it could undermine the first development objective (to strengthen public finances) with the GoT having to run down cash balances to below its target minimum and/or increase public borrowing to meet recovery needs. Second, it could leave significant recovery needs unmet, increasing poverty and vulnerability. Given the urgency of the situation and the GoT's need to prioritize and finance post-disaster recovery, the time available is too short to complete a new reform program for a regular DPO.

2. THE IMPACT OF CRISIS, ECONOMIC DEVELOPMENTS AND OUTLOOK

6. **When the parent operation was approved in November 2021, Tonga's macroeconomic outlook was expected to gradually recover over the medium term**. Following a contraction of 0.8 percent in FY21, the projections indicated that growth would rebound in FY22 and FY23 to around three percent per year as tourism and related industries gradually recovered, with borders gradually reopening in March 2022. Growth was also projected to be supported by a recovery in agriculture and reconstruction activity related to Tropical Cyclones (TC) Gita and Harold.[3] The fiscal balance was projected to register a small deficit of 1.2 percent of GDP in FY22 before returning to a surplus by FY23. This was to be supported by a rebound in tax revenues in line with the economic recovery and a decline in current expenditure as economic stimulus spending was unwound. Inflation was expected to remain around two to three percent over the medium term. The current account deficit would widen in FY22, before narrowing over the medium term. Despite a decline in FY22, foreign reserves were expected to remain at adequate levels (seven months of imports cover).

7. **However, the volcanic eruption in January 2022, compounded by the COVID-19 outbreak and the Russian invasion of Ukraine, have substantially changed the economic outlook.** The economy is now expected to contract by 1.6 percent in FY22, reflecting the impact of the HT-HH disaster on agricultural production, the commercial sector, and tourism.[4] Domestic lockdowns associated with the COVID-19 outbreak and higher global commodity and transport prices due to the Russian invasion of Ukraine are also weighing on growth. This represents a 4.2 percentage point downgrade compared to the previous projection. The economic recovery is expected to take place over a three-year period, reflecting the pace of post-disaster reconstruction, the recovery in tourism arrivals, and agriculture. Previous disasters in Tonga have shown that recovery generally takes two to three years, due to capacity constraints of both the government and the domestic construction industry. Consequently, reconstruction and repair activity for housing, transport infrastructure, public buildings, and schools, is projected to ramp up over the next two years before scaling back from FY25 onwards. Tourism activity is expected to remain subdued at least

[3] Category 4-5 cyclones that struck the country in 2018 and 2020, causing cumulative damages and losses of over 50 percent of GDP.
[4] The effects on tourism are compounded by the extension of border closures due to the HT-HH disaster and COVID-19 outbreak.

until early 2023, with borders now expected to remain closed until at least July 2022. Arrivals are expected to return to around one-third of pre-pandemic levels in FY23, and three-quarters in FY24—reflecting permanent scarring of the tourism sector.[5] Crop production is expected to rebound strongly in FY23, and to return to full capacity in FY24. The projected rebound in agriculture output in FY23 has been dampened somewhat by the impacts of the Russian invasion of Ukraine, which are expected to increase costs for fertilizers and transport (both domestically and internationally). Combined, these factors are expected to drive a recovery in growth to over three percent in FY23 and FY24, followed by 2.5 percent in FY25 (Table 1, Table 2). Growth is expected to return to its long-run potential (1.8 percent) in FY26.

Table 1: Contributions to Growth (Percentage Point)

Sector	FY19	FY20	FY21	FY22 *Parent*	FY22 *SF*	FY23 *Parent*	FY23 *SF*	FY24	FY25
Agriculture, forestry and fishing	0.6	0.1	-0.2	0.7	-0.9	0.5	0.6	0.5	0.4
Construction	0.8	-0.7	0.3	0.4	0.2	0.3	0.7	0.7	0.3
Secondary (ex. construction)	-0.2	0.2	-0.1	0.3	-0.1	0.3	0.2	0.3	0.2
Services	0.4	0.5	-0.6	1.3	-0.5	1.6	1.4	1.3	1.2
Other	-0.9	0.5	-0.3	-0.1	-0.3	0.6	0.3	0.4	0.4
Total	**0.7**	**0.7**	**-0.8**	**2.6**	**-1.6**	**3.3**	**3.2**	**3.2**	**2.5**

Source: GoT and WB staff estimates

8. **The HT-HH disaster and higher global commodity prices will put some upward pressure on inflation in the short term**. The HT-HH shock has caused substantial impacts on agricultural crops, resulting in local market shortages of some fruits and vegetables. This has been compounded by higher global commodity prices due to the Russian invasion of Ukraine, which resulted in a 7 percent increase in regulated domestic petrol prices in early March. These dynamics have exacerbated pre-disaster price pressures, which saw headline inflation rise by 7.1 percent during July – November 2021. This predominantly reflected higher import prices of energy and food. These compounding effects saw year-on-year inflation register 9 percent in February 2022. Inflation is expected to remain elevated in FY23 due to continued high global commodity prices, offset somewhat by the rebound in domestic crop production. Over the medium term, inflation is expected to return to more moderate rates due to base effects and as domestic crop production returns to full capacity.

9. **The triple shocks of the HT-HH disaster, COVID-19 and higher commodity prices are expected to increase poverty and vulnerability.** Extreme poverty was less than 1 percent in FY16 (the latest household income and expenditure survey, HIES), among the lowest in the Pacific. However, a quarter of the population suffers from hardship (a lack of cash for basic goods). Many of these people are facing significant additional hardship due to the impacts of the triple shocks. Two-thirds of households derive income from agriculture. Tonga's latest HIES indicates that households reliant on agriculture for their primary source of income are more likely to be poor. The impact of the HT-HH disaster on crops, livestock and housing is thus likely to exacerbate poverty and vulnerability. Prior to the pandemic, around 30 percent of households had at least one member working in tourism-linked sectors—the sectors hardest hit by the border closure and domestic lockdowns. Salaried employment is also likely to have been affected by the HT-HH disaster and lockdowns. In 2020, business surveys indicated that over 60 percent of firms reduced staff and/or reduced workers' hours in response to the economic downturn. Businesses are likely to have responded in a similar fashion to the most recent disaster and domestic lockdowns. Finally, higher prices will push up the cost of living for all households, but the impacts will be especially acute for the poor and vulnerable. WB modeling estimates that a sustained 10 percent increase in prices could lead to a 5.7 percentage point increase in poverty (at the US$5.50 poverty line), in the absence of mitigation measures.

[5] Following two years of COVID-related border closures, key tourism operators that had assets destroyed by the HT-HH disaster may not rebuild their businesses, leading to a permanent loss in tourism capacity.

Table 2: Key Macroeconomic Indicators

	FY19	FY20	Proj. FY21 *Parent*	Est. FY21 *SF*	Proj. FY22 *Parent*	Proj. FY22 *SF*	FY23 *Parent*	FY23 *SF*	FY24	FY25
Real Economy			Annual percentage change, unless otherwise indicated							
Real GDP growth	0.7	0.7	-3.2	-0.8	2.6	-1.6	3.3	3.2	3.2	2.5
GDP deflator	7.7	-4.0	1.2	2.0	2.7	6.5	1.9	4.8	3.6	2.1
Inflation (CPI, average)	3.5	0.4	0.1	1.4	3.0	7.2	2.0	5.2	3.0	2.3
Fiscal Accounts			Percent of GDP, unless otherwise indicated							
Total Revenues and Grants	41.7	43.8	43.7	44.4	44.9	51.3	43.8	45.3	42.6	42.2
Total Expenditures	38.5	38.5	45.4	44.8	46.1	51.8	43.0	49.2	44.6	41.8
General Government Balance	3.2	5.3	-1.7	-0.4	-1.2	-0.5	0.8	-3.9	-2.1	0.5
Balance of Payments			Percent of GDP, unless otherwise indicated							
Overall Balance	-0.4	4.9	0.9	16.2	-8.0	5.1	0.2	-6.2	-4.7	0.3
Current Account Balance	-0.9	-3.9	-6.9	5.0	-13.3	-0.1	-6.4	-12.3	-10.7	-5.7
Trade Balance	-41.5	-43.3	-56.9	-53.0	-57.0	-66.7	-49.6	-60.5	-54.8	-48.3
Goods Exports	3.1	3.7	3.1	3.1	3.4	2.2	3.5	2.6	3.1	3.3
Goods Imports	-42.7	-42.0	-43.6	-45.6	-45.5	-54.3	-44.4	-50.5	-46.7	-43.2
Services (net)	-1.8	-5.0	-16.5	-10.4	-14.9	-14.6	-8.7	-12.6	-11.2	-8.4
Investment Income (net)	7.6	8.5	5.0	12.4	5.2	9.5	6.3	7.0	6.8	6.9
Current Transfers (net)	33.0	30.9	44.9	45.6	38.5	57.0	36.9	41.2	37.3	35.7
Capital and Financial Accounts	0.5	8.8	7.8	11.2	5.2	5.2	6.6	6.1	6.0	6.0
Gross Reserves (in US$ m, e.o.p)	212.8	237.0	246.3	318.0	204.9	345.0	206.0	309.7	281.1	283.1
In months of next year's imports	8.3	9.9	8.6	10.5	7.0	11.0	7.0	9.7	8.6	8.6
Other Memo Items										
GDP (nominal Pa'anga m)	1,164.0	1,129.2	1,106.2	1,142.7	1,165.5	1,197.9	1,226.0	1,295.8	1,385.1	1,450.4
Nominal public sector debt (% GDP)	41.3	43.3	46.2	44.7	42.7	42.7	40.8	39.2	38.8	38.1
Net Remittances (% of GDP)	27.7	29.0	29.6	39.8	28.7	36.9	28.1	32.5	29.2	27.3

Source: GoT, IMF and WB staff estimates

10. **The current account deficit is expected to increase in FY23 and FY24, before narrowing from FY25 onwards.** The current account is expected to be balanced in FY22 despite the impacts of the disaster, as a higher trade deficit is more than offset by continued high remittances and additional development partner grants to support the recovery effort. Substantial deficits are projected in FY23 and FY24 as imports remain elevated due to reconstruction activity and short-term domestic crop shortages, while grants and remittances gradually decline from their unprecedented levels. Short-term trade pressures will be compounded by higher import prices and lower global demand due to the Russian invasion of Ukraine. The deficit is expected to return to pre-crisis levels in FY25. Total grants (both capital and current) are expected to remain above pre-crisis levels in the medium term, due to development partner support to enhance resilience to climate change and natural hazards (Table 3, Table 4). Reserves are projected to decline from 11 months of imports cover in FY22 due to the delayed recovery in tourism receipts and the temporary spike in imports to support reconstruction activities, before stabilizing at over 8 months of imports cover over the medium term.[6]

[6] This level of reserves exceeds the international reserve adequacy metrics from the 2020 Article IV report of 4.1 months of imports under a standard shock probability scenario, and 6.6 months of imports under a higher shock probability scenario.

