MONETARY POLICY STATEMENT

February 2024

National Reserve Bank of Tonga

Contents

Executive Summary

Recovery from the double shock in 2022 is ongoing as there were several constraints that hampered a faster recovery and a stronger rebound in the economy. Supply side constraints and adverse weather conditions also added to the inflationary pressure. The Reserve Bank estimates growth at 2.2% for FY 2024, a downward revision from the 2.6% in the previous Monetary Policy Statement. The revised estimate was largely attributed to the slower than anticipated growth in the agricultural sector. The Reserve Bank forecasts the economy will further grow by 2.7% in the FY 2025. However, to sustain the ongoing recovery, prudent macroeconomic management and effective implementation of structural reforms remain critical.

- After two years above the reference rate, the headline inflation eased to 4.6 percent in July 2023 primarily supported by the favorable movement in the global energy prices, with pass-through to domestic energy prices and productions. However, the headline inflation rebounded to 6.7 percent by December 2023 before slightly easing to 6.4 percent in January 2024. The rebound was driven mainly by a strong upsurge in local food prices.
- External stability is maintained with the foreign reserves equivalence of over 11 months of imports, well above the IMF prescribed level of 7.5 months of imports.
- Financial conditions are sound. Credit growth is recovering at 8.5 percent in December 2023 and lending rates slowly declined, although remain high for most borrowers. Structural factors are contributing to the high level of lending rates. However, the continual rise in non-performing loans is a concern which requires the Reserve Bank's ongoing monitoring and supervisory actions to safeguard the stability of the banking system.
- The persistently high level of excess liquidity in the banking system undermines effective monetary policy transmission. Relatively low term deposit rates and limited trading activities in the Government bond market continue, while the interbank and repo market remain inactive.
- Geographic constraints (remoteness and dispersion, and exposure to shocks) along with fragility from thin institutional capacities, translate to elevated cost structures in Tonga[1] for both households and doing business. Our heavy reliance and dependence on imported goods significantly drives up domestic prices. For instance, electricity prices are at least twice as expensive as those in Fiji and New Zealand, and the costs of food items like chicken has experienced over 100 percent volatility within the last 12-month period.
- Vulnerability to disasters extends to the private sector and repeated shocks to supply chains from disasters and global shocks are major constraints to investments and private sector development. The result is limited capacity and investment in the private sector, where gains can be quickly reversed by regular disasters and global shocks.

The outlook for Tonga remains uncertain, influenced by both the global and domestic economic factors as well as the country's vulnerability to disasters and global shocks. Potential challenges include domestic inflationary pressures, capacity constraints, and impact of adverse weather conditions on economic recovery.

[1] NRBT 2024 survey of selected products recorded Import prices for selected products ranging from 28 percent to 60 percent of final price to the public, while a wider range was observed for costs of insurance and freight (CIF) from a low of 18 percent to a high of 60 percent of the product final price to the public. Taxation of same products ranges from a low of 8 percent to a high of 25 percent.

Monetary Policy Decision

Monetary Policy Remaining Vigilant to Inflationary Concerns

1. The Monetary Policy stance for the next six months will prioritize two key objectives. Firstly, monetary policy aims **to maintain macroeconomic stability by keeping inflation below the reference rate**[2] in the near term and addressing elevated costs structure in Tonga in the short to medium term. In addition to monetary policy tools, this will involve collaboration with the Government on targeted reforms and policy measures aimed at reducing basic household costs and business operation expenses associated with Tonga's high cost structure. Secondly, **measures will be implemented to ensure financial stability and enhance access to financing for vulnerable sectors**. These efforts will support sustainable economic growth and help mitigate inflationary pressures in the medium term.

2. While the Reserve Bank will continue to remain vigilant of inflationary concerns in the near term, the Reserve Bank's monetary policy considerations are based on the following:

- Headline inflation experienced fluctuations, exceeding the 5 percent reference rate in December 2023 at 6.7 percent. However, it has eased to 6.4 percent in January 2024 and is expected to trend downwards below the reference rate during 2024. Nonetheless, the inflation forecast is highly prone to the volatility in local food prices associated with Tonga's high susceptibility to natural disasters, the current rising energy prices due to production cuts and the Red Sea shipping attacks, and other external shocks. These may push inflation to remain above the 5 percent reference rate for longer. Annual average inflation decreased to 6.4 percent in December 2023 from 10.9 percent in December 2022.
- The tight labour market, compounded by skill mismatches and labour force migration, increases inflationary pressures as businesses are forced to raise compensation rates to attract and retain workers or recruit from abroad. Addressing labour supply and skills shortages is critical, given their adverse impacts on economic activities and wage inflation.
- Empirical analysis by the NRBT suggests that the increase in the Statutory Reserve Deposits (SRD) ratio has not yet produced significant impact on inflation. The increased SRD requirement in 2023 is sufficient to signal lagged effect in 2024.
- Revised economic growth forecasts for the current financial year reflect lower than expected production in both the primary and secondary sectors, necessitating financial sector support to stimulate private sector growth. Capital investments in resilient and sustainable infrastructure are vital to mitigate Tonga's climate risks.
- Foreign reserves remain comfortable, with excess liquidity in the banking system exceeding $311 million.
- While the banking system remains sound with adequate capital and ample liquidity, the rise in non-performing loans poses profitability and investment financing risks. Enhanced supervision of banks and non-bank financial institutions is imperative to moderate financial stability risks.

