GOVERNMENT OF TONGA

MEDIUM-TERM DEBT STRATEGY

FINANCIAL YEARS 2026 - 2028

MINISTRY OF FINANCE

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Contents

I. ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
ADF	Asian Development Fund
ATM	Average term (time) to maturity
ATR	Average term (time) to refixing
AUD	Australian dollar
NRBT	National Reserve Bank of Tonga
CNY	Chinese renminbi (yuan)
DMU	Debt Management Unit
DSA	Debt Sustainability Analysis
DSSI	Debt Service Suspension Initiative
EUR	Euro
EXIM Bank	Export-Import Bank
FY	Financial Year
GDL	Government Development Loans
GDP	Gross Domestic Product
GoT	Government of Tonga
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IFI	International Financial Institutions
IMF	International Monetary Fund
JICA	Japan's International Cooperation Agency
MoF	Ministry of Finance
MTDS	Medium-term debt strategy
MDB	Multilateral Development Banks
ODA	Official Development Assistance Loans
PRF	Pacific Resilience Facility
TOP	Tongan Pa'anga
SDG	Sustainable Development Goals
SECURE	Stand-by Emergency Credit for Urgent Recovery
XDR	Special Drawing Rights
USD	United States dollar
WB	The World Bank

II. FOREWORD

The Government of Tonga continues to navigate a challenging global environment marked by economic uncertainty, climate and nature vulnerability, and ongoing recovery from external shocks. Against this backdrop, the Medium-Term Debt Management Strategy (MTDS) 2026–2028 reaffirms the Government's strong commitment to prudent debt management and fiscal sustainability.

This Medium-Term Debt Management Strategy (MTDS) 2026–2028 reaffirms our ongoing focus on reducing debt distress and improving economic resilience. Our approach continues to prioritize cost-effective financing, the avoidance of non-concessional borrowing, and active repayments. The Government is also committed to strengthening the domestic debt market, fostering long-term sustainability, and reducing reliance on external borrowing.

As we embark on the next phase of debt management, we remain grateful to our stakeholders for their continued support in achieving these goals. Together, we will continue to work toward a prosperous and resilient Tonga.

MINISTRY OF FINANCE TONGA

Ms. Lesieli Tufui Faletau

Acting Chief Executive Office for Finance

III. EXECUTIVE SUMMARY

The Government of Tonga (GoT) has prepared this Medium-Term Debt Management Strategy (MTDS) to guide borrowing and debt management decisions for the period 2026–2028. The strategy aligns with international best practices and reflects Tonga's evolving macroeconomic environment, financing needs, and policy priorities.

Tonga's public debt portfolio is predominantly external (83.8%) and largely concessional in nature, with multilateral institutions such as IDA, ADB, and the IMF as key creditors. However, the largest individual creditor exposure remains with China Exim Bank, constituting 37.4% of the total debt stock. Currency risk is concentrated in CNY and SDR, while all debt is on fixed interest terms, mitigating interest rate volatility.

As of February 28, 2025, total public debt stood at $428.9 million (34.2% of GDP). The debt-to-GDP ratio has declined by 8.3 percentage points since 2020 due to active repayments and prudent borrowing policies. Government guarantees and on-lent debt account for a further 3.6% of GDP and are monitored closely as contingent liabilities.

Domestic bond issuances in 2024 supported critical government obligations, while external debt service pressures have been partly alleviated by China's loan rescheduling. Going forward, the strategy supports continued reliance on concessional financing, cautious use of guarantees, and progressive development of the domestic debt market.

The MTDS will be reviewed regularly to ensure responsiveness to economic developments, reinforcing Tonga's commitment to debt sustainability and transparency.

IV. INTRODUCTION

The Medium-Term Debt Management Strategy (MTDS) 2026–2028 provides a comprehensive framework to guide Tonga's public debt management over the next three fiscal years. Building upon the successes of the previous MTDS 2021–2025, this updated strategy reflects the Government's continued commitment to fiscal prudence, sustainable debt management, and ensuring the resilience of Tonga's economy in an uncertain global environment.

The Government of Tonga remains focused on managing its debt in a way that ensures long-term financial sustainability, particularly amidst economic challenges, climate change risks, and ongoing recovery from external shocks. The MTDS 2026–2028 emphasizes two key strategies:

- Managing Borrowing and Prioritizing Debt Repayment: The Government will maintain a status quo approach by prioritizing active debt repayments and avoiding non-concessional borrowing. This strategy supports the broader goal of reducing the IMF's debt distress rating from "high" to a more sustainable level, thereby enhancing access to concessional financing.

- Development of the Domestic Debt Market: The strategy includes advancing the domestic debt market, with a key goal of reducing dependence on external borrowing. A significant step in this direction is the planned issuance of a $30.0 million domestic bond in FY2025/26, which will help stimulate economic development through private sector and strengthen investments and accessibility in education sector.

Looking forward, the Government acknowledges the importance of addressing risks associated with foreign exchange rate volatility and refinancing, as external debt remains a significant portion of the debt portfolio. Strengthening the domestic debt market will be crucial in reducing vulnerabilities to external shocks and diversifying the financing base.

Institutional reforms have significantly strengthened Tonga's debt management framework, enhancing both credibility and transparency. A major milestone was the successful upgrade to the Meridian debt recording and management system, which enables more accurate, timely, and comprehensive debt data reporting. In parallel, Tonga has actively engaged in the World Bank's Sustainable Development Financing Policy through policy actions aimed at improving debt transparency and accountability. Tonga's participation in the World Bank's Resilient Debt Clause initiative also reflects its proactive approach to managing climate-related risks. Collectively, these reforms provide a solid institutional foundation for implementing the MTDS 2026–2028 and achieving long-term fiscal sustainability.