Table 3: Balance of Payments Sources and Uses

US$			Est.	Proj.			
	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Total financing needs	**10.4**	**24.1**	**-17.8**	**7.8**	**79.3**	**86.0**	**57.0**
Current account deficit	4.6	19.3	-25.0	0.5	70.0	65.0	36.1
Scheduled debt amortization	5.8	4.8	7.2	7.3	9.2	21.0	20.9
Total financing sources	**10.4**	**24.1**	**-17.8**	**7.8**	**79.3**	**86.0**	**57.0**
FDI inflows	0.5	3.5	7.0	2.6	6.8	8.5	9.5
External debt disbursements	-0.1	0.0	14.0	-0.4	10.1	0.1	-0.5
Other net inflows on capital & financial account	7.9	44.8	42.2	32.6	27.0	48.8	49.9
Use of FX reserves	2.1	-24.2	-81.0	-27.0	35.3	28.6	-2.0

Note: Change in reserves: "-" denotes an accumulation; "+" denotes a reduction.
Source: NRBT; Ministry of Finance; World Bank staff projections

Table 4: Financing the budget deficit

Percent of GDP	**FY22**	**FY23**
Overall Balance (excluding grants)	**-29.6**	**-26.1**
Budget support grants	11.4	2.0
of which: WB DPO2/Cat-DDO	*3.6*	*0.0*
WB Supp. Financing	*3.8*	*0.0*
ADB	*3.0*	*0.9*
Australia	*0.5*	*0.4*
New Zealand	*0.5*	*0.5*
European Union	*0.0*	*0.2*
Project grants & In-Kind	17.6	20.1
Other external financing (net) (a)	-1.5	0.2
External grants and financing	**27.6**	**22.3**
Domestic financing (net)	**2.0**	**3.7**
Total grants and financing	**29.6**	**26.1**

(a) FY23 includes the IMF RCF.

11. **The GoT has built credibility for prudent fiscal management through sustained recent efforts to increase domestic revenues, contain spending, and avoid any new non-concessional external borrowing.** This has resulted in an average fiscal surplus of 2.5 percent of GDP over the period FY14-FY21, despite multiple external shocks (including COVID-19, TC Harold, and TC Gita). Tonga participated in the Debt Service Suspension Initiative (DSSI) and the DSSI extension that ended in December 2021.

12. **Modest fiscal deficits are projected over the period FY22 to FY24 (Table 5).** The FY22 fiscal deficit (including grants) is expected to be slightly lower than was projected in the Parent DPO2/Cat-DDO (a 1.2 percent of GDP deficit), as lower domestic revenues and additional spending to fund immediate response and early recovery efforts are more than offset by substantial additional development partner support (including this proposed supplemental financing). The FY22 deficit will be financed by drawing down cash reserves. Fiscal deficits averaging 3.0 percent of GDP are projected in FY23 and FY24—compared to pre-disaster projections of fiscal surpluses averaging 1 percent of GDP. The deficits will be financed by a US$9.9m disbursement from the International Monetary Fund's (IMF) Rapid Credit Facility (RCF), the drawing down of cash reserves to their target minimum (one month of recurrent expenditure—consistent with Prior Action #2 in DPO1 of this programmatic series), and new domestic bonds.

13. **Domestic revenues (as a share of GDP) are projected to decline due to lower economic activity and temporary tax relief measures, before recovering over the medium term.** Domestic revenues are projected to be over 1.0 and 1.6 percentage points of GDP lower in FY22 and FY23, respectively, compared to pre-disaster forecasts. In FY22, income tax and excise tax collections (which represent over 40 percent of domestic revenues) are expected to be 15 and 10 percent below pre-crisis projections, due to the impacts of the disaster and COVID-19 lockdown on economic activity. Temporary recovery-related tax and customs exemptions are also expected to reduce revenue collection by US$0.4m (0.2 percent of GDP). In FY23, domestic revenues are projected to rebound in line with the economic recovery and the winding down of temporary exemptions. The shortfall in domestic revenues in FY22 and FY23 will be offset by additional development partner grants to support disaster recovery and reconstruction. Over the medium term, domestic revenues are projected to improve due to the economic recovery and recent legislative and institutional reforms to improve revenue administration and compliance.[7] Grant receipts are

[7] These include the Revenue Services Administration Act 2021 and associated regulations supported by DPO1, establishment of a Large

projected to gradually return to pre-COVID levels, from their unprecedented levels in FY21 to FY23.

Table 5: Key Fiscal Indicators

			Est.	Proj.			
	FY19	FY20	FY21	FY22	FY23	FY24	FY25
			Percent of GDP, unless otherwise indicated				
Overall Balance (including grants)	3.2	5.3	-0.4	-0.5	-3.9	-2.1	0.5
Overall Balance (excluding grants)	-15.1	-13.6	-20.4	-29.6	-26.1	-19.9	-16.6
Primary Balance	3.8	6.0	0.0	0.0	-3.3	-1.1	1.6
Total Revenues and Grants 1/	**41.7**	**43.8**	**44.4**	**51.3**	**45.3**	**42.6**	**42.2**
Domestic Revenues	23.4	24.9	24.4	22.3	23.1	24.7	25.2
of which: Consumption Tax	13.3	14.2	14.5	13.7	13.7	14.3	14.4
Taxes on Income and Profits	4.7	4.6	4.4	4.0	4.3	4.6	4.7
Other Tax Revenue	2.8	2.3	2.4	2.1	2.3	2.7	2.8
Non-tax Revenues	2.5	3.7	3.0	2.5	2.8	3.1	3.3
Grants	18.3	18.9	20.0	29.1	22.2	17.9	17.0
Total Expenditure 1/	**38.5**	**38.5**	**44.8**	**51.8**	**49.2**	**44.6**	**41.8**
Current Expenditure	30.3	33.3	38.4	43.3	37.6	34.9	33.4
Wages and Compensation 2/	11.6	13.2	14.1	14.9	13.7	13.0	12.9
Goods and Services	13.0	15.0	18.9	22.0	18.3	16.2	14.6
Interest Payments	0.7	0.7	0.4	0.5	0.6	1.0	1.2
Current Transfers	2.5	2.4	2.4	3.4	2.9	2.5	2.5
Other Expenses	2.5	2.1	2.6	2.4	2.1	2.2	2.2
Development Expenditure	8.3	5.1	6.4	8.6	11.6	9.7	8.4
General Government Financing	**-3.2**	**-5.3**	**0.4**	**0.5**	**3.9**	**2.1**	**-0.5**
Domestic (net)	-2.0	-4.3	-1.0	2.0	3.7	5.5	2.9
External (net)	-1.2	-1.0	1.4	-1.5	0.2	-3.4	-3.4
Memorandum Items							
Cash Reserves (Pa'anga m)	97.5	97.6	93.0	87.1	40.6	40.3	40.3
In months of current expenditure	3.3	3.1	2.5	2.0	1.0	1.0	1.0
Wages and Compensation							
as % domestic revenues	49.3	52.9	57.9	66.9	59.4	52.7	51.1
as % current expenditure	38.2	39.5	36.8	34.5	36.5	37.3	38.6

Source: GoT, IMF and WB staff estimates
1/ Excludes in-kind development grants and expenditure
2/ Includes employer contributions to defined-contribution pension scheme

14. **Disaster recovery spending will drive higher expenditure over the projection period.** Overall spending is expected to be around 6 percentage points of GDP higher in FY22 and FY23, and 3 percentage points higher in FY24, compared to pre-disaster projection. These increases are mainly driven by elevated goods and services and capital spending associated with post-disaster recovery. In FY22, this includes urgent repairs and rehabilitation to critical infrastructure, commencement of housing repairs and reconstruction, and cash support and electricity fee relief to households and businesses (including top-ups to social protection programs for poor and vulnerable households). It also reflects higher health spending to address the COVID-19 outbreak. Over the medium term, elevated spending reflects retrofitting and reconstruction to increase infrastructure resilience, along with support for agriculture and

Taxpayer Office designed to improve tax compliance and on-time filing for large taxpayers, and improvements in value-added tax compliance through the rollout of point-of-sale devices in businesses.

tourism sector recovery. Higher global commodity prices and supply chain disruptions are also pushing up construction, fuel, and transport prices, contributing to higher recovery costs. Current transfers are also expected to rise due to the increased fiscal cost of electricity subsidy for vulnerable households due to higher global energy prices.

15. **Monetary policy is expected to remain accommodative, as the National Reserve Bank of Tonga (NRBT), the central bank, aims to support the economic recovery.** The monetary policy reference interest rate has been zero percent for several years, leaving the statutory reserve deposit ratio (10 percent) and the target minimum loans/deposit ratio (80 percent) as the NRBT's key policy instruments. However, the transmission mechanism for monetary policy is weak due to high excess reserves, a lack of competition in the banking sector, conservative lending practices, and various other structural impediments to finance. To support economy recovery, the NRBT has approved the provision of liquidity support to the banking system and maintains a weekly dialogue with the commercial banks to track loan performance and liquidity. The nominal and real effective exchange rates have remained relatively stable against the currencies of Tonga's major trading partners over the last few years, and the exchange rate peg is expected to continue providing a credible nominal anchor over the medium term.

16. **Public debt is sustainable despite the impacts of the HT-HH disaster, reflecting the government's commitment to seek available grant financing and only to consider highly concessional debt as a last resort.**[8] An updated Debt Sustainability Analysis (DSA) was prepared by WB staff in consultation with the IMF for the purposes of this supplemental financing operation. In this updated DSA, Tonga is assessed at high risk of external and overall debt distress. The risk ratings are unchanged from the December 2020 IMF/WB joint DSA, and from the DSA prepared for the Parent DPO2/Cat-DDO. The present value (PV) of public and publicly guaranteed (PPG) external debt to GDP and public debt to GDP are projected to breach their respective DSA thresholds in FY32 and FY30 (Figure 1, Figure 2). Both were projected to breach their respective thresholds in FY29 in the DSA that accompanied the parent operation.[9] A natural disaster shock would lead to an earlier breach.[10] In the baseline scenario, debt dynamics are projected to stabilize from FY37 onwards. The DSA baseline scenario assumes that all new financing from IDA and the Asian Development Bank (ADB) is provided on credit terms, given its role to inform judgment on Tonga's capacity to receive credit financing from these institutions. This assumption underpins the projected large primary deficits over the medium- to long-term, which drive the debt dynamics. If Tonga continues to receive 100 percent grant financing from IDA and the ADB, the PV of external and public debt to GDP is expected to rise modestly over the projection period but to remain below the thresholds. While debt is judged to be sustainable, this assessment hinges in part on the GoT's continued access to grants and highly concessional financing. Continued adherence to the GoT's policy of avoiding new non-concessional external debt is important to protect Tonga's hard-won fiscal sustainability. Once the recovery in underway, the GoT remains committed to the ongoing fiscal adjustment plan designed to stabilize debt dynamics, safeguard long-run fiscal sustainability, and support key development goals.[11] The GoT's commitment to the fiscal adjustment plan is reiterated in the FY23 Budget Strategy.

[8] In FY08 and FY10 the GoT took on two loans totaling over TOP$255m (36 percent of FY10 GDP) to finance the reconstruction of Nuku'alofa and road rehabilitation following the 2007 riots. Substantial debt service payments on these loans are due in FY24–FY29.

