# MONETARY POLICY STATEMENT

**August 2026**

**National Reserve Bank of Tonga**

# Contents

## Background

Over the past six months, Tonga's macroeconomic conditions have remained broadly sound, although elevated inflation has emerged as the key/main macroeconomic concern.

Headline inflation exceeded the 5% reference rate in April 2026, rose to 7.9% in May 2026 before easing a month later to 7.1% and peaked at 9.3% in July 2026, reflecting heightened inflationary pressures associated with the extended US-Israel-Iran conflict that began in February 2026. Core inflation remained high at 9.1% in June 2026 and 9.0% in July 2026, reflecting the broader pass-through of accumulated inflation hikes in previous years to base costs, keeping the cost of living in Tonga relatively higher and elevating the risks of prolonged high inflation.

The Government's inclusion of subsidies and cost of living measures in the FY2027 Budget will help cushion the impacts of higher prices on the public, and especially vulnerable households.

Gross foreign reserves remained above the IMF's prescribed level of 7.5 months of import cover, providing adequate coverage for projected import demand in the near term. Though it has increased, it has leveled off at just below $1 billion, with the medium-term outlook uncertain and risks tilted to the downside, particularly if the ongoing US-Israel-Iran conflict continues. Additional pressures may arise from potential remittance headwinds, including evolving access conditions to seasonal employment programs in Australia and New Zealand, and the remittance levy introduced by the United States that was effective 1 January 2026.

The financial system remains broadly stable with banks well-capitalized and with high liquidity. However, persistent excess liquidity weakens monetary control over the price of money and slows the adjustment of financial conditions to be aligned with underlying macroeconomic needs. The excess liquidity in the banking system remained high at around $76 million in June 2026 after the NRBT mopped up $271 million through its Notes issuance, compared to an excess of $300 million in August 2025 and $200 million in December 2025.

Credit growth remained resilient in June 2026 at 4.9%, with total bank lending reaching a record $634.5 million, on the back of increased lending to businesses and households. The continued expansion in credit reflects sustained lending activity and supports business confidence and the broader economic recovery. However, credit growth and investment appetite may dampen given the escalating uncertainties in global markets leading to higher business costs and weaker demand. Furthermore, non-performing loans remained elevated at 14.3%, well above NRBT's 10% benchmark, despite a slight decline from a year earlier. This highlights the need for continued supervisory vigilance and strengthened credit risk management.

Interest rate movements remained modest, with the weighted average interest rate spread broadly stable at 6.1% in June 2026. Higher weighted lending rates, particularly for businesses and households, were offset by increases in weighted average deposit rates, resulting in limited movement in the overall spread.

Since the last Monetary Policy Statement (MPS), Tonga Statistics Department published its first estimate for Tonga's real GDP growth for FY2025. It recorded a strong rebound of 4.4%. Nevertheless, growth is expected to moderate in the near to medium term, although recent improvements in sectoral performance and aggregate demand are expected to provide continued support.

While external monetary stability and financial stability have been maintained, persistent inflationary pressures, particularly from energy and food prices, alongside elevated core inflation, continue to pose risks to internal stability, fiscal stability through added pressure on the Government to increase subsidies addressing cost of living concerns, and macroeconomic stability.

Tonga's headline inflation increased sharply from 2.0% in January 2026 to 9.3% in July 2026, a rise of 7.3 percentage points in just six months. This increase is significantly larger than among regional peers over the same period: Fiji rose from -2.5% to 5.7%, Samoa from -2.0% to 3.1%, Solomon Islands from 0.6% to 4.6% by June, while inflation in Australia remained at 3.8% and New Zealand increased only modestly from 3.1% to 4.1%[1].

The comparatively rapid acceleration highlights Tonga's greater vulnerability to **imported and supply-side inflation**, reflecting its high dependence on imported fuel, food and other essential goods, limited domestic production capacity, and exposure to external price and transport shocks. These pressures can pass through quickly into domestic prices and, if prolonged, risk becoming embedded in inflation expectations and broader price-setting behaviors.

Over the last 16 years, due to factors such as the weak monetary policy transmission to address inflation, a strong external balance, and a battered economy that was constantly rebuilding, monetary policy was geared towards supporting economic growth by allowing the accumulation of broad money and the non-sterilization of reserves. The zero-rate policy previously employed by the NRBT was helpful in providing opportunities for growth but in consequence, inflation was not prioritized. This was a trade-off befitting the time. However, Tonga has now become one of the top-three most expensive countries in the 14-member PICs due to persistently high inflation in the past 6-7 years since COVID.

As such, **price stability must remain the NRBT's first and foremost policy priority**. Even where the initial shock is externally driven, persistently high inflation erodes household purchasing power of our people, raises business costs, weakens real incomes and can place pressure on our exchange rate Peg.

NRBT is continuing to prioritize building credibility of monetary policy, continuing issuing NRBT notes to enhance its ability to influence market rates and be able to better control inflation to be within NRBT's reference rate.

[1] Economics and Research Department, NRBT, August 2026.

NRBT will therefore act within its available policy tools to put in place the relevant market-based infrastructure to be in a position to contain inflation second-round effects and prevent temporary external shocks from becoming persistent domestic inflation. This includes strengthening analysis of liquidity forecast and actual outcomes, engaging with Treasury (MOF) on cash flow forecasts and until Treasury Single Account (TSA) framework is fully operationalized, formalize the Master Repurchase Agreement and develop a Central Securities Depository (CSD) to facilitate interbank lending and repo transactions, develop a collateral policy and the continuation of issuance of NRBT Notes.

The increasing monetary policy costs should not be viewed solely as an administrative expense, but as an investment in achieving its core policy objectives and the NRBT's contribution to the betterment of people's lives by keeping prices for goods and services affordable.

While elevated inflation remains a key concern, the neutral stance to date reflects the NRBT's assessment that inflationary pressures have mostly been driven by global supply side shocks, foreign reserves remain above minimum thresholds while economic growth and credit growth remain moderate. The easing of headline inflation in June 2026 amidst national celebrations and a time of heightened demand was unexpected. However, headline inflation rebounded sharply to 9.3% in July 2026 and risks escalation in the near term. As such, monetary policy remains neutral to balance ongoing underlying inflationary concerns with the need to address low economic growth potential, structural excess liquidity, and heightened external uncertainties.

NRBT 3-decade historical experience provided under the review section warrants a more active and market-based monetary policy framework, working alongside the exchange rate Peg, strengthen policy transmission, anchor inflation expectations and better protect both price stability and external competitiveness. Current efforts are focused on building the banks' confidence and participation through the development of digital platforms and supporting regulatory frameworks for interbank lending activities. These measures will deepen market activity and provide the foundation for moving beyond fixed rate, full allotment note issuance toward a more flexible market response policy rate framework.

As the above measures strengthen and market pricing become more reliable, the NRBT Policy Rate will have a clearer signaling role and a stronger basis for transmission to bank funding costs, deposit and lending rates, and ultimately economic activity and inflation. This transition is therefore central to improving the effectiveness of NRBT's monetary policy operations.

## Monetary Policy Stance

The Board of Directors has approved recommendations to maintain the **neutral monetary policy stance** over the next six months, with the monetary policy rate at 2%. The stance will remain data-dependent, with scope to tighten monetary policy should demand-side inflationary pressures resurface or intensify.

Monetary policy is gradually establishing the "new normal" of a more market-based approach to influencing and maintaining price stability. Since the reintroduction of NRBT Notes issuances in September 2025, all banks' participation in the activity has increased significantly. Through this open market operation, the NRBT has mopped in more than 80% of the excess liquidity in the system. While the NRBT has yet to accomplish full absorption of excess liquidity due to external factors outside its control, it is stepping up its efforts in providing a financial environment that is conducive to the pass-through of its policy rate to market rates.

In pursuit of its mandate, the NRBT hereby implements the following policy measures over the next six months:

1. **Monetary Policy:**
   a. **Maintain the NRBT policy rate at 2% and the Interest Rate Corridor (IRC) as follows:**
      - Policy Rate: 2% (mid-rate)
      - Marginal Deposit Facility (MDF): 0%
      - Marginal Lending Facility (MLS): 4%

   b. **Continue issuing NRBT 7-days Notes at fixed rate full allotment** to commercial banks at the policy rate of 2%.

   c. **Maintain the Statutory Reserve Deposit at 15%.**

   d. **Manage the Exchange Rate Basket** to optimize the pass-through to inflation through import prices.

   e. **Continue to strengthen the monetary policy transmission mechanism through improved liquidity management and reactivating the interbank lending market by:**
      - Ongoing collaboration with MOF on establishment of Treasury Single Account (TSA). MOF has started gradually moving funds from its accounts at the commercial banks to the TSA.
      - Improving the liquidity forecasting model by coordinating with MOF on weekly cash flow projections.
      - Developing a Central Securities Depository (CSD) to allow the registry and trading of securities in the secondary market.
      - Developing a Master Repurchase Agreement to facilitate interbank trading and repos.

- Developing a Collateral Policy for pricing securities on a mark-to-market basis.
- Enhancing communication of monetary policy through multiple communication tools to ensure that it is understood at various levels of stakeholders.

2. **<u>Financial Sector Policies:</u>**

   a. **Financial deepening.**

      i. Expand safe and inclusive access to credit for viable investments in tourism, agriculture, fisheries, MSMEs, and other productive sectors.
      ii. Promote the development of FinTech innovative solutions and increase the number of FinTech tested within the Regulatory Sandbox Framework.
      iii. Finalize the Roadmap for Inclusive Green Financing.
      iv. Finalize Tonga's Financial Sector Strategy as Tonga's first short to medium-term strategy under preparation to assist NRBT and key stakeholders address structural gaps in regulatory, financial institutions competition, credit risk constraints, financial markets, and enable more effective support private-sector-led growth.