This strategy will be subject to annual reviews to ensure its responsiveness to changing economic conditions and financing needs. The Government remains committed to working closely with international partners, regional institutions, and the private sector to support Tonga's long-term fiscal stability and development goals.

V. OBJECTIVES AND SCOPE OF THE DEBT MANAGEMENT STRATEGY

The GoT has set two main objectives for debt management:

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

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

The MTDS focuses on Tonga's public debt portfolio, covering both domestic and external borrowings undertaken directly by the Government. This includes loans that are on-lent to state-owned enterprises (SOEs) and private companies, as the original borrowing remains a direct obligation of the Government and is therefore included in the MTDS analysis. **However, publicly guaranteed debt is excluded from the MTDS as further consolidation is required.**

VI. CHARACTERISTICS OF THE EXISTING DEBT PORTFOLIO

A. Composition as of 28th February 2025.

Table 1- Total Public Debt outstanding and debt related exposures for FY2025

	Debt Outstanding and Disbursed (DOD) in TOP$m	% of GDP
Total Public Debt	***428.9***	***34.2%***
External Debt	359.3	28.7%
Domestic Debt	69.7	5.6%
Total Government Guaranteed Loans	***16.2***	***1.3%***
Total Government On-lend Loans	***29.2***	***2.3%***
On-lend to SOEs	3.2	0.3%
On-lend to Private Sector	26.0	2.0%
Total Public Debt with other debt related exposures	**474.4**	**37.8%**

Source: MOF – Financial Framework Division (FFD)

As of 28th February 2025, the public debt outstanding and disbursed (DOD), comprising of the Government's direct debt obligation, amounted to $428.9 million paʻanga or 34.2% of the GDP. This includes both external and domestic borrowings undertaken by the Government.

In addition to its direct debt, the Government has issued guarantees for loans contracted by public and private entities. While not included in the public debt total above, the estimated stock of government guaranteed loans is $16.2 million (1.3% of GDP). The most recent guarantee was issued in 2022.

The Government also on-lends borrowed funds to state-owned entreprises (SOEs) and private companies. As of 28th February 2025 :

1. On-lends to state-owned entreprises (SOEs) were totaled to $4.0 million (0.3% of GDP, 1.1% of Total External Debt) and
2. On-lends to private companies amounted to $25.2 million (2.0% of GDP, 7.0% of Total External Debt).

The Government also provides direct loans to the private sector, under the Agriculture and Fisheries Market Funds. Although both facilities have been closed since 2014, Ministry of Finance is actively working to recover as much as possible of the disbursed outstanding amount totaled to $1.2 million.

It is important to note that on-lent loans and government administered funds are recorded as assets of the State, not liabilities. However, they carry fiscal risks if the government is unable to recover the whole amount lent to the respective entities. The ***Table 1*** above details the breakdown composition of Tonga's public debt and other debt related exposures[1].

External debt represents 83.8% of the total public debt portfolio, while Treasury bonds outstanding amount makes up the remaining 16.2%. The GoT's largest creditor is the Exim Bank of China, whose two loans represent 37.4% of the total debt portfolio and 44.6% of the total external debt outstanding. The remainder of the external debt portfolio is concessional with loans from the Asian Development Bank (13.2%), the International Development Association (27.1%), the International Fund for Agricultural Development (2.8%) and the International Monetary Fund (12.2%). ***Table 2*** below outlines the creditor composition of the total debt outstanding and disbursed.

Table 2 - Creditor Composition for FY2025

Creditor	Debt Outstanding and Disbursed (DOD) in TOP$m	% of Total Public Debt	% of GDP
External Loans	***359.3***	***83.8%***	***28.7%***
Asian Development Bank	*47.4*	*11.1%*	*3.8%*
International Development Association	*97.5*	*22.7%*	*7.8%*
International Fund for Agricultural Development	*10.1*	*2.4%*	*0.8%*
International Monetary Fund	*44.0*	*10.2%*	*3.5%*
Exim Bank	*160.3*	*37.4%*	*12.8%*
Domestic Loans	***69.7***	***16.2%***	***16.2%***
Total Public Debt	**428.9**	**100.0%**	**34.2%**

Source: MOF – Financial Framework Division (FFD)

Domestic Debt is composed of Treasury bonds with tenors ranging from 3 years to 6 years with the 5-year bonds making up the majority, accounting to 65.2% of the total domestic debt portfolio. ***Table 3*** presents the outstanding amounts by tenor as of 28 February 2025. All bonds issuance is authorized and capped by the Minister of Finance, while the National Reserve Bank of Tonga (NRBT) serves as the registrar of the domestic bonds issuance.