3. Monetary policy actions are centered around reducing the cost of living while fostering sustainable economic growth. The policy tools will be reinforced by complementary supply side polies in coordination with the Government to reduce inflation and bolster the potential for economic growth. The NRBT aims to:

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[2] Inflation reference rate of 5 percent (lowered from 6 – 8 percent) last updated in 2016 by IMF to be more consistent with historic inflation rates taking into account vulnerability to shocks beyond the control of NRBT. Changes to the reference rate will need to publicly disclose.

- Develop financial instruments to address sector supply disruptions (internal imbalances), including potential concessional credit and credit guarantees for MSMEs, agriculture, fisheries, manufacturing, women, and youth in business, in consultation with the Ministry of Finance.
- Develop the domestic financial market to provide local investment opportunities while providing increased access to finance for businesses and individuals, including projects in relation to the Blue Economy and Climate Change. Such mobilization of excess liquidity would support enhancing the effectiveness of monetary policy.
- Enhance access to bank financing by the productive and vulnerable, yet under-served, sectors, by requesting the Government's support for the establishment of a MSME Centre to provide financial training and facilitate increasing access to finance for MSMEs in agriculture, fisheries, tourism, manufacturing including handicrafts, women and youth. This is essential to reduce the banks' screening time and costs.
- Collaborate with the Government to address base cost pressures susceptible to inflationary increases such as freight costs, transportation costs, and taxation aiming to reduce Tonga's elevated cost structure. Additionally, support and contribute to reforms targeting specific goods, including energy (petroleum and electricity), and landing costs for essential household food and construction materials. Moreover, focus on upskilling the labour force, with particular emphasis on measures to enhance women's participation.
- Address financial sector structural factors in 2024 to enhance the credit environment and lower credit costs for banks. This includes establishing a domestic credit registry, collaborating with Government to strengthen insolvency and debt enforcement capabilities, and enhancing financial consumer protection measures, such as establishing a Financial Consumer Grievance Mechanism.

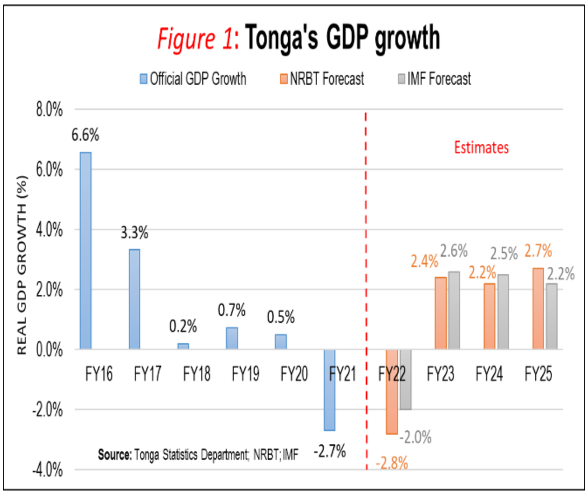
4. The Reserve Bank will implement the following policy instruments:
   i. Maintain monetary policy rate of zero percent.
   ii. Maintain the Statutory Reserve Deposit ratio at 15 percent.
   iii. Cease the deposit facility offered to the retirement funds, which would support the banks' lending activities and liquidity needs.
   iv. Develop initiatives to provide access to more favourable exchange rates for targeted groups such as exporters and remittance recipients.
   v. Collaborate with Government agencies to align monetary and fiscal policy, particularly in reducing inflation, and coordinating price control measures to break the cycle of high inflation with low growth.

Annex

1. Annex 1 - **Economic and Financial Developments**

a. GDP Growth

Tonga's economy is projected to grow moderately by 2.2% in FY2023/24, a downward revision from 2.6% in the August 2023 MPS. The revised estimate largely stemmed from a much slower than expected recovery in the agricultural sector during the first half of FY 2023/24 (compared to the same time in the previous FY) and lower production in the second half, mainly due to the adverse effects of the El Nino weather conditions, and slower implementation of Government projects. Nevertheless, improvement in the supply logistics and shipment schedules along with the inflow of tourists contribute positively to the economic activities in FY2023/24.