3. **<u>Work Closely with the Government Fiscal Policy</u>:**

   a. **Productive Sector Structural Reforms:**

      i. Seek Government support through MOF to mitigate instabilities to the internal sectors including agriculture, fisheries, manufacturing, lead sector reforms aligned with the national budget and fiscal policy, to build capacity and enable effective access to available credit / financing.
      ii. Seek Government support through MOF to consider viable and bankable projects within their Public Private Partnership for funding through ADB local currency bond issuance, and remove barriers to and develop incentives for greater investments (both local and foreign direct investments) in Tonga.

   b. **Capital Market Development:**

      i. Coordinate with MOF to develop a yield curve for bonds and securities.

# Annex

# Annex 1 – Review of Monetary Policy

**Modernization of the NRBT's operations to strengthen monetary policy transmission, while safeguarding internal and external stability.**

**Monetary Policy Actions:** Since the last Monetary Policy Statement (MPS) – February 2026, the NRBT has progressed with the modernization of its monetary policy operations through the following actions:

- Continued with the interest rate corridor and set the monetary policy rate at a conventional mid-rate of 2%.
- NRBT's Note issuance increased significantly from an initial uptake of $25.3 million in September 2025 to $110 million in January 2026 (last MPS) and further to $271.0 million in June 2026. The latter represents about 83% of total excess liquidity in the system. Since the last MPS, two banks revised their investment limits upwards by more than 100%, essentially doubling their investments in NRBT Notes. While this reflects improving market responsiveness, the uptake remains insufficient to normalize liquidity pricing through interest rate-based instruments.
- Excess liquidity is reinforced by structural factors such as official project funds deposited at the commercial banks contributing to the excess liquidity while project execution remains gradual. Ministry of Finance has assisted and moved T$15.3 million held at their accounts with the commercial banks to the NRBT. Work is ongoing to gradually move Government time deposits from commercial banks to the TSA. This complements the Notes issuance program in reducing excess liquidity in the banking system and supports more effective interest-rate signaling.
- Ongoing engagement with banks in order to reconcile bidding patterns with system-wide excess liquidity forecasts and to encourage review of internal investment limits where appropriate. Banks' responsiveness is important in ensuring full allotment of NRBT notes and the pass-through of monetary policy to banks' interest rates.
- Developed a liquidity forecasting tool with the help of IMF technical assistance. NRBT has started forecasting weekly liquidity balance using this new model. However, the model needs to be further enhanced by data from the fiscal side and so collaboration on cash flow projections is essential.
- Continued training of staff in the newly established Liquidity Forecasting Unit at NRBT to enhance liquidity management.
- Reviewed the Exchange Rate Policy Framework in March 2026 to ensure the exchange rate basket remains representative of trade patterns and trends of foreign exchange flows and aligns with international best practices. Analysis has shown that this revision has reduced the volatility of the exchange rates and has kept the pa'anga slightly stronger by 0.05% than what it would have been under the previous exchange rate basket composition. The slight appreciation helps reduce imported prices, even if only by a little.
- Statutory reserve deposit (SRD) is another tool the NRBT can use to mop up liquidity. SRD ratio was maintained at 15% since April 2023 as per February 2023 Monetary Policy action plan after remaining at 10% since 2017. According to the

NRBT Act 2020 section 39(1), the SRD ratio can be imposed up to a maximum of 25%. Because SRD is currently not remunerated, it represents a tax on the financial system and any increase in SRD ratio may interfere with the monetary policy stance and undermine financial deepening. Therefore, any increase of the SRD may increase lending rates unnecessarily or further reduce the deposit rates as opportunity costs will increase. As such, the SRD framework needs to be reorganized to support the approved interest rate corridor as recommended by the IMF in their TA report of 2025.

*The issuance of NRBT Notes has played a key role in reducing excess liquidity* in the system, but structural constraints such as perceived country risks and institutions' risk tolerance policies, among others, have limited some banks' participation, which constrained full absorption. Confidence in interbank market trading and repo facilities also needs to be strengthened with a Central Securities Depository and a Master Repurchase Agreement to automate and reliably facilitate the interbank and repo activities. As such, the interbank lending market is still inactive, and the pass-through of monetary policy to market rates has not been established. However, the increase in participation reflects the growing confidence in the monetary policy tool, the increase in commercial banks' liquidity management capacity and ability to estimate weekly demands, establish buffers for precautionary demand, and that interest rate signals are becoming the primary tool for liquidity management, establishing the new norm of monetary policy operations.

NRBT's aforementioned monetary policy actions for the next six months will address issues raised by commercial banks to further strengthen the monetary policy framework, get ready for the second phase of competitive bidding at Fixed Amount Variable Rates, and consider various short-term tenors to establish a short-term yield curve. As market pricing becomes more reliable, the NRBT Policy Rate is expected to have a clearer signaling role and a stronger basis for transmission to bank funding costs, deposit and lending rates, and ultimately economic activity and inflation. This transition is therefore central to improving the effectiveness of NRBT's monetary policy operations.

*NRBT notes issuance sterilizing excess liquidity carries a direct financial cost.* However, this cost should be viewed against the higher economic cost of continuing with ineffective monetary transmission. Reactivating the interbank market, strengthening the interest rate corridor and restoring credibility of the policy signal are necessary investments in macroeconomic stability and part of NRBT's core public mandate. Without an effective transmission mechanism, the policy rate has little influence on commercial pricing. The cost of inaction by NRBT in implementing the solicited modernization measures or opting for less relevant alternatives would be significantly higher and continue to put pressure on our exchange rate Peg, which has been discussed already when adopting the shift to modernization of monetary policy.

*Monetary policy is complex and often misunderstood.* The fast-evolving financial landscape is complex and requires effective communication across different levels of stakeholders. The NRBT will endeavor to communicate monetary policy through various communication tools to prevent policy misalignment and ensure effective implementation.

**Financial Sector Policy Actions:** The NRBT also proceeded to develop the financial system and promote financial inclusion by doing the following:

- Supported the implementation and setup of the framework for ADB's WE-LIFT project, which supports greater access for women entrepreneurs.
- Continued conversations with FinTech providers with one to trial an innovative solution for credit data within the Regulatory Sandbox Framework. Application has been received and the environment is being set up.
- Inception report for the roadmap for inclusive green financing has been finalized. Consultations with relevant stakeholders have also taken place.
- The inception report for Tonga's Financial Sector Strategy is being finalized. The NRBT wanted to ensure that the Strategy covers strategies that will help identify gaps to finance, both from the supply side and demand side, constraints for the NRBT as a regulator, impact studies on sovereign risk if certain sectors remain unregulated (e.g. Insurance, retirement funds), and to clearly point out practical and effective solutions for the financial system.

Although the volume of credit has increased to its highest level on record ($634.5 million), the distribution of credit is still uneven. Annual credit growth of 4.9% was recorded in the year to June 2026, driven mainly by higher business and household loans, including increased lending to public enterprises and private firms in the agricultural, distribution, and construction sectors. This is a much more subdued growth compared to a decade ago despite comparable growths in money supply. The loans to deposit ratio has stagnated below 60% at 56.9% in June 2026 compared to 59.7% in December 2025. Private sector credit as a percentage of GDP has also stagnated around 40 percent, much lower than our neighbouring countries of Samoa (approaching 100%) and Fiji (around 120%).

The weighted average interest rate spread remained relatively steady in June 2026 at 6.1% similar to December 2025. This was largely driven by a 3.4 bps increase in the weighted average lending rate to 7.6%, which more than offset the 1.1 bps rise in the weighted average deposit rate to 1.5%.

NRBT strengthened the financial integrity framework following the enactment of the Money Laundering and Proceeds of Crime (MLPC) Act 2025 with the development of the MLPC Regulations 2026, and provision of financial intelligence to the Government working group to manage emerging money laundering / terrorism financing (ML/FT) risks and support Tonga's application for the 2026 re-rating of its AML/CFT compliance under the 2021 Mutual Evaluation Report by the Asia Pacific Group on Money Laundering (APG). Strong AML/CFT compliance protects confidence in Tonga's banking system, supports continued access to correspondent banking relationships and cross-border financial flows, and reduces the risk of financial-sector disruption that could weaken monetary policy transmission and place pressure on the foreign reserves and the exchange rate.

**Fiscal Policy Coordination:** *Policy Coordination Without Compromising Autonomy.* Monetary policy alone cannot address the supply side of inflation. Fiscal policy also plays a crucial to ensure productivity, infrastructure and market development. This coordination is essential while preserving NRBT's operational independence.

- The NRBT continued providing monetary policy advice to the Minister for Finance as and when required to ensure policy alignment and effective coordination of monetary and fiscal policies.
- NRBT participated in National Disaster Response committee meetings and contributed to policy discussions regarding actions to be taken to address global energy shocks to both supply and prices.
- As part of its contribution to cushioning the impacts of high inflation, the Government has passed measures worth over $30 million in its FY2027 Budget.

However, progress with the following measures has been minimal:
- Greater financial access through the Government Development Loans (GDL) remains constrained, with the Government and TDB working to expand access and address implementation barriers.
- Critical structural reforms on the Government side to build capacity of the key productive sectors (tourism, agriculture etc.) to assist in improving Tonga's long-term growth potential as part of shared national objectives and strategies were held back.
- Development of a macroprudential policy framework and tools to support directing utilization of excess liquidity to productive and underserved sectors while safeguarding the stability of the financial system. NRBT is constantly developing its strategy and is engaging technical assistance in this area with development partners.

**Monetary Outcomes:** During the review period, the monetary outcomes are as follows:

**Table 1. Selected Macroeconomic/Monetary Indicators**

| Selected Macroeconomic Indicators | 2006 | 2016 | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|---|---|
| Real GDP (%p.a.) | -2.2 | 6.6 | -2.1 | 3.4 | 1.4 | 4.4 | 2.2 (f) |
| Inflation (%p.a.) Period Average* | 7.3 | -0.6 | 6.8 | 12.6 | 8.0 | 2.9 | 4.0 |
| Gross Official Reserves (TOP $'Millions) | 83.2 | 354.9 | 871.2 | 921.4 | 924.3 | 925.1 | 991.8 |
| Gross Official Reserves (Months Of Imports Cover) | 4.3 | 5.3 | 14.4 | 11.9 | 11.9 | 10.6 | 11.5 |
| External Current Account Balance (%GDP) | -6.4 | -7.5 | -5.8 | -5.8 | -6.7 | -4.9 | -4.4 |
| NEER End of period** | - | 90.7 | 93.2 | 94.8 | 95.8 | 94.7 | 95.5 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| REER (percentage change per annum) | - | -7.7 | 7.2 | 9.6 | 3.6 | -1.7 | 3.4 |
| Credit to the Private Sector (annual percent change) | 22.6 | 20.5 | -1.8 | 9.6 | 6.6 | 8.5 | 2.0 |
| Money Supply (annual percent change) | 14.4 | 16.7 | 10.6 | -0.5 | 7.5 | 4.4 | 11.6 |

Notes: Period: Financial Year (FY), *Average - FY, CPI 2021 =100, Inflation rates for 2006 and 2016 were derived, given that the available 2021-base index only extends back to 2018.
**End of period
Source: NRBT, August 2026.

