# NATIONAL RESERVE BANK OF TONGA

# Monetary Policy Statement

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Salote Road
Nuku'alofa
Tonga.

Postal Address: Private Mail Bag No. 25
Post Office
Nuku'alofa
Tonga
South Pacific

Enquiries: Phone: (676) 24-057
Website: www.reservebank.to
Email: nrbt@reservebank.to

Subscription: Economics Department
National Reserve Bank of Tonga

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## List of abbreviations

| | |
|---|---|
| AML | Anti-Money Laundering |
| APR | Annual Percentage Rate |
| AUD | Australian Dollar |
| CBDC | Central Bank Digital Currency |
| CFT | Counter-Financing of Terrorism |
| CNY | Chinese Yuan |
| Covid-19 | 2019 Novel Coronavirus |
| DEPS | Domestic Electronic Payment System |
| ESA | Exchange Settlement Accounts |
| EXIM | Export-Import |
| FEC | Foreign Exchange Control |
| FEDs | Foreign Exchange Dealers |
| FJD | Fijian Dollar |
| FinTech | Financial Technology |
| FY | Fiscal Year |
| GBP | Great Britain Pound |
| GDL | Government Development Loans |
| GDP | Gross Domestic Product |
| HTHH | Hunga Tonga Hunga Ha’apai |
| IFRS | International Financial Reporting Standards |
| IMF | International Monetary Fund |
| MAFFF | Ministry of Agriculture, Food & Forests and Fisheries |
| MOF | Ministry of Finance |
| MPS | Monetary Policy Statement |
| MSME | Micro Small and Medium Enterprises |
| NBFIs | Non-Bank Financial Institutions |
| NEER | Nominal Effective Exchange Rate |
| NRBT | National Reserve Bank of Tonga |
| NZD | New Zealand Dollar |
| OET | Overseas Exchange Transactions |
| OPEC | Organization of the Petroleum Exporting Countries |
| RBA | Reserve Bank of Australia |
| RBNZ | Reserve Bank of New Zealand |
| RCF | Rapid Credit Facility |
| REER | Real Effective Exchange Rate |
| RFB | Retirement Fund Board |
| ROA | Return on Assets |
| ROE | Return on Equity |
| RSE | Regional Seasonal Employees |
| SPBD | South Pacific Business Development |
| SRD | Statutory Reserve Deposits |
| SWP | Seasonal Worker Program |
| TC | Tropical Cyclone |
| TOP | Tongan Pa’anga |
| UK | United Kingdom |
| US | United States |
| USD | United States Dollar |
| WEO | World Economic Outlook |

## Governor's Foreword

The Tongan economy suffered a double blow from the catastrophic impact of the Hunga Tonga Hunga Ha'apai (HTHH) volcanic eruption and tsunami in January 2022, and the local COVID-19 outbreak since February 2022, amid the prolonged adverse effects of global inflation due to the COVID-19 related disruptions on global supplies and shipping services, rising food and energy prices and of course the effects of the war in Ukraine. These developments have further derailed economic recovery from previous cyclones such as TC Gita and TC Harold.

Primary goals of the Government are to reinstate and reconstruct the economy, improve economic growth and reduce poverty. As stimulus packages boost government expenditure and increase aggregate demand, these also add to imported inflation.

Fighting inflation or supporting economic growth is the main challenge facing the National Reserve Bank of Tonga. Monetary policy has to be conducted carefully to maintain internal and external stability and preserve financial stability while facilitative to the efforts of the Government to improve economic growth with equity.

These are the main economic challenges that the country faces:

1. High inflation. Tonga's annual headline inflation peaked at 9.3% in December 2021 but slowed down to 7.8% in March 2022, which are well above the Reserve Bank's 5% reference rate. The cascading global impact of the ongoing pandemic and geopolitical tensions contribute to the surges in imported prices of goods and services. Inflation has increased for the same reasons in other Pacific Island countries. The higher imported commodity prices as well as the expectation of higher imported prices and supply side bottlenecks have been passed through to domestic producer prices, combined with the ongoing disruptions to domestic supply from natural disasters. The bulk of the inflationary pressures are therefore supply-driven and are beyond the Reserve Bank's control. Domestic inflation is transitory and will moderate once the agricultural sector recovers and secures the domestic food supply.
2. Excess liquidity, (about $330 million) remains in the banking system as a result of the high inflows of budget supports, project grants, and relief funds from development partners to assist the Government's recovery programme and also the significant inflows of private remittances. These have increased the foreign reserves and money supply way beyond the country's demand for money. The delay in the implementation of Government projects, partly due to the international border closure, contributes to the high liquidity levels holding up, while credit growth has turned negative since mid-2020. Mopping this huge excess supply of liquidity from the banking system through open market operations is a costly exercise and beyond the Reserve Bank's current financial capacity.
3. The slowdown in credit growth reflects loan-run offs amid limited local lending opportunities as the ongoing pandemic-related uncertainties weighed on business confidence and investments.
4. Weak economic growth. The Reserve Bank estimates GDP growth to contract again by 2.0% in FY 2021-22, following an estimated -2.5% growth in FY 2020-21.

Given those competing challenges, the Reserve Bank has carefully examined various channels of monetary policy that could appropriately address them.

Using monetary policy to fight inflation includes measures that would slow down economic growth and aggregate demand, as reflected below. Examining the underlying sources of inflation is also key to the consideration of the appropriate tool that would effectively contribute to curbing inflation.

i. <u>Increase interest rates</u>, (current actions taken by the central banks in New Zealand, Australia and USA to fight inflation).
   If the Reserve Bank opts to increase interest rates to curb inflation, this would undermine the request from the Minister of Finance to reduce interest

rates as a way of encouraging credit growth in order to facilitate economic growth.

While decreasing interest rates as requested by the Ministry of Finance would ease borrowers' debt service burden, it would not necessarily increase credit growth, given the ongoing COVID-19 related uncertainties. What can be done to encourage lending in the domestic market are enabling infrastructures, such as:

- bankruptcy laws,
- enhancing the land administration system, and
- completing the establishment of the domestic credit registry.

The rising corporate and household indebtedness also limit borrowers' capacity to borrow which further hinders any additional lending by the banks.

The effectiveness of direct controls to reduce interest rates, would be hard to monitor due to the differences in types and sizes of loans, but it may pose risks to financial stability, through impacts on banks' profitability and capital position.

ii. <u>Slow down bank lending</u> to reduce aggregate demand and economic growth.
Slowing down bank lending will undermine the efforts of the Government to increase economic growth and rollout concessional loans through the Tonga Development Bank. Credit growth is also already negative therefore this tool would be redundant at this point.

iii. <u>Re-value the Pa'anga</u> to make it stronger. The scope of the exchange rate to counter inflation is restricted by the exchange rate regime being pegged to a basket of the major trading partners' currencies.
To use the flexibility in the exchange rate to strengthen the Tongan pa'anga to counter inflation would disadvantage recipients of foreign exchange, particularly remittances, an important income subsidy and social safety. The pass through of a stronger exchange rate to import prices and to overall consumer prices, however, is minimal (less than 0.5 percentage points).
Revaluation losses and undue pressure on the foreign reserves may also result.
The costs of an exchange rate policy to strengthen the Tongan pa'anga therefore far outweighs the benefits, while it reduces the much-needed liquidity in the banking system for banks to lend and to support economic activity.
Many of Tonga's major trading partner countries such as the United States, Australia, and New Zealand have already taken action in tightening monetary policy to curb inflation. The effects of these actions will also pass through to Tonga's inflation through imports as reflected in the annual headline inflation trending down to 9.1% in February 2022 and 7.8% in March 2022 without any interventions from the Reserve Bank.

iv. <u>Mop the excess liquidity</u> by increasing the Statutory Reserve Deposit ratio and/or issuing Reserve Bank notes. These two options will signal that the Reserve Bank is conducting contractionary monetary policy, which will undermine the Minister of Finance's 2023 Budget policies. The buildup of excess liquidity is beyond the Reserve Bank's control therefore issuing Reserve Bank notes would be a very expensive exercise while having limited impact on fighting inflation.

Given the above, with the understanding that impacts of our trading partners fighting inflation will be imported to Tonga through our exchange rate basket, the Reserve Bank will therefore take a wait-and-see approach to inflation over the next 6 months.

The Reserve Bank will however continue to maintain its current accommodative monetary policy stance and work in tandem with the Government towards supporting economic growth and macroeconomic stability, while remaining alert to inflation and maintaining financial stability.

To facilitate the Government's efforts in the 2022/23 Budget Strategies, the Reserve Bank will continue to maintain the current policy efforts:-

i. Maintain the monetary policy rate at 0% (zero interest rate policy);
ii. Maintain the current weights in the Exchange rate basket, which supports the country's economic fundamentals;

iii. Reduce the minimum loans/deposit ratio from 80% to 70% and push the banks to meet this target within the next 6 months;

iv. Maintain the Statutory Reserve Deposit (SRD) at 10% and stand ready to increase to 15% if high inflation persists;

v. Maintain the inflation reference rate at 5%.

vi. Continue to facilitate an enabling financial infrastructure to support prudent credit growth by establishing a domestic credit registry;

vii. Liaise with the Government on:
- developing bankruptcy laws to reduce the default risks component of the interest rate structure;
- enhancing the efficiency of the land administration system;
- establishing a Loan guarantee scheme to assist the micro, small and medium enterprises (MSMEs); and
- establishing an interest rate subsidy available to all banks in order to promote low cost lending to targeted sectors such as micro small and medium enterprises.

viii. Continue to enhance financial sector supervision to better monitor the corporate and household indebtedness, and enhance anti money laundering supervision, while protecting financial consumers' interests, through:
- robust risk assessments and stress-testing; and
- up to date prudential guidelines for risk management at banks and non-bank financial institutions.

ix. Maintain clear channels of effective communications with the financial institutions to ensure delivery of essential financial services to the public, especially during pandemic-related lockdown periods;

x. Continue to improve the efficiency of the payments system, through the rollout of the Domestic Electronic Payment System (DEPS) which will automate the settlement and clearing system;

xi. Continue to combat de-risking by global and local banks in order to retain banks' correspondent bank relationships and foreign exchange dealers' bank accounts such as:
- addressing the recommendations from Tonga's Mutual Evaluation Report to strengthen the Anti- money laundering and Combating the financing of Terrorism supervision of financial institutions and cash dealers;
- encouraging the development of technological solutions (FinTech) including exploring the feasibility of issuing central bank digital currency (CBDC);
- completing the setup of the Reserve Bank's Know Your Customer (KYC) system with the plan to set up a National KYC framework linking it to the e-Government project.