Table 3 - Domestic Debt Outstanding by Tenors

Treasury Bonds Tenor	Debt Outstanding and Disbursed (DOD) in TOP$m	% of Total Domestic Debt
3 – years	*9,026,000.00*	*13.0%*
4 – years	*508,000.00*	*0.7%*
5 – years	*45,412,000.00*	*65.2%*
6 – years	*14,704,000.00*	*21.1%*
Total Public Debt	**69,650,000.00**	**100.0%**

Source: MOF – Financial Framework Division (FFD)

Holdings of domestic government securities are highly concentrated in a few financial institutions. Commercial banks and two Pensions funds are the main holders of government securities and take most of the volume auctioned. However,

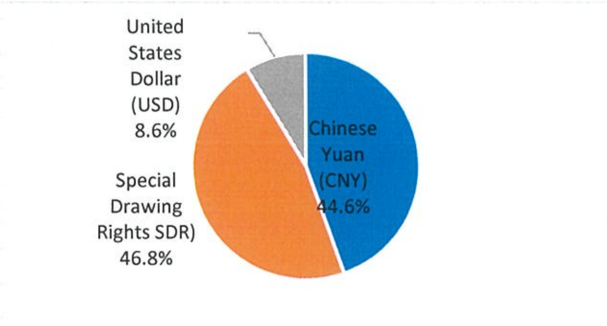
[1] 'Debt related exposures' is used in this context to describe the inclusion of the Government Guaranteed Loans (classified as contingent liabilities) and On-lent Loans (classified as financial asssets of the Government) in the summation with the Total Public Debt as both carry fiscal risks in the event of borrowers default in repayment.

there is no restriction on potential bondholders because government boards, private companies and individuals can also apply to the volumes offered by the government.

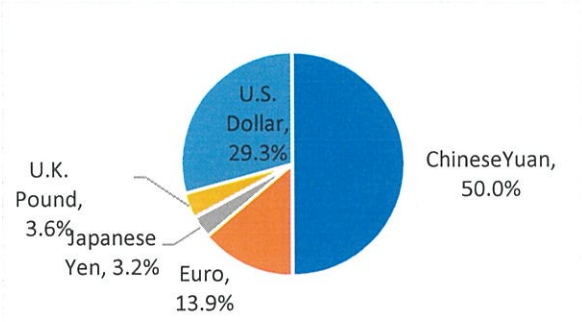
Although the loans from EXIM Bank of China has the largest share of external debt in the total portfolio, the major currency holding of the external debt has shifted. The Special Drawing Rights (XDR) now holds the largest currency share triggered by the commencement of principal repayments of the China Loans. The second largest currency share is the Chinese Renminbi (Yuan) in the debt portfolio. About 46.8% of the external debt is denominated in XDR (reflecting loans on concessional terms from ADB, IDA and IFAD) whilst CNY represents 44.6% of the total portfolio. However, after decomposition of the XDR into its constituent currencies, the portfolio contains 50% of debt exposed to fluctuations of the CNY exchange rate against TOP. ***Figure 1*** shows the foreign currencies to which the debt portfolio is exposed.

Figure 1 - Currency Exposure of External Debt Outstanding as of 28th February 2025.

Currency composition of the External Debt Portfolio



Currency composition with decomposition of XDR

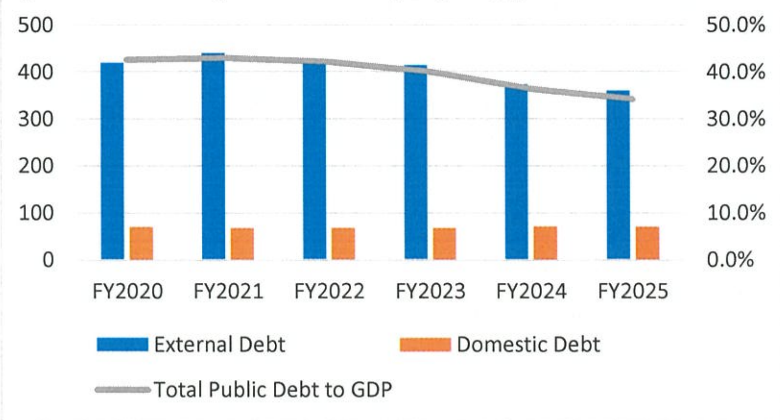


Source: MOF – Financial Framework Division (FFD)

B. Evolution of the debt portfolio in recent years and key development in 2025.

The GoT prudent debt management in recent years has helped stabilize the debt level. The GoT continue to refrain from incurring new non-concessional external borrowing since the establishment of the first MTDS in 2018. This sound fiscal management has contributed to a decline in the Debt to GDP ratio by 8.3% since 2020 and the total level of debt by 12.2% or $59.5 million over the past five years as illustrates in ***Figure 2***. The loans owed to China Exim Bank continue to represent the largest component of the GoT outstanding debt portfolio, and its repayment remains an ongoing priority. In 2024, the domestic debt

Figure 2 - Evolution of Debt-to-GDP in past five (5) years



Source: MOF – Financial Framework Division (FFD) experienced an increase due to the GoT's initiation of $3.0 million new bond issuances with the intention to support the settlement of liabilities to China Exim Bank.

On the external debt side, the GoT continue to face high debt service. The agreement between the EXIM Bank of China and the GoT for the postponement of principal repayments alleviated refinancing pressures and expanded fiscal space. However, the total reimbursements of the two Chinese loans are now condensed from 2024 to 2030. In addition, principal repayments on several other concessional loans are now due to commence, further contributing to the rise in external debt servicing. This includes the two Rapid Credit Facility (RCF) loans received from the International Monetary Fund (IMF) in response to the economic impact of the COVID-19 pandemic, for which repayment obligations are also starting within this medium term. To ensure debt sustainability, the GoT has maintained a strict policy of avoiding new non-concessional borrowing over the past five years. This fiscal discipline has been at the core of the Government's approach to avoid putting further pressure on Tonga's debt service.