### Internal Price Stability

Tonga's long-standing monetary and exchange rate policy framework has delivered relative stability in the external current account and nominal exchange rate but has been less effective in containing domestic price volatility and insulating the economy from repeated shocks. Over a prolonged period of effectively zero policy signaling, as provided in *Table 1* above, average inflation has fluctuated widely from 7.3% in 2006, to -0.6% in 2016, and then 4.0% in 2026, with the start of FY2027 recording 9.3% headline inflation in July 2026.

By comparison, the current account balance has remained within a narrower range at around -6.4% of GDP in 2006, -7.5% in 2016 and -4.4% in 2026, while the NEER has been broadly stable, fluctuating by around 5% between 2016 and 2026. This suggests that the exchange rate framework has provided an important external anchor, but the monetary framework has had limited influence over domestic interest rates, liquidity conditions and inflation transmission.

The divergence between a relatively stable NEER and a more volatile REER moving by as much as around 14% in the last 5 years, largely reflecting domestic inflation differential. It highlights the weakness of relying on exchange rate stability alone to preserve price competitiveness and external balance. At the same time, broad money growth remained persistently positive at around 14.4% in 2006, 16.7% in 2016 and 11.6% in 2026, without a sufficiently active policy-rate and money-market mechanism to influence how liquidity translated into savings, credit and domestic demand.

The recent rise in headline inflation above the 5% reference rate since May 2026, driven initially by imported fuel, electricity and airfares but accompanied by persistently high core inflation of around 9.1%, therefore exposes a structural weakness in the existing framework, that it has not provided adequate safeguards or sufficiently flexible policy tools to mitigate either external supply shocks or their second-round domestic effects.

When compared to our neighbouring countries, Samoa's GDP growth was 2.1% in 2006, 8.0% in 2016, and 4.2% in 2025 while Fiji was 1.9%, 2.4% and 3.2% respectively over the same periods. Samoa's average headline inflation for FY2026 was 1.4% after recording an annual headline inflation of 5.1% for June 2026 before easing to 3.1% in July 2026. Fiji's average headline inflation for FY2026 was -3.1% (deflation) after recording 6.1% annual inflation for June 2026 before also easing to 5.7% in July 2026. The comparison highlights Tonga's greater vulnerability to external shocks and stronger pass-through of imported prices to domestic prices and core inflation.

As part of efforts to address the high cost of living caused by the energy crisis and persistent high inflation, the Government provided measures worth over $30 million that included subsidies for electricity tariffs and domestic transportation costs (both inter-island shipping and domestic airfares), with increased cost of living assistance to the elderly and adjustments to the public servants. The Government subsidies and assistance for FY2027 will help cushion the impacts of high inflation, especially for vulnerable households.

**External Monetary Stability**

Foreign reserves increased by 3.1% ($30 million) since the last MPS to a record high of $991.8 million in June 2026, equivalent to 11.5 months of import cover. This was supported by inflows of foreign aid, budget support funds from development partners, and remittances. Over the last 30 years, the foreign reserves was stable and not falling rapidly.

At the same time, the nominal and real effective exchange rates increased by 0.9% and 3.5%, respectively, reflecting a general strengthening of the Tongan pa'anga against major trading currencies, while domestic inflation remained higher than that of trading partners.

**Financial Stability**

The stability of the financial system is maintained with adequate capital provisions and comfortable liquidity levels. Monetary aggregates reached record levels, reflecting both resilient credit conditions and high liquidity. The issuance of NRBT Notes effectively absorbed excess liquidity while maintaining an environment conducive to lending, which continued to expand across key sectors. However, the ratio of non-performing loans (NPL) to total loans remains a concern as it stayed high at 14.2%, above NRBT's benchmark. Even more worrying is the majority of the non-performing loans are concentrated in one institution.

This interest rate spread remained relatively steady in June 2026 at 6.1% similar to December 2025. This was largely driven by a 3.4 bps increase in the weighted average lending rate to 7.6%, which more than offset the 1.1 bps rise in the weighted average deposit rate to 1.5%.

**Economic Growth**

The National Account Statistics Bulletin reported real GDP growth of 4.4% in FY2025, exceeding the NRBT's forecast of 2.6% forecast and marking a strong rebound from the 1.4% growth recorded in FY2024, which was revised downward from 1.7%.

*Weak Credit Allocation to Productive Sectors.* Despite high liquidity, credit is not flowing efficiently into productive investments. Although bank lending continues to grow, structural barriers constrain access to finance in key growth sectors. Agriculture, fisheries, construction, and manufacturing remain underserved due to land administration delays, limited suitable collateral and credit histories, and high-risk premiums, many of which are beyond the NRBT's direct control.

**Outlook:**

a) Inflation is projected to remain above the 5% reference rate through the remainder of 2026 and into 2027, driven by persistent food, energy, and core inflation pressures.

   NRBT's prioritization of price stability falls short to absorb Tonga's high exposure to imported inflation and external supply shocks. Inflation rose well above the 5% reference rate in FY2026, with imported inflation reaching 13.2% and core inflation remaining above 9%, demonstrating that Tonga is more vulnerable than most of its regional peers to fuel, food, transport and global supply-chain shocks as provided in both *Table 1* and *Figure 3* of this paper.

   Our experience suggests that NRBT's monetary policy safeguards are not yet developed to accommodate the scale and speed of both external and internal shocks as we had experienced post COVID-19 in 2023 and again in 2026 post Iran-US crisis and El Nino. Tonga's remoteness, import dependence, narrow production base, labour shortages, climate risks and rapid pass-through of global energy and transport costs require a monetary policy framework that can respond more quickly and flexibly than in the past.

   NRBT has made important progress in 2025 towards a more responsive and modernized monetary policy framework, but the persistence of high core inflation and repeated imported shocks reinforces the need to complete these reforms so that monetary and exchange rate policies together provide a stronger safeguard for price stability, the exchange rate Peg and external balance.

b) Foreign reserves are expected to remain above the IMF's prescribed level of 7.5 months of import coverage in the near term. However, given Tonga's high vulnerability to natural disasters, narrow economic base, import dependence and exposure to global commodity, geopolitical and supply-chain shocks, maintaining reserves merely at the international benchmark may not provide a sufficient buffer. A higher level of foreign reserves is therefore warranted to strengthen resilience, protect the exchange rate peg and provide adequate capacity to absorb potentially severe and prolonged external shocks.

c) Remittance inflows may face downside risks as seasonal worker programmes become increasingly accessible to workers from a broader range of countries, potentially reducing Tonga's share of overseas employment opportunities. In addition, recent U.S. policy measures, including the 1% levy on remittances and the repatriation of undocumented immigrants, could further weigh on remittance inflows to Tonga.

d) Credit growth is expected to remain positive in the short term, supported by initiatives to improve access to finance and Government policies aimed at promoting private sector development. Vulnerabilities to asset quality will continue to be managed through effective oversight and prudent risk management.

However, credit growth and investment appetite may dampen given the escalating uncertainties in global markets leading to higher business costs and weaker demand.

e) The issuance of the NRBT notes has reduced excess liquidity from $280 million in December 2025 to $76 million in June 2026, but more needs to be done for the interbank market to be reactivated and for the pass through of the policy rate to interest rates.

Monetary policy transmission through interest rates and the exchange rate policy in Tonga's environment should be viewed as mutually reinforcing to contain second-round inflation effects, anchor expectations and prevent external shocks from becoming embedded in domestic prices, while exchange rate policy preserves confidence in the Peg, foreign reserves and external balance. NRBT's policy framework therefore appropriately places price stability first, while recognising that the origin of inflation is largely external and that domestic monetary measures cannot fully offset supply shocks.

f) GDP growth is projected to be moderate at 2.2% in FY2026 and 1.5% in FY2027, reflecting ongoing external shocks, higher energy and shipping costs, geopolitical uncertainties, and risks to agricultural activity. While key sectors and public investment will continue to support growth, the outlook remains subject to significant downside risks.

Stagflation effects are anticipated with the fuel price shocks simultaneously keeping inflation above the reference rate and reducing real purchasing power, constraining household spending and economic activity. In prioritising price stability, collaboration with Government continues to be critical in aligning fiscal policy to supporting economic growth and job creation while also mitigating pressure on inflation.