High price of local food items remains a key issue, given the lingered supply and demand imbalances in the primary sector. In the midst of the recovery from the pandemic and the HTHH incident, several factors occurred over the year, which interrupted sectoral activities. In the first half of FY2023/24, total agricultural exports declined by 86.2 tonnes (-1.9%) compared to the same period in FY2023. The early onset of the El Nino event significantly affected some of Tonga's major export crops (i.e. squash, watermelon and yam-early) in late 2023. Tonga continues to be highly susceptible to natural disasters, which could dampen the pace of recovery in the near future. On the other hand, total marine exports increased in the same period by 233.7 metric tonnes (+37.2%). However, local supply was low driving prices up due to unfavorable weather conditions (i.e. strong winds) in recent months. Supply shortages were also exacerbated by the low availability of domestic labour. Concurrently, national events and private festivities increased in the first half of the FY, further amplifying supply constraints, resulting in higher local food prices.

Activities in the industrial sector continue to trend favourably given the successful completion and ongoing implementation of several donor-funded projects. Under the housing reconstruction project from the HTHH incident, several houses are already completed in the outer islands, which also included solar power systems under the Tonga Outer Island Renewable Energy project. Meanwhile, the sectoral growth is buoyed by the current construction of the Tonga High School Sports Complex, Tonga Climate Resilience Transport, Tonga Dialysis Centre, and the Upgrade of Queen Salote Ports which received an additional US$30 million boost. Private projects have also rebounded strongly particularly from private organisations such as churches and private-owned businesses. Nonetheless, despite the stabilisation in supply chains and logistics, the domestic labour and skill shortages remain as major challenges to the sectoral growth. With the elevated prices of construction materials, and other goods and services, the infrastructure projects may require more funding than the initial budget hence piling up more constraints.

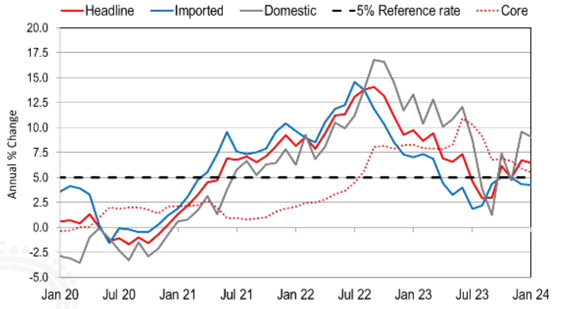
Despite the sluggish recovery within the service sector and particularly with regards to the tourism infrastructure, other sectoral activities were vibrant in the second half of 2023. Over the six months to December 2023, visitor arrivals data was higher by 116.1% (+38,806 visitors) compared to the same period in 2022. This is reflective of the arrival of more cruise ships and yachts during the year. Though majority of the accommodation businesses have yet to rebuild from the HTHH tsunami, several tourism-related businesses were still able to cater for the arrival of travelers. This includes restaurants and food vendors, recreational activities, handicrafts and tourism transport. Demand and household spending sprung back while wholesalers and retailers are still facing high prices from the suppliers. Freight charges have stabilised, yet remain high compared to pre-pandemic levels. A few local enterprises and communities held national festivals during the Christmas Holiday season that further supported the trading sector. Coincidently, the wholesale and retail import payments was $16.7 million (+9.5%) higher over the six months to December 2023, compared to the same period in 2022.

Demand for labour picked up as domestic economic activities continue to recover. New business ventures and development projects were established and implemented over the year, demanding more workers. The Reserve Bank's survey on job advertisement recorded an increase of 28.5% (+214 job vacancies) over the year to December 2023. This also further indicates the ongoing loss of domestic labour to the labour mobility schemes and higher emigration. Businesses have recruited from offshore to fill this gap but visa requirements remain as an obstacle. Recovery in various sectors are at risk from the prolonged labour shortages, putting more constraints on growth while adding to inflationary pressure.

Growth is anticipated to accelerate to 2.7% in the FY2024/25 underpinned by an expected recovery in the agricultural sector along with related projects aimed at supporting households and export activities. Moreover, delayed public infrastructure projects along with new investment projects aimed at boosting the tourism sector will also support growth and employment opportunities in the economy. Some of the development projects that are yet to be officially implemented include the Fanga'uta Lagoon Bridge, Tapanekale Housing, Aged-Care Service Centres and the US$23 million Wind Power project. The outlook for the service sector is optimistic in the medium to long-term, as sectoral performance is expected to improve on account of reconstruction of the accommodation businesses, coupled with the successful completion of infrastructure projects. These projects are anticipated to ease the movement of goods and services, and accelerate activities within the sector.

b. Inflation

Figure 2: **Inflation**
Year-ended



Source: Tonga Statistics Department; National Reserve Bank of Tonga

Despite the improvement in the global productions and supply chains, many prices proved to be sticky and still remained above their pre-pandemic levels. Freight charges show no further increase, but only a slight improvement compared to the COVID-19 period. The elevated prices in Tonga were sustained further by the rebound in demand and consumption amidst slow recovery in the domestic economy. Domestic labour and skill constraints also put more pressure on the elevated prices.