[9] Like in the DSA from the parent operation, the PV of external PPG debt-to-exports ratio shows a temporary breach of the threshold in the short term due to the decline in export earnings triggered by the pandemic and natural disasters. The indicator then breaches and remains above the threshold from FY29. The external debt servicing to exports ratio also shows a temporary breach due to the impact of the recent external shocks but remains around the threshold over the projection period. The external PPG debt servicing to revenue ratio remains below the threshold.

[10] This reflects a once-off shock to the debt level of 14 percentage points of GDP in the second year of the projection period.

[11] The adjustment comprises: (i) a comprehensive reform program to reduce tax expenditures by limiting the number of tax exemptions and zero-ratings (equivalent to 7 percent of GDP); (ii) ongoing efforts to control wage bill expenditure (a key source of fiscal risk); (iii) continued

17. **Completion of one of Tonga's FY22 Performance and Policy Actions (PPAs) under the WB's Sustainable Development Finance Policy (SDFP) may be slightly delayed.** Tonga's two FY22 PPAs are: (i) Cabinet approval for submission to Parliament of a new Public Financial Management (PFM) bill; and (ii) a zero non-concessional borrowing ceiling on contracting new external PPG debt in FY22. The PPA1 is planned to be a Prior Action in the next programmatic DPO series. Prior to the disaster, the GoT was on track to complete the two FY22 PPAs by April 30, 2022. In December 2021, the Ministry of Finance (MoF) had prepared a draft PFM Bill and had begun consultations across GoT. Public consultations were scheduled for January 2022, and Cabinet submission in March 2022. However, the HT-HH disaster has diverted the GoT's limited capacity and resulted in a delay in finalizing the bill. GoT is now targeting completion of the PPA by mid-June 2022. The GoT has avoid any new non-concessional external borrowing in FY22, and remains committed to the PPA, despite the large unanticipated public financing needs caused by the disaster. This proposed supplemental financing operation will thus help to ensure that the GoT is not forced to leave substantial recovery needs unmet, while still complying with the PPA.

Figure 1: PV of External PPG Debt-to-GDP Ratio

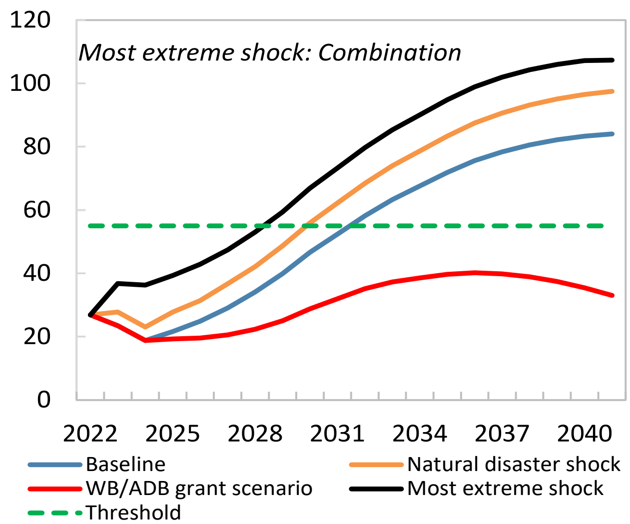
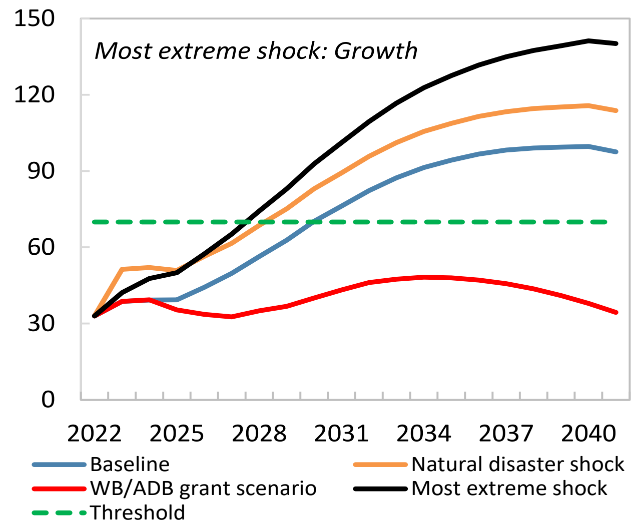


Figure 2: PV of Public Debt-to-GDP Ratio



Source: Updated DSA prepared by WB staff.

18. **Macroeconomic risks are tilted to the downside and have deteriorated.** Uncertainty regarding the economic outlook remains high. COVID-19 remains a risk to the economic outlook. A prolonged domestic outbreak and the risk of new variants globally could delay further the opening of the borders, delaying the recovery in tourism-related services, and putting further pressure on the current account, budget, and household incomes. Another natural disaster would put additional pressure on the fiscal and external accounts, as well as businesses and households. Further upwards pressure on global commodity prices—due to a prolonged conflict in Ukraine or another global shock—would exacerbate pressures on the current account, budget, and household purchasing power. On the upside, to the extent that international arrivals recover faster than expected, economic growth could outperform the baseline projections.

19. **The macroeconomic policy framework is adequate for the purposes of this supplemental financing operation.** Economic growth is expected to rebound to over 3 percent in FY23 and FY24 driven by reconstruction activity, a strong rebound in agriculture production, and a gradual recovery in tourism receipts as borders reopen.

adherence to the no new non-concessional borrowing policy, and implementation of the MTDS and loan guarantee policy; (iv) use of a sinking fund to manage the resources set aside over the coming years to meet future debt repayments; and (v) prioritizing capital grants to support key goals to enhance resilience and build human and physical capital.

Once the recovery is underway, the government is committed to a high-quality fiscal adjustment to stabilize debt dynamics and strengthen climate resilience. Key pillars of the fiscal adjustment—including reform to tax exemptions and zero ratings—will be supported by the next DPO series. The GoT has built credibility for prudent fiscal management through sustained recent efforts to increase domestic revenues, contain spending, and avoid any new non-concessional external borrowing. Monetary policy has been appropriately accommodative, and the exchange rate peg is expected to continue providing a credible nominal anchor. Foreign reserves are projected to remain adequate at over eight months of imports. Public debt is sustainable, but the risk of debt distress is high.

3. RESPONSE TO THE CRISIS

3.1. THE GOVERNMENT'S RESPONSE

20. **Following the disaster, the GoT immediately activated its key emergency institutions to lead the post-disaster response and disaster response and coordinate humanitarian aid.** Tonga has a well-developed DRM framework, which has been strengthened in recent years including via the parent DPO2/Cat-DDO and ongoing WB-funded investment projects.[12] On January 19, the Prime Minister declared a national State of Emergency (renewed on February 12 and March 1).[13] Search and rescue operations and emergency response teams were mobilized to the outer islands. On January 18, GoT activated the "cluster" system to coordinate humanitarian partners. The National Emergency Fund (NEF) was fully drawn down to finance urgent repairs to key infrastructure and commence the ash clean up. The GoT also quickly initiated a package of relief measures to mitigate the negative impacts on households, communities, and businesses.[14] Telecommunication services were re-established in Tongatapu following repair of the international submarine fiberoptic cable on February 22. Telecommunication services in outer islands were restored via a donation from a private company. Repairs to the domestic fiberoptic cable are expected to be completed by December 2022.

21. **Development partners and the international humanitarian community mobilized swiftly to provide immediate financial assistance and aid**. This has included the provision of humanitarian relief supplies by international and in-country non-government organizations and the navies of Australia, Fiji, New Zealand (NZ), Japan and China. Damage assessments, such as air surveillance assessments, have been conducted by the NZ and Australian Defence Forces. Bilateral partners have also provided prefabricated homes, heavy machinery, relief supplies, and medical supplies. Partners have contributed more than US$20m in financial assistance for FY22 (both in-kind and budget support) including the ADB (US$11m), Australia (US$2.9m), NZ (US$2m), Papua New Guinea (US$1.4m), US (US$1.3m), Japan (US$1m). However, this support is insufficient to close the unanticipated fiscal financing gap (see paragraphs 23 and 24).

22. **The HT-HH disaster is estimated to have caused physical damages and economic losses of up to US$182m (36.4 percent of GDP), and to have created a fiscal financing need of at least US$188m (37.5 percent of GDP) for disaster recovery.** On January 21, MoF requested the WB to conduct a rapid post-disaster damage assessment to support GoT's recovery planning and assist in mobilizing the resources needed for longer-term recovery. The WB presented a Global RApid post-disaster Rapid Estimation (GRADE) report within two weeks, with damages in selected sectors estimated at US$90.4m (18.5 percent of GDP, see footnote 2). In the following weeks, Tonga's

[12] For example, multi-hazard early warning systems have been strengthened under the Pacific Resilience Project (P154840).
[13] The State of Emergency was declared pursuant to the *Emergency Management Act 2007.* The country was already under a State Emergency for the COVID-19 public health emergency, which has been exacerbated due to the first community transmission of COVID 19 on February 1.
[14] This included additional social protection payments to poor and vulnerable households, temporary electricity fee waiver for households and businesses, replacement supplies for public services (including education and health), grants to communities to support urgent reconstruction activities, the extension of forbearance measures, and temporary customs and import duty exemptions for construction materials, foods, and other essential goods.

National Emergency Management Office completed a more comprehensive Initial Damage Assessment, which resulted in an upward revision of the damage estimate to US$102.2m. Based on impacts of past natural disasters in Tonga and estimates from the WB GRADE team, economic losses caused by this event could be up to an additional US$80m (Table 6). After accounting for over US$9m in in-kind humanitarian aid, an additional US$13m was required to address the immediate response needs for the first six weeks post disaster (US$22.2m in total). This included repairs to essential infrastructure (including the fiberoptic cable), supplies for public services (including education and health), and immediate relief for households and businesses. For the longer-term recovery, the GoT's preliminary Recovery and Resilience Building Plan estimates that fiscal financing needs are likely to be at least US$165.7m (33.1 percent of GDP) from FY22-FY25 (Table 7).[15] Combined, the immediate response needs (US$22.2m) and longer-term recovery needs (US$165.7m) give the total recovery needs of US$187.9m. Overall, around 25 percent of the recovery needs are expected in FY22, a further 31 percent in FY23, and the remaining 44 percent over the medium term (FY24–FY25).