On the domestic debt side, the GoT primary issued Treasury bonds to refinance maturing obligations. The GoT is also planning to issue $30.0 million of new bonds in the coming financial year to support economic development of private sectors and strengthen the investment and accessibility in the education sector.
While the Government's bond issuances were successfully received, two instances of undersubscription occurred during the rollover of existing bonds. This apparent disconnect between liquidity and subscription rates highlights the importance of investor confidence, interest rate expectations, and perceived credit risk in influencing market participation. Although higher liquidity may suggest a favorable environment for bond uptake, it does not guarantee full subscription unless market conditions and sentiments are also aligned. The market condition, however, does present an opportunity for Tonga to further develop its domestic bond market. Strengthening market infrastructure, enhancing transparency, and promoting investor awareness will be vital to broadening the investor base and sustaining bond market resilience. At the same time, reliance on domestic borrowing should be balanced with prudent fiscal policies to avoid crowding out private sector investment and to ensure long-term debt sustainability.

Most recent assessment of IMF in 2024 continues to classify Tonga as being at high risk of debt distress under the IMF-World Bank Debt Sustainability Analysis framework. Tonga consistently manage its debt level in alignment to the adopted limit on external debt level set at 50.0% of GDP and the allocation debt share of 70.0%. Despite several years of fiscal consolidation, Tonga is still assigned 100.0% grants financing status under Multilateral development banks (MDBs). The GoT also continues to refrain from incurring new external borrowing until Tonga's debt levels decline sufficiently to regain eligibility for multilateral concessional loan facilities.

Under the Debt Service Suspension Initiative (DSSI), the GoT has benefited from a temporary suspension of debt service payments to the Exim Bank of China. The effective periods of the suspension have ended and the GoT commenced the principal repayments in FY2024. To date, the first suspension has been fully paid, while the servicing of the remaining suspended amounts will continue until March 2027.

C. Cost and Risk Indicators

The cost of the existing debt portfolio is relatively low primarily due to the share of concessional external debt. As of the end of February 2025, the present value (PV) of total public debt was estimated at 28.6% of GDP[2] compared to the nominal debt stock of 34.2% of GDP, underscoring the concessional nature of the portfolio.

Table 4 - Cost and Risk Indicators of Debt Outstanding for FY2025

Risk Indicators		External Debt	Domestic Debt	Total Debt
Amount (in millions of TOP)		359.3	69.7	428.9
Amount (in millions of USD)		149.1	28.8	177.9
Nominal debt as percent of GDP		28.7	5.6	34.2
PV as percent of GDP[1]		23.0	5.6	28.6
Cost of debt[2]	Interest payment as percent of GDP[3]	**0.3**	**0.2**	**0.4**
	Weighted Av. IR (percent)	**0.9**	**2.8**	**1.2**
Refinancing risk[2]	ATM (years)	**7.4**	**2.6**	**6.7**
	Debt maturing in 1yr (percent of total)	**5.4**	**15.5**	**6.9**
	Debt maturing in 1yr (percent of GDP)	**1.8**	**0.9**	**2.7**
Interest rate risk[2]	ATR (years)	**7.4**	**2.6**	**6.7**
	Debt refixing in 1yr (percent of total)	**5.4**	**15.5**	**6.9**
	Fixed rate debt incl. T-bills (percent of total)	**100.0**	**100.0**	**100.0**
	T-bills (percent of total)	**0.0**	**0.0**	**0.0**
FX risk	FX debt (percent of total debt)			83.8
	ST FX debt (percent of reserves)			2.3

Source: MOF – Financial Framework Division (FFD)

The external debt portfolio comprising of **83.8%** of the total public debt benefits from a lower weighted average interest rate (IR) of **0.9%**, compared to **2.8%** for domestic debt. Overall, the weighted average interest rate across the portfolio stands at **1.2%**. The latest issuances of Treasury bonds have been achieved at interest rates consistent with past issuances.

Refinancing risk is moderate, with an average time to maturity (ATM) of **6.7 years** for total debt, but significantly lower for domestic debt at **2.6 years**. Approximately **6.9%** of the total debt stock matures within one year, representing **2.7%** of GDP.

Interest rate risk is minimal, with **100%** of the debt stock on fixed interest rates and no exposure to Treasury bills. The average time to refixing (ATR) matches the ATM, at **6.7 years**, indicating stability in debt servicing costs.

Foreign exchange (FX) risk remains a key vulnerability, with 83.8% of the debt denominated in foreign currency. However, short-term FX debt accounts for only 2.3% of official reserves, mitigating immediate external liquidity pressure. *Table 4 above* provides a detailed breakdown of the cost and risk indicators of debt outstanding as of the end of February 2025.

While the short-term FX liquidity pressures are currently mitigated, Foreign Exchange risk remains the significant long-term vulnerability in Tonga's debt profile. The large share of foreign currency denominated debt of 83.8% of the portfolio means that the debt servicing costs are highly sensitive to exchange rates movements.

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

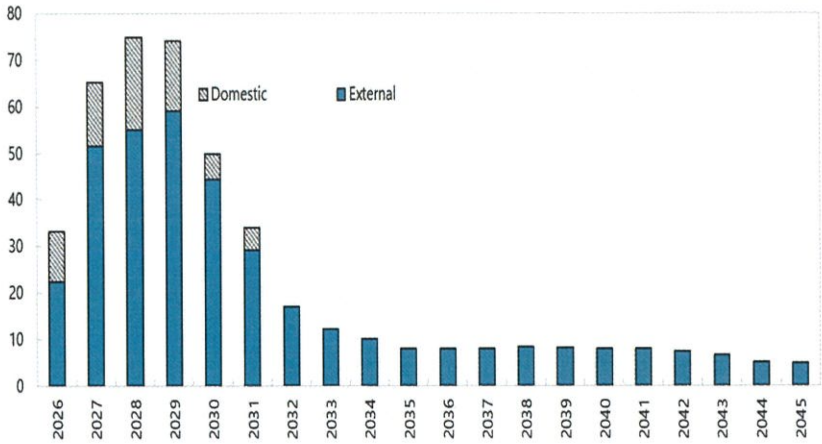
In particular, exposure to the Chinese Renminbi (CNY) is substantial, with CNY denominated loans accounting to 50.0% of the total public debt portfolio due to the decomposition of the XDRs. For FY2026, 65.0% of the projected debt service, Tongan Pa'anga equivalent, denominated in CNY. This exposure is however, expected to decline gradually, with repayments reducing the share by 7.2% in FY2027, 5.0% in FY2028, 2.2% in FY2029 and final drop of 31.0% in FY2030 marking the end of the repayments to the China Exim Bank.