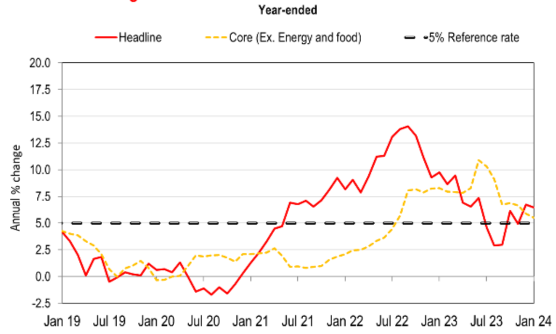
After two years above the 5% reference rate, headline inflation dropped to 4.6% in July 2023 primarily supported by the favourable movement in the global energy prices, and the pass-through to domestic energy prices and productions. However, the headline inflation rebounded to 6.7% in December 2023 before easing slightly to 6.4% in January 2024. The escalated headline inflation was driven by a strong rebound in local food prices. The average annual inflation for the 2023 was 6.4% compared to 10.9% in 2022.

Domestic inflation was 9.1% in January 2024. This is lower than the 9.6% in December 2023 and the 13.3% in January 2023. The pass-through of the lower energy prices to the local electricity tariff and other related costs, helped to contain the inflationary pressure over the year. The accelerated domestic prices in January 2024 reflect the resurgence of the prices of local food items in December 2023. Despite its slight decline in the beginning of 2024, prices were still significantly high and electricity tariff rebounded for the first quarter of 2024. The elevated price of local food items reflects the high demand for food amidst the pressured supply levels during the Christmas Holiday season. Exporting activities have also picked up, reducing the availability of crops for the local markets. Labour market conditions persists in a state of tightness, driven by domestic demand for labour conflicting with the rising trend of labour force migration to seasonal work programs and other similar mobility schemes, alongside emigration. This dual pressure of limited supply and skill mismatches exacerbates inflationary tendencies, as numerous businesses find themselves compelled to raise compensation rates in order to both attract and retain workers. The elevated prices may also reflect the influence of the current El Nino event on the prospects of the local agricultural growers. In addition, prices for catering services, electricity tariff, transport components, kava, and household items (i.e. beds, local mats, domestic helper) also increased. In 2023, domestic prices recorded an annual increase of 8.7% on average compared to 11.3% in 2022.

Imported inflation eased in January 2024 due to declines in energy prices (fuel & LP gas) over the year. In January 2024, the average price of Brent Crude Oil was US$78.9/barrel compared to US$84.1/barrel in January 2023. Nevertheless, imported food items, which has the largest weight in the CPI basket, continued to rise over the year along with international airfares, alcoholic beverages, goods for personal care, household items, clothing & footwear, and construction materials. Importers are still facing high prices from the global suppliers' prices largely due to the prolonged effects of the pandemic and the ongoing wars. On average, imported prices increased by 4.6% in 2023, a substantial decrease from the 10.7% in 2022. This is reflective of the improvement in global supply chains and logistics throughout the year.

Geographic constraints (remoteness and dispersion, and exposure to shocks) along with fragility from thin institutional capacities, translate to elevated cost structures in Tonga for both households and businesses. Evidently, prices of certain imported goods such as petroleum are higher in Tonga compared to our neighbouring countries. The high dependence on imported diesel for the generation of power particularly contributed to Tonga's electricity price being almost 50% higher on average compared to Fiji, Samoa, and New Zealand. Prices of other commodities observed the same trend especially for Fiji and New Zealand who both have a share of local production.

Figure 3: **Core Inflation vs. Headline Inflation**



Sources: Tonga Statistics Department ; National Reserve Bank of Tonga.

Core inflation (excluding food & energy prices) settled at 5.5% in January 2024 which is the lowest rate since the 4.5% in July 2022. The slowdown is driven largely by the base effects of several prices that scaled up in the same period, supported by lower price of tertiary education, local tobacco, and clothing. Nevertheless, prices of core components in the CPI basket hit new highs in January 2024, reflective of the further increases over the month in the price of construction materials, household items, goods for personal care, and alcoholic beverages.

According to the local businesses, the main drivers influencing the pricing of goods are largely from the suppliers' prices abroad, and shipping and stevedore costs, which vary by shipments. This is followed by Government taxes and margins at specified rates. To manage rising prices and the pass-through effects to households, the Government may seek alternatives to support local businesses such as subsidies on regulated goods namely "healthy" food items and prudent monitoring of stevedore fees to be more economical for businesses. Authorities may seek to consider the consequences to households' cost of living should stevedore services be privatized.