Table 6: Estimated Damages and Losses

	Damages		
Sectors	**TOP**	**USD**	**% GDP**
Residential housing	45.5	19.9	4.0
Non-residential buildings	60.6	26.5	5.3
Infrastructure	66.8	29.2	5.8
Agriculture & Fisheries	43.3	19.0	3.8
Education	5.0	2.2	0.4
Water, sanitation and hygiene	2.0	0.9	0.2
Other economic & social impacts	10.2	4.5	0.9
Total damages	**233.4**	**102.2**	**20.4**
Estimated losses	**182.7**	**80.0**	**16.0**
Total Damages & Losses	**416.2**	**182.2**	**36.4**

Source: GoT and WB staff estimates

Table 7: Estimated Response and Recovery Needs

	USD mn				% of GDP			
	FY22	**FY23**	**FY24/FY25**	**Total**	**FY22**	**FY23**	**FY24/FY25**	**Total**
Immediate Response	**22.2**			**22.2**	**4.4**			**4.4**
of which: Humanitarian Relief	9.1				1.8			
Essential Services	6.7				1.3			
Education	2.9				0.6			
Households & Livelihoods	1.9				0.4			
Safety & Protection	1.2				0.2			
Business Support	0.4				0.1			
Recovery Needs	**25.0**	**58.4**	**82.2**	**165.7**	**5.0**	**11.7**	**16.4**	**33.1**
of which: Housing	6.8	10.4	2.9		1.4	2.1	0.6	
Public Infrastructure & Buildings	12.1	32.0	52.8		2.4	6.4	10.6	
Agriculture & Fisheries	3.0	7.9	13.1		0.6	1.6	2.6	
Economic & Social	3.1	8.1	13.4		0.6	1.6	2.7	
TOTAL	**47.2**	**58.4**	**82.2**	**187.9**	**9.4**	**11.7**	**16.4**	**37.5**
AGGREGATE TOTAL	**187.9**				**37.5**			

Source: GoT and WB staff estimates

23. **The proposed US$20m DPO supplemental financing is needed to close the FY22 financing gap and support the GoT in its recovery efforts.** Combined with revenue shortfalls due to lower economic activity caused by the disaster, the unanticipated public financing needs are estimated to be US$52.5m (10.5 percent of GDP) in FY22 (Table 8). An unmet public financing gap of US$20m remains despite the mobilization of domestic resources, the

[15] The Recovery and Resilience Building Plan outlines US$240m in financing needs. However, this figure includes US$81m for key projects designed to increase national resilience to future natural disasters, including an evacuation bridge at Fanga'uta (US$22m), a second (redundancy) submarine fiberoptic cable (US$35m), and key renewable energy investments (US$24m). The disaster recovery financing needs presented in this Program Document do not include these resilience-building project financing needs.

US$8m Cat-DDO drawdown, and over US$20m in support from other development partners. DPO supplemental financing is required to close this unanticipated financing gap. The government is unable to obtain sufficient funds from other sources in the required timeframe and on sufficiently concessional terms. Tonga is already at a high risk of debt distress and has no access to international capital markets, limiting the alternative sources of funding available. Other development partners have already provided substantial additional funds and in-kind support, and are unlikely to be able to mobilize substantial additional support in FY22 to help close the remaining unmet financing gap. The supplemental financing would allow government the fiscal space to pursue near-term recovery priorities, such as support for housing repair and reconstruction (including through cash or in-kind assistance), support for early-stage agriculture and tourism sector recovery, and additional targeted social protection measures, among other priorities.

24. **Additional development partner support will be required to close the FY23 financing gap.** The unanticipated public financing needs are estimated to be US$61.5m (12.3 percent of GDP) in FY23. The GoT has already announced TOP$20m in reprogrammed spending as part of the FY23 Budget Strategy and are expected to draw down cash reserves to their target minimum. Of the $15m of additional IDA project financing requested from the CRW to support the recovery, half is expected to be disbursed in FY23 (see footnote 1). Despite these measures, additional development partner support of around US$37m (7.4 percent of GDP) is required to close the public financing gap. This is equivalent to around 60 percent of the FY23 financing needs. The GoT has already requested a US$9.9m loan from the IMF's RCF. This will be considered by the IMF Board in July 2022. On April 6, 2022, Australia announced an additional AU$16m of support (around US$11.8m) for disaster recovery. Half of this is assumed to be disbursed in FY23. After accounting for these sources, the GoT would require a further US$21m (4.2 percent of GDP) to close the unanticipated public financing gap. If additional external support is not forthcoming, the GoT may consider a further domestic bond issuance. However, it is unlikely that the domestic market will be able to absorb a large increase in public debt (a recent bond issuance was undersubscribed by almost 20 percent of the planned issuance). Instead, as in previous periods when faced with a financing gap, the GoT would likely adjust spending to remain with its revenue envelope—including by leaving recovery needs unmet. Additional external financing (on grant terms) is thus essential to support disaster recovery while also protecting Tonga's hard-won fiscal sustainability.

Table 8: Estimated Financing Needs and Sources, FY22 and FY23

	TOP millions		USD millions		Percent of GDP	
	FY22	FY23	FY22	FY23	FY22	FY23
Estimated Financing Needs	**120.0**	**140.6**	**52.5**	**61.5**	**10.5**	**12.3**
Revenue shortfall	12.1	7.2	5.3	3.1	1.1	0.6
HT-HH additional expenditure	107.9	133.4	47.2	58.4	9.4	11.7
Available Resources	**74.3**	**56.2**	**32.5**	**24.6**	**6.5**	**4.9**
1. The World Bank Group	**18.3**	**17.1**	**8.0**	**7.5**	**1.6**	**1.5**
Cat-DDO	18.3	0.0	8.0	0.0	1.6	0.0
IDA (via Investment Projects)	0.0	17.1	0.0	7.5	0.0	1.5
2. Other External Financing (Confirmed)	**45.9**	**0.0**	**20.1**	**0.0**	**4.0**	**0.0**
3. Domestic Sources	**10.1**	**39.1**	**4.4**	**17.1**	**0.9**	**3.4**
Spending reprioritization	3.0	20.0	1.3	8.8	0.3	1.8
Cash buffer, domestic bonds	3.0	19.1	1.3	8.4	0.3	1.7
National Emergency Fund	4.0	0.0	1.8	0.0	0.4	0.0
Unmet Need (Financing Gap)	**45.7**	**84.3**	**20.0**	**36.9**	**4.0**	**7.4**
World Bank Supplemental DPO Financing	**45.7**	**0.0**	**20.0**	**0.0**	**4.0**	**0.0**
4. Required External Financing to close Financing Gap	**0.0**	**84.3**	**0.0**	**36.9**	**0.0**	**7.4**
Of which, IMF (requested)	0.0	22.6	0.0	9.9	0.0	2.0
Australia (indicative)	0.0	13.5	0.0	5.9	0.0	1.2
Others (GoT seeking support)	0.0	48.3	0.0	21.1	0.0	4.2

Source: GoT and WB staff estimates

3.2. THE BANK'S RESPONSE, STRATEGY, AND COLLABORATION WITH DEVELOPMENT PARTNERS

25. **At the request of the GoT, the Bank responded immediately to the disaster by disbursing the entire US$8m from the Parent Cat-DDO and mobilizing support for post-disaster assessments.** The funds from the Parent Cat-DDO were disbursed less than 24 hours after receiving the GoT's request to support immediate and longer-term recovery needs. In addition, the Bank mobilized a US$100,000 "Just-in-Time" grant from the Global Facility for Disaster Reduction and Recovery (GFDRR) to support initial post-disaster assessments, including the GRADE assessment. The remote-based assessment referenced published datasets, satellite/aerial imagery, remote-sensing data, and information from early assessments (including social media data). The GRADE assessment supported the quantification of the spatial extent and severity of the impacts related to the HT-HH event and helped inform immediate post-disaster recovery planning and decision-making. Critical reforms supported by the Bank's DPO program, including for housing sector resilience, disaster risk financing, and proactive disaster risk management legislation, helped the GoT to make informed decisions on accessing post-disaster financing instruments and developing resilient recovery plans during the aftermath of the disaster.

26. **The WB is supporting the emergency response through active investment projects and is seeking additional project financing for post-disaster reconstruction**. Immediately after the disaster occurred, several active investment projects delivered infrastructure, equipment, and institutional strengthening that has helped to enhance the GoT's response to the disaster.[16] Tonga's IDA19 resources were already fully programmed prior to the HT-HH disaster. However, an additional US$15m from the CRW will be channeled in response to the disaster through ongoing investment projects to support reconstruction, repairs, and resilience building for school infrastructure and to strengthen multi-hazard early warning systems through the Tonga Safe and Resilient Schools

[16] For example, the Pacific Resilience Project (P154840) supported the development of emergency operation centers, emergency communications equipment, and training in multi-hazard early warning systems. The Tonga Climate Resilient Transport Project (P161539) supported a rapid ground assessment of damages to the transport sector. The Pathway to Sustainable Oceans Project for Tonga (P164941) is prioritizing the procurement of vessels critical to government operations, as well as Fish Aggregation Devices.

Project (P174434) and the Tonga Pacific Resilience Project (P158489). Other projects in the portfolio are also investigating ways to reprioritize activities to support the post-disaster recovery, including for transport infrastructure and the fisheries sector. The WB and GoT are also discussing ways for the country to utilize its IDA20 envelope to support the longer-term recovery and reconstruction, as well as ensure that contingent financing is available to the GoT.[17] Nevertheless, supplemental financing to the DPO2/Cat-DDO remains the most appropriate instrument for providing quick disbursing budget support to the GoT.

27. **GoT has requested partners, including the WB, to provide additional financial support to fill the estimated financing gap.** As outlined in paragraph 21, the ADB and bilateral partners mobilized substantial aid to support the immediate response effort. The ADB provided US$10m from its Contingent Disaster Financing grant as part of the third phase of its Pacific Disaster Resilience Program. The ADB also provided US$1m from its Asia Pacific Disaster Response Fund. The GoT has requested a US$9.9m drawdown from the IMF's RCF and is planning to host a HT-HH Donor Forum in May to secure grant commitments for longer-term recovery and reconstruction. The WB team is coordinating longer-term support and financing needs with other key development partners, including through the Joint Policy Reform Matrix that includes the WB, ADB, Australia, NZ, and the European Union, which meets regularly to support GoT jointly on agreed policy reforms (including under the Parent DPO2/Cat-DDO). While the Bank's DPO funds are not earmarked for specific expenses, quick disbursement of the supplemental financing would allow the GoT the fiscal space to pursue immediate post-disaster recovery priorities that remain unfunded (see paragraph 23).

28. **The proposed supplemental financing is consistent with the Bank's FY17-FY21 Regional Partnership Framework (RPF) for nine Pacific Island countries, which includes Tonga.**[18] The operation is in line with the RPF's third focus area on protecting incomes and livelihoods from the impacts of climate change and natural hazards, and the fourth focus area—strengthening the enablers of growth and opportunities—by providing the government with the fiscal space to respond quickly to the volcanic eruption and tsunami. The operation also supports the WB's adoption of the Green, Resilient and Inclusive Development (GRID) approach, particularly to help countries safeguard development and better respond to a range of risks and uncertainties including natural, climate, and health-related shocks.

4. THE REFORM PROGRAM SUPPORTED THROUGH ORIGINAL OPERATION: AN UPDATE

29. **The GoT remains fully committed to the DPO Program, and there has been satisfactory progress with implementation since the approval of the Parent DPO2/Cat-DDO in November 2021 (see Table 9)**. The GoT has a history of committing to and successfully completing development operations, with 11 DPOs approved by the Board between FY11 and FY22. Implementation progress in each reform area of the DPO2/Cat-DDO has been satisfactory, with no policy reversals during the short implementation period thus far. The parent operation is being implemented in compliance with the provisions of the Financing Agreements for the DPO2 and the Cat-DDO.