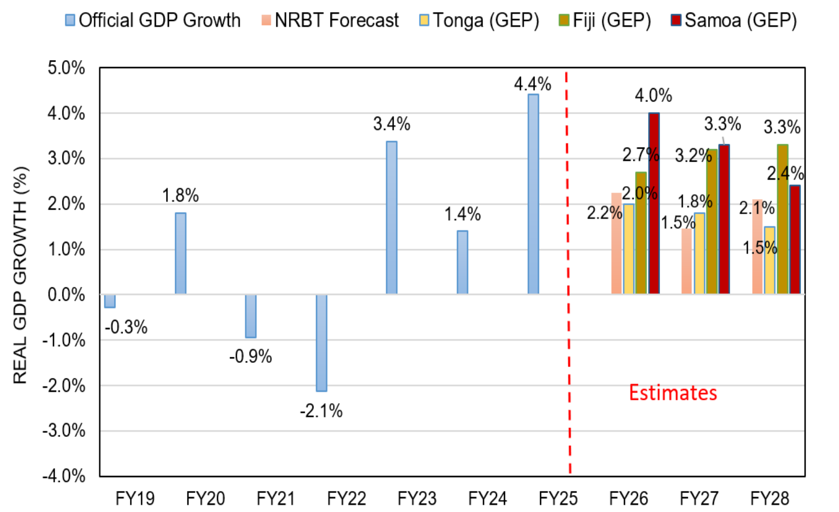
# Annex 2 - **Economic and Financial Developments**

## a. GDP Growth

**Tonga's growth trajectory shows resilience but with moderating momentum.** The latest National Account Statistics Bulletin reported real GDP growth of 4.4% in FY2025**,** significantly higher than the 2.6% forecast in the February 2026 Monetary Policy Statement (MPS)**,** and a strong rebound from the 1.4% growth in FY2024 (downward from 1.7%). Growth was broad-based, led by the services sector, followed by industry and agriculture**,** with consumption remaining robust. Expansion in gross fixed capital formation**,** particularly investment in construction and durable equipment, supported the strong rebound. Meanwhile, the Reserve Bank of Fiji (RBF) estimates a 3.0% growth for Fiji in FY2025, revised down from 3.4%.

**However, the outlook for FY2026 has softened.** In light of newly released data and the widening impacts of the fuel crisis and geopolitical uncertainties stemming from the US-Israel and Iran conflict in the second half of FY2026, the National Reserve Bank of Tonga (NRBT) has revised its FY2026 growth estimate downward to 2.2%**,** compared with the 2.6% forecast in its February 2026 MPS. Growth is expected to be driven mainly by agriculture**,** tourism-related activities**,** construction**,** and public administration and defence**.** Tonga hosted several major national events in the second half of FY2026, including the Queen Salote College Centennial Celebration and the Second Centenary of Christianity in Tonga, which buoyed growth across multiple sectors. The 2.2% growth projection remains slightly above the World Bank's June 2026 Global Economic Prospects (GEP) forecast of 2.0%, a downward revision from 2.3% in January 2026. Nonetheless, Tonga's outlook lags regional peers, with Samoa and Fiji projected to grow by 4.0% and 2.7%**,** respectively, in FY2026. In June 2026, RBF revised its forecast for FY2026 from 3.0% to 1.5%, underscoring the broader regional slowdown. According to the World Bank, higher energy prices and shipping disruptions are exerting upward pressure on food, electricity, and transport costs, weighing on consumption, investment, and fiscal balances, particularly as financial buffers remain limited.

*Figure 1:* **GDP growth**




**Source:** Tonga Statistics Department; NRBT; World Bank

Economic activity strengthened during the July 2025-June 2026 period, supported by robust agricultural performance, sustained construction activity associated with major public infrastructure projects, and resilient services underpinned by tourism, labour mobility, and remittance inflows. Strong growth in agricultural export earnings and domestic production, together with higher travel receipts, remittance inflows, and continued expansion in construction-related activity, reflected broad-based improvements in domestic and external demand. These gains were partly offset by weaker marine production and export volumes, softer merchandise trade as reflected in lower container registrations, and subdued manufacturing activity. Overall, domestic demand and external inflows continued to support economic growth, although uneven sectoral performance highlighted persistent structural challenges across key productive sectors.

Agricultural activity strengthened over the July 2025-June 2026 period, remaining the primary driver of growth within the productive sector. Agricultural export volumes increased to 8,635.0 tonnes, up 14.3%, while export earnings surged by 66.9% to $9.8 million, reflecting stronger export demand, improved production outcomes, favourable weather conditions, and the continued benefits of previous agricultural development initiatives. Domestic agricultural production, covering the period to March 2026 (first quarter), also increased by 17.8% to 2,393.2 tonnes, indicating improved local supply and continued recovery in domestic production. Overall, agriculture continued to make a significant contribution to economic activity during the financial year, underscoring the sector's importance in supporting export growth, rural incomes, and domestic food supply. In contrast, marine sector activity remained subdued. Local marine production declined by 18.0% to 89.9 metric tonnes, while marine export volumes fell by 3.9% to 1,059.9 metric tonnes, reflecting ongoing operational challenges, weather-related disruptions, and softer production outcomes. Nevertheless, marine and fisheries export receipts increased by 14.3% to $2.2 million, suggesting improved export values partly offset weaker export volumes. Overall, the marine sector remained a drag on the primary sector despite modest improvements in export earnings.

Services sector activity remained resilient throughout the review period, supported by continued strength in tourism, labour mobility, and household demand. Container registrations declined by 4.8% to 11,944 containers, indicating softer merchandise trade and import-related activity during the financial year. In contrast, vehicle registrations for the financial year increased by 15.0% to 3,725.0 units, reflecting continued household consumption and business investment, partly influenced by vehicle import policy changes encouraging purchases ahead of tighter import restrictions. Visitor arrivals increased by 3.4% to 129,068 passengers, while travel receipts rose significantly by 19.8% to $212.8 million, highlighting sustained tourism demand and higher visitor spending. This economic windfall was driven by a highly concentrated calendar of cultural, religious, and international maritime events. Remittance inflows also expanded by 13.2% to $612.2 million, continuing to provide strong support for household incomes, private consumption, and domestic economic activity. Overall, the services sector remained a key pillar of economic growth, with strong external inflows helping offset weaker trade-related activity.

Industrial activity remained supportive of overall economic growth, underpinned by ongoing public infrastructure investment and continued construction activity. Major infrastructure projects, including hospital developments, Government facilities, port maintenance works, and residential construction, continued to sustain demand for construction materials and related services. Electricity consumption, covering the period to May 2026, increased by 8.0% to 80.7 million kWh, while electricity production rose by 11.7% to 89.2 million kWh, reflecting stronger economic activity and sustained demand from construction and commercial sectors. Meanwhile, the number of electricity consumers increased marginally by 0.2% to 26,841 consumers in May 2026. The increase in electricity demand reflected stronger consumption among existing customers, indicating higher economic activity, rather than a substantial increase in the number of electricity users. In contrast, lending to the manufacturing sector declined by 3.2% to $19.2 million in June 2026, indicating subdued investment and continued challenges within the sector. Overall, industrial activity remained well supported by infrastructure investment, although manufacturing continued to lag other sectors.

Labour market conditions remained broadly favourable during the review period, with the majority of advertised vacancies concentrated in the industries and services sector. This contributed to a 7.0% increase in job advertisements to 915 vacancies, excluding re-advertised positions. Meanwhile, international migration patterns shifted, with participation in the Pacific Australia Labour Mobility (PALM) scheme increasing by 10.8% to 3,441 workers over the year, while participation in New Zealand's Recognised Seasonal Employer (RSE) scheme declined by 26.8% to 1,240 workers. Although the resulting remittance inflows supported household incomes and private consumption, continued outward migration has constrained domestic labour availability, contributing to persistent skills shortages in the construction sector and specialised occupations. Ultimately, these tight conditions pose distinct risks of wage-push inflation for monetary policy, reinforcing the urgent need for targeted domestic training and increased workforce participation to sustain long-term growth.

**Building on this moderating momentum, Tonga's growth trajectory is projected to weaken in FY2027,** with the forecast revised downward to 1.5% from 2.0% in the February 2026 MPS. The adjustment reflects the heavy toll of the fuel crisis and ongoing US-Israel and Iran conflict, which continue to disrupt trade channels, elevate energy and shipping costs, and erode business confidence. While the Government remains committed to implement major multi-million-dollar projects outlined in the FY2027 Budget Statement, risks are compounded by the ongoing El Niño phenomenon, following the FY2024 episode that caused a 10.1% contraction in agricultural output. With agriculture, the largest contributor to GDP, expected to weaken in FY2027, the implications for overall growth are substantial. At the same time, limited access to financing constrains private sector investment, while heightened production costs and exposure to natural disasters amplify vulnerabilities across industries. To cushion future shocks, Tonga will need to diversify energy sources, invest in renewables, and strengthen resilience through better disaster preparedness, climate-smart farming, and sturdier infrastructure. Moreover, heightened uncertainty in global economic policies and shifting dynamics in major economies add external pressures, while domestic vulnerabilities such as potential political disputes, adverse weather conditions including the upcoming cyclone season, and prolonged labour availability challenges underscore the fragility of Tonga's growth path.

**Key structural reforms to unlock growth potential are critical to reverse the economy's growth trajectory.** Tonga's weaker medium-term growth outlook points to the need for reforms that raise productive capacity rather than relying mainly on public construction, remittances, and event-driven services.

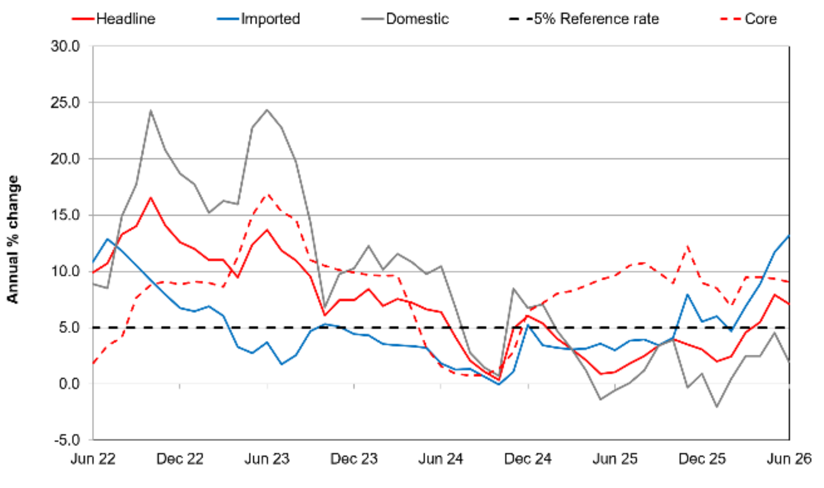
Priorities include improving agricultural productivity and climate resilience, reviving fisheries and manufacturing including higher value-added capacities, lowering energy and transport costs through renewable energy and better infrastructure, expanding skills and labour-force participation, and improving access to finance for productive private-sector investment. These reforms would help diversify the economy, reduce import dependence, strengthen exports, and lessen Tonga's vulnerability to external supply shocks, natural disasters, and labour shortages that currently constrain growth and add to inflationary pressures.