Having said the above, the Reserve Bank will continue to watch the trend of inflation and will liaise with the Government on the best way forward, as some of the monetary interventions will offset the Government's growth strategies.

Sione Ngongo Kioa

Governor

# 1. Global Developments

## World Growth

Global growth is expected to slow down in 2022 to 4.4% from 5.9% in 2021, according to the International Monetary Fund's (IMF) January 2022 World Economic Outlook (WEO). This is a downward revision from the 4.9% growth projected in its October 2021 WEO. The weaker than previously expected growth for 2022 is due to the Omicron Covid-19 variant triggering further mobility restrictions, border closures, and health impacts resulting in the markdown of the two largest economies namely the United States and China.

Global growth is expected to slow to 3.8% in 2023 (slightly higher than the 3.6% growth estimated in the October 2021 WEO). However, the 2023 growth is conditional on the expectation that the current hindrance to growth will improve in the second half of 2022, such as improved vaccination rates worldwide by the end of 2022. The overall risk to the global baseline is also tilted to the downside.

Table 1: World Data (Real GDP Growth, Inflation, and Unemployment)

| | Real GDP growth (%) | | | Inflation (%) | | |
|---|---|---|---|---|---|---|
| | 2021 | 2022f | 2023f | 2021 | 2022f | 2023f |
| World Growth | 5.9 | 4.4 | 3.8 | | | |
| Australia | 5.0 | 4.3 | 2.0 | 3.5 | 3.3 | 2.8 |
| China | 8.1 | 4.8 | 5.2 | | | |
| Euro Area | 5.2 | 3.9 | 2.5 | 2.2 | 3.0 | 1.7 |
| Japan | 1.6 | 3.3 | 1.8 | -0.2 | 0.7 | 0.7 |
| New Zealand* | -1.3 | 5.3 | 2.9 | 1.5 | 6.6 | 3.2 |
| United Kingdom | 7.2 | 4.7 | 2.3 | | | |
| United States | 5.6 | 4.0 | 2.6 | 4.3 | 5.9 | 2.7 |

Note: f – forecast
*New Zealand forecast is based on the year ended March
Data not yet available for China and United Kingdom's inflation
Source: IMF (World Economic Outlook, October 2021 & January 2022), RBA February 2022 MPS, RBNZ February 2022 MPS

## Global Inflation

Elevated inflation is expected to persist longer than previously envisaged with broadening price pressures. Energy costs have picked up sharply as fossil fuel prices continued to increase throughout 2021. Global oil prices averaged around US$102.05 per barrel in February 2022, significantly higher than the US$73.25 per barrel in August 2021, and US$66.87 per barrel in February 2021, as reported by Reuters. The IMF projected global oil prices to increase by 12% in 2022, while non-oil commodity prices are expected to rise by 58%. Food prices have also increased in some areas, while ongoing supply chain disruptions, port congestions, soaring freight rates, and high demand for goods have led to price pressures in the United States and emerging developing countries.

The Russia-Ukraine war and the China "zero-tolerance Covid-19" policy will further disrupt global supply chains and add to the bottlenecks that may trigger new waves of price pressures across economies.

Monetary policy in major economies have responded to keep inflation anchored, through withdrawals of monetary stimulus and lifting of policy rates. Consequently, risks to financial stability, currencies, and fiscal positions – particularly in high debt distress countries – may emerge. Fiscal policies remain expansionary to support economic recovery, but with more limited space as debt levels increased significantly since the pandemic.

The slower growth momentum in the global economy may result in a reduction in much-needed foreign support from Tonga's development partners through budget support, aid, and grants to fund the development projects and assist economic recoveries. At the same time, remittances from the Tongan diaspora may also be affected by the slowdown in major remitting economies.

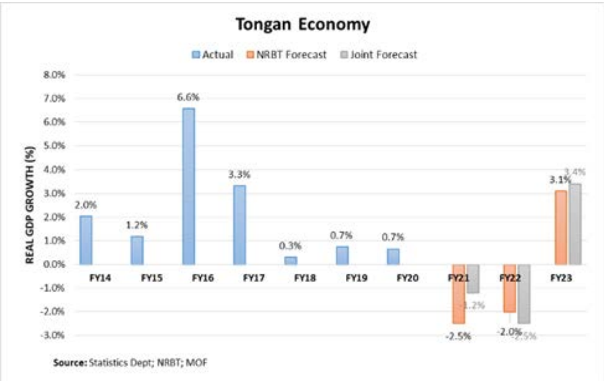
Tonga is also an import-dependent economy and a price taker, hence highly vulnerable to external shocks. The sharp pickup in global inflation is supply-driven and will flow onto Tonga's economy through imports and the exchange rate basket. These are beyond the Reserve Bank's control. Nevertheless, corrective actions to curb inflation by our major trading economies namely the United States, Australia, and New Zealand, will over time take effect on imported inflation and gradually reduce Tonga's headline inflation.

## 2. Domestic Production

### Real GDP Growth

The Tongan economy suffered multiple crises over the past six months to February 2022. In January 2022, the Hunga Tonga Hunga Ha'apai (HTHH) volcanic eruption and tsunami destroyed some of the low-lying areas around Tongatapu, 'Eua, and Ha'apai while the ashfall from the volcano covered most of Tonga. Several communities have been relocated such as the residents of Kanokupolu, Ha'atafu, 'Atataa, Fafaa, Fonoifua, Nomuka, Mango, Pangaimotu, and Tungua. The volcanic eruption also severed the undersea fiber cables cutting off all international communications and internet connections for several weeks. According to the World Bank's GRADE report (Global Rapid post-disaster Damage Estimation), the damages from the HTHH disaster are estimated to be at T$208.0 million, around 18.5% of GDP. In February 2022, the community outbreak of the Omicron variant prompted a hard red light national lockdown for more than two weeks, before easing to an orange light lockdown on 21st February 2022.

Figure 1: Real GDP Growth

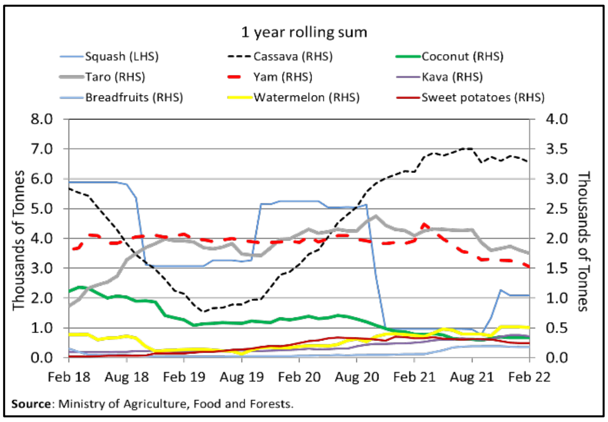



Against this background, the Reserve Bank has reviewed its growth estimates for FY 2021-22. In contrast to the anticipated recovery of 1.2% estimated in the August 2021 MPS, the Reserve Bank now estimates the Tongan economy to contract again in FY 2021-22 by 2.0%. The 3.2 percentage point downgrade reflects the severe impacts of the HTHH event on domestic production, damages to the tourism sector, and further delays in the implementation of major infrastructure projects that would have otherwise created economic activities. The Omicron outbreak and lockdown resulted in reduced business operations, lower profitability, higher unemployment, and supply shortages in consumption goods.

### Primary Production

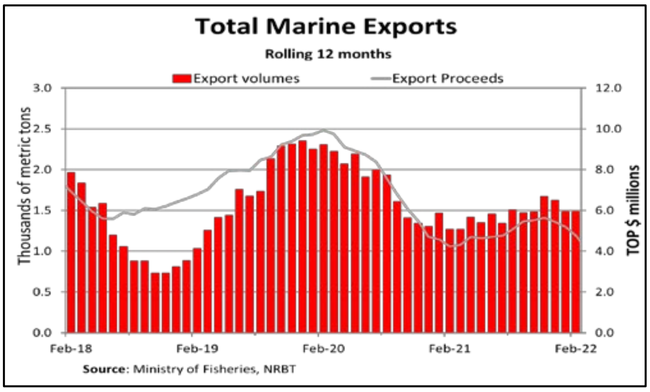
The primary sector performance improved in the last half of 2021, supported by a 10.9% increase in the agricultural exports sector reflecting the return of squash exports and the harvesting season.

Figure 2: Major Agricultural Exports (tonnes)




The HTHH volcanic eruption, tsunami inundation, and ashfall left severe damages to the agricultural and fisheries sectors, estimated at T$48.1 million (according to the World Bank's GRADE report). This included damages to plantations, fishing boats, and boat ramps. Fish and marine organisms in the affected areas were also contaminated. The HTHH damages are anticipated to reverse the improved performance in exports of root crops and marine products and contribute to domestic food shortages and inflation. As a result, a deeper contraction of 2.4% is projected for the primary sector for the current FY 2021-22.

Figure 3: Marine Exports (metric tons)



### Secondary Production

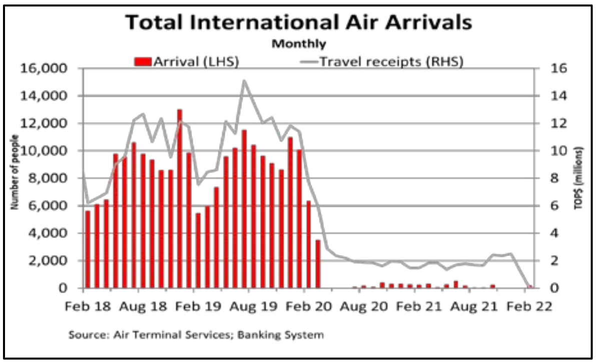
The secondary sector indicators continue to slow down towards the end of 2021, mostly driven by the slowdown in construction activities following the TC Harold and TC Gita reconstruction projects, and the Road Improvement projects. Covid-19 travel restrictions also delayed the implementation of major infrastructure projects that would have otherwise provided economic activities such as the new Parliament House, the Fanga'uta Bridge, and the Queen Salote wharf upgrade.

The HTHH disaster left severe damage to the residential and non-residential buildings, infrastructures, power lines, and water supplies. The Omicron outbreak prompted hard lockdown and curfews with only essential services operating. These events further disrupted scheduled construction projects. This will have spillover effects on manufacturing, mining, and quarrying sector.

As a result, the secondary sector is projected to also contract by 2.6% in the current fiscal year.