30. **Most of the Results Indicators (RIs) are on track to being achieved.** Regarding RI#1, the ratio of domestic revenues to GDP in FY21 increased due to improved administration and stronger than expected collection, resulting in an average ratio of 24.6 percent for FY20 and FY21. The target was 25 percent by FY24. RI#2 is on track, with the cash balance registering 2.5 months of recurrent expenditure in FY21. Consistent with the Medium-Term Debt Strategy (MTDS), the GoT has avoided taking on any new non-concessional external debt (RI#3). Under the Public Service Commission's (PSC's) oversight, public sector overtime spending is now being more closely scrutinized, with

[17] The Bank will continue supporting GoT's DRM reform agenda, learning lessons from the HT-HH disaster to provide not only disaster risk financing solutions but also leverage technical knowledge on DRM.
[18] Report #120479, extended by the Board of Executive Directors on February 6, 2020, to FY23.

cases of suspected excessive overtime referred to the Auditor General for investigation. Overtime management has also been added to the PSC-led Chief Executive Officer's (CEO's) annual performance review (RI#4). The policy framework outlined in the disaster risk financing strategy (DRFS) has guided the GoT's fiscal response to the HT-HH disaster, and the preparation of an event-specific housing recovery strategy. That strategy is being led by the Housing Sector Resilience Office (HSRO, RI#5) to support housing resilience and a "build back better" recovery. The National Deployment and Vaccination Plan for COVID-19 Vaccines 2021-2023 (NDVP) has been GoT's guiding policy framework for the vaccine rollout. Implementation has been highly effective, with 90 percent of the eligible population fully vaccinated as of April 13, 2022—meaning that RI#8 has been achieved ahead of the target.[19] Labor mobility reforms have also had a positive impact, with registration in the Ministry of Internal Affairs (MIA) worker pools already achieving 99 percent of the FY23 target of 2,000 workers (RI#9), and women's participation increasing to 45 percent in December 2021 (compared to a target of 37 percent).

31. **Reforms supported by the First Resilience DPO (DPO1) have also delivered sound results.** All the PAs from the DPO1 are making satisfactory progress and the GoT is committed to implementation of the reform program. Regulations to the Revenue Services Administration Act (PA#1) helped to improve compliance, delivering higher collections in FY21 (RI#1, see previous paragraph). Implementation of the cash management policy (PA#2) has reduced idle cash from 3.5 months of recurrent expenditures in FY19 to 2.5 months in FY21 (RI#2). Civil service reforms (PA#3) have strengthened public sector human resource management and are helping with the rationalization of unfilled vacancies, reducing wage bill pressure (RI#4). The national housing recovery and resilience policy (PA#4) guided preparation of event-specific TC Harold and HT-HH housing recovery strategies. Public fixed asset registries of public schools and health facilities are being developed with WB technical assistance (RI#7), governed by the policy supported in DPO1 (PA#5), and will include geospatial information/hazard mapping to inform government's decision-making on risk-informed investment planning. Policy frameworks for the technical and vocational education and training (TVET) sector (PA#6) and labor mobility (PA#7) are guiding subsequent investments and reforms in the sectors, including the improvements to labor mobility supported in the DPO2/Cat-DDO, and preparation of the Tonga Qualifications Authority Bill (planned to be a PA for the next DPO series). There is no new data yet for RIs #6, #10 and #11, as the corresponding Prior Actions are at the very early stage of implementation.

Table 9: Summary of Implementation Progress on Policy Actions from DPO2/Cat-DDO

DPO2/Cat-DDO Prior Actions (PAs)	Progress Update
Pillar I: Strengthen Public Finances	
PA#1: To support enhanced debt management and fiscal sustainability, the Recipient: (i) through its Cabinet, has approved the Medium-Term Debt Strategy (MTDS) Fiscal Years 2021 – 2025 and a Government Guarantee Policy that establishes the criteria and guidelines for assessing and approving requests for government guarantees; and (ii) through its Ministry of Finance, has made the MTDS and the Government Guarantee Policy publicly accessible on its website.	**Satisfactory progress.** The FY23 Budget Strategy outlines the government's commitment to implementing the MTDS 2021 – 2025, including using the MTDS as a framework to guide fiscal policy and debt management decisions. The government has also reiterated its commitment to continue Tonga's strong track record of prudent fiscal management, avoiding new non-concessional debt, and meeting the nation's debt obligations. The GoT has not taken on any new non-concessional external debt, consistent with the RI. Regarding the Guarantee Policy, the GoT is yet to receive a request for a guarantee. However, the government is committed to utilizing the policy when requests for guarantees arise.
PA#2: To strengthen public sector wage bill management, the Recipient, through its	**Satisfactory progress.** The revised Public Service Policy and Instructions 2010 were gazetted and came into effect on February 28, 2022. The revised

[19] COVID-19 vaccination is voluntary.

Cabinet, has endorsed an amendment to the Public Service Policy and Instructions 2010 that introduces a limit on overtime allowances in the public service sector.	instructions provide for the temporary relaxation of overtime limits "where there is a state of natural disaster or emergency or pandemic". This has allowed flexibility for essential work to be completed in response to the HT-HH disaster and the domestic outbreak of COVID-19. The PSC will submit an implementation report to the Cabinet regarding the reform by July 2022.
Pillar II: Enhance Resilience to Climate Change, Natural Disasters, and Health-related Risks	
PA#3: To establish a more comprehensive, proactive and integrated model of disaster risk management, the Recipient, through its Cabinet, has approved a Disaster Risk Management Bill for submission to the Recipient's Parliament.	**Satisfactory progress.** The DRM Bill was approved by Parliament in October 2021 and transmitted to the King for royal assent. The bill was returned to the Attorney General Office for minor technical adjustments and is scheduled to be returned for royal assent and gazettal by July 2022. The bill calls for the adoption of implementing regulations and a national DRM policy framework. Both are part of MEIDECC's Strategic Roadmap 2021 – 2023 and are planned to be part of the next programmatic DPO series. WB and NZ are providing technical assistance. Annual reporting on disaster risk reduction initiatives (the RI) will be measurable once the bill is enacted. The bill, once enacted, will inform the longer-term HT-HH recovery process by enhancing island-level decision-making and resilient recovery.
PA#4: To strengthen financial resilience of the Recipient's government, households, and businesses to disasters, the Recipient, through its Cabinet, has approved a national disaster risk financing strategy 2021-2025 that establishes a financial risk-layering policy to maximize disaster and climate risk financing.	**Satisfactory progress.** Consistent with the DRFS, the GoT quickly responded to the HT-HH disaster by reprioritizing current spending, drawing down the NEF, and drawing down the WB and ADB contingent financing instruments to finance immediate needs. Also consistent with the strategy, and drawing on actions supported by previous DPOs, the GoT is preparing an event-specific housing recovery program. The FY23 Budget Strategy affirms the government's commitment to implementing the DRFS, including to: (i) replenish contingent financing and rebuild fiscal buffers; (ii) redouble efforts to register and insure more public assets and explore options to develop the private insurance market; (iii) improve transparency of post-disaster spending; (iv) strengthen the nation's social protection system and make it more adaptive; and (v) prioritize investments in national risk reduction and climate adaptation actions. Key reforms that are part of the DRFS implementation plan are planned to be included in the next programmatic DPO series, including actions to strengthen the DRM regulatory and policy framework and build out the national social security system. Establishment of national registries of public schools and health facilities that include asset vulnerability information (including the identification of locations for safer construction) is ongoing, consistent with the RI.
PA#5: To protect the population from a public health emergency and support the economic recovery, the Recipient: (i) through its Cabinet has approved the National Deployment and Vaccination Plan for COVID-19 Vaccines 2021-2023 that provides the guiding policy framework for the vaccine rollout and health system strengthening activities; and (ii) through its Minister for Trade and Economic Development, has approved for implementation the special guidelines for expedited clearance of essential medical goods, including COVID-19 vaccines.	**Satisfactory progress.** The NDVP has been GoT's guiding policy framework for the vaccine rollout. Implementation has been highly effective, with over 98 percent of the eligible population having received at least one dose, 90 percent having received two doses, and 53 percent having received a booster (as of April 13, 2022). Consequently, the RI has been achieved well ahead of target (FY23). The special guidelines for expedited clearance of essential medical goods were implemented in August 2021 and have been used repeatedly for the importation of vaccines, pharmaceutical drugs, and personal protective equipment.
Pillar III: Support Economic Recovery and Improved Labor Market Outcomes	

PA#6: To enhance the management of labor mobility supply, the Recipient, through its Cabinet, has established work ready pools, reformed procedures for recruitment, and enhanced pre-departure training.	**Satisfactory progress.** The reforms have already delivered impressive results. As of end-December 2021, 1,984 Tongans were registered in the MIA worker pools, of which 45 percent are female. This is close to achieving the FY23 target of 2,000 workers, of which 37 percent are female. The FY23 Budget Strategy confirms that labor mobility remains a key priority for the government.
PA#7: To strengthen financial sector stability, protect customers, and encourage an expansion in financial services, the Recipient, through its Cabinet, has approved a Credit Unions Bill for submission to the Recipient's Parliament.	**Satisfactory progress.** The Credit Union Act was approved by Parliament in August 2021, received royal assent in October 2021, and was gazetted in November 2021. The Credit Union Act will come into force on a date proclaimed by Cabinet as published in a notice in the Gazette. The NRBT will submit an annual report on credit union sector regulatory and supervisory activities to the NRBT Board, consistent with the RI.
PA#8: To foster an inclusive, respectful, and safe work environment for the public service sector, the Recipient, through its Cabinet, has approved a sexual harassment policy.	**Satisfactory progress.** The PSC has undertaken an extensive rollout of the sexual harassment policy across Tonga. According to the PSC, there has been overwhelming support for the policy from public servants. Prior to the HT-HH disaster, the PSC was working with ADB TA to prepare the process for case management, establish the case database, establish the independent advisory body to oversee the grievance process, and to amend the annual civil service survey to include questions regarding sexual harassment policy awareness (the RI). The disaster has delayed finalization of these activities. However, ADB TA remains engaged, and completion is expected by July 2022.

5. RATIONALE FOR PROPOSED SUPPLEMENTAL FINANCING

32. **Although there has been satisfactory progress with the Program to date, the unanticipated financing gap caused by the HT-HH disaster recovery needs is now directly hampering the achievement of results.** In the absence of supplemental financing, the GoT will likely need to reduce the FY23 budget allocations of some of the ministries and agencies responsible for implementing the Program. This is likely to directly cause delays in implementation and the achievement of development outcomes. For example, it may not be possible for the HSRO (RI#5) and the National Disaster Risk Management Office (RI#6) to complete their planned recruitment efforts and risk mitigation work plans in FY23. Effective implementation of the sexual harassment policy (RI#10s) will require considerable administrative attention across the public service. Absent the supplemental financing for the parent DPO, there could be substantial pressure to divert administrative capacity and/or slash the wage bill, undermining capacity for robust implementation. In addition, the parent operation was declared effective on December 16, 2021, only a month before the HT-HH disaster event, meaning there has been a very short implementation period thus far.