Though headline inflation is above its reference rate, the Reserve Bank is projecting inflation to be on a downward trend and to return below the 5% threshold during 2024. The inflation forecast is highly prone to the volatility in local food prices which may push inflation to remain above the 5% reference rate for longer. Tonga's high susceptibility to natural disasters, shocks on the global energy markets, and other external shocks also pose risks to the inflation outlook.

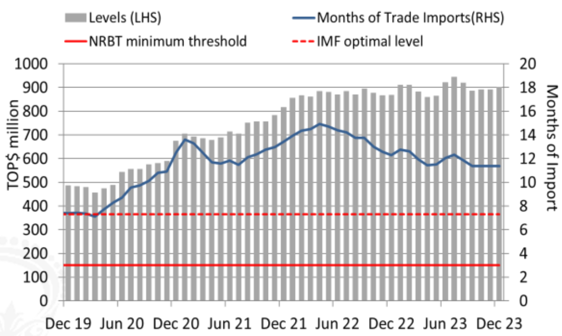
In the February 2023 MPS, measures adopted to curb inflation, through lowering the excess liquidity, included increasing the Statutory Reserve Deposit (SRD) requirement from 10% to 15%, effective in May 2023. Although headline and core inflation have eased compared to the levels in the February 2023 MPS, the NRBT's analysis shows higher SRD had limited impact on inflation. The excess liquidity dampened the impact of the higher SRD on inflation. In consideration of the cooling down of inflation, the Reserve Bank will lower the SRD to support lending and promote economic growth.

The Reserve Bank will continue to vigilantly monitor the development in both the international and domestic economies, to ensure a low and stable inflation for Tonga. Inflation escalated and broadened throughout the economy and it is a battle that requires effective policies and efforts from all relevant stakeholders particularly the Reserve Bank and Government. As indicated in the August 2023 Monetary Policy Statement, the following policy actions are put forward again for consideration to support price stability in the medium to long term:

- Reviewing of input costs (e.g. stevedoring costs, Government taxes) of imported goods to examine if the Government can offer assistance to counter any further hikes of global commodity prices.
- Reviewing of price-controlled goods by the Tonga Competent Authority (TCA), including the scope for inclusion of any other essential goods.
- Expediting the upskilling of the existing labour supply to minimize skills mismatch, while exploring ways to better manage the availability of labour supply for critical sectors.
- Encouraging investments and production of import food substitutions to reduce reliance on imported food.
- Accelerating measures to meet targets on renewable energy transition to mitigate impacts of global oil price volatility.
- Accelerating implementation of infrastructure projects to improve supply chains and logistics
- Enhancing Tonga's climate resilience to reduce the adverse impacts and disruptions of the natural hazards on the domestic production and supply capacity.