NRBT can support this reform agenda through monetary and financial-sector policies that improve the allocation and cost of finance while preserving price and external stability. This includes supporting risk-sharing facilities, interest rate subsidies and others that would effectively address the barriers to accessing finance. NRBT can create a more predictable financial environment in which Government and private-sector structural reforms can translate into stronger investment, productivity and sustainable growth.

## b. Inflation

**The annual headline inflation exceeded the 5% reference rate in April 2026 and closed the financial year 2026 at 7.1%.** It reached 7.9% in May 2026, the highest level since 8.4% in January 2024. The surge was driven mainly by energy-related goods and services and food-related goods

***Figure 2:*** **Headline Inflation Year-ended**

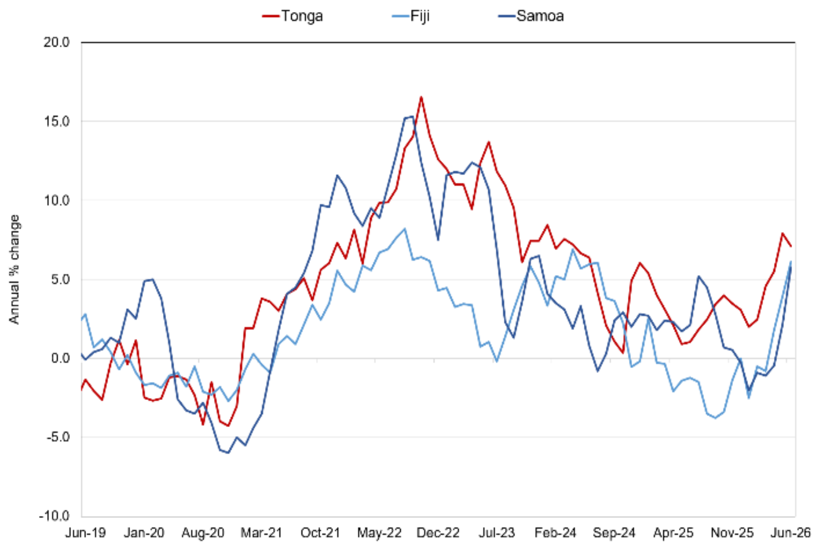



**Source**: Tonga Statistics Department

and services, highlighting the pressures from the US-Israel and Iran conflict. Notably, while core inflation contributed 2.9 percentage points the greatest contribution from core prices (excluding energy and food) are secondary effects of energy and food prices. Food services contributed 1.3 percentage points while international airfares contributed 2 percentage points to headline inflation.

**Tonga's inflation averaged 4.0% for the Financial year ending June 2026, well above -0.5% in Fiji and 1.4% in Samoa.** While Fiji and Samoa's inflation eased from their annual averages in June 2025, Tonga's inflation continued to rise. The domestic component was low and broadly similar across Samoa (2.3%) and Tonga (1.6%), highlighting that the divergence in headline inflation stemmed mainly from imported goods where Tonga averaged 6.7% compared with Samoa's 0.6%. Samoa's latest Consumer Price Index (CPI) report showed that the annual inflationary pressures were concentrated in energy-related and food items, while divisions such as miscellaneous goods and services, clothing and footwear, recreation and culture, furnishings, household equipment and maintenance, and communication made negative contributions to annual CPI. By contrast, Tonga's CPI showed positive contributions across these same categories, reinforcing upward pressure on headline inflation. In late 2023, the transport component helped offset price increases in Samoa, easing overall inflationary pressures, whereas Tonga's transport costs remained elevated. This divergence reflects the relative weight of energy-related items, which account for about 27% of Samoa's CPI basket compared with only 20% in Tonga's. As a result, declines in energy costs exerted a stronger dampening effect on Samoa's headline inflation, while Tonga's lower energy weighting meant similar alleviation was less impactful, leaving overall inflation pressures more persistent.

*Figure 3:* **Regional Inflation Trends**




**Source:** Samoa Bureau of Statistics, Fiji Bureau of Statistics, Tonga Statistics Department

**Imported inflation in Tonga surged as the escalation and prolonged duration of the US-Israel and Iran conflict triggered immediate and widespread economic repercussions.** Rising commodity costs, disrupted logistics, and heightened uncertainties across trade channels amplified pressures on the domestic economy. Consequently, import inflation closed FY2026 at 13.2%, a record high, with the main contributors being international airfares, fuel, food items, LP gas, and other fuels. The global fuel crisis severely constrained air traffic, prompting airlines to cut flights and raise fares to offset costs, spilling over to Tonga particularly amidst national celebrations in the first half of 2026. Although global oil prices ultimately eased, persistent geopolitical tensions continue to weigh on stability. At the same time, Food and Agricultural Organization cautioned that global food prices are unlikely to recover quickly from the fuel shock and heightened input costs, with the ongoing El Niño phenomenon posing additional risks to production and price stability. On an annual average basis, import inflation rose to 6.7% in FY2026, from 2.4% in FY2025, highlighting the scale of external shocks and their transmission into Tonga's domestic economy.

**Domestic prices in Tonga displayed mixed trends, reflecting volatility across key sectors and underscoring instability in the price environment amid heightened global uncertainties**. Lingering risks from labour shortages and mismatched skills, along with elevated living cost, continue to sustain inflationary pressures. In May 2026, domestic prices rose by 4.5% year-on-year before easing to 2.1% in June, the highest increase since 4.7% in February 2025. The main contributors were food and beverage serving services, electricity tariffs, kava, and passenger transport services. While local food prices rose over the month, they were much lower than the previous year, despite June being a vigorous month. However, the El Niño phenomenon and other natural hazards pose ongoing risks to food supply and prices. Food holds the largest weight within Tonga's CPI domestic category and informal market dominance exerts a powerful influence on pricing, shaping how external cost pressures and other shocks are transmitted. These dynamics mean that pass-through can be partly muted at times, but can also be over-transmitted when local supply constraints or seasonal demand amplify external shocks. This dual effect makes it difficult for formal policy measures to achieve their intended outcomes, highlighting the need for stronger monitoring of informal markets and resilience strategies to manage volatility. On average, domestic prices rose by 1.6% in FY2026, slowing from 3.4% in FY2025.

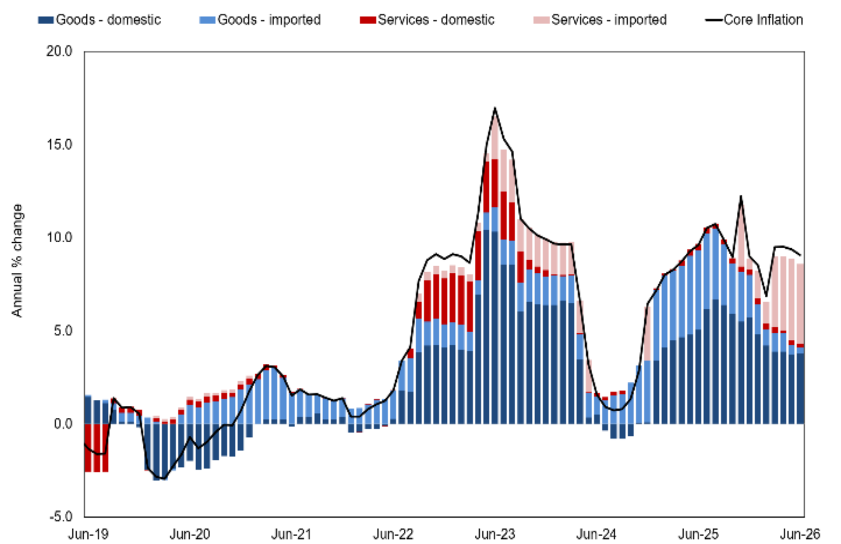
The Tonga Statistics Department's latest Food Price Index reported an annual decline of -0.8% compared to June 2025, driven mainly by lower domestic food prices. With food comprising 43% of the CPI basket and imports accounting for 25%, these allocations are highly influential in overall inflation. Imported categories such as Live Animals, Meat and Other Parts of Slaughtered Land Animals, Oils and Fats, Fruits and Nuts, Ready-made Food and Other Food Products, and Non-alcoholic beverages contributed strongly to food inflation. In contrast, domestic food items such as Vegetables, Tubers, Plantains, Cooking Bananas and Pulses, Fruits and Nuts, and Milk, Other Dairy Products and Eggs offset some of the annual increases from local categories of Live Animals, Meat and Other Parts of Slaughtered Land Animals, Oils and Fats, Ready-made Food and Other Food Products, and Non-alcoholic beverages.

Although the annual trend shows alleviation, monthly changes moved upward, signaling renewed momentum in inflationary pressures.

The global energy shock from the US-Israel and Iran conflict transmitted into Tonga's economy immediately, unlike the usual lag in global fuel price pass-through, intensifying local inflationary pressures. This pushed annual energy inflation to 35.4% in June 2026, the highest since August 2022. Brent Crude averaged at US104.4/barrel in May 2026 before coming down to US$85.8/barrel in June 2026. Consequently, several local energy prices surged to new record highs, with petrol at $4.15/litre, diesel at $5.05/litre, kerosene at $4.30/litre, and LP gas at $5.00/kg. Meanwhile, electricity tariffs spiked to $1.25/kWh in June before easing slightly in July.

**Core inflation remained above the 5% reference rate, settling at 9.1% in June 2026 and 9.0% in July.** The largest contributor was imported services particularly international airfares, followed by goods. Goods (domestic and imported) account for about 75% of core inflation compared to 25% of services. Within the domestic category, alcoholic beverages, tobacco, and kava are key drivers, alongside food and beverage serving services (take-away food). However, if food and beverage serving services (take-away food), which represent 15% of the overall CPI basket, are excluded from core on the basis that they are food-related, the share of core items shrinks to only 31% of the CPI basket. This reclassification shifts the balance of core inflation toward imported goods and services, making them the structural root of inflationary pressures. Imported goods include alcoholic beverages and tobacco, clothing and footwear, construction materials, household items, personal care products, vehicles, ICT equipment, garden products and pets, and books and stationery. The implication is that, once food services are excluded, core inflation becomes far more exposed to external shocks such as fuel prices, commodity prices, shipping costs, and global supply chain disruptions, leaving the Bank with limited control through domestic measures and underscoring the need for resilience against external cost pressures.