33. **In the absence of supplemental financing for the Parent DPO, public finances would be significantly weakened—jeopardizing achievement of the PDO—and the implementation of the government's post-disaster recovery plan would be placed at risk.** In addition to the direct impact on the budgets of implementing agencies, the absence of supplemental financing would pose two risks. First, it could undermine the first development objective (to strengthen public finances) with the GoT forced to run down cash balances to below their target minimum and/or increase debt to potentially unsustainable levels to meet recovery needs (RI#2, RI#3, and Tonga's FY22 PPA2). Further depleting cash reserves should be avoided, as it would increase the risk of payment arrears due to minor discrepancies in treasury inflows and outflows. This could have significant knock-on effects to the domestic economy, stifling the recovery. Second, GoT could be forced to leave significant recovery needs unmet, increasing poverty and vulnerability. Moreover, implementation of the reforms supported by the parent operation

could face substantial delays due to competing budgetary and capacity priorities arising from post-disaster recovery.

34. **Supplemental financing for the Parent DPO is a preferable option to accelerating the processing of the FY23 DPO, with the need to respond to urgent recovery needs inconsistent with the time required to process a new DPO**. Preliminary preparations of a new programmatic DPO series began in December 2021—just a few weeks before the disaster occurred. Several of the proposed reforms are significant and complex, meaning that they will require substantial attention from government to complete.[20] Requiring progress on these reforms to be accelerated in the months following the disaster would be inconsistent with the GoT's current need to prioritize post-disaster recovery and with the capacity constraints currently faced by government. Furthermore, recent community transmission in other Pacific Island countries has highlighted how quickly the virus can overwhelm the region's weak health systems, leading to a public health emergency. Tonga's extreme exposure and vulnerability are exacerbated by the ongoing post-disaster context, combined with the current COVID-19 outbreak and higher global commodity prices. Supplemental financing provides the opportunity to respond quickly to the urgent needs created by the current disaster and to contribute to a timely economic recovery.

6. OTHER DESIGN AND APPRAISAL ISSUES

6.1. POVERTY, SOCIAL AND ENVIRONMENTAL IMPACT

35. **There are no changes to the assessment of poverty and social impacts since the Parent DPO2/Cat-DDO was approved.** Reforms supported by all three pillars of the parent operation are expected to help reduce poverty and boost shared prosperity. The reforms under Pillar 1 will help ensure that the GoT has the fiscal space to respond to future economic shocks and disasters, which tend to impact the poor disproportionately, while maintaining basic services on which the bottom 40 per cent are particularly dependent. Under Pillar 2, the DRM Bill and DRFS are expected to have significant positive poverty and social impacts, since they are designed to enhance the resilience of vulnerable households and to ensure that vulnerable groups are supported adequately before, during and following a disaster. Labor mobility reforms under Pillar 3 are expected to have significant net positive effects through the provision of substantial household benefits, which translate into positive poverty and distributional effects. These effects are enhanced through targeting the participation of women and workers from outer islands, while minimizing worker pre-departure costs. Implementation of the sexual harassment policy is expected to have significant positive effects by helping to reduce gender-based violence and sexual harassment in the workplace, thus addressing a key constraint that is material to women's economic participation.

36. **There are no changes to the assessment of environmental aspects since the Parent DPO2/Cat-DDO was approved.** Policy actions under the parent operation are not expected to have significant negative impacts on Tonga's environment, forests, and natural resources. The DRM Bill and the DRFS would likely have significant positive environmental impacts through the encouragement of sustainable risk reduction investments while all other reforms are expected to not have any negative environmental impacts. Tonga has an established environmental impact assessment (EIA) process administered by the Ministry of Meteorology, Energy, Information, Disaster Management, Environment, Climate Change, and Communications. It is mandatory for the EIA of all new developments to be approved by the Minister and CEO of Environment and Climate Change. While EIA registrations have increased recently, indicating improved oversight of developments, the quality of the EIAs and assessments varies, and compliance is limited. Support from development partners aims to address this, including through

[20] Some key Prior Actions discussed as part of the next DPO include reforms to reduce tax exemptions, a new PFM Act (the FY22 PPA), regulations to the Disaster Risk Management Act, a national social protection policy, and legislative and policy reform to strengthen primary and post-secondary education.

World Bank-financed infrastructure investment projects in transport and school infrastructure.

6.2. PFM, DISBURSEMENT AND AUDITING ASPECTS

37. **The PFM, disbursement, audit, and fiduciary arrangements of the parent operation apply to this supplemental financing operation.** The budget is publicly available on the MoF website.

38. **Overall, the fiduciary risks associated with the proposed operation are substantial, with no significant changes since the Parent DPO2/Cat-DDO.** The NRBT publishes its annual report together with the audited accounts and the report of the independent auditors on those accounts. The FY20 annual report has been published and the audited financial accounts were unqualified. The NRBT has an established Revaluation Reserve Account, which provides an additional buffer for any foreign exchange losses and maintains foreign reserves composed of a basket of currencies reducing the sensitivity to exchange rate risk as movements of these currencies generally offset each other. There is no indication of substantial issues within the foreign exchange environment. An IMF Safeguards Assessment was concluded in December 2021; however, the report is yet to be shared with WB staff. Consequently, there is insufficient information available to draw any substantiated conclusions regarding the Central Bank's foreign currency management environment. The Fiduciary risk is therefore assessed as "Substantial" due to the inadequate knowledge of the foreign exchange control environment. To mitigate this risk, the WB is requiring additional measures for this operation as detailed below.

39. **As was the case for the financing provided by the parent operation, the proposed supplemental financing will be disbursed according to IDA disbursement procedures for development policy operations.** Once the DPO grant is approved by the Board and becomes effective, the proceeds of the grant will be deposited by IDA in one tranche, at the request of the Recipient, into a Foreign Currency Dedicated Account at the NRBT, which will form part of Tonga's foreign exchange reserves. An amount equivalent to the DPO grant proceeds will then be credited promptly to a GoT account to finance budgeted expenditures.

40. **Flow of funds (including foreign exchange) is subject to GoT's regular Financial Management processes.** While it is not possible to track the ultimate use of the foreign exchange provided by the development policy operation proceeds, grant proceeds will flow from the Foreign Currency Dedicated Account at the NRBT into a local currency bank account of the government used to finance budgeted government expenditures. GoT will provide confirmation to the Bank when an amount equivalent to the grant amount has been credited promptly to a local account used to finance budgeted expenditures by way of a letter within 30 days of the crediting of the funds into the local account. GoT has provided this confirmation in a timely manner in the past, including for the DPO1 and DPO2/Cat-DDO. The proceeds of the operation would not be used to finance expenditures excluded under the General Conditions for IDA Financing: Development Policy Financing, dated December 14, 2018 (revised on August 1, 2020, April 1, 2021, and January 1, 2022) (General Conditions). If the proceeds of the DPO grant are used for ineligible purposes after being deposited in a government deposit account, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled. As with the parent operation, the Bank will retain the right to request the GoT to arrange special audits of the Foreign Currency Dedicated Account established in the NRBT. The same audit requirements will be applied as per the parent operation.

41. **The closing date for the supplemental financing operation is November 30, 2024, unchanged from the parent operation.** All terms and conditions remain unchanged from the parent operation.

6.3. MONITORING, EVALUATION AND ACCOUNTABILITY

42. **There has been no change to monitoring and evaluation arrangements under the Parent DPO2/Cat-DDO.** Through the Budget Support Management Committee, the MoF will provide overall guidance for the budget

support program, and will assume overall responsibility for coordinating the implementation, monitoring and evaluation of the operation. The MoF will also be ultimately responsible for reporting progress and coordinating actions among other concerned government agencies. Specific indicators that the WB will monitor for each of the policy areas supported by the parent operation are set out in Annex 1. The Bank will continue to work with the Government to assess the progress of implementation of the policy actions supported by the parent operation.

43. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

7. SUMMARY OF RISKS AND MITIGATION

44. **The overall risk rating has increased to substantial from moderate under the Parent DPO2/Cat-DDO (Table 10).** Following the recent disaster, the macroeconomic, institutional capacity, and 'other' (COVID-19) residual risks have increased to substantial from moderate under the parent operation. Environmental and social risk remains substantial, unchanged from the parent operation, given Tonga's high degree of vulnerability to disasters. Fiduciary risk remains substantial, unchanged from the parent operation, given that the IMF Safeguards Assessment of the NRBT is yet to be shared with WB staff. The most important risk categories are described in more detail below:

- **Macroeconomic risk has increased from moderate to substantial.** This reflects the economic impact of the recent disaster and the associated deterioration of the fiscal position. This has increased the likelihood of downside risks that would delay the achievement of results. The significant fiscal costs of recovery and reconstruction may constrain the fiscal resources available for progressing reform implementation and directly impact some targets, e.g., the HSRO and RI#5, the NDMO and RI#6, and the sexual harassment policy and RI#10s. Absent supplemental financing, the GoT may be forced to run down its cash reserves to below the target minimum or seek new external debt to meet recovery needs, putting at risk achievement of RI#2 and RI#3 (and Tonga's FY22 PPA). These risks are being mitigated by: (i) the provision of this supplemental financing, along with substantial development partner assistance—and the expectation that additional commitments will be made for the medium-term recovery—helping to close the financing gap; and (ii) the response by the GoT to control spending and the ongoing commitment to seek only highly concessional financing. Risks have also increased due to the impacts of the Russian invasion of Ukraine on global demand and commodity prices. This could further increase import costs, putting additional pressure on Tonga's external and fiscal accounts. However, the NRBT has substantial international reserves to mitigate a deterioration in the balance of payments. Despite these mitigation measures, residual risk has increased since the parent operation was presented to the WB Board.
- **Risks related to institutional capacity have increased from moderate to substantial.** Given the impact of the recent disaster, there is now a risk that achievement of the target results associated with the reform program could be delayed, as significant parts of the bureaucracy need to shift their attention to recovery efforts, at least in the short term. This risk is being mitigated by: (i) additional development partner financial

support (to alleviate the acute fiscal pressure); and (ii) additional technical assistance to support disaster recovery planning and execution. Despite these mitigation measures, the downside risk of delayed implementation has increased the residual risks around limited institutional capacity.

- **Other risks have increased from moderate to substantial due to the domestic outbreak of COVID-19.** Domestic transmission has compounded the negative effects of the HT-HH shock. Domestic lockdowns have disrupted recovery efforts and have further stretched the government's weak capacity. Risks related to institutional capacity would be compounded by a severe domestic outbreak and associated lockdowns—a risk which has materially increased since the parent operation was presented to the WB Board. This risk is being mitigated to some degree by additional in-kind donations to support the management of the COVID-19 outbreak (including additional vaccines, cold chain equipment, personal protective equipment, and treatment facilities).