### Tertiary Production

Figure 4: International Air Arrivals & Travel Receipts

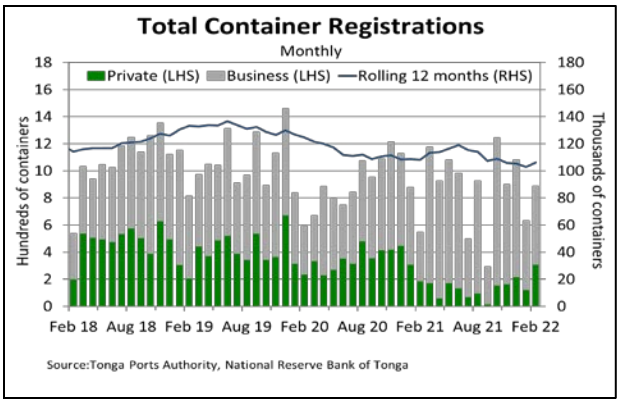



The tertiary sector started to show some recovery as aggregate demand starts to improve despite the stagnant tourism industry. Businesses have diversified and adapted to the Covid-19 restrictions.

However, the HTHH disaster wiped out most of the tourism businesses near the seafront in Tongatapu. Most of these damages were catastrophic and will require significant maintenance work or complete reconstruction, further restraining the sector's recovery from the global pandemic.

Global supply bottlenecks and congestions continue to disrupt shipping schedules leading to supply-demand mismatches in domestic trade. Container registrations continued to fall by 9.9% over the six months to February 2022, mostly due to lower business containers. Importers have experienced significant delays in shipments and hikes in freight charges caused by port congestions and additional security measures. This led to temporary supply shortages, and higher production costs contributing to higher producer prices.

Figure 5: Total Container Registrations




Stronger consumer spending funded by remittances has benefitted domestic wholesale and retail trade during the festive season. However, the private sector was hard hit by the damages from the HTHH disaster. The severed undersea fiber optic cables cut off all international communications largely affecting business operations and trade. At the same time, many businesses were faced with significant clean-up costs from the ashfall. The Omicron outbreak further disrupted business operations during the hard lockdown periods, directly impacting domestic production and revenues.

Consequently, these adverse impacts have reversed the anticipated positive growth for the tertiary sector, with a negative growth of 0.7% now expected for FY 2021-22.

### Unemployment

The Reserve Bank's survey on job vacancies showed an increase in advertised vacancies over the six months and year to December 2021, by 74.2% and 8.7%, respectively. Most of the advertised vacancies were for public administration. This survey, however, does not capture employment in the informal sector as they are not formally advertised.

According to the latest Population Census in 2021, Tonga's population has declined since the last 2016 census by 0.4% (442 people). The lower population was due to migration overseas, participation in the seasonal working programs, and Tongan residents being stranded overseas due to the border closure. During the year, Tonga continues to participate in the Seasonal Worker Programme (SWP) to Australia. Tonga also resumed its participation in the Regional Seasonal Employee (RSE) scheme in New Zealand. More Tongans are joining the seasonal working schemes which will put pressure on the domestic labour supply needed for recovery works and project implementations.

### Outlook

The Reserve Bank projects a moderate recovery of 3.1% for the FY 2022-23, which is lower compared to the 3.5% growth forecasted in the August 2021 MPS. This anticipated recovery is supported by the reconstruction works from the HTHH disaster and the likely reopening of the international borders.

Nevertheless, downside risks to the outlook remain as the community outbreak of Omicron is still not contained, in addition to the uncertainty of the global exit from the pandemic. Geopolitical tensions continue to disrupt global supply chains and weaken the economic prospects of our major trading partner countries. At the same time, Tonga's vulnerability to natural disasters remains a major threat, particularly during this cyclone season.

Due to the persistently weak growth rates, the estimated economic contractions, and the rather precarious outlook, the Reserve Bank considers supporting economic recovery and growth its primary focus for the next six months. In that regard, the accommodative monetary policy stance remains on hold, which also supports the Government's fiscal policy objectives.

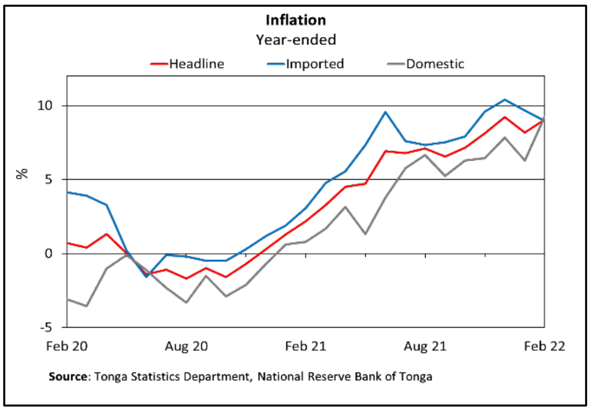
## 3. Inflation

Tonga has experienced persistently high inflation rates above the 5% reference rate over the six months to February 2022. Imported inflation picked up sharply on the back of higher global inflation and increasing global prices for oil, food, and commodities. Soaring freight rates and shipping surcharges also contributed to the rising import prices. These also passed through to domestic energy prices and producer prices. The shocks to the domestic food supply from the HTHH disaster and the Omicron outbreak also contributed to the higher domestic prices. Poorer households are hardest hit by this inflationary pressure, as their purchasing power diminishes.

### Consumer Price Index (CPI)

The annual headline inflation peaked at 9.3% in December 2021 since the onset of the Covid-19 global pandemic. In February 2022, headline inflation slightly fell to 9.1% before easing to 7.8% by March 2022. Over the year to February 2022, annual inflation averaged 6.8% compared to a deflationary period in the past year with an average of -0.2%.

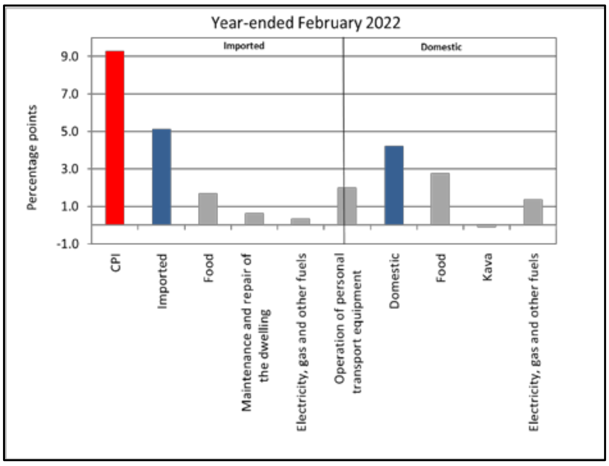
Figure 6: Inflation




Imported prices rose by 8.9% over the year to February 2022, contributing 5.0% to the overall increase in headline inflation. The higher imported prices are largely attributed to increases in the prices of fuels, food items, construction materials, gas, and other fuels.

Local prices also rose by 9.2% in the year to February 2022, contributing 4.1% to headline inflation. The higher domestic prices were driven mostly by higher local food prices reflecting the impact of the HTHH disaster on the agricultural sector. Electricity prices consistently picked up by 12.8% over the six months to February 2022, alongside the higher fuel prices.

Figure 7: Contributions to Inflation




Tonga as an import-dependent economy is prone to external shocks. More than 55% of the CPI basket are imported goods and services, therefore movements in global prices will flow through in imported inflation. Tonga is also heavily reliant on imported fuel for energy, hence movements in oil prices will not only be reflected in imported inflation but will also have spillover effects on domestic producer prices. Similarly, elevated freight charges will result in a mark-up for all consumer prices. The strong inflow of remittances and the cash grants from fiscal stimulus packages also fuel inflation.

The Reserve Bank has been closely monitoring inflation developments since June 2021 when headline inflation exceeded the 5% reference rate. The Reserve Bank noted that these sources of inflation are supply-driven and are beyond its control. Elevated inflation pressures were also experienced by our major trading partners and neighbouring Pacific Island countries. Many of our inflation-targeting trading partners have already tightened monetary policies to curb inflationary pressures. The Reserve Bank has considered the following monetary policy tools to combat inflation:

a. Increasing the monetary policy rate from 0%. This will motivate banks to keep their liquidity stock at the central bank and earn interest, instead of lending out to the public. This will also signal an increase in interest rates to the banks which they will pass on to their customers. Such action aims at slowing down consumption, aggregate demand, and credit growth, thus lowering inflation. On the other hand, it will also hamper economic recovery.

b. Increasing the SRD ratio from 10% to mop up the excess liquidity in the banking system. This will also reduce the money supply and aggregate demand while slowing down credit growth and thereby mitigate pressure on inflation. Meanwhile, this also would hold back economic recovery.

c. Revalue the exchange rate basket to strengthen the Tongan pa'anga and ease imported inflation. For example, it is estimated that a 5% revaluation would result in fuel prices being 5 seniti cheaper which would then flow to lower inflation. This however will markedly reduce the foreign reserves and the purchasing power of foreign exchange recipients such as the Government's receipt of budget support, grants, and receipt of export proceeds and remittances. For instance, a 5% revaluation would have meant T$23.7 million less in remittances received during 2021.

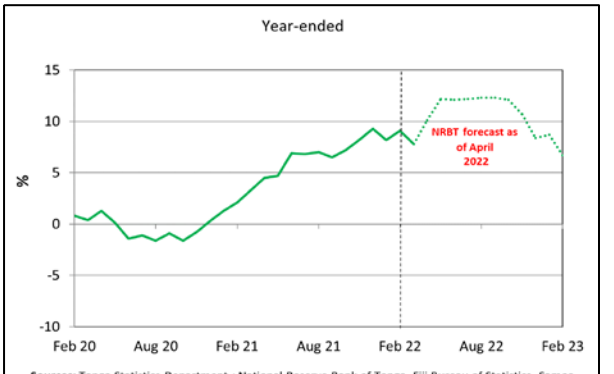
After carefully weighing these options, the Reserve Bank decided to leave its monetary policy rate and the SRD ratio unchanged, in favour of supporting economic recovery. Moreover, its current exchange rate basket and strategy has been effective in reducing exchange rate volatility and neutralising the impact of higher inflation. The NEER has been appreciating over the year to February 2022, which may assist in offsetting some of the impacts of imported inflation.

### Outlook

Given the latest developments both externally and domestically, the Reserve Bank now projects inflationary pressure to persist longer than previously envisaged, stretching throughout 2022 before gradually easing below the 5% reference by the first quarter of 2023.

Downside risks to the outlook are high with geopolitical tensions such as the Russia-Ukrainian war, combined with stringent Covid-19 restrictions in China threatening to further compound global prices and supply-side bottlenecks. The uncertainties on new Covid-19 variants also remain. Shipping costs are also anticipated to remain at high levels up until 2023.