*Figure 4:* **Core Inflation - Goods vs Services**




Source: NRBT's Calculation

**On the outlook, inflation is projected to remain above the 5% reference rate through 2027.** Food-related and energy-related goods and services continue to lead the upward trajectory, while core inflation follows a counter-cyclical pattern observed, typically lagging headline inflation before overtaking it within a 1-to-2-year cycle. This dynamic highlight that even when headline inflation eases, core pressures resurface and surpass it, reinforcing the second-round effect and persistence in the inflation outlook. Global uncertainties such as stalled peace talks and geopolitical tensions pose risks and encourage price setters to maintain elevated price levels. Tonga's geographical remoteness and structurally higher transportation costs, compounded by trade turbulence, fragile supply chains, and the heightened risk of natural hazards (including the current El Niño phenomenon), further amplify uncertainty and vulnerability in the inflation outlook.

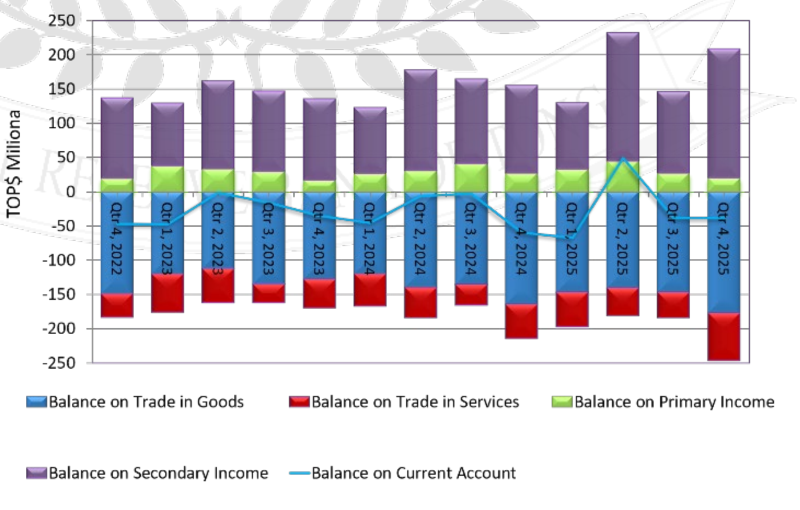
While much of the current inflation is supply-driven, the persistence of high inflation underscores the need for NRBT to continue its modernization of monetary policy to strengthen its capacity to influence the demand side sourced inflation by rebuilding a credible interest-rate transmission mechanism.

**NRBT initiatives to modernize its monetary policy tools to strengthen transmission in pursuit of its price stability objective commenced in 2025.** Concurrently, monitoring the development in both the international and domestic economies will continue, to ensure that any potential pass-through effects and external shocks that could influence price stability are mitigated. The NRBT is seeking closer collaboration with the Government to align monetary and fiscal policies designed to curb inflation and boost economic growth.

## c. External sector

**According to the latest Balance of Payment report** released by Tonga Statistics Department for Quarter 4 2025, current account deficit narrowed by 16.8% to $95.2 million over the year to December 2025. This improvement was mainly driven by a 19.5% increase in the secondary income accounts, reflecting higher inflows of foreign aid and remittances over the year. In addition, the primary income declined 0.3% over the year, contributing to the narrowing of the current account deficit. This stemmed from a 35.6% decline in the primary income

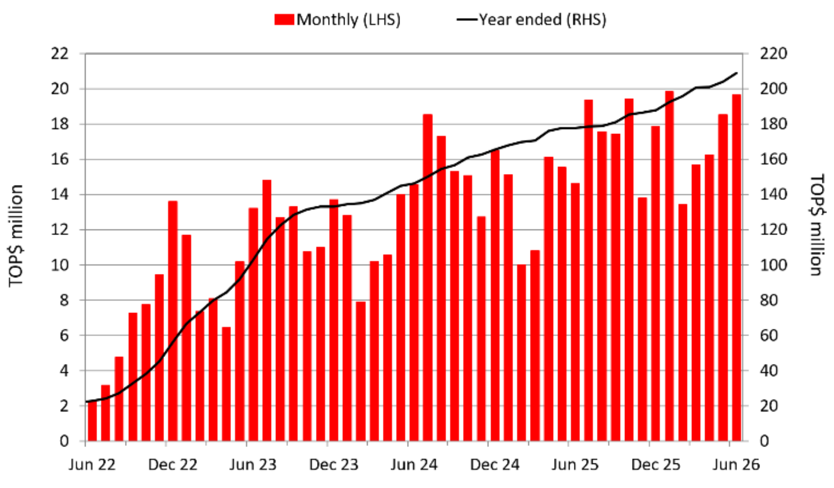
*Figure 5:* **BOP - Current Account**
Quarterly



account, particularly compensation of employees and investments, which partly offset the 10% increase in imports. Tonga's Balance of Payment position continued to be characterized by the country's reliance on imports relative to its narrow export base, as well as on remittances and foreign aid. The NRBT also monitors the following high-frequency performance indicators sourced from its Overseas Exchange Transactions data, to assist with the assessment of the external sector.

**Foreign exchange inflows increased by $197.2 million (12.6%) over the year to June 2026, attributed mainly to higher receipts from interbank transfers, capital official transfers and travel activities.** Financial transfer receipts increased by $57.9 million (19.8%) to $350.0 million over the year to June 2026, underpinned by higher interbank receipts. The increase in the capital account stemmed from higher receipts from development partners for the Government projects. Travel receipts also recorded robust growth, increasing by $31.2 million (17.6%) over the year, mainly for the Queen Salote College Centennial Celebration, Second Centenary of Christianity in Tonga, and holiday festivities. Meanwhile, private transfers and employee compensation continued to support growth in private remittances, which increased by $71.5 million (13.2%) over the year to June 2026. Export receipts also recorded an increase of $4.3 million (47.1%) over the year, predominantly due to higher agricultural and other exports, supported by favorable weather conditions.

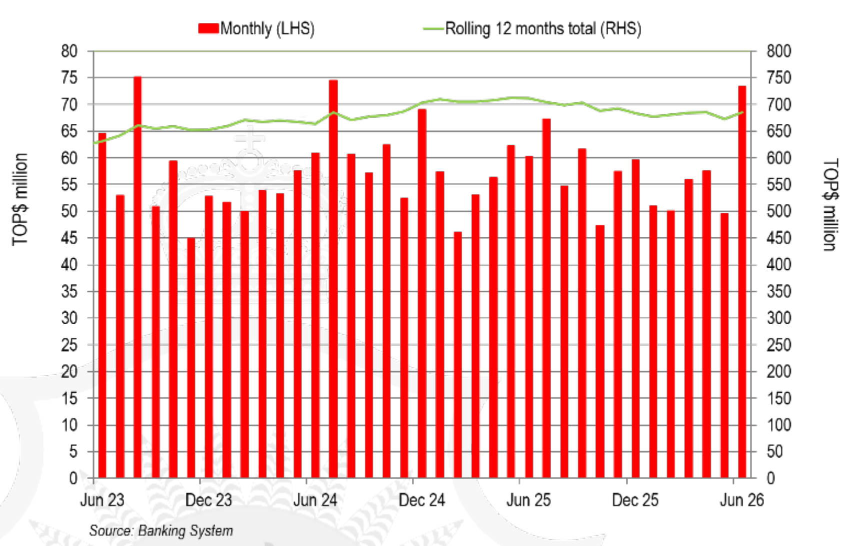
***Figure 6:* Travel Receipts**




*Source: Banking System*

**Payments for services and private transfers drove the increase in foreign exchange outflows.** Foreign exchange outflows increased by $43.1 million (3.4%) over the year to June 2026, driven mainly by higher payments for services, which rose by $50.5 million (15.0%), particularly for computer services. This increase reflected payments by the Ministry of Revenue for the implementation of a new taxation system as part of the Government's efforts to modernize public revenue collection. Payments for construction services to overseas contractors also increased, mainly due to ongoing Government payments for the Fanga'uta Bridge project. Private transfers abroad increased further by $31.7 million (39.0%), reflecting higher financial support sent to families overseas. These increases were partly offset by a $26.0 million (3.7%) decline in import payments, largely due to lower payments for other imports, mainly Government imports, and oil.