Table 10: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Low
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Low
4. Technical Design of Project or Program	Low
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and Social	Substantial
8. Stakeholders	Low
9. Other	Substantial
Overall	Substantial

ANNEX 1: PARENT PROJECT POLICY AND RESULTS MATRIX

Prior Actions		Results			
DPO1	**DPO2/Cat-DDO**	**Indicator**	**Baseline**	**Current**	**Target**
Pillar I: Strengthen Public Finances					
Prior Action #1. To improve compliance and the efficiency of revenue collection, the Recipient, through its Cabinet, has approved amendments to the regulations under the Revenue Services Administration Act		**Results Indicator #1:** Domestic revenue as a share of GDP	24 percent (average FY16-FY18)	24.6 percent (average FY20-FY21)	25 percent or higher (FY25)[21]
Prior Action #2. To support enhanced cash management, the Recipient, through its Cabinet, has approved a policy that establishes a liquidity buffer target band	**Prior Action #1.** To support enhanced debt management and fiscal sustainability, the Recipient: (i) through its Cabinet, has approved the Medium-Term Debt Strategy (MTDS) Fiscal Years 2021 – 2025 and a Government Guarantee Policy that establishes the criteria and guidelines for assessing and approving requests for government guarantees; and (ii) through its Ministry of Finance, has made the MTDS and the Government Guarantee Policy publicly accessible on its website	**Results Indicator #2:** Cash balance as a share of recurrent expenditure (months) **Results Indicator #3:** Percent of new external debt that is concessional	3.5 months (average during FY19) 100 percent (FY16-FY18)	2.5 months (FY21) 100 percent (FY20-FY21)	1 – 2 months (average FY22-FY24) 100 percent (FY21-FY24)
Prior Action #3. To strengthen public sector wage bill and human resource management, the Recipient has adopted and commenced implementation of: (a) a standardized public service job descriptions template; and (b) a	**Prior Action #2.** To strengthen public sector wage bill management, the Recipient, through its Cabinet, has endorsed an amendment to the Public Service Policy and Instructions 2010 that introduces a limit on overtime allowances in the public service sector	**Results Indicator #4:** Public-sector wage bill as a share of domestic revenue	54 percent (average of FY16-FY18)	55.4 percent (average FY20-FY21)	53 percent or lower (average FY24-FY25)[21]

[21] Due to the impact of the disaster and the delay in the economic recovery, achievement of the targets for RI#1 and RI#4 (domestic revenue as a share of GDP and wage bill as a share of domestic expenditure) may take longer to achieve than was envisaged when the Parent DPO2/Cat-DDO was presented to the WB Board.

Prior Actions		Results			
revised public service Classification of Positions					
Pillar II: Enhance Resilience to Climate Change, Natural Disasters, and Health-related Risks					
Prior Action #4. To improve the resilience and responsiveness of future event-specific housing programs, the Recipient, through its Cabinet, has approved a national housing recovery and resilience policy	**Prior Action #3.** To establish a more comprehensive, proactive and integrated model of disaster risk management, the Recipient, through its Cabinet, has approved a Disaster Risk Management Bill for submission to the Recipient's Parliament	**Results Indicator #5:** The Housing Sector Resilience Office (HSRO) is established, and its work plan is submitted to the National Emergency Management Committee on an annual basis **Results Indicator #6:** Annual report submitted to the National Disaster Risk Management Committee on the implementation of disaster risk reduction initiatives under the national disaster risk management policy	No dedicated unit for housing-sector recovery and risk reduction exists (FY19) N/A	The HSRO is established. Its annual work plan for FY22 was submitted and approved (FY21) No report (FY21)	The HSRO is established, and its annual work plan is submitted to the National Emergency Management Committee (FY23) Report submitted (FY24)
Prior Action #5. To improve the life-cycle management and resilience of public infrastructure to natural disasters and the accuracy of financial reporting, the Recipient, through its Cabinet, has approved a comprehensive policy framework for the public fixed-asset registry	**Prior Action #4.** To strengthen financial resilience of the Recipient's government, households, and businesses to disasters, the Recipient, through its Cabinet, has approved a national disaster risk financing strategy 2021-2025 that establishes a financial risk-layering policy to maximize disaster and climate risk financing	**Results Indicator #7:** Establishment of national registries of public schools and health facilities that include asset vulnerability information, and are used for policy and operational decisions to enhance resilience of public assets	No registries exist (FY19)	No registries exist (FY21)	Registries finalized (FY23)
	Prior Action #5. To protect the population from a public health emergency and support the economic recovery, the Recipient: (i) through its Cabinet has approved the National Deployment and Vaccination Plan for COVID-19 Vaccines 2021-2023 that provides the guiding policy framework for the vaccine rollout and health system strengthening activities; and	**Results Indicator #8:** Proportion of the eligible population (aged 15 years and over) that have received the COVID-19 vaccine, disaggregated by sex	N/A	86.8 percent (female) and 94.3 percent (male) (March 15, 2022)	75 percent (female) and 75 percent (male) (FY23)

Prior Actions		Results			
	(ii) through its Minister for Trade and Economic Development, has approved for implementation the special guidelines for expedited clearance of essential medical goods, including COVID-19 vaccines				
Pillar III: Support Economic Recovery and Improved Labor Market Outcomes					
Prior Action #6. To enhance the quality and relevance of skills training, the Recipient, through its Cabinet, has approved a technical and vocational education and training sector policy framework **Prior Action #7.** To foster greater participation and gender equity in access to overseas employment opportunities, the Recipient, through its Cabinet, has approved a labor mobility policy framework	**Prior Action #6.** To enhance the management of labor mobility supply, the Recipient, through its Cabinet, has established work ready pools, reformed procedures for recruitment, and enhanced pre-departure training	**Results Indicator #9:** Increased number of Tongans in Ministry of Internal Affairs (MIA) worker pools, with increased female participation	511 Tongans in the MIA worker pools, of which 32 percent are female (Dec 2019)	1984 Tongans in the MIA worker pools, of which 45 percent are female (December 2021)	2000 Tongans in the MIA worker pools, of which 37 percent are female (June 2023)
	Prior Action #7. To strengthen financial sector stability, protect customers, and encourage an expansion in financial services, the Recipient, through its Cabinet, has approved a Credit Unions Bill for submission to the Recipient's Parliament	**Results Indicator #10:** Improved reporting on credit union sector regulatory and supervisory activities	N/A	No annual reporting (FY21)	Annual reporting submitted to NRBT Board (FY24)
	Prior Action #8. To foster an inclusive, respectful and safe work environment for the public service sector, the Recipient, through its Cabinet, has approved a sexual harassment policy	**Results Indicator #11:** Confidential data is collected and maintained annually on: (i) sexual harassment complaints and how they were dealt with, disaggregated by ministry, procedure followed (formal or informal) and gender; and (ii) officials' experiences of sexual harassment, and knowledge and satisfaction of the policy	N/A	No data available on either indicator (FY21)	Data is collected annually on both indicators (FY23)

ANNEX 2: FUND RELATIONS INDEX

Tonga—Assessment Letter for the World Bank
March 9, 2022

This letter provides the IMF staff's assessment of Tonga's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to the World Bank's Second Resilience Development Policy Operation (DPO) Supplemental Financing for Tonga.

Recent Developments, Outlook, and Risks

1. **Earlier this year, Tonga was hit by a double blow from the Hunga Tonga Hunga Ha'apai Volcanic Eruption and a local outbreak of COVID-19**. The explosion from the underwater volcano on January 15 was the largest recorded globally over the last three decades. The ensuing tsunami and ashfalls caused extensive property and agriculture damages across the country, with an estimated total cost of about US$90 million or 18 percent of FY2021 (July 2020-June 2021) GDP.[1] Furthermore, the subsequent relief efforts were hampered by the first reported community transmission of COVID-19 on February 1. In response, the authorities announced a State of Public Health Emergency involving a national lockdown and stricter quarantine protocols for handling of humanitarian relief supplies. At the same time, the authorities are augmenting their efforts to facilitate Tonga's adaptation to the new COVID-19 norm, including by enhancing contact-tracing capability and accelerating the booster shot campaign. As of February 10, 2022, about 98 percent of the eligible population (aged 12 and above, or 71 percent of the total population) have received the first dose, 89 percent the second dose, and 11 percent the booster shot.

2. **Economic activity showed early signs of recovery before the January disaster**. After sustaining a double shock from Tropical Cyclone (TC) Harold (April 2020) and the pandemic overseas, Tonga's economy had been slowly regaining some momentum since 2021, underpinned by strong remittances and policy support. Construction activity held up better than expected despite closed international borders, reflecting reconstruction demand. Even the tourism sector, which took the brunt of the hit from the pandemic, managed to diversify into other related businesses. Headline inflation rose markedly to an average of 7.1 percent during July—November 2021, predominantly reflecting higher import prices of energy and food. Domestic inflation was lower at an average of 6 percent over the same period.

3. **The short-term growth outlook is subject to large uncertainties**. Following an estimated contraction of 0.8 percent in FY2021, Tonga's real GDP in FY2022 is projected to decline by another 1.5 percent, reflecting substantial disruptions to economic activity due to the damaged capital and COVID-19 containment measures, as well as losses in agricultural production from the volcanic ashfall. Annual GDP growth is projected to subsequently rebound to 3 percent over FY2023-FY2024, supported by a gradual reopening of international borders over FY2023, a pickup in reconstruction activity, and continuing remittance inflows and donor support. Inflation is projected to gradually

[1] https://www.worldbank.org/en/news/press-release/2022/02/14/tonga-volcanic-eruption-and-tsunami-world-bank-disaster-assessment-report-estimates-damages-at-us-90m

decline to 2.3 percent (y/y) at end-June 2022, in line with the projected moderation in international commodity prices, and to stay around 2½ percent (y/y) over FY2023-FY2024, below the National Reserve Bank of Tonga's (NRBT's) reference rate of 5 percent.

4. **The medium-term outlook is fragile**. Tonga's long-term growth potential is low due to its exposure to natural disasters, persistent loss of workers to emigration, narrow production base, and limited economies of scale owing to geographical barriers. Without bold structural reforms to boost climate resilience and private sector development, growth is expected to slow down to its long-term potential rate of 1½–2 percent. Over the medium term, the current account balance is expected to gradually deteriorate relative to its pre-pandemic levels, reflecting heavy import-dependence, weak competitiveness, and large infrastructure needs. International reserve coverage is expected to trend down to around 7½ months of imports in the medium term given the deteriorating current account deficits and large external debt repayments coming due starting in FY2024.

5. **The external sector position for FY2021 is assessed to have been substantially stronger than the level implied by fundamentals and desirable policies**, which was affected heavily by the impact of the pandemic, protracted closure of the border, the sharp loss in foreign exchange earnings from tourism, and an unprecedented increase in remittance inflows. Remittance inflows are estimated to have increased by about 11 percentage points of GDP in FY2021, which, combined with large inflows of grants related to COVID-19 and the TC Harold reconstruction efforts, more than offset the loss in tourism receipts and agricultural exports due to border closures and disruptions in transportation.

6. **The balance of risks is tilted to the downside**. In addition to frequent natural disasters, a faster-than-manageable local community transmission of COVID-19 is a major risk in the short term, especially given a high incidence of noncommunicable diseases and weak health care capacity in Tonga. Meanwhile, a further and quicker rise in international food and energy prices could significantly weaken private consumption by reducing households' real purchasing power and deteriorate the current account balance. In the medium term, loss of correspondent banking relationships is an important downside risk, given Tonga's heavy reliance on remittances.