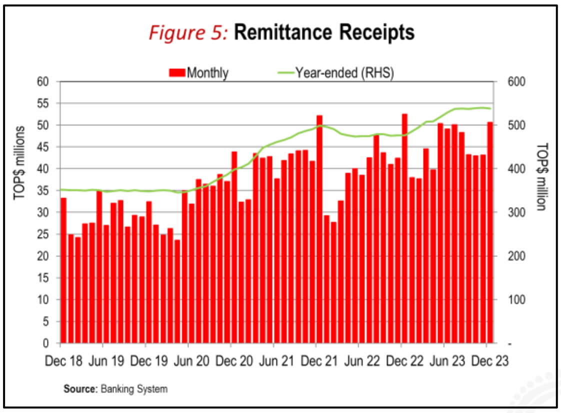
c. Foreign Reserves

Figure 4: **Gross Official Foreign Reserves**

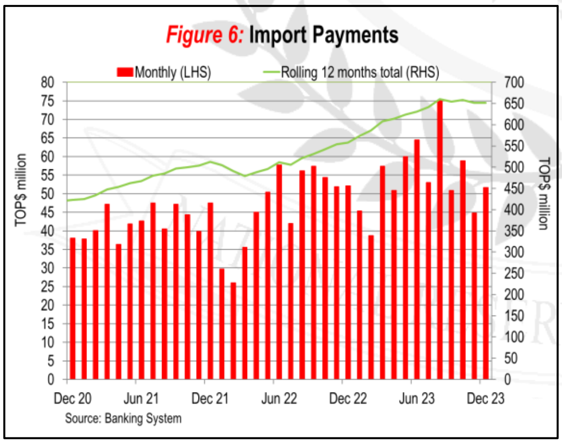


Source: Banking System; Statistics Department

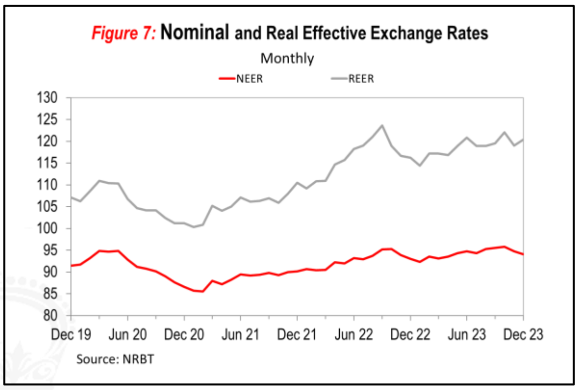
Tonga's foreign reserves continued to remain comfortable at above 11 months of imports by the end of December 2023, which is higher than the recommended optimum level of 7.5 months. Foreign reserves were 2.1% (T$19.7 million) lower than June 2023, but higher than last year by $32.8 million (3.8%), with a total of $901.7 million. These were mostly inflows from development partners for budget support and development projects, coupled with increasing remittances and travel receipts outweighing the outflows for import and debt repayments. Private transfers and employees' compensation continue to drive private remittances growth over the year to December 2023 by 12.8% ($61.2 million). The Christmas and New Year festivities along with other activities such as the annual church conferences, school anniversary celebrations and the Heilala festival also contributed to the rise in remittances. Travel receipts surged over the year by 137.0% ($77.0 million) in line with the robust travel activities following the reopening of borders in late 2022 supporting recovery in the tourism industry. Foreign exchange outflows remain high in year ended December 2023, supported by the ongoing rise in the payments for the import of goods and services, which rose by 16.7% and 31.5% respectively, coinciding with the rising imported inflation.



Foreign reserves is projected to still remain comfortable at around 11 months of import cover by the end of FY 2023/24, sustained by large inflows of donor funds for development projects in the near term. However, import outflows are projected to continue to increase in line with the domestic economic recovery including the expected implementation of major infrastructure projects. Remittances is projected to ease in the near to medium term, partially offset by the increase in travel receipts in line with the recovery in the tourism industry. Tonga is at high risk of debt distress as assessed by the IMF with around 87% of total public debt from external sources. Debt servicing is expected to increase substantially in FY 2023/24 as the principal repayment of the major Export – Import Bank of China loan commences (68% of external debt), putting pressure on foreign reserves in the near to medium term.



Safeguarding the foreign reserves remains a top priority for the Reserve Bank for maintaining external stability. In consideration of the anticipated pressure on the foreign reserves identified above and the weak foreign investment and export proceeds inflows, prudent management of the foreign reserves, including adopting measures to manage any further capital outflows if needed, will continue.



The Nominal Effective Exchange Rate (NEER) declined by 0.8% over the last six months to December 2023 reflecting the weakening of the TOP against some of its major trading partner currencies such as the NZD, AUD, GBP and the EUR. The Real Effective Exchange Rate (REER) also decreased by 0.3% during the same period, in line with the lower NEER. This may imply an increase in Tonga's trade competitiveness. Over the year, both the NEER and REER increased by 2.7% and 3.1% respectively.

d. Monetary Sector

The banking system remains sound with adequate capital and ample liquidity. Total credit reached new high levels, indicating recovery in economic activities, and a high demand for finance to fund both public and private projects. The weighted average interest rate spread narrowed on the back of lower lending rates, outweighing the decline in the weighted average deposit rates. However, the rise in non-performing loans is a concern for the Reserve Bank. Enhanced supervision of banks is crucial while also stepping up the supervision of non-bank financial institutions to ensure risks to financial stability are moderated.

In December 2023, money supply peaked at $868.1 million, rising by $26.3 million (3.1%) from June 2023, and by $16.9 million (2.0%) from December 2022. The annual rise was attributed to higher net foreign assets, reflecting higher foreign reserves and remittances. Net domestic assets, on the other hand, declined underpinned by lower capital accounts and net credit to the central Government mainly on higher government deposits. Reserve Money increased from

June 2023 by $11.2 million (1.9%) but declined over the year to December 2023 by $1.2 million (0.2%) to $611.9 million.

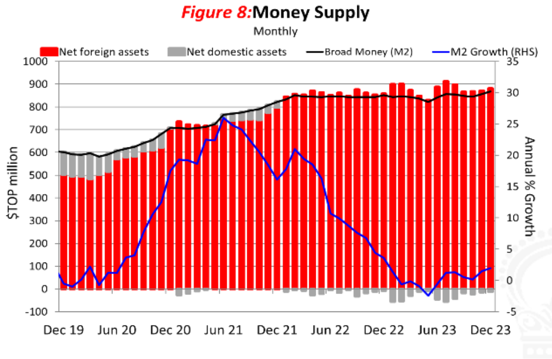


Figure 8: **Money Supply**

Sources: National Reserve Bank of Tonga, Banking System

The annual decline was solely driven by a decline in banks' Exchange Settlement Accounts, mainly on higher withdrawal from the Reserve Bank vault and net sales of foreign currency to the commercial banks. On the other hand, the Statutory Reserve Deposits and Currency in Circulation both increased, in line with the growing deposits and higher demand for currency.