*Figure 7:* **Import Payment**

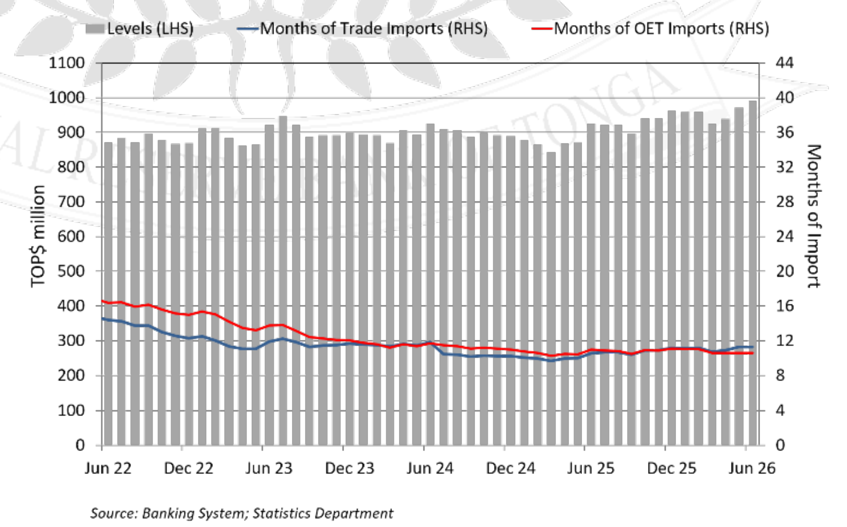



*Source: Banking System*

## Foreign Reserves

**Foreign reserves remained comfortable above the adequacy thresholds, supporting Tonga's external stability.** Tonga's official foreign reserves stood at $991.8 million at the end of June 2026, sufficient to cover 11.5 months of imports and remained above the IMF's prescribed threshold of 7.5 months. This was sustained by substantial inflows of budget support, official grants, and remittances over the year, reinforcing

*Figure 8:* **Gross Official Foreign Reserve**
Monthly

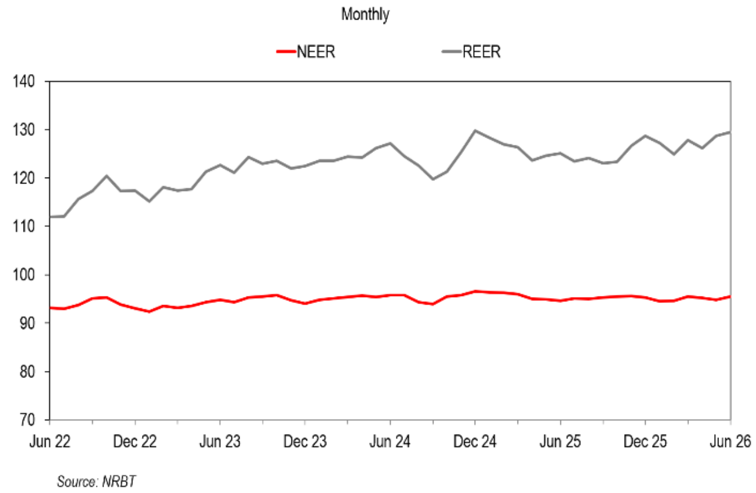



*Source: Banking System; Statistics Department*

Tonga's external resilience and capacity to safeguard macroeconomic stability.

**Tonga's Effective exchange rates strengthened during the review period.** The Nominal Effective Exchange Rate (NEER) increased by 1.1% over the last six months to June 2026, reflecting the strengthening of the TOP against most of its major trading partners currencies such as AUD, NZD, FJD, JPY, EUR and GBP. The Real Effective Exchange Rate (REER) rose by 1.8% (forecasted number) during the same period, in line with Tonga's relatively higher inflation rate. This may indicate a loss in Tonga's trade competitiveness. Over the year, both the NEER and REER increased by 0.9% and 3.5%, respectively.

*Figure 9:* Nominal and Real Effective Exchange Rates




Source: Bank of England; IMF; NRBT

**Foreign reserves is expected to remain above the minimum threshold in the near term, sustained by budget support, official grants and remittances.** However, the medium-term outlook remains uncertain from higher import payments associated with ongoing public infrastructure projects, increased offshore investments, debt-servicing obligations and the ongoing crisis in the Middle East. Remittance inflows may also weaken over the medium term due to ongoing changes in US policies affecting remittance transfers and immigration enforcement, including the repatriation of undocumented migrants. In addition, the number of seasonal workers abroad may decline as Tonga's key labour-market destinations increasingly open employment opportunities to workers from a broader range of countries, potentially reducing remittance inflows. Against these risks, the NRBT continues to prioritise safeguarding foreign reserves to maintain external stability, support international trade, and preserve the exchange rate peg.

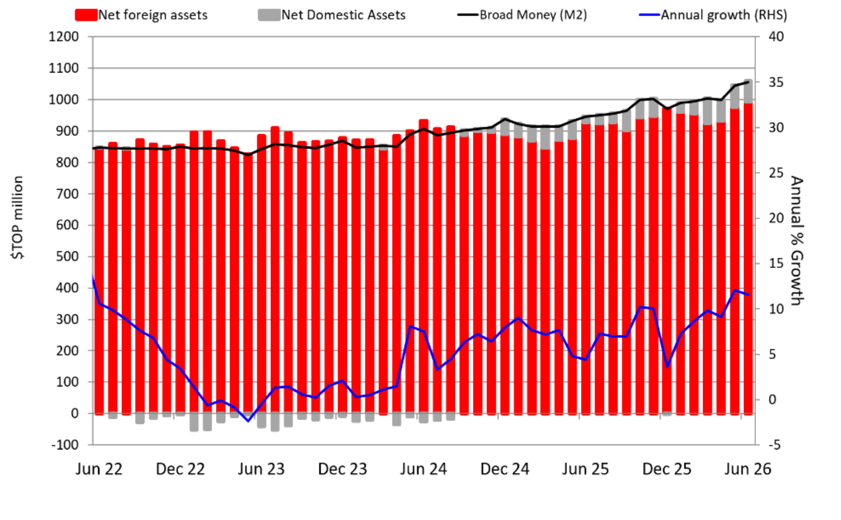
## d. Monetary Sector

The banking system remained stable through June 2026, supported by ample liquidity, strong capital buffers, and sustained profitability. Monetary aggregates reached record levels, reflecting both resilient credit conditions and high liquidity. The issuance of NRBT Notes effectively absorbed excess liquidity while maintaining an environment conducive to lending, which continued to expand across key sectors. Capital positions stayed well above prudential thresholds, accompanied by modest improvements in non-performing loans. Profitability remained firm, with return on equity easing to 12.1%

(from 12.9% in June 2025) and return on assets edging down to 2.0% (from 2.1%), underscoring the resilience of the financial system overall.

**Monetary aggregates reached record highs in June 2026, reflecting strong growth in both broad money and reserve money.** Broad money rose to a new peak of $1,055.5 million in June 2026, increasing by $84.1 million (8.7%) since December 2025 and by $109.5 million (11.6%) over the year. The annual growth was driven primarily by higher net foreign assets, reflecting increased foreign reserves, and further supported by higher net domestic assets through greater holdings of NRBT notes by commercial banks. Reserve money also reached a record of $713.6 million in June 2026, up by $56.9 million (8.7%) from December 2025 and higher by $82.6 million (13.1%) compared to June 2025. This increase was attributed to higher other deposits, currency in circulation, and statutory reserve deposits, which outweighed declines in Exchange Settlement Account balances.

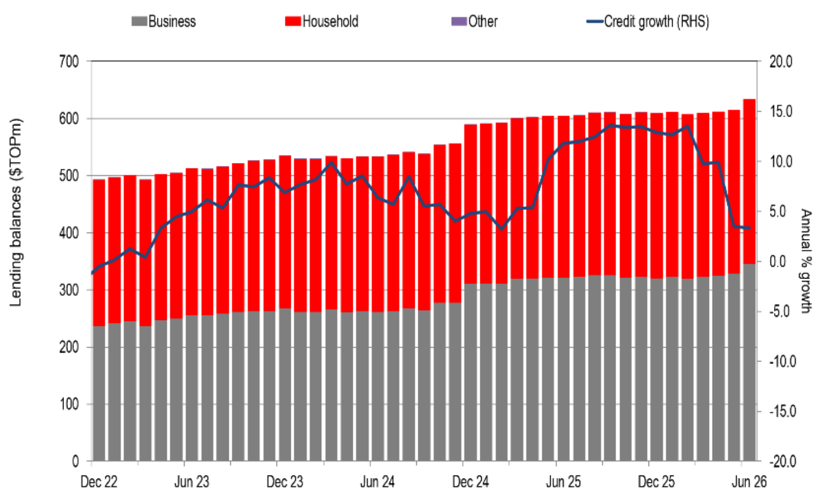
*Figure 10:* **Money Supply**
Monthly




Sources: National Reserve Bank of Tonga, Banking Systems

**Credit growth remained resilient in June 2026, with lending activity continuing to underpin business confidence and economic recovery.** Banks' total lending reached a new peak of $634.5 million in June 2026, recording firm six-month growth of 3.4% ($19.3 million) and annual growth of 4.9% ($29.6 million). The annual expansion was driven by higher business and household loans, including increased lending to public enterprises and

*Figure 11:* **Banks' Lending**




Source: Banking System

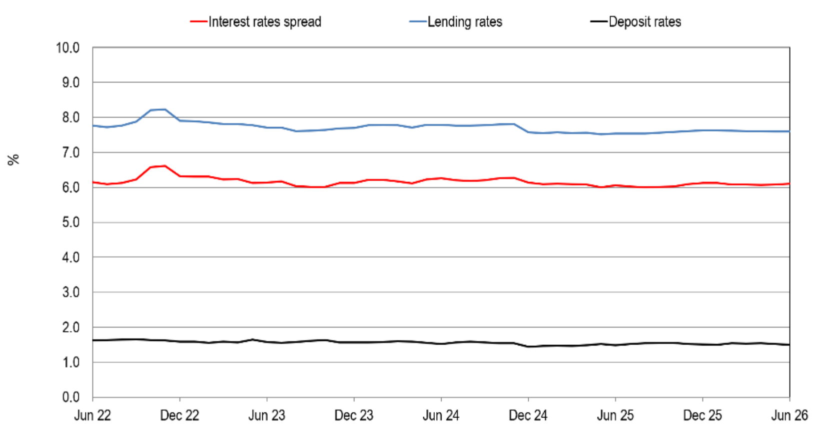
private firms in the agricultural, distribution, and construction sectors. Household credit also rose, led by other personal and vehicle loans. Credit growth has strengthened since December 2025, reflecting sustained lending activity that continues to support business confidence and the broader economic recovery throughout 2026.

While credit growth strengthened and remained resilient at year end, excess liquidity persisted due to limited investment opportunities and an inactive interbank market. This continued to weaken monetary policy transmission, constraining the NRBT's ability to effectively influence interest rates and inflation. The reintroduction of NRBT Notes has played a key role in reducing excess liquidity, though structural constraints continue to limit policy transmission. The issuance of NRBT Notes to commercial banks, initiated in September 2025, reduced excess liquidity from $280 million in December 2025 to $76 million in June 2026.

