MONETARY POLICY STATEMENT

August 2025

National Reserve Bank of Tonga

Contents

Background

Over the past six months, Tonga's macro-economic indicators have remained sound. Internal and external monetary stability have been maintained as the financial system remained sound, supported by adequate capital provisions and excess liquidity. The Tongan economy has recovered gradually with improvements observed in sectoral performance and aggregate demand. However, the outlook is full of uncertainties and risks have escalated.

- The global economy has weakened due to the US tariffs and escalating policy uncertainties, slowing down the global disinflation and stressing financial markets;
- Tonga is expected to record growths of above 2% in the near to medium term, continuing to lag behind the world and the region reflecting fragile recovery;
- Headline inflation has dropped below the 5% reference rate while core inflation remains high above 5%, a cause for concern as headline inflation may rebound if food and energy prices take a turn due to global movements;
- Foreign reserves is comfortable but largely dependent on foreign aid and remittances. Declines in growth of our trading partners may have significant impact on balance of payments should remittances and official grants decline. The additional 1% tax on remittances by the US also pose a threat to the level of remittances inflow to the country;
- The financial system remains sound, annual credit growth was healthy at 13.4 percent in line with the economic recovery. At the same time, indebtedness issues are on the rise and non-performing loans are still a concern at 14.1% of total loans;
- Interest rate spread narrowed by 20.4 basis points to 6.1 percent due to a decline in weighted average lending rate from 7.57 percent to 7.55 percent, while weighted average deposit rate increased from 1.44 percent to 1.49 percent.

Given the above, the NRBT Board of Directors has approved that monetary policy moves towards a neutral stance, and to modernise the monetary policy framework. This would ensure the NRBT can be in a stronger position to influence the interest rate channel more effectively when it comes to addressing inflation while at the same time continuing to support economic recovery and fulfill the Bank's multi-faceted mandates.

Monetary Policy Stance

Based on the latest economic developments and outlook, the NRBT will move towards a **neutral monetary policy stance** over the next six months, with the real policy rate projected to be around zero, up from negative territory earlier in the year. The stance will remain data-dependent, with room to ease if growth falters or tighten if inflationary pressures re-emerge. The NRBT remains committed to maintaining price stability, external stability, and financial stability and will continue to gradually modernize its monetary policy framework and operations to achieve its objectives.

In pursuit of its mandate, the NRBT hereby implements the following measures:

1. **New Monetary Policy Interest Rate Corridor.** The NRBT announces that it will now adopt a conventional mid-corridor framework where its policy rate will be the mid-rate of the interest rate corridor (IRC) instead of the floor rate framework it employed in the past.

2. **Policy Rate announcements** by the NRBT will indicate where the policy rate will be and where it is likely to be heading. The standing facilities at the NRBT will be at +/- 200 basis points or 2 percentage points from the Policy Rate. As such the Marginal Deposit Facility (MDF) or interest on the ESA will be the policy rate minus (-) 200 basis points (bps). The Marginal Lending Facility (MLF) or overnight repo transactions will be conducted at policy rate plus (+) 200 bps.

3. **As such, the Interest Rate Corridor (IRC) will be as follows:**
    a. **Policy Rate: 2%** (mid-rate)
    b. **Marginal Deposit Facility (MDF): 0%** (2% - 2% = 0%)
    c. **Marginal Lending Facility (MLS): 4%** (2% + 2% = 4%)

4. **Strengthen the monetary policy transmission mechanism, gradually.**
    a. **Reactivate interbank lending market and enhance liquidity management** by:
        i. Issuance of NRBT Notes at fixed rate full allotment to commercial banks at the policy rate (2%).
        ii. Continuing active consultations with the banks and engage with MOF to enhance NRBT's liquidity management and forecasting framework.
        iii. Maintaining the Statutory Reserve Deposit at 15 percent.

5. **Review the Exchange Rate Policy Framework**.

6. **Strengthen the Communication Framework for improved transparency and outreach.** Strengthen the timeliness, clarity, and accessibility of monetary policy communication to policymakers, market participants, and the public. Measures will

include the regular publication of monetary policy statements and supporting reports outlining the rationale for policy decisions. These steps aim to enhance policy predictability, anchor expectations, and reinforce the credibility of the monetary policy framework.

7. **Enhance coordination between Monetary Policy and Sustainable Fiscal Policy:** Strengthen collaboration with fiscal policy on shared national objectives and strategies, and advance critical structural reforms to improve Tonga's long-term growth potential, optimizing limited resources for timely and efficient policy execution for maximum impact.

8. **Address Financial Deepening Stagnation through rolling out initiatives under the National Financial Inclusion Strategy.** This includes the implementation of a FinTech Regulatory Sandbox Framework for greater Digital Financial Services, passing of a financial consumer protection policy, and project implementations to support micro small and medium enterprises financing and inclusive green financing.

9. The NRBT also acknowledges that there are factors outside of its control that will also have an impact on the conduct of monetary policy. Nonetheless, effort is being made to collaborate with all relevant stakeholders for the achievement of its monetary policy objectives.

The NRBT will continue to push through with the modernisation of its monetary policy tools to better support its monetary policy initiatives to stimulate interbank trading, with a view to align short-term interest rate with the NRBT policy rate, enhance the transmission of monetary policy to commercial banks' lending and deposit conditions, and ultimately overall macroeconomic conditions, in particular inflation. The modernisation of monetary policy tools to build the market infrastructure will also support financial deepening and resilience of the financial system. These measures will enable the NRBT to play a more active role in promoting price stability and macroeconomic growth, supplementing the Government's fiscal expansion