The Reserve Bank estimates excess liquidity of $311 million in the banking system in December 2023, lower than $330 million reported in the August 2023 MPS. The excess liquidity helped to lower interest rates and thereby support further lending and economic growth. Lowering the excess liquidity also helps to strengthen the monetary policy transmission mechanism.

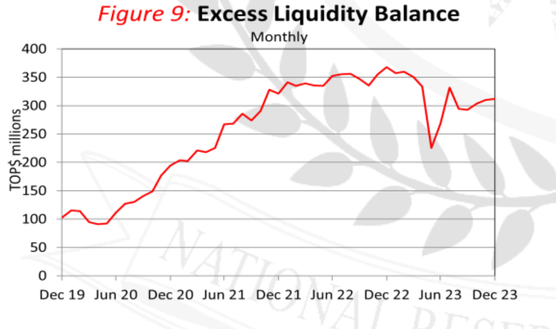


Figure 9: **Excess Liquidity Balance**

Source: NRBT; Banking System

The weighted average interest rate spread significantly narrowed over the year to December 2023 by 19.0 basis points to 6.1% and slightly lower by 0.72 basis points from the previous MPS in August 2023. Over the year to December 2023, the weighted average lending rate significantly declined by 21.3 basis points outweighing the 2.2 basis points fall in the weighted average deposit rate. The decline in the weighted average lending rate was mostly driven by lower business loan rates within the agricultural, construction, transportation and fisheries sectors, as well as decreased household lending rates, mainly vehicle loan rates. However, the lower average deposit rate solely stemmed from the decline in demand deposit rates reflecting also an increase in the volume of demand deposits, which are mostly at zero interest.

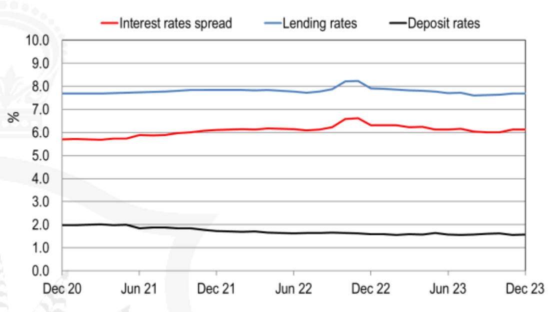


Figure 10: **Weighted Average Interest Rate Spread**

Source: Banking System

Total lending reached a new high level of $535.3 million in December 2023, with an annual growth of 8.5%, compared to 8.3% in June 2023 and 4.5% in December 2022. Lending to both businesses and households grew over the year by 13.1% and 4.3% respectively. Business loans within the transport, agricultural and manufacturing sectors increased, along with lending to all sectors of households. Both rises reflected greater demand for credit, improved capacity for more loans and the lower lending rates. The lower interest rates offered on the Government Development Loans (GDL) scheme also supported the improved credit growth.

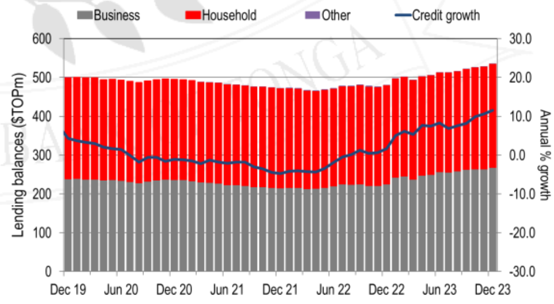


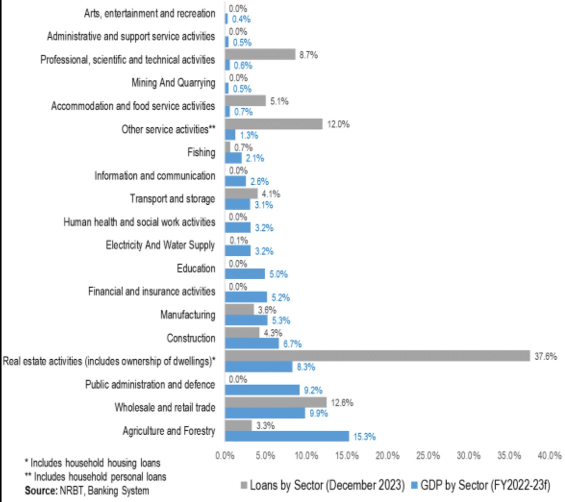
Figure 11: **Banks' Lending**

Source: Banking System

Non-performing loans to total loans increased to 12.2% in December 2023 from 9.1% in June 2023 and 6.5% in December 2022. This reflects the downgrading of business loans mainly in the distribution, construction and agricultural sectors.