Figure 8: Headline Inflation Forecast




**Sources:** Tonga Statistics Department ; National Reserve Bank of Tonga, Fiji Bureau of Statistics, Samoa Bureau of Statistics

On the upside, our major trading partner countries have adopted tightening monetary policies to counter inflation. Once these actions take effect it will flow on through imports and reduce imported inflation. The anticipated recovery of the agricultural sector from the HTHH disaster will secure the domestic food supply and ease pressure on domestic inflation. The exemption of import duty and taxes on households' imports of food products and other relief items for those affected by the HTHH disaster and Covid-19, will buffer against rising inflation over the coming months.

Faced with the difficult policy tradeoff between economic recovery and high inflation, the Reserve Bank still considers keeping the monetary policy stance on hold so as not to offset fiscal initiatives to revive the economy. At the same time, it will remain alert by taking a wait-and-see approach to inflation, monitoring the impact of our stronger trading partner countries' policies in countering inflation and addressing global supply chain mismatches. Nonetheless, the Reserve Bank stands ready to tighten monetary policy should inflation pressures remain elevated unsustainably.

## 4. External Sector

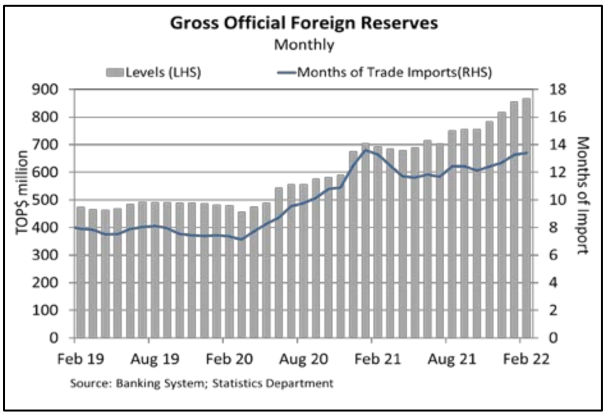
Tonga is particularly prone to external shocks given its large reliance on imports, foreign aid, and remittances, compared to its narrow export base. This highlights the Reserve Bank's objective in maintaining external stability through the prudent management of foreign reserves and exchange rate.

The impact of the HTHH disaster on the foreign reserves is similar to past disasters, where inflows of budget support, foreign aid and remittances contribute to the higher foreign reserves levels. However, the internet outage from the severed internet cable have disrupted the flow of funds to and from Tonga during January and February 2022. The hard Covid-19 lockdowns also restricted banking services and business operations, including the remittance payouts, cash deposits and withdrawals.

### Official Foreign Reserves

Gross official foreign reserves rose in the six months to February 2022 by $115.6 million (15.4%), to a record high of $867.3 million. This is equivalent to 13.4 months of imports cover, which is well above the Reserve Bank's minimum threshold of 3 months of imports cover of goods and services. Factoring in Tonga's vulnerability to natural disasters and external shocks would require an adequate level of at least 6 months of imports cover according to the IMF estimates. Foreign reserves are held mostly in USD, AUD, and NZD.

Figure 9: Gross Official Foreign Reserves

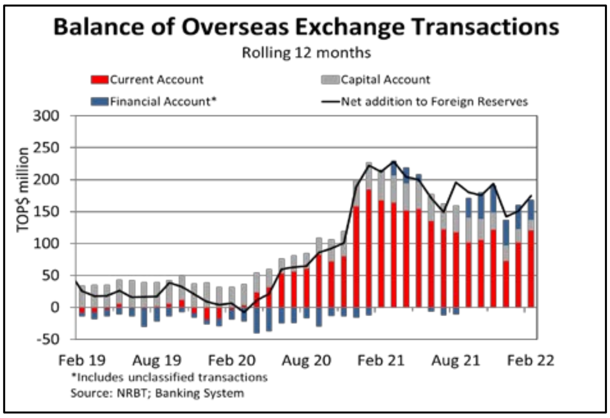



Higher receipts of budget support, relief funds, official grants, external debt proceeds, capital inflows, and remittances were the main drivers of the higher foreign reserves. These foreign exchange receipts also contributed to flooding the banking system with excess liquidity, similar to previous years. With increasing fiscal needs, further inflow of budget financing is expected. The sterilisation of these inflows hinges on a number of factors including the domestic implementation capacity and the pace of economic recovery.

### Overall Overseas Exchange Transactions (OET) Balance

The Reserve Bank collects and analyses OET data from the commercial banks and authorised foreign exchange dealers to assist in monitoring the external monetary position and ensuring that an adequate level of foreign reserves is maintained.

Figure 10: Balance of Overseas Exchange Transactions




In the six months to February 2022, the OET balance recorded a significantly higher overall surplus of $115.6 million, compared to the $59.3 million surplus in the previous six months to August 2021. This was attributed to the higher net receipts of primary income and transfers, coupled with a slight improvement in the trade deficit.

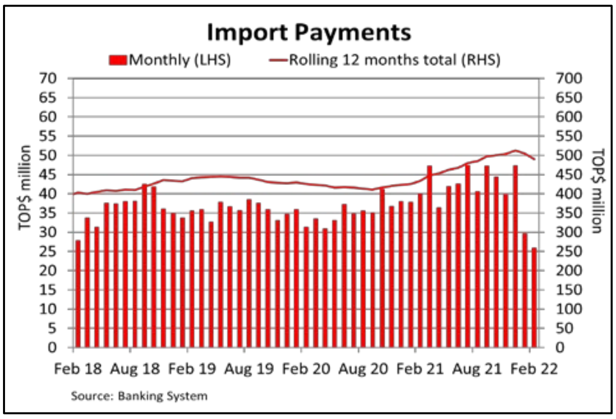
### OET Payments

Total OET payments fell in the six months to February 2022 by $30.6 million (7.8 %) to $360.0 million. This was mainly driven by a sharp drop in import payments for imports of goods, transfers, and primary income. This largely reflects the impact of the disruptions from the HTHH disaster and internet outage on foreign exchange transactions. Majority of the OET payments are denominated in USD, NZD, AUD, and FJD.

Import payments fell by $21.8 million (8.5%) in the six months to February 2022 across all import categories.

The sharp drop in January and February 2022 coincides with the limited communications and mobility restrictions. Nevertheless, global oil, food, and commodity prices continued to increase. Import payments account for 65.1% of total OET payments, of which more than 54% are paid in USD.

Figure 11: Import Payments




Service payments rose by $16.3 million (26.2%) in the six months to February 2022. This reflected higher payments mostly for freight services, professional & management services, and telecommunication services. The higher freight services reflect the soaring shipping costs during the global pandemic as a result of port congestions, delayed shipments, and additional security measures. Service payments accounts for around 21.8% of total OET payments.

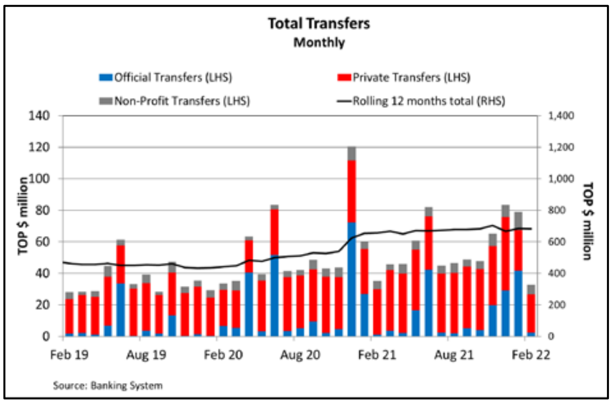
Primary income payments decreased by $13.8 million (77.6%) to $4.0 million during the six months to February 2022 resulting from a fall in dividends paid out to non-resident shareholders.

Capital payments slightly rose by $0.3 million in the six months to February 2022 to $0.4 million, mostly for private capital transfers. Financial payments however, fell by $6.4 million to $11.7 million, following a large repayment of external debt.

OET Receipts

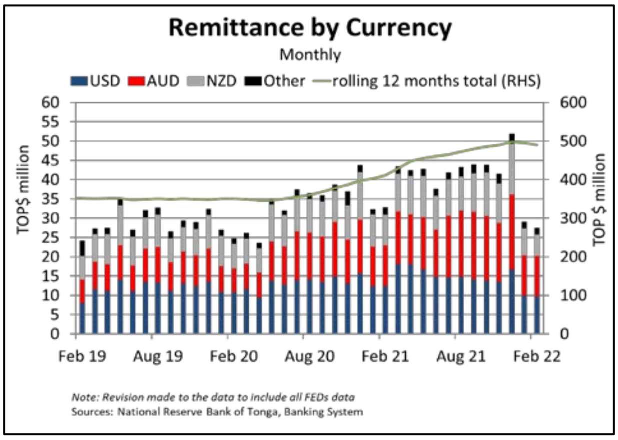
Total OET receipts rose over the six months to February 2022 by $37.0 million (8.0%) to $501.2 million. This was mostly driven by higher official transfers from development partners in response to the HTHH disaster. Services receipts also rose mostly from communication services, while export receipts marginally rose from agricultural exports. Majority of the OET receipts are denominated in USD, AUD, and NZD

Figure 12: Transfer Receipts




Remittance receipts fell in the six months to February 2022 by 5.4% ($13.6 million) to $237.4 million reflecting the communications breakdown in January and the hard lockdowns in February. The decline was notable in personal transfers and compensation of employees. Nevertheless, remittances still accounted for around 47% of total OET receipts and is the top source of foreign exchange inflows.

Figure 13: Remittances



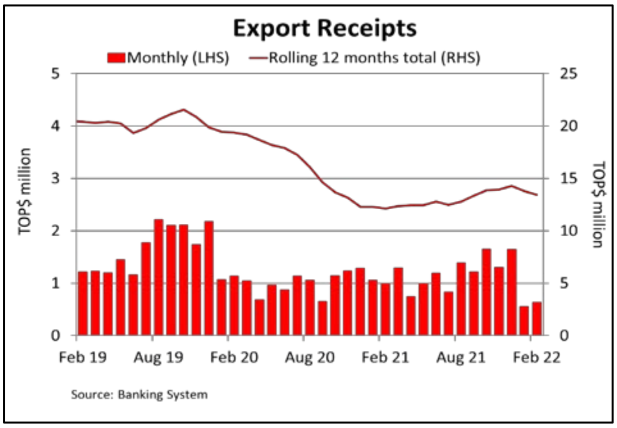

Remittances are mostly used by households for consumption, thus also helping to fuel inflation. Remittance receipts are denominated mostly in AUD, USD, and NZD. Foreign Exchange Dealers (FEDs) continue to be the preferred channel for remittances as FEDs' share of remittances increased over the year by 1.5% to 87.7%. Following the HTHH disaster, inflow of remittance in-kind such as boxes and drums of food were sent from family and friends overseas to assist their loved ones with their daily needs.