Fiscal Policy

7. **The fiscal balance switched to a deficit in FY2021 due to COVID-related policy support measures**. The government achieved a much-needed fiscal consolidation during FY2016–FY2020 through improvements in revenue collection, generally effective controls on current spending, and the help of donor support. In response to the pandemic, the government implemented a fiscal package worth about 5.3 percent of GDP on health care and social protection, complemented by tax relief, targeting a budget deficit of 3½ percent of FY2021 GDP. The preliminary outturns nonetheless suggest a much smaller deficit of 0.4 percent, mainly reflecting under-execution of current expenditures due to capacity constraints and the suspension of interest payments under the G-20 Debt Service Suspension Initiative.

8. **Tonga's overall risk of public and external debt distress remains high**. Debt repayments are expected to spike starting from FY2024 due to scheduled repayments to China Exim Bank. Under current policies and financing commitments (i.e., budget support gradually declining to pre-pandemic levels and capital grants phasing out), most of the external debt service payments coming due from FY2024 onwards will need to be refinanced with new borrowings. In addition, Tonga will need to incur new borrowings to help finance its large spending needs to cover infrastructure gaps and meet its climate resilience and development goals. As a result, the present value of the public debt-to-GDP ratio is expected to rise to above the 70 percent of GDP benchmark from FY2029 under current policies and financing commitments. Over the medium term, Tonga could face the risk of a deterioration in debt-carrying capacity (currently assessed as "strong") given the exposure to large natural disasters, which could erode its productive capacity and reserve coverage.

9. **The short-term priority should focus on supporting reconstruction and recovery**. The fiscal balance is expected to deteriorate in FY2023, led by a pickup in much needed reconstruction and COVID-related spending. While tax revenues are expected to improve from their low levels in FY2022 and current expenditures to normalize, significant capital investment is needed in the next few years to repair and replace damaged public infrastructure. However, no additional grants have been committed for FY2023 after the volcanic eruption to meet the reconstruction needs, leading to a projected fiscal deficit of -6.5 percent of GDP in FY2023.

10. **In the medium term, a combination of domestic fiscal measures and external donor support are needed to simultaneously reduce the risk of debt distress and achieve development goals**. Once the recovery firmly takes hold, with full opening of international borders and resumption of tourism, Tonga should embark on gradual fiscal adjustment to build adequate fiscal buffers for debt servicing, emergency spending (e.g., for cyclones), and infrastructure needs. The fiscal adjustment will require both domestic efforts and donor support. Domestic fiscal measures should comprise improved revenue mobilization, current spending controls, and public financial management. New donor commitments after FY2025, in line with historical trend, are also needed to finance the significant investment needs to cover infrastructure gaps.[2] The government's medium-term policy agenda is broadly in line with these priorities.

Monetary and Exchange Rate Policies

11. **Monetary policy should stay supportive until recovery is firmly underway**. Monetary policy has been appropriately accommodative thus far, given the generally low inflation in FY2021 and the slow recovery. The recent uptick in inflation is largely due to global factors and expected to be temporary. Based on this assessment, it remains appropriate for the NRBT to stay on hold, keeping the monetary policy rate and the statutory reserve deposit rate at current levels. However, if

[2] For the World Bank (IDA) and other multilateral development banks, regular credit terms on all lending are assumed for all years in the projection period for which grant finance has not already been committed, consistent with Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf).

global energy and food prices surprise on the upside and generate strong second-round effects, leading measures of core inflation[3] to rise well above the reference rate and persistently stay at the elevated levels, the NRBT should tighten the monetary policy stance using its usual monetary policy instruments. Exchange rate stability has been maintained, including after a review of currency basket-weights in 2018.

Financial Stability

12. **Bank balance sheets were strong before the 2022 Volcanic Eruption**. Banks were profitable, well-capitalized, with declining nonperforming loans (NPLs) due to loan write-offs and settlements. High profitability reflected large non-interest margins and a decline in provision-related expenses due to lower NPLs. After several years of double-digit increases, credit growth moderated due to delays and cancellation of projects and lower household demand due to stretched debt-servicing capacity.

13. **Financial sector vulnerabilities will need to be closely monitored and improvements in supervision accelerated**. NPLs could pick up following the volcanic eruption and the outbreak of COVID-19, possibly leading to a deterioration in bank profitability and capital buffers. The NRBT should ensure that banks closely monitor credit risks of hard-hit sectors and actively provision for credit losses. Financial supervision should continue to be upgraded and deepened, especially by strengthening stress testing, enhancing household debt monitoring, and improving supervision of nonbank financial intermediaries. Given Tonga's heavy reliance on remittances (about 40 percent in FY2021), enhancing the AML/CFT framework and enforcement—in line with the recommendations from the 2021 Asia-Pacific Group Mutual Evaluation Report—is also essential and would help mitigate the risk of loss of correspondent banking relationships.

Structural Reforms

14. **The series of recent natural disasters has increased the urgency for broad-based reforms aimed at enhancing climate resilience and private sector development**. Despite important progress, structural constraints continue to impede private sector development. Tackling these barriers would require bold reforms aimed at upgrading workers' skills, enhancing healthcare capacity, easing access to bank credit, and streamlining the land lease processes. While the Disaster Risk Management bill passed in 2021 is an important first step toward strengthening the institutional framework for disaster risk management and preparedness, effective implementation of the law and other climate-related strategic plans will be essential, including by enhancing coordination across relevant ministries and management of scarce human and financial resources.

Fund Relations

[3] The NRBT does not publish core inflation series. IMF staff's own estimate of core inflation was 2.4 percent (y/y) as of September 2021 after declining from its peak of 4.2 percent in June 2021.

15. The 2020 Article IV consultation was concluded on January 25, 2021, along with the IMF Executive Board's approval of the disbursement of US$9.95 million in emergency financing under the IMF's Rapid Credit Facility to Tonga to help meet its urgent fiscal and balance of payments needs due to the COVID-19 pandemic and Cyclone Harold. Tonga has now shifted to a standard 12-month Article IV consultation cycle with the IMF. Tonga is a major recipient of IMF technical assistance, including from the Pacific Financial Technical Assistance Center (PFTAC).

Table 1. Tonga: Selected Economic Indicators, FY2020–FY2027 1/

Population (2020): 106 thousands
Major exports: root crops, vanilla, squash, fish
Quota: SDR 13.2 million

		Estimates	Projections					
	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027
Output and prices		(Annual percent change)						
Real GDP[2]	0.7	-0.8	-1.5	3.0	3.0	2.5	1.8	1.8
Consumer prices (period average)[3]	0.4	1.4	4.9	2.6	2.6	2.5	2.5	2.4
Consumer prices (end of period)[3]	-1.4	6.9	2.6	2.6	2.6	2.3	2.8	2.1
GDP deflator	-3.6	1.4	4.9	2.6	2.6	2.5	2.5	2.4
Central government finance		(In percent of GDP)						
Total Revenue	43.8	44.4	52.2	40.8	38.5	40.5	30.3	29.5
Revenue (excluding grants)	24.9	24.4	22.6	24.2	23.9	23.8	23.8	24.0
Grants	18.9	20.0	29.5	16.6	14.5	16.7	6.5	5.5
Total Expenditure	38.5	44.7	52.2	47.3	43.3	44.8	44.8	44.9
Expense	33.4	38.0	45.8	36.8	34.6	33.3	33.2	33.3
Transactions in Nonfinancial Assets (Net)	5.1	6.7	6.4	10.5	8.7	11.5	11.6	11.6
Overall balance	5.3	-0.4	0.0	-6.5	-4.9	-4.3	-14.5	-15.4
Net Acquisition of Financial Assets	6.0	2.1	0.1	4.4	0.0	0.0	0.0	0.0
External financing (net)	-0.4	2.7	-0.4	-1.6	-3.9	3.9	13.3	14.2
Domestic financing (net)	1.1	-0.2	0.5	12.5	8.8	0.4	1.2	1.2
Money and credit		(Annual percent change)						
Total liquidity (M3)	1.2	7.0	3.2	8.2	5.5	4.8	4.2	4.1
Of which: Broad money (M2)	0.2	0.6	3.3	8.6	5.7	5.0	4.4	4.3
Domestic credit	-16.1	-8.2	8.5	61.2	28.6	4.4	3.7	5.6
Of which: Private sector credit	1.1	1.0	0.3	1.1	1.6	2.1	2.6	3.0
Interest rates (end of period)								
Average deposit rate	2.3	2.2	2.3	...	...	...	...	...
Average lending rate	8.1	8.0	7.9	...	...	...	...	...
Balance of payments		(In millions of U.S. dollars)						
Exports, f.o.b.	18.2	16.6	11.2	13.1	21.1	22.2	24.3	25.0
Imports, f.o.b.	211.6	191.1	268.6	292.3	270.6	274.1	286.8	291.4
Services balance	-20.6	-90.5	-93.2	-103.9	-91.8	-63.0	-57.9	-59.9
Investment income balance	41.8	61.8	49.7	52.3	51.3	51.5	53.0	53.6
Transfers balance	152.9	228.0	299.3	236.7	251.8	227.4	182.9	180.3
Of which: Remittances	143.4	199.2	193.3	187.7	199.4	171.3	169.8	173.4
Of which: Official grants	20.1	33.1	112.7	59.0	63.3	73.4	32.3	27.3
Current account balance	-19.4	24.9	-1.5	-94.1	-38.1	-36.0	-84.5	-92.4
(In percent of GDP)	-3.9	5.0	-0.3	-16.9	-6.4	-5.8	-13.0	-13.7
Overall balance	24.3	64.7	35.9	-71.1	-37.7	18.2	10.7	10.4
(In percent of GDP)	4.9	12.9	6.9	-12.7	-6.3	2.9	1.6	1.5
Terms of trade (annual percent change)	0.1	-0.5	0.6	0.4	0.1	...	...	...
Gross official foreign reserves								
In millions of U.S. dollars	237.2	317.9	353.8	282.7	245.1	263.2	273.9	282.4
(In months of next year's total imports)	9.9	10.4	10.6	8.6	7.3	7.5	7.6	7.5
Debt (in percent of GDP)								
Public debt (external and domestic)	43.3	44.7	42.7	51.2	53.3	55.1	67.4	80.2
Of which: External debt	37.1	38.8	36.5	32.2	26.6	29.3	41.6	54.2
External debt service ratio	1.5	0.7	1.4	2.1	4.1	3.8	3.6	3.5
Exchange rates								
Nominal effective exchange rate (2005=100)	93.0	88.5	...	...	...	...	...	...
Real effective exchange rate (2005=100)	108.4	104.4	...	...	...	...	...	...
Memorandum items:								
Remittances (in percent of GDP)	29.0	39.8	37.0	33.6	33.4	27.4	26.2	25.7
Tourism (in percent of GDP)	8.2	0.8	0.4	0.5	3.6	6.8	7.7	7.9
FDI (in percent of GDP)	-0.7	-1.4	-1.2	-1.2	-0.8	-0.9	-0.9	-0.9
Nominal GDP (millions of US$)	494.4	500.1	522.1	558.3	596.6	624.9	649.1	673.5
GDP Growth 2018 - 2023 (Calendar Year Basis)	-0.1	-1.1	0.8	3.0	2.8	2.1	1.8	1.8

Sources: Tonga authorities; and IMF staff estimates and projections.
[1] Fiscal year beginning July.
[2] Including preliminary data.
[3] CPI basket and methodology changed in September 2018.