Credit growth is expected to accelerate over the year to June 2024. Stronger demand for credit is anticipated as the economy continues to recover, improving business confidence and investment appetite, thereby creating more employment opportunities. There were a number of loan campaigns in the second half of 2023, which is expected to improve competition and help to maintain lower interest rates.

Figure 12: **GDP vs Credit by Sector**



* Includes household housing loans
** Includes household personal loans
Source: NRBT, Banking System

Though credit has grown, the distribution of credit is of a concern. Major productive and vulnerable sectors of the economy such as agriculture, manufacturing, fishing, and construction, are under-served in terms of accessing bank financing, as reflected on Figure 12. The Reserve Bank continues to explore means of facilitating loans to these sectors in order to support growth-enhancing efforts, supported by its financial inclusion initiatives.

The banking system continued to be profitable over the year to December 2023, and is expected to perform better compared to the previous year. The return on equity was estimated at 13.4% (9.1% in December 2022 and 12.6% in June 2023), and the return on assets was 3.4% (2.2% in December 2022 and 3.1% in June 2023). Higher profitability was driven by non-interest income and mostly from foreign exchange dealings (due to the rise in remittances and foreign exchange during the holiday seasons) and other fee income. Interest income also increased despite the lower average weighted lending rate, reflecting new loan disbursements and settlements during the year. In addition, a write-back of loan loss provisions on recovery of loans during the year contributed to boosting banks' profits over the year. The capital position of the banking system remained strong with the consolidated risk-weighted capital ratio at 30.9%, well above the 15% minimum requirement. The asset quality of the banking system weakened over the year to December 2023 as non-performing loans (NPLs) increased due to deterioration in larger loans however; banks are prudently managing their NPLs with adequate provisions in place. Any further deterioration in asset quality will continue to affect banks' profitability and capital position. Liquidity as measured by the liquid asset ratio (LAR) was at 48.3% over the year to December 2023, which is well above the minimum requirement of 5%.

e. Key Challenges

The Reserve Bank will continue its efforts to reduce domestic inflation in the short term while closely monitoring global and domestic developments and their impact on the monetary policy objectives, including the following factors beyond its control:

- Narrow-based and geographically isolated economy that is highly vulnerable to domestic and external shocks such as global financial market volatility and global commodity prices developments, impacting the Tongan pa'anga exchange rate, inflation, as well as returns on foreign investments.
- Impediments to growth and growth potential such as the high vulnerability to natural hazards and climate change, labour supply shortage and skills mismatch taking a toll on the implementation of the reconstruction and donor-funded infrastructure projects and inflation.
- De-risking and de-banking issues may impact the flow of remittances to Tonga and competition in foreign exchange dealings.
- Data quality and limited data availability such as lack of timely employment and wages data.

Annex 2 - Monetary Policy Objectives

The Reserve Bank's principal objectives as laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, 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.

Subject to subsections (1) and (2), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth. Safeguarding macroeconomic stability requires addressing the imbalances in key macroeconomic variables in a sustainable manner, such as the foreign reserves and current account deficit, inflation, fiscal deficit and debt levels, and risks to employment, economic growth, and financial stability. This warrants policy trade-offs that must be carefully weighed to ensure the imbalances are manageable.

The Reserve Bank's monetary policy objectives are, therefore to maintain an adequate level of foreign exchange reserves and promote price stability in order to ensure internal and external monetary stability. Price stability entails low and stable inflation, which contributes to economic welfare, better economic performance, and sustainable economic development. Given Tonga's high dependence on imports, narrow export base, its small size, and vulnerability to external shocks and natural disasters, it is crucial to maintain the foreign reserves at an adequate level to meet the country's foreign currency needs such as payments for imports and the Government's external debt obligations.

In meeting the monetary policy objectives, the Reserve Bank can most effectively contribute towards macroeconomic stability, sustained economic growth, and raised prosperity for Tonga.

In accordance with Section 50(A) of the National Reserve Bank of Tonga (Amendment) Act 2014; The Bank shall, at least every six months, publish a Monetary Policy Statement and submit a copy to the Minister. The Statement shall contain:

a. review of economic developments and the conduct of monetary policy in the period since the previous Statement;
b. a statement of how the Bank intends to conduct monetary policy over the coming six months to achieve its objectives specified under the Act; and
c. a statement of any other development outside its control, which are adversely affecting, or may adversely affect in future, the successful pursuit of the Bank's objectives under the Act.