Services receipts was higher in the six months to February 2022 by $13.9 million (33.8%), totaling at

$55.0 million. This owes to a large receipt for telecommunication services, in addition to professional, management and technical service receipts. Insurance receipts increased also, as well as travel receipts from the resumption of the repatriation flights. Service receipts account for 11.0% of total OET receipts.

Export receipts rose over the six months to February 2022 by $0.6 million (8.9%) to $7.0 million. Receipts from agricultural exports and other exports rose, while marine export proceeds fell.

Figure 14: Export Receipts




Capital receipts rose over the six months to February by $0.9 million (10.9%) to $8.9 million, mostly from higher private capital receipts. Financial receipts, on the other hand, fell by $6.7 million (11.8%) to $50.4 million mostly due to lower interbank transfers.

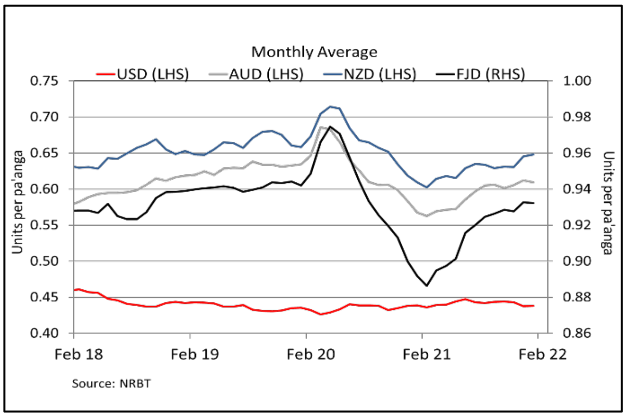
The balance of unclassified transactions recorded an average outflow of $3.3 million per month over the year to February 2022, similar to the monthly average outflow in the previous year. This was due to higher financial claims by non-residents, mostly from interbank transfers.

Despite the comfortable levels of foreign reserves, Tonga's narrow export base, lackluster travel receipts and lack of stable foreign exchange earnings compared to its import needs and other foreign exchange obligations such as Government's debt obligations and high vulnerability to external shocks, it is still crucial that adequate foreign reserves are maintained.

## Exchange Rates

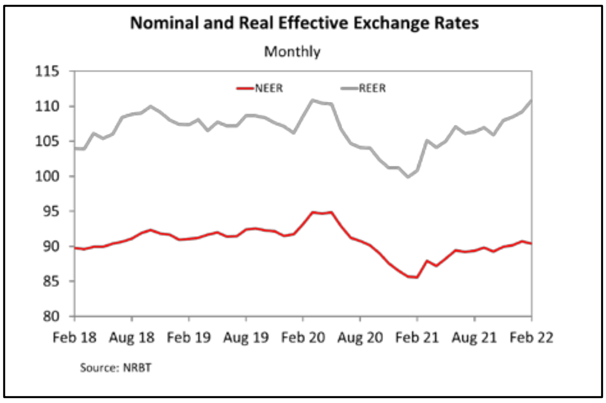
The Reserve Bank determines the rate at which the Tongan pa'anga is exchanged for foreign currencies on a daily basis by reference to a weighted basket of currencies of Tonga's major partners in foreign trade and foreign exchange receipts and payments.

Figure 15: Foreign currency Exchange Rates




Majority of the major trading partner currencies weakened against the TOP over the six months to February 2022, except for the USD and CNY. As a result, the Nominal Effective Exchange Rate (NEER) slightly increased by 1.1% reflecting a general strengthening of the TOP that may partially offset imported inflation. The Real Effective Exchange Rate (REER) also increased by 4.3% in line with the rising inflation rate. This indicates a loss of Tonga's international trade competitiveness. Since majority of the official government receipts and remittances are denominated in USD, the stronger USD will lead to higher TOP equivalent to finance Government's fiscal stimulus, and higher remittances for households buffering elevated inflation.

Figure 16: Effective Exchange rates




In light of the elevated inflation remaining above the 5% reference rate, the Reserve Bank conducted a review of the exchange rate basket to determine the impact on inflation if the Tongan Pa'anga is revalued to make it stronger. The outcome of the exercise confirmed that:

- Because Tonga is a net importer and a price taker, a 5% revaluation of the Pa'anga will have minimal impact on import prices (less than 0.5 percentage points).
- A 10% revaluation will cost more than $64.4 million in revaluation losses of which a large portion will be borne by the Government.
- This will reduce our foreign reserves and weaken our external position.
- Further loss of international trade competitiveness.
- Less TOP equivalent received from Budget support, foreign aid, and remittances reducing the Government's and Households' purchasing power.

The revaluation of the Pa'anga is clearly a costly exercise that will not achieve the desired outcome of reducing inflation. Because the sources of inflation are supply driven and are beyond the Reserve Bank's control, the current exchange rate basket is in a better position to pick up on the monetary policy tightening of our stronger trading partner countries through imported inflation.

### Outlook

The Reserve Bank expects foreign reserves to remain comfortable at more than 3 months of import cover over the next six months, with more budget support and relief funds from development partners to support Tonga's economic recovery. Remittance inflows from the diaspora is still expected during these difficult times, supported by the rising number of seasonal workers in New Zealand and Australia. Stronger recovery from the agricultural sector will contribute to higher export proceeds. The likely reopening of the international borders will also revive tourism receipts.

Conversely, the recovery and reconstruction work from the HTHH disaster will push-up payments for imports and services. Combined with the higher global inflation and freight rates, and scheduled debt repayments the rise in OET outflows will put pressure on the foreign reserves.

The downside risks to the forecast are the ongoing geopolitical tensions, the strict Covid-19 restrictions, and a new Covid-19 variant further disrupting global supply chains and leading to another wave of price pressures.

The Reserve Bank recognises the significant challenges that the economy is facing, but given the prolonged high uncertainty with COVID-19 development, and the widening fiscal deficit, the Reserve Bank chooses not to put undue pressure on the foreign reserves yet, but keep it as a last line of defense should global conditions deteriorate. In the meantime, it will take a wait-and-see stance as global efforts to level out supply-demand mismatches and reduce inflation take effect.

## 5. Monetary Sector

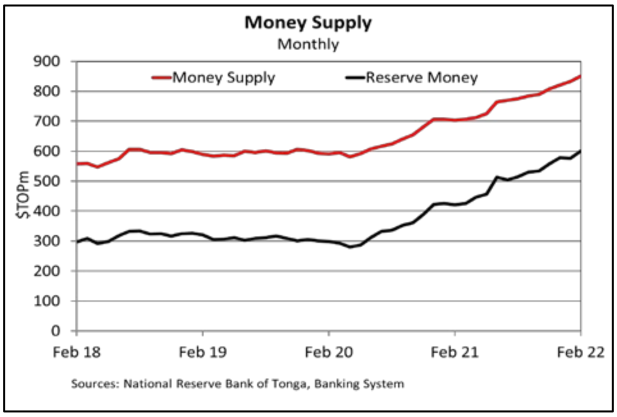
The Reserve Bank is tasked with the promotion of financial stability, and a sound and efficient financial system as one of its principal objectives.

### Money Supply

Over the past six months to February 2022, the Reserve Bank continued to deliver on its functions of issuing currency and monitoring the money supply. In this regard, the Reserve Bank monitors a number of indicators including broad money (M2 consisting of net foreign assets and net domestic assets), and reserve money (M1 narrow money).

Broad money rose significantly over the six months to February 2022, by $75.9million (9.8%) to a new high level of $851.2 million. Net foreign assets increased by $112.3 million (15.1%) to $855.2 million, driving the overall rise in money supply. This is in line with the strong growth in foreign reserves. Net domestic assets however, fell by $36.4 million (109.0%) to -$3.0 million. This was due to the decline in net domestic credit as Government deposits increased from receipts of budget support and relief funds.

Figure 17: Broad Money and Liquidity

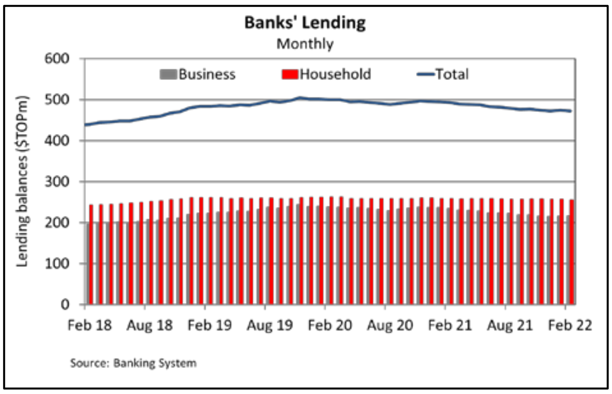



Reserve Money or Liquidity in the banking system increased significantly to a high level of $600.7 million, by $85.7 million (16.6%) over the six-months to February 2022. The commercial banks' Exchange Settlement Accounts (ESA) increased by $54.1 million (16.5%) to $382.4 million, due mostly to net sales of foreign exchange to the Reserve Bank mostly from remittances. Currency in circulation also rose by $26.7 million (23.6%) to $140.1 million, reflecting higher demand for currency notes in line with the fundraising festivities during the year, and remittance payouts after the HTHH disaster. The statutory reserve deposits (SRD) also rose by $4.9 million (6.7%) to $78.2 million portraying an increase in deposits.

The Reserve Bank considered mopping up the excess liquidity in the banking system by increasing the SRD ratio to help contain inflation. But given the adverse impacts of recent disasters further derailing economic recovery, the SRD ratio was left unchanged leaving the excess liquidity in the system for lending. Additionally, mopping up liquidity may also trigger an increase in interest rates, which may in turn discourage lending.

### Lending

Figure 18: Total Lending




Annual credit growth has been negative since July 2020, reflecting the weak economic pace, the high uncertainties of the Covid-19 pandemic affecting both the banks' willingness to lend further, and businesses and households' appetite to borrow. Over the six months to February 2022, the total loans fell by $6.4 million (1.3%) to $472.5 million. Both business and household loans decreased. The lower lending to businesses (including GDL) was underpinned by lower loan balances for public enterprises, and businesses within the construction, professional & other business services, and agricultural sectors. Large loan repayments offset new loans offered during this period. For households, housing loans, other personal loans, and vehicle loans declined over the six-month period.