Furthermore, beginning in FY2026, the amortization of IMF Rapid Credit Facility (RCF) loans in USD, will introduce additional FX exposure. Forecasts indicate a potential 1.6% depreciation of the TOP against the USD in fiscal year 2026, with further weakening possible in subsequent fiscal years.

These FX pressures if unmitigated could challenge budget execution during the period of FY2026 – 20231. Continuous risk monitoring and a cautious external borrowing strategy remain crucial.

The existing domestic debt portfolio faces notable refinancing risk. As end of February 2025, 15.5% of Domestic Debt is set to mature within one year, and the ATM for domestic debt stands at just 2.6 years. In contrast, external debt reflects a more moderate short-term refinancing risk, with only 5.4% maturing within one year and a longer ATM of 7.4 years.

Figure 3 - Redemption Profile of Debt Outstanding as of 28th February 2025



Source: MOF – Financial Framework Division (FFD)

However, the external redemption profile is not as smooth or evenly distributed as might be expected from a portfolio dominated by concessional loans. Instead, maturities are concentrated between FY2027 and FY2030, reflecting the amortization of two Chinese loans and the commencement of IMF repayments. This concentration is largely due to the DSSI-related deferrals on Chinese loans and does not reflect an extension of the portfolio's ATM, which remains relatively long due to the concessional nature of the debt. While the short-term burden appears manageable with the external debt maturing within one-year accounts for just 1.8% of GDP, the clustered repayments over the medium term underscore a latent refinancing risk.

Given that the entire portfolio is on fixed interest rates and no Treasury bills are issued, interest rate risk is fully aligned with the redemption profile. Consequently, refinancing risk and interest rate risk indicators are effectively identical.

VII. MACROECONOMIC ASSUMPTIONS AND MAIN RISK FACTORS

A. Macroeconomic developments and baseline assumptions

Tonga's medium-term macroeconomic outlook anticipates steady, modest growth driven by ongoing recovery from past economic shocks and supported by development partner assistance. Real GDP average growth is projected at 2.8 percent in FY2024/25, rising to 3 percent in subsequent years, reflecting gradual improvements in private sector activity, remittance inflows, and externally financed capital projects. Nominal GDP is expected to grow from $1,253.6 million in FY2024/25 to $1,418.7 million by FY2027/28.

Table 5 – Macroeconomic Projection for FY2026 - 2028

	2024/25e	2025/26e	2026/27e	2027/28e
TOTAL PUBLIC DEBT	*428.9*	*381.0*	*331.9*	*280.8*
Nominal GDP	*1253.6*	*1301.9*	*1358.6*	*1418.7*
Real GDP Growth	*2.5%*	*3%*	*3%*	*3%*
Exchange Rate (TOP/USD)	*2.43*	*2.37*	*2.49*	*2.49*
Inflation Rate	*5.4%*	*5.4%*	*5.4%*	*5.4%*
Primary Balance % of GDP	*4.6%*	*5%*	*5%*	*5%*

Source: MOF – Financial Framework Division (FFD)

The primary balance is projected to remain in surplus over the medium term, strengthening from 4.6 percent of GDP in FY2024/25 to 5 percent by FY2025/26 onward. This surplus reflects the Government's ongoing commitment to fiscal prudence and is consistent with a balanced budget approach, where recurrent revenues match expenditures, and the remaining fiscal gap relates only to external debt principal repayments.

Inflation is expected to remain contained at around 5.4 percent, a measly excess from the threshold of 5%, however, Government continue to liaise with NRBT on relevant measures to address the impact of inflation. The exchange rate is projected to remain stable, with minor fluctuations, averaging around TOP 2.49 per USD in the outer years, helping to anchor external price pressures.

Tonga's total public debt is forecast to decline from $428.9 million in FY2024/25 to $280.8 million by FY2027/28, supported by sustained primary surpluses, minimal to no new borrowing, and ongoing principal repayments, particularly for legacy external loans.

B. Key macroeconomic risks

Tonga's economic outlook remains cautiously optimistic, supported by continued donor engagement, robust remittance inflows, and recovery in tourism and agriculture. However, the economy is vulnerable to several external macroeconomic shocks that could disrupt this trajectory. Fluctuations in global commodity pricesparticularly oil and food pose inflationary risks and could increase the cost of government operations and essential imports. Furthermore, the exchange rate volatility, especially with respect to the USD and CNY, can heighten the cost of external debt servicing, given that a significant portion of Tonga's debt is denominated in foreign currencies. These pressures could strain fiscal buffers and weaken purchasing power, particularly among vulnerable households.

Tonga's high reliance on remittances partially driven by the Regional Seasonal Employment (RSE) and Pacific Australia Labour Mobility (PALM) schemes presents both opportunity and risk. Any tightening of these programs, whether due to host country policy changes or labor market saturation, could sharply reduce income inflows, affecting household consumption, domestic demand, and government revenues. In addition, Tonga's dependence on imports and narrow export base leaves it exposed to international trade disruptions. Ongoing global geopolitical tensions, including the US-China trade relationship and supply chain vulnerabilities, could reduce trade volumes or raise prices, impacting both the balance of payments and inflation. These structural dependencies underscore the need for economic diversification and policy agility.