**Credit growth is expected to remain resilient in the near term, supported by favorable economic conditions and targeted policy measures.** Credit growth is projected to stay firm through the first half of FY2027, underpinned by the ongoing economic recovery and stronger business confidence. Rising investment appetite is anticipated to generate additional employment opportunities, further sustaining demand for credit. Government initiatives to promote private sector development, such as increased allocations for the GDL scheme, already underway, and the issuance of ADB Local Currency Bonds are also expected to reinforce credit expansion. These measures may help absorb excess liquidity in the financial system while supporting stable lending interest rates.

**The weighted average interest rate spread remained stable in June 2026, with only marginal annual narrowing despite sectoral lending pressures.** In June 2026, the weighted average interest rate spread held at 6.1%, narrowing slightly by 2.3 bps over the year, despite a notable widening of 4.2 bps since June 2025. The annual change reflected a 5.2 basis point increase in the weighted average lending rate, which offset the 1.0 bp rise in the weighted average deposit rate. Lending rates rose mainly for private businesses in the professional and other services, manufacturing, and tourism sectors, alongside higher household loan rates across all categories.

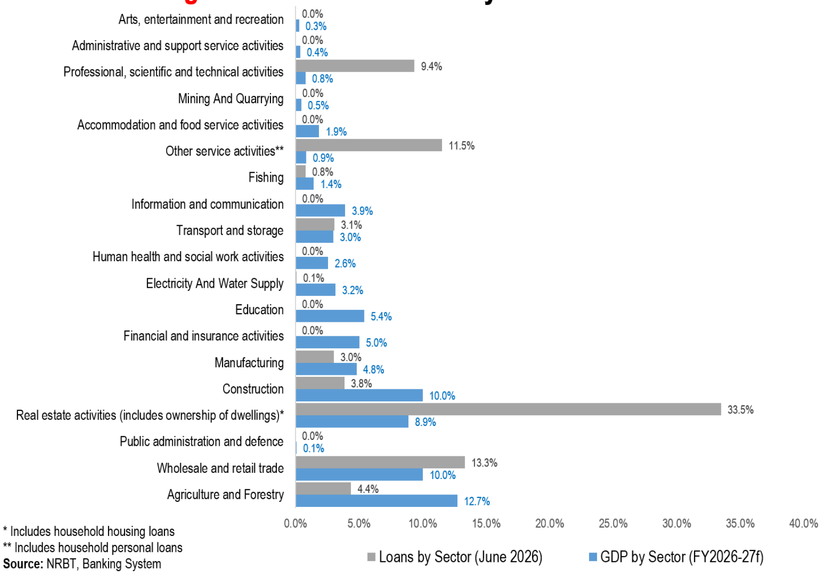
*Figure 12:* **Weighted Average Interest Rate Spread**




**Source:** Banking System

**Although bank lending continues to grow, structural barriers still limit access to finance for key growth sectors.** Agriculture, fisheries, construction, and manufacturing remain underserved due to ongoing issues such as land administration delays, lack of suitable collateral, limited credit history, and high-risk premiums, many of which are beyond the NRBT's direct control. To overcome these challenges, the NRBT works closely with Government agencies to push for reforms that expand credit access, lower borrowing costs, and encourage both local and foreign investment. Key measures include creating concessional lending facilities for specific sectors, introducing a partial credit guarantee scheme with the ADB and IFC, passing the Credit Registry Bill and building an in-house credit registry, along with broader initiatives to support private sector growth.

*Figure 13:* **GDP vs Credit by Sector**

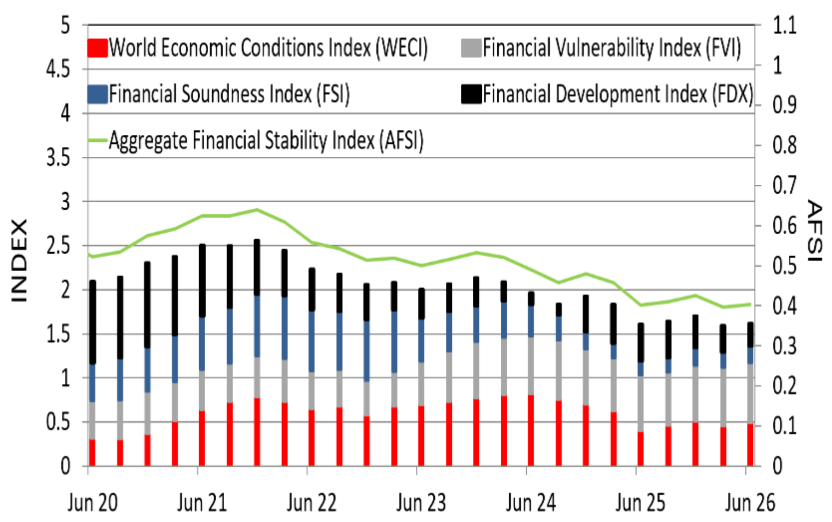



* Includes household housing loans
** Includes household personal loans
**Source:** NRBT, Banking System

**Deteriorating asset quality is still a concern and highlights the need for strengthened supervisory oversight of financial institutions**. The ratio of non-performing loans (NPLs) to total loans eased slightly to 14.3% in June 2026, compared with 14.5% a year earlier. This modest improvement primarily reflects the upgrade of a large exposure following the completion of a 12-month restructuring program, during which adherence to revised contractual obligations was closely monitored. Looking ahead, the NRBT will continue to intensify monitoring of asset quality trends and lending standards to mitigate the build-up of risks within the financial sector.

**Tonga's financial stability remains resilient amid growing pressures from policy uncertainties and global shocks.** The Aggregate Financial Stability Index fell slightly by 0.02 points between June 2026 and December 2025 but recorded an increase of 0.002 points over the year. GDP growth continued to outpace total lending, resulting in weaker outcomes for the Financial Development Index (FDX) which drove the overall decline annually. This decline was further sustained by weaker performance in the Financial Soundness Index (FSI), driven by a higher share of NPL, and aligned with global uncertainties stemming from trade, debt, and energy prices, which lowered the World Economic Conditions Index (WECI). On the other hand, improving Government finances, the current account, and net exports relative to GDP continued to support positive movement in the Financial Vulnerability Index (FVI).

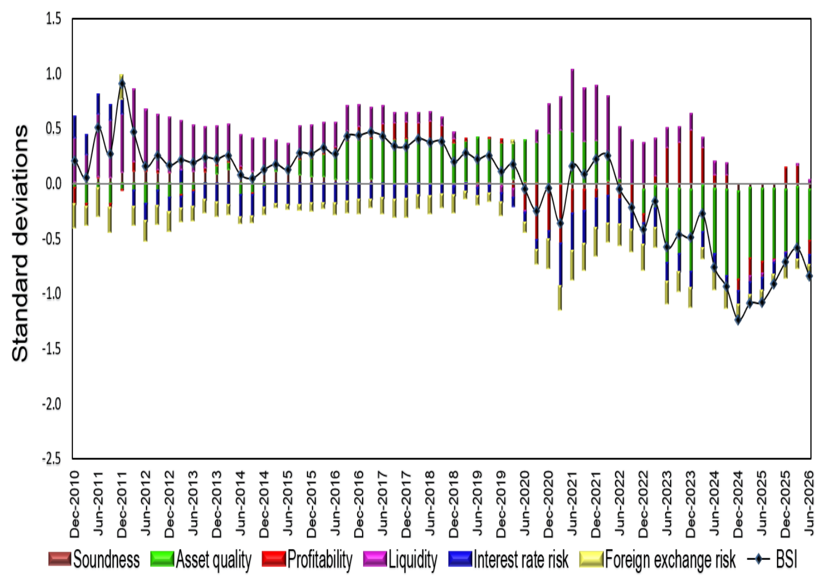
***Figure 14:* Aggregate Financial Stability Index**




Source: Tonga Statistics Department, National Reserve Bank of Tonga, IMF, Chicago Board Exchange

**Tonga's banking stability demonstrated resilience, but vulnerabilities continued.** The Banking Stability Index declined by 0.1 points over the six months to June 2026 but increased by 0.2 points over the year. While asset quality, liquidity and foreign exchange risk showed improvement during the year, capital adequacy, profitability and interest rate risk deteriorated, exerting significant pressure on the sector. These movements indicate that although Tonga's banking system made progress in certain fundamentals,

***Figure 15:* Banking Stability Index for Tonga**




Source: Banking Systems, National Reserve Bank of Tonga vulnerabilities increased, particularly with weaker capital, declining profitability, and increased exposure to interest rate risks.

# Annex 3 Key Challenges to Monetary Policy

Key challenges that are outside of the NRBT's control could potentially deter its efforts over the next six months to achieve its monetary policy objectives include:

- Tonga's high exposure to imported and supply side inflation because of our relatively small size, remote and import dependent economy. The escalation of the Middle East conflict poses downside risks to Tonga's growth outlook and upside risks to inflation, with higher oil prices, geopolitical uncertainty, and supply chain disruptions expected to sustain inflationary pressures and weigh on domestic activity.
- Natural hazards and climate change impacts, particularly those associated with the ongoing El Niño conditions, may adversely affect the primary sector, resulting in weaker agricultural and fisheries output. This will have flow-on impacts to tourism and hospitality services such as catering services, hotels, and restaurants.
- Potential changes in Government priorities that may set back the implementation of scheduled development projects. Such delays or uncertainties could increase our country's risk profile and discourage foreign investment.
- Lack of coordination and delays in structural reforms for private sector development, address supply-side bottlenecks in domestic production and bring down core inflation will leave cost of living at very high levels, while increasing the risk of trapping the economy in low growth trajectory.
- Limited fiscal policy coordination in supporting the effective absorption of excess liquidity and developing the domestic financial market constrains the effectiveness of monetary policy instruments in achieving and maintaining price stability.
- Developing a sufficiently credible transmission mechanism in Tonga through which the adopted monetary policy stance can influence domestic financial conditions, while simultaneously managing imported inflation and safeguarding the exchange-rate peg and foreign reserves remains challenging because of the long period of no sterilization and zero policy signal.
- Tonga remains data-impoverished, with limited availability and regularity of key economic indicators, particularly labour, wages, tourism, and fiscal data. These data gaps constrain the quality of economic analysis, policy formulation, and the effective monitoring and evaluation of policy outcomes.