Government Development Loans (GDL) at the end of February 2022 was at $8.0 million, which is equivalent to around 43% of the total allocation of $18.4 million. The majority was for the agricultural sector (46%), fisheries sector (14%) and education (15%). This leaves an unutilised balance of $10.2 million specifically for the Tourism, Fisheries and Agricultural sectors. The GDL scheme offers low cost loans at an interest rate of 3% to targeted sectors, which would also assist affected sectors recover from the impact of the global pandemic and the recent natural disasters.

The Reserve Bank plans to complete the setup of the credit registry, and reinstate consultations with the Government on options that can further boost credit growth such as developing bankruptcy laws and enhancing the efficiency of the land administration system. This would lower the risks of borrowing, thereby improving banks' appetite to lend and at the same time reduce lending interest rates. Liaisons with the Government and relevant stakeholders on establishing loan guarantee schemes and interest rate subsidy will continue, to promote low cost lending to targeted sectors. Nonetheless, the ongoing heightened pandemic-related uncertainties and high vulnerability to external shocks weigh on both banks and businesses' appetite for investments and hence any further credit growth. Concurrently, corporate and individuals' rising indebtedness limiting their capacity to borrow further hinders any additional lending by the banks. Bringing in the credit offered by the non-bank financial institutions to the consideration of overall indebtedness is vital and warrants closer supervision.

### Deposits

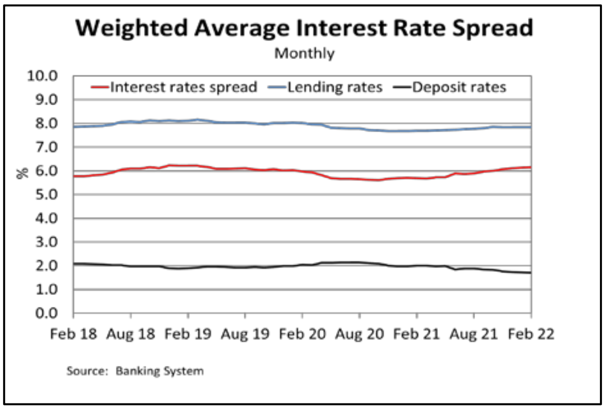
The total banks' deposits increased over the six months to February 2022 by $55.6 million (7.0%) to $848.6 million. All deposit types increased. Demand deposits rose the most mainly from the retirement funds, churches, individuals, and businesses. Time deposits also rose mostly from Churches and non-profit ogranisations. Saving deposits increased mainly on deposits from individuals. Receipt of budget support, donor funds, and grants from development partners pushed Government deposits higher. The delays in the implementation of the donor-funded projects is reflected in the slow utilisation of some of the development accounts. Retirement funds are also large deposit holders seeking better yields on their funds. Higher remittance receipts also contributed to the rise in deposits of the non-profit organizations particularly from the annual church donations. The usage of the churches' funds also remains uncertain.

The bank's total loans to deposit ratio (including GDL) declined over the six-month to February 2022 from 59.0% to 54.5%. This remains well below the Reserve Bank's 80% minimum loans to deposit threshold.

Given the current constrained economic environment, meeting the loans to deposit 80% threshold is not practical, hence the Reserve Bank is considering a more realistic target.

### Interest Rates

Figure 19: Weighted average interest rates




The weighted average interest rate spread, which is the difference between the average weighted lending rate and the average weighted deposit rate, expanded over the six months to February 2022, by 24.69 basis points to 6.14%. The weighted average deposit rate declined while the weighted average lending rates increased.

All deposits rates declined, led by time deposit rates, followed by demand deposit rates, and saving deposit rates. The higher volume of deposits also contributed to the lower weighted average deposit rate.

On the other hand, the weighted average lending rate increased due mainly to higher lending rates to businesses within the utilities, constructions, manufacturing, and distribution sectors. Moreover, the declining loan balances also contributed to the higher weighted average lending rate, despite the excess liquidity.

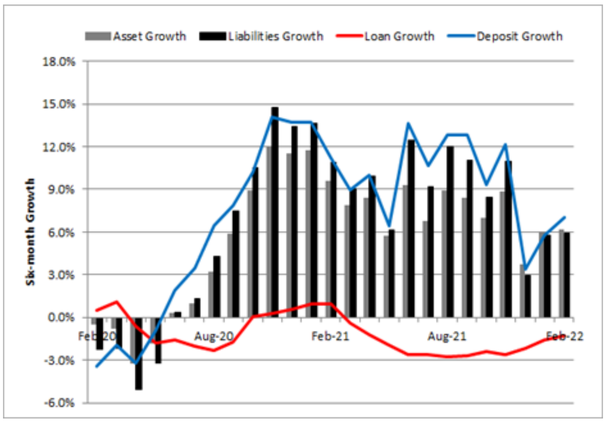
The Reserve Bank has considered using its regulatory powers to support credit growth. This includes placing a limit on the weighted average interest rate spread or directing banks to reduce lending interest rates. However, the challenge in effectively implementing such measures to spur credit growth and achieve economic growth is large. In addition, a reduction of interest rates will further contribute to the heightened inflationary pressure. In this regard, alternative policy tools to encourage further credit growth would be more appropriate. The Reserve Bank stands ready to tighten monetary policy to contain inflation while also contributing to maintaining financial stability.

### Banking System Performance

As the regulator and supervisor of financial institutions, the Reserve closely monitors the performance of the banking system to ensure financial stability is maintained.

The banking system remained sound over the 6 months to February 2022. The ongoing global pandemic, the HTHH volcanic eruption and tsunami in January 2022, and the local COVID-19 outbreak in February 2022 derailing the economy's recovery, dampened business and investment confidence. Concurrently, significant inflows of aid funds to the Government and private remittances resulted. Banks offered disaster relief packages which included loan moratoriums and interest rate reductions. Credit growth therefore continued to slow while the buildup in deposits persisted. Banks also remained profitable with strong capital position and high liquidity while non-performing loans declined.

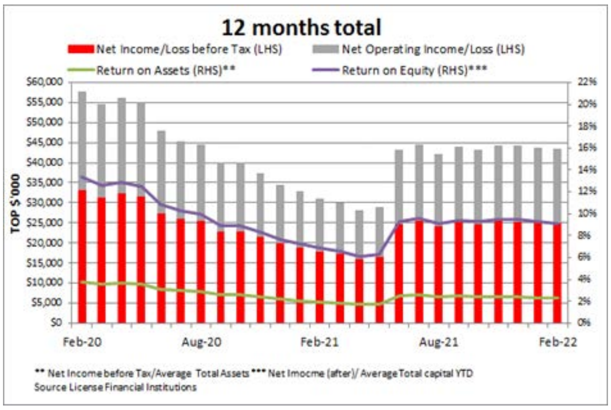
Figure 20: Total Banking System Balance Sheet Development




The total assets of the banking system rose by 6.2% ($67 million) to $1.1 billion over the six months to February 2022. This was on the back of higher Exchange Settlement Accounts (ESA), rising by $50.6 million, which outweighed a 1.3% ($6 million) contraction in total loans.

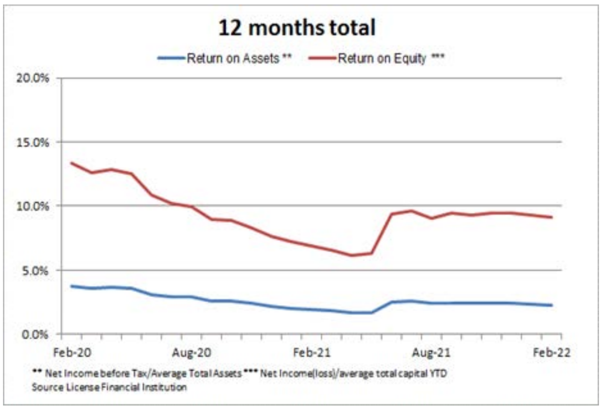
Total liabilities also increased by 5.9% ($52.6 million), which is mostly due to a 7% ($55.6 million) rise in total deposits. This reflected churches' annual donations, retirement fund deposits, and Government fund injections during the year.

Figure 21: Total Banking System's Profitability




Banks' higher profitability reflected lower loan loss provisions expenses as the asset quality of the banking system improved. The Return on Assets (ROA) was at 2.3% and Return on Equity (ROE) was 9.1%, which are both higher than the ROA of 2.4% and ROE of 7.4% recorded in August 2021.

Figure 22: Total Banking System's ROE & ROA

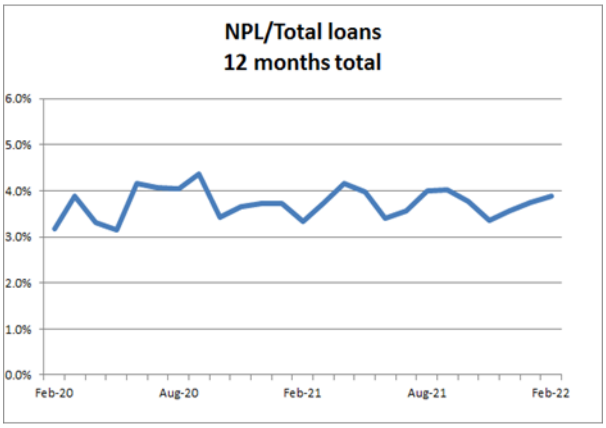



The banking system's capital position strengthened reflecting banks' higher profits. The risk-weighted capital ratio was at 34.7% in February 2022 rising from 31.7% in August 2021, and remained comfortably above the Reserve Bank's minimum requirement of 15%.

The banking system's liquidity position also continued to remain comfortable with the liquid asset ratio at 54.1% remaining well above the 5% minimum requirement.

Total non-performing loans declined by $0.8 million (4.5%) to $18 million over the 6-month period ended February 2022, which represented 3.9% of total loans. This was driven mainly by the upgrade and restructuring of various housing loans. The non-performing private individual loans accounted for 67% of the total non-performing loans, improving from 68% in August 2021. The remaining 32% are non-performing business loans mostly in the construction, agriculture, distribution, professional and other services sectors.

Figure 23: Total Banking System Asset Quality Indicators




Provisions against loan losses declined over the past six months to February 2022 by $0.9 million to $24 million which continues to align with the lower NPLs and IFRS 9 requirements. Nonetheless, adequate provisions were maintained with the total coverage ratio increasing to 133.2% from 132.4% over the past six months.

The Reserve Bank is now testing the Domestic Electronic Payment System (DEPS) with live data from the participants' (Commercial Banks) transactions with a target launch timeline of mid-2022.