As a small island developing state (SIDS), Tonga remains extremely vulnerable to climate change and natural disasters such as cyclones, droughts, and volcanic activity. The economic and fiscal impacts of such events are often severe and long-lasting, damaging infrastructure, disrupting key sectors like agriculture, tourism, and fisheries, and necessitating large-scale emergency spending. The 2022 Hunga Tonga-Hunga Ha'apai volcanic eruption and tsunami exemplified the catastrophic potential of natural hazards. Climate-related risks are likely to intensify in the coming years, placing additional pressure on public finances, especially in the absence of a dedicated contingency or disaster relief fund. Strengthening disaster risk management frameworks, building climate-resilient infrastructure, and improving access to pre-arranged financing mechanisms such as insurance or contingency credit lines are vital to mitigating future shocks.

VIII. SOURCES OF POTENTIAL FINANCING

A. External financing

The GoT continues to abstain from incurring new external borrowing in order to maintain total public debt at a prudent and sustainable level. Emphasis remains on prioritizing debt repayments, which enhances the country's eligibility for future concessional and non-concessional financing. Currently, Tonga qualifies for 100% grant financing from both the World Bank and the Asian Development Bank, a status enabled by its classification as being at high risk of debt distress. This allows access to highly concessional grant resources, particularly those earmarked for disaster recovery and resilience-building.

According to the November 2024 Joint IMF–World Bank Debt Sustainability Analysis (DSA), Tonga's debt remains sustainable, albeit under high risk. The DSA recommends that Tonga strengthen domestic revenue mobilization through improved tax administration and a review of existing tax exemptions. Recognizing the Government's already limited fiscal space, the report notes the difficulty of further reducing current expenditures. As such, the policy direction is focused on enhancing revenues through targeted reforms, including a review of government fees and charges to better reflect the cost of service delivery, and on improving the efficiency of public spending.

Aligned with the GoT's policy to avoid non-concessional borrowing, Tonga's classification by the Japan International Cooperation Agency (JICA) as an Upper-Middle-Income Country is acknowledged. This income status qualifies Tonga to access concessional financing under JICA's Official Development Assistance (ODA) loan criteria, specifically for projects related to disaster recovery and resilience. For initiatives such as the SECURE project, concessional terms include a 0.55% interest rate, a 40-year repayment period, and a 10-year grace period. Given Tonga's high vulnerability to natural disasters and the impacts of climate change, such financing instruments remain a viable and affordable option to support long-term recovery and development.

In 2021, Tonga also became a member of the Asian Infrastructure Investment Bank (AIIB), which offers a range of financial instruments such as loans and guarantees to member countries for economic development. Any future borrowing from the AIIB will be subject to an assessment of concessionality to ensure alignment with the Government's sustainable debt management strategy.

The IMF has cautioned that Tonga's primary fiscal deficit may widen over the long term under the baseline scenario, primarily due to expected declines in committed grant inflows and increasing expenditure needs. However, the GoT maintains a strong commitment to fiscal discipline through expenditure prioritization, budget tightening, and by focusing on private sector–led economic initiatives and timely external debt repayments. These measures have supported a balanced fiscal position and reflect a broader shift toward sustainable development financing and economic resilience.

Should Tonga's debt sustainability indicators improve particularly with a reclassification from high to moderate risk of debt distress under the DSA framework the GoT may

cautiously consider resuming concessional external borrowing. This shift may become necessary if grant flows decline over the medium term. Nevertheless, any future borrowing will be confined to concessional loans with a minimum 35% grant element, in line with international debt sustainability standards and the Government's commitment to responsible fiscal management.

B. Domestic Financing

The GoT plans new bond issuances in FY2026 to support private sector–led economic development initiatives and strengthen investment and accessibility in the education sector. The GoT issues Treasury bonds with maturities ranging from 3 to 6 years. These bonds have a bullet repayment structure and currently pay a coupon rate between 2% and 3.5%. The Ministry of Finance does not issue short-term instruments and does not use other source of domestic financing.

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Tonga's domestic debt market is still at an early stage of development with limited absorption capacity. However, the GoT is committed to strengthening communication with investors to better respond to their needs and to support more efficient budget financing. The GoT remains committed to the continued issuance of bonds for refinancing maturing obligations with extended maturities to mitigate refinancing risks. Furthermore, the GoT, as in prior fiscal years, issue new bonds as necessary for budgetary financing purposes to support development priorities.

The Ministry of Finance determines the terms and interest rates on Treasury bonds. It sends the bond prospectus to the National Reserve Bank of Tonga (NRBT), indicating the total amount to be issued and the fixed interest rate. The NRBT distributes the prospectus to market participants, who must submit their offers within one month. There are no restrictions on potential bondholders both individuals and institutions may apply. The Ministry of Finance reviews the bids and finalizes the terms and conditions, which are then implemented by the NRBT.

The GoT maintains the availability of Treasury Bills for issuance, contingent upon necessity. While the issuance of Treasury Bills is not currently required, this option is retained as a contingency given prevailing market preferences for Treasury Bonds with shorter maturities and higher interest rates.

Over the medium term, the GoT is initiating groundwork to support the development of the domestic bond market, including capacity-building efforts and improved investor communication strategies. This approach also complements the GoT's efforts under the World Bank Sustainable Development Finance Policy (SDFP) to enhance debt transparency through regular quarterly bulletins, annual debt reports, and planned investor-focused outputs.

IX. STRATEGY FOR THE PERIOD 2026-2028

A. Government Borrowing for FY2026.

For FY2026, the GoT plans to issue $30.0 million in domestic Treasury bonds to meet financing needs aligned with the MTDS priorities. This borrowing directly supports the dual strategic goals of

(i) managing borrowing and prioritizing debt repayment, and
(ii) developing the domestic debt market to reduce reliance on external financing.

In response to Tonga's longstanding recovery from the triple natural disaster shocks and the economic effects of the COVID-19 pandemic, the new issuance will support resilience and long-term development. The proceeds from the bonds will be allocated as follows:

C. 33% to strengthen investments in Tonga's Technical and Vocational Education and Training (TVET) sector,

D. 67% directed to support economic development initiatives, both will be administered under the Government Development Loan (GDL) facility managed by the Tonga Development Bank.

These domestic financing efforts contribute not only to maintaining a sustainable financing gap but also to stimulating inclusive private sector growth and expanding access to education and skills training both essential to building national resilience.

B. Description of Debt Strategy for FY2026-2028

The Medium-Term Debt Strategy (MTDS) was developed through a cost-risk analysis of the public debt portfolio. The results show that this strategy strikes a good balance between reducing exchange rate risk and refinancing risk without significantly increasing the cost of debt. It is expressed in proportions allocated to each external and domestic instrument to finance government gross borrowing requirements from 2026 to 2028.

Table 6 - Average Percentage of Gross Borrowing over Strategy Period

Instrument	Strategy	Financial Conditions		
	Proportion of financing (in%)	Maturity (yr)	Grace (yr)	Interest Rate
ADB	0.0%	24	8	1.0%
IDA	16.2%	40	10	0.75%
IFAD	3.0%	40	10	1.0%
IMF	0.0%	10	5	0.0%
Eximbank China	0.0%	20	5	2.0%
Treasury bonds 2-years	0.0%	2	1	Market
Treasury bonds 3-years	16.5%	3	2	Market
Treasury bonds 4-years	0.0%	4	3	Market
Treasury bonds 5-years	46.5%	5	4	Market
Treasury bonds 6-years	17.7%	6	5	Market
External Sources	**19.3%**			
Domestic Sources	**80.7%**			

Source: MOF – Financial Framework Division (FFD)

The strategy focuses on two key pillars:

1. Managing Borrowing and Prioritizing Debt Repayment: The Government of Tonga will maintain a cautious borrowing approach, avoiding non-concessional loans and emphasizing active debt repayment. This will support the reduction of Tonga's IMF debt distress rating and improve access to concessional financing.
2. Development of the Domestic Debt Market: The Government aims to reduce reliance on external borrowing by focusing on developing the domestic debt market. This includes the issuance of Treasury bonds, such as the planned $30.0 million bond issuance in FY2026, to finance domestic development priorities and education sector.

Over the three-year horizon, the strategy will primarily rely on domestic financing sources. On average, government gross borrowing will consist of 19.3% from external loans and 80.7% from domestic issuances, as shown in Table 6 below. The main source of financing will be 5-year and 6-year Treasury bonds, accounting for 35.2% of total borrowing, while other bonds contribute 9.0%. Disbursements from prior loan commitments will play a minor role in the borrowing mix. IDA loans are expected to cover 16.2% of borrowing needs, and ADB and IFAD loans will represent 1.7%. Exim Bank of China loans, which have already completed their disbursement period, will not contribute. While ADB and IDA remain important sources, they will primarily provide grants.

While the strategic borrowing mix for the next three years is subject to annual revision, it is anticipated that new external borrowings will remain minimal. Instead, the Government will focus on issuing long-term domestic Treasury bonds, particularly to meet significant repayment obligations to Eximbank China and the IMF. External financing during this period will primarily comprise disbursements from existing loan commitments, as no new external loans are currently planned.

This approach aligns with Tonga's classification as being in high debt distress, which qualifies it for 100% grant funding from major development partners such as the ADB and World Bank. As such, the Government aims to maximize access to grants, potentially reducing the need for further borrowing.

Treasury bonds issuance focuses on longer maturities. The existing Domestic debt portfolio with maturities exceeding 5 years comprises 86.31% (72.38% at 5 years and 13.93% at 6 years). The GoT aims to finance budget in the upcoming FY by issuing longer-term bonds (greater than 5 years) to mitigate foreign exchange exposure and refinancing risk, despite the potentially higher cost compared to external borrowing. In light of the aforementioned, the GoT will issue new Treasury bonds value at $30.0 million in the subsequent FY.

The strategy also emphasizes issuing longer-term Treasury bonds to mitigate both foreign exchange and refinancing risk. The existing domestic debt portfolio, with maturities exceeding five years, accounts for 86.3% of total debt (72.4% at 5 years and 13.9% at 6 years). This strategy aims to maintain this focus and issue new Treasury bonds worth $30.0 million in the coming fiscal year.

The Ministry of Finance has also set a fiscal anchor based on the nominal external debt-to-GDP ratio, requiring it to remain below 50.0%. As of 28th February 2025, Tonga's nominal external debt stood at 29.6% of GDP well within this limit. More importantly, the present value of external debt was estimated at 23.0% of GDP, reflecting a continued decline in the country's debt burden compared to previous fiscal years.