### Supervision of Non-Bank Financial Institutions (NBFIs)

The Reserve Bank continues to strengthen its supervision of the non-bank financial institutions to promote financial stability while protecting the interest of their consumers. This is in consideration of their various roles in driving inclusive access to finance and economic growth, major influencers of banking system liquidity and important buffers against natural disasters and similar shocks.

The NBFIs' operations were disrupted by the volcanic eruption and tsunami in January 2022 and the local Omicron outbreak since February 2022. Nonetheless, adjustments were made to the NBFIs' operations to ensure the continuity of their services. The Reserve Bank also allowed extension of due dates for submission of NBFIs' reports and waived administrative penalties for late reporting. In addition, the Reserve Bank permitted temporary customer identification arrangements for one foreign exchange dealer for ease of disbursement of much-needed remittances.

NBFIs offered disaster relief packages to their customers / members. SPBD offered loan moratoriums and restructured loan and rehabilitation loans. The Retirement Fund Board allowed withdrawals up to $800 per member from their own contribution.

Addressing the issues raised in the initial rounds of consultations on the new laws for the supervision and regulation of insurance and retirement funds are key to reinstating the next round of consultations. Meanwhile, the Reserve Bank continued to monitor these NBFIs through collecting of monthly and quarterly financial reports to better understand the services they offer and ensure that they remained solvent.

The Reserve Bank continued to supervise and regulate the operations of the licensed foreign exchange dealers (FEDs) and South Pacific Business Development (SPBD), under the Foreign Exchange Control Act 2018 and Microfinance Institution Act 2018 respectively. In addition to reports submitted by FEDs and SPBD, the Reserve Bank also conducted standard quarterly spot check visits and annual compliance checks for all FEDs to ensure that they remained compliant with their respective license conditions. Regular reports from SPBD help inform assessments of household indebtedness and access to credit. The Reserve Bank also conducted assessments of new products launched by these licensed NBFIs to ensure the protection of their customers' interests are intact and associated risks are adequately managed.

The Reserve Bank continues its work to license moneylenders in Tonga. 60 moneylenders are licensed as of December 2021, in which about 93% are from Tongatapu, 5% from Vava'u and 2% from 'Eua. Some of the moneylenders who have been registered with the Reserve Bank are to be exempted given the nature of their businesses do not meet the moneylender definition under the Moneylenders Act 2018. The Reserve Bank will continue to liaise with moneylenders who are yet to be licensed so that they submit a license application with the Reserve Bank. The Reserve Bank is in the process of setting reporting requirements for licensed moneylenders, which is set to commence after pre-reporting trainings are completed in the second quarter of 2022.

### Financial Inclusion Initiatives

The Reserve Bank continues to promote financial inclusion through close collaboration with the financial institutions to collect data on access and usage of finance. This report will assist the Reserve Bank and financial institutions in identifying the gaps in access and usage of finance, driving product improvement and innovation to better address their customer's financial needs. A Financial Inclusion Strategy is being considered for guiding the financial inclusion activities in Tonga. This includes stakeholder coordination and collaboration in developing of better quality financial product and services (including more reliable, safe and affordable digital financial services) that better suit consumers' needs. The use of digital financial services is expected to continue to increase particularly during the lockdown period and preference for more contact-less services. The Reserve Bank is supporting the development of innovative products and Fintech solutions in this regard.

### Transaction Reporting Authority (TRA)

The Reserve Bank is the appointed Transaction Reporting Authority responsible for administering the requirements of the Money Laundering and Proceeds of Crime (MLPC) Act to combat money laundering and the financing of terrorist financing.

The Transaction Reporting Authority's capacity and AML/CFT supervisory role has been enhanced to address the recommendations from Tonga's Mutual Evaluation by the Asia Pacific Group on Money Laundering. In this regard, all relevant staff working on the FIU and AML/CFT supervision roles have now been pooled under the TRA. Priority areas include strengthening AML/CFT supervision of banks, non-bank financial institutions and cash dealers as well as further amendments to the Money Laundering and Proceeds of Crime Act and Regulations to meet the minimum FATF standards. Enhanced collaboration with regional AML/CFT supervisors and FIUs is ongoing with the aim of strengthening the exchanges of relevant intelligence and supervisory information, as well as enhancing the FIU's information database and analytical tools.

The Reserve Bank also continues to work on developing its own Know Your Customer (KYC) system, to collect and maintain its customers' information. This is a stepping stone to an envisioned national KYC system that will ensure transparency and compliance across the financial system assisting with addressing de-risking and de-banking issues. The project is ongoing with consultations with the relevant Government ministries before the private sector is consulted.

### Outlook

The Reserve Bank forecast a positive annual credit growth of 1.3% for the year ended June 2022. Based on consultation with banks, loans for housing and the construction sector for reconstruction and rebuilding purposes are expected to increase over the next six months. Further growth is expected in loans to the construction sector in the rollout of the Government's infrastructure projects. New loans to the public enterprises are also in the pipeline. These lending opportunities are expected to be offset by ongoing loan-run offs and hinge on the upturn in economic activities and business and investment confidence which continue to depend largely on pandemic-related developments such as the reopening of the international border.

The growth in deposits is also expected to continue on the back of the receipt of more relief funds for the HTHH disaster and the Omicron outbreak, as well as continuous build-up of retirement funds deposits and remittance inflows. Banks' high liquidity is anticipated to be sustained.

The outlook is for non-performing loans to deteriorate as a result of the impact of the HTHH volcanic eruption and tsunami and the prolonged pandemic disruptions on businesses and individuals and their repayment capacity.

Weaker asset quality may also trigger raising further loan loss provisions. Together with the stagnant credit growth and extension of disaster relief packages weighing on banks' interest income, the banks' profitability is also expected to be adversely affected.

The stability of the financial system will be maintained going forward through the close monitoring and supervision of banks and non-bank financial institutions and implementing of various policy measures as outlined below:

- Ensure banks maintain prudent lending practices and vigilant monitoring of asset quality and profitability while continuing to roll out Covid-19-related assistance to customers up to early 2022.
- Closely monitor likely impacts of Covid-19 on the local businesses such as the tourism sector and other private businesses and their capacity to service their debt.
- Update the Prudential Standards for risk management at banks and non-bank financial institutions.
- Undertake robust stress tests to ensure capital adequacy is maintained.
- Continue to develop an enabling financial infrastructure to support prudent credit growth.
  - ✓ Complete the Credit Registry Project that is to be effective in 2022.
  - ✓ Support structural reforms to improve the credit environment, such as working closely with the Ministry of Land and Natural Resources to strengthen the land administration system; and following up with the Ministry of Trade and Economic Development on the development of a bankruptcy law.
- Implement and develop the legislations for the licensing and supervision of non-bank financial institutions
  - ✓ Ongoing implementation of the Moneylenders Act and Microfinance Act with the development of new Prudential Statements.
  - ✓ Implementation of the Credit Union Act.
  - ✓ Further stakeholder consultation on the Insurance Bill and Pension Fund Bill
- Establish a Financial Stability Unit to develop and implement a macro prudential and financial stability policy.
- Modernise and improve the efficiency of the payments system by completing the rollout of the Domestic Electronic Payment System (DEPS) for the automation of the daily cheque settlement system for banks. This initiative is at its final stage of industry consultations with the aim to launch in mid-2022.
- Continue efforts to address de-risking by global banks of local banks' correspondent bank accounts and foreign exchange dealers' local and overseas bank accounts. This includes:
  - ✓ Addressing the recommended actions in Tonga's Mutual Evaluation report to enhance AML/CFT supervision and risk-based implementation of AML/CFT requirements.
  - ✓ Developing of the Reserve Bank's Know Your Customers (KYC) System to be linked to the national KYC framework and the e-Government project.
  - ✓ Collaborating with Pacific central banks and other stakeholders on regional initiatives where appropriate.
- Encourage the development of technological solutions (FinTech) in the financial system that would facilitate low-cost remittance of funds while still complying with the AML/CFT requirements. This includes providing an enabling regulatory environment that will support these initiatives within the applicable legal and regulatory requirements and protect the interest of financial consumers. Furthermore, the feasibility of issuing central bank digital currency is to be also explored.
- Build capacity of the supervision team in new areas such as FinTech and cyber related risks, and AML/CFT supervision.

Risks to this outlook and the stability of the financial system include:

- The development in credit growth and non-performing loans, which will depend on the severity and evolution of the Covid-19 pandemic.
- The economy's vulnerability to further natural disasters and other external shocks.
- The rising cyberattacks and cyber risks posed by increased usage of digital financial services.

## 6. Fiscal Agency Issues

As the fiscal agent and principal banker for the Government, the Reserve Bank continues to facilitate Government transactions in a safe and secure manner. Monitoring of the fiscal policy outcomes and their impact on the monetary policy objectives is also crucial. This is to ensure that the monetary policy can support the fiscal policy, while not jeopardising the achievement of the monetary policy objectives.

The net credit to Government fell by $26.4 million (11.4%) over the six months to February 2022, according to the banking system data. These movements reflect an increase in Government deposits by $29.7 million (11.5%), attributed mostly to receipts of relief funds for the HTHH disaster.

The FY2021-22 Government budget estimates an increase in total expenditure by $98.1 million (23.5%). This reflects the Government's continued efforts to strengthen public health care facilities, recovery efforts on sectors affected by previous tropical cyclones and improvements to public infrastructures such as road maintenance.

Total external debt accounts for 87% of the total public debt with the loan from Export-Import Bank of China (EXIM) holding around 67.7% of the total external debt portfolio. A total of $11.9 million in debt service payment is scheduled for the second half of the FY 2021-22. Total public debt estimated for the year ended June 2022, declined to $503.7 million (48.7% of GDP) due to ongoing loan repayments, and the deferrals of principal loan repayments under the G20's Debt Service Suspension Initiative (DSSI).

With the devastating impacts of the HTHH volcanic eruption and tsunami on various sectors of the economy, a total of T$565.8 million is required in funding according to the Government's HTHH Recovery and Resilience building plan 2022-2025. The four key priority sectors outlined in this plan includes housing recovery, food security and livelihood, tourism industry, and public infrastructure. The Government has rolled out financial support packages to affected households, including the exemption of import duties and taxes on food, clothing, and health products sent from relatives abroad. Donor partners have provided timely assistance for Tonga's recovery efforts, both in cash and in-kind, following the aftermath of the HTHH volcanic eruption.

Meanwhile, the local Omicron outbreak continues to hamper recovery efforts as the country goes into extended lockdowns and curfews affecting normal business activities.