Table 7 - Strategic Targets to attain by the end of FY2028

Risk indicators	Strategic targets	Current level as of 30th June 2025
Average time to maturity (ATM) of the domestic debt portfolio	Minimum 3 years	2.6 years
Percentage of debt denominated in foreign currencies in total debt	Maximum 70%	83.8%

Source: MOF – Financial Framework Division (FFD)

C. Rationale for the choice of the strategy for the period 2026–2028

The Medium-Term Debt Management Strategy (MTDS) for FY2026–2028 aims to mitigate key risks in the current public debt portfolio while aligning with Tonga's national development priorities and legal frameworks, including the Public Finance Management Act (PFMA) 2002 and the Government of Tonga's Debt Management Strategy (2021–2025).

Foreign exchange risk remains significant, as foreign currency-denominated debt currently accounts for 83.82% of the total public debt portfolio. The GoT is committed to reducing this share to 70% by the end of the FY2028 strategy period. This substantial reduction is expected to result from the current policy stance of avoiding new external loans except those on highly concessional terms due to Tonga's classification as being at high risk of debt distress in the latest IMF-World Bank DSA. As such, Tonga is currently eligible for 100% grant financing, and the strategy seeks to capitalize on this by limiting new borrowing and maximizing the use of grant resources.

To meet residual financing needs, the GoT is prioritizing development of the domestic debt market by issuing longer-term Treasury bonds. This also contributes to reducing refinancing risk, as longer maturities will lower the proportion of domestic debt maturing within one year and extend the Average Time to Maturity (ATM) of the domestic portfolio.

For external debt, refinancing risk associated with the repayment of loans from Exim-Bank China between FY2026 and FY2028 will be partially managed through the general domestic revenue.

Interest rate risk is minimal and closely linked to refinancing risk, as all current instruments carry fixed interest rates, and no variable-rate or short-term T-bills are outstanding. Therefore, interest rate changes only impact new debt issued, or maturing debt rolled over.

The strategy acknowledges that the shift toward domestic financing will increase the average cost of debt, given that interest rates on domestic bonds are typically higher than on concessional external loans. However, this trade-off is accepted in order to strengthen resilience to currency and refinancing risks.

To sustain this approach, the GoT remains committed to broader fiscal consolidation, including through tax policy reforms aimed at improving domestic revenue mobilization and enhancing expenditure efficiency. These efforts are crucial to maintaining fiscal space, particularly in the event of reduced access to grants should Tonga's risk rating improve to "moderate" over the medium term.

If implemented as planned, the MTDS is expected to result in an increase in domestic debt outstanding from $69.7 million to $99.7 million by the end of FY2028. The GoT recognizes the risk that the domestic market may be unable to absorb such a volume of issuance. In that case, the strategy allows for flexibility to access concessional external financing and revise the strategy accordingly.

D. Implementation of the strategy

The MTDS relies on the Government's ability to strengthen domestic debt market access over the strategy period. Given projected financing needs of $43.6 million in FY2026, $19.9 million in FY2027 and $15.1 million in FY2028. The Government will continue issuing domestic bonds to meet funding requirements, while ensuring alignment with cost-risk trade-offs and maintaining debt sustainability.

Strengthening the domestic debt market's absorption capacity is essential to support the strategic shift toward domestic borrowing. As the government is currently a price taker in the market, it is critical to develop a robust and collaborative relationship with investors. Regular and transparent communication with investors will help build trust and encourage sustained participation in government securities issuances. This will, in turn, reduce the risk of undersubscription in bond rollovers.

In parallel, the got may consider diversifying the investor base, including exploring avenues to attract interest from regional or foreign investors in Tongan securities, particularly in light of prevailing liquidity conditions.

The Debt Management Unit under MOF will be responsible for monitoring the implementation of the strategy. Key performance indicators include (i) average time to maturity (atm) of the domestic debt portfolio and (ii) share of foreign currency-denominated debt in the total public debt portfolio.

Progress against these strategic targets will be reported in the annual budget statement to ensure transparency and accountability.

While the strategy covers a three-year period (FY2026–FY2028), the GoT will review the MTDS annually. MOF will assess whether progress toward the FY2028 targets remains on track and whether macroeconomic or financing conditions have changed substantially. If necessary, the government may revise the strategy or formulate a new one to respond to evolving conditions.

X.CONCLUSIONS

The Strategy for the three-year horizon spanning 2026-2028 continues to target the reduction of exchange rate risk and refinancing risk inherent in the current public debt portfolio. Given the persistently high proportion of the external debt within the existing public debt portfolio, the strategy for the ensuing three FYs will continue to prioritise the avoidance of new external borrowing, except for highly concessional loans. The strategic objective remains the reduction of the external debt share to 70.0% of the total public debt. Consequently, and to reiterate, the strategy relies on domestic market development still through the rollover of maturing bonds, with a focus on longer maturities such as five or six years, and proposes the issuance of new domestic bonds, preferably with extended maturities, mirroring the rollover approach.

In light of this, and as a result, this approach is anticipated to mitigate foreign exchange rate risk and refinancing risk associated with the repayment of Government loans to China and the IMF, without significant increases in the overall cost of debt.

The Ministry of Finance is confident this MTDS will maintain public debt at prudent levels. However, it realizes that the implementation of the strategy might be challenging as the domestic debt market is expected to preserve sufficient liquidity to absorb Treasury bonds issuance. The Ministry will maintain oversight of the implementation of this MTDS and reserves the prerogative to revise it in response to evolving circumstances. Uncertainties surrounding the domestic market's absorptive capacity and future debt distress levels could significantly alter the baseline scenario underpinning this analysis. These uncertainties underscore the imperative for sustained fiscal consolidation to mitigate the risk of debt distress.