The Government is expected to continue with its expansionary fiscal policy focusing development plans on economic recovery efforts from the HTHH volcanic eruption and coping with the disruptions imposed by the local Covid-19 outbreak. Government receipts are also expected to rise in line with financial support from development partners and the private sector. However, domestic revenue collection is anticipated to weaken before slowly recovering as various sectors of the economy recover from the disruptions in early 2022.

The Reserve Bank will closely monitor the developments in fiscal policies and its implications on the monetary policy objectives.

### Government Bonds

The Reserve bank continues to facilitate the issuance of Government bonds, as the Registrar of Government securities.

Six bond series with a total of $16.901 million matured in 2021 and were all rolled over. For the rolled over bond issues, 5 were oversubscribed and 1 was undersubscribed. This indicates there is still a strong demand for investment in Government bonds due to the lower interest rates offered on bank deposits and lack of investment opportunities. The banks and retirement funds hold the majority of the Government bonds. At the end of February 2022, Government bonds totaled to $67.3 million. A total of $15.0 million bonds will mature in 2022, and $10.1 million in the year 2023. The electronic transfer of principal and interest on maturing bonds continued with 61% of the bondholders preferring direct credit to their nominated bank accounts, while 39% still prefer payments by bank cheque.

However, the purchasing of the bonds is still being done through bank cheques. The Reserve Bank is looking into ways that would also allow for electronic transfers during the bidding and purchasing of Government bonds. The issuing of more Government bonds would further assist in developing the financial markets as well as strengthen the monetary policy transmission.

## 7. Monetary Policy Measures

In the context of moderate yet highly uncertain growth outlook, comfortable external position but heightened inflationary pressure, high liquidity overhang as credit growth dips further, and the financial system remaining sound, the Reserve Bank Board of Directors considers the current accommodative monetary policy stance to be appropriate for meeting its monetary policy objectives for the next six months. Meanwhile, it takes a wait-and-see stance on inflation.

To stimulate economic growth and support macroeconomic recovery while continuing to closely monitor developments in inflation, the Reserve Bank will:

a. Maintain the monetary policy rate at 0% (zero interest rate policy) with the aim to encourage the banks to lend out their liquidity stock, rather than being held at the central bank at no return (zero interest rate). This also signals to the banks that interest rates should be at least on hold which should be passed on to their customers.
b. Maintain the current weights in the Exchange rate basket, which supports the country's economic fundamentals.
c. Reduce the minimum loans/deposit ratio from 80% to 70% for the banks to meet within the next 6 months. The loans/deposit ratio has consistently dipped well below the 80% minimum level therefore reducing the threshold is to give banks a more practical target. Banks continue to be encouraged to utilise their excess liquidity for further lending.
d. Maintain the Statutory Reserve Deposit (SRD) at 10%. Instead of mopping up the excess liquidity to counter inflation, the Reserve Bank decides to leave the excess liquidity in the banking system to support economic activities.
e. Maintain the inflation reference rate at 5%. The current inflationary pressure is to be expected since Tonga had experienced a period of negative inflation rates since the onset of the pandemic, in addition to ongoing shocks to global prices. However, the global economy is already adjusting their policy settings to counter inflation which will pass through into Tonga's imported inflation. Tonga is also recovering from the shock of the HTHH disaster to its domestic food supply.
f. Continue to develop an enabling financial infrastructure to support prudent credit growth such as:
   - ✓ Completing the setup of the domestic credit registry; and
   - ✓ Liaising with relevant Government ministries on:
     - o Developing bankruptcy laws; and
     - o Enhancing the efficiency of the land administration system.

   This would reduce the risk of lending by banks thereby improve their appetite to grow their loan books and at the same time reduce the lending interest rates.
g. Continue to explore other tools to encourage higher credit growth such as liaising with the Government to establish a loan guarantee scheme and interest rate subsidy. Because some of the targeted sectors (e.g. MSMEs) pose high credit risk to banks, a loan guarantee or interest rate subsidy will mitigate the risks taken on by banks and enable them to lend to such sectors at lower interest rates. This promotes a more inclusive access to finance.
h. Continue to collaborate with the MOF and facilitate fiscal policy measures, including through issuing Government bonds, to foster compatibility with monetary policy objectives for a more inclusive and sustainable growth.

The Reserve Bank is also considering additional policy measures to further support economic growth in the medium to longer term such as:

i. Exploring ways to strengthen the monetary policy transmission mechanism such as:
   - ✓ Developing the domestic financial market; and
   - ✓ Establishing a new corridor for setting of interest rates.

This would strengthen the impact of monetary policy instruments on the economy through supporting growth and employment and mitigating the effects of inflation.

The Reserve Bank closely monitors the policy actions of Tonga's major trading partner countries to counter inflation, and stands ready to adjust its policy settings should inflation continue to increase unsustainably by:

- ✓ Increasing the SRD ratio to 15% to rein in credit growth;
- ✓ Increasing the monetary policy rate; or
- ✓ Revaluing the exchange rate;

It should be noted however, that the revaluation of the Tongan pa'anga would benefit importers and other foreign exchange payments, but at the loss of international competitiveness of exporters, and reduced purchasing power for recipients of remittances which is estimated to be more than 40% of GDP. Foreign investment and other foreign exchange receipts would similarly be impacted. In terms of the fiscal position, the benefits of lower external debt payments would be offset by the lower TOP equivalent of budget support and project funds received from donor partners. Additionally, a stronger Tongan pa'anga yields revaluation losses and can pose risk to the fiscal budget should the Government cover any deficit in the Reserve Bank's revaluation account as required by law. For instance, a 10% revaluation of the Tongan pa'anga will result in $64.4 million revaluation loss, of which $54.1 million is to be funded by the Government.

**To maintain a stable, sound and efficient financial system, conducive to macroeconomic stability and growth, the Reserve Bank will:**

j. Continue to enhance financial sector supervision through:
   - ✓ Robust risk assessments and stress-testing, and
   - ✓ Updating of Prudential Statements for prudent risk management at banks and non-bank financial institutions.

   This includes better monitoring of corporate and household indebtedness on aggregate terms and enhancing AML/CFT supervision, while protecting financial consumers' interests. This will assist in monitoring the impact of growth-enhancing initiatives on financial stability and the early identification of vulnerabilities in the financial system to be promptly addressed.

k. Maintain clear channels of effective communications with the financial institutions to ensure delivery of essential financial services to the public especially during pandemic related lockdown periods. This is to allow adequate preparations by financial institutions to comply with the lockdown restrictions and social distancing requirements, while continuing to serve the public. At the same time, financial institutions also need to safeguard their employees during the pandemic to ensure minimal disruptions to the provision of financial services.

l. Modernise and improve the efficiency of the payments system, including by completing the rollout of the Domestic Electronic Payment System (DEPS) for increased automation of the settlement/clearing system. This will also assist in enhancing the security of payments while reducing settlement and clearing costs.

m. Continue to implement measures to combat de-risking by global and local banks in order to retain banks' correspondent bank accounts and foreign exchange dealers' bank accounts, such as:
   - ✓ Strengthening the AML/CFT supervisory framework;
   - ✓ Encouraging the development of technological solutions (FinTech);
   - ✓ Collaborating with relevant stakeholders; and
   - ✓ Completing the setup of the Reserve Bank's Know your Customer (KYC) system to be linked to the national KYC framework and the e-Government project.

As a small country dependent on foreign aid, remittances, and imports, it is crucial for Tonga to comply with the AML/CFT requirements in order to maintain its correspondent banking relations.

These monetary policy measures are designed to ensure that the banking system have sufficient liquidity for further lending, reduce borrowing costs, support credit growth, and boost investments. Consequently, the Reserve Bank closely monitors its exchange rate policy to ensure it continues to support the value of the foreign reserves, reduce exchange rate volatility, and minimise the impact of imported inflation. This would enable our exchange rate policy to contribute to the achievement of the Reserve Bank's objectives of maintaining internal and external monetary stability while promoting macroeconomic stability and economic growth. Nonetheless, measures to secure the stability of the financial system runs in parallel to mitigate potential adverse shocks to the financial system that may further hinder macroeconomic recovery and growth.

# Appendix 1: Monetary Policy Objectives

The Reserve Bank's obligations concerning monetary policy are laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, which states that the principal objectives of the Bank shall be to:

1) Maintain internal and external monetary stability.
2) Without prejudice to its principal objective, the Bank shall:
   (a) promote financial stability, and
   (b) Promote a sound and efficient financial system.
3) Subject to subsections (1) and (2), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth.

In addition, Section 30(2) of the NRBT Act, states that the Bank shall exclusively hold and manage the official international reserves of the Kingdom and maintain an adequate level of foreign exchange reserves. Under the Act, the Reserve Bank shall maintain internal and external monetary stability by maintaining official foreign exchange reserves and promoting price stability.

Maintaining an adequate level of foreign reserves is vital for a small open economy such as Tonga. It is highly dependent on imports for the supply of most of its goods, which need to be settled in foreign currency. Given Tonga's vulnerability to external shocks and natural disasters, its small size, narrow export base, and dependence on imports, the foreign reserves must be maintained at an adequate level to meet individuals' needs for essentials and support economic growth. The Foreign Exchange Act 2018 enhances the Reserve Bank's ability to safeguard the country's foreign reserves.

An adequate level of foreign reserves also minimises volatility in the exchange rate and provides confidence that businesses and individuals in Tonga can meet their foreign currency obligations. The Reserve Bank targets a level of foreign reserves equivalent to 3 months of imports.

Imported goods account for 55% of the CPI basket, so changes in the prices of imported goods and the exchange rate have a significant influence on the overall level of domestic prices.

Price stability contributes to economic welfare, better economic performance, and sustainable economic development. When inflation is low and stable it is easier for people to distinguish changes in relative prices and to adjust their decisions regarding consumption, saving, and investment accordingly. Importantly, an environment of stable prices also reduces the risk in long-term financial agreements, as lenders and investors will be less likely to demand a high inflation risk premium to compensate for the loss of purchasing power. This reduces the costs to borrowers and increases the incentives for businesses to invest.

The high proportion of Tonga's exports and imports as a share of production means that domestic prices are likely to move closely with the prices of traded goods, which in turn depends closely on the value of the exchange rate. Vulnerability to external shocks, such as oil price increases, adverse weather conditions, global pandemics, and high dependence on remittances and imports, heighten the importance of promoting external stability, exchange rate stability, and therefore overall price stability.

By promoting external stability through maintaining an adequate level of foreign reserves and promoting price stability, the Reserve Bank through its conduct of monetary policy can most effectively contribute towards macroeconomic stability, sustained economic growth, and raised prosperity for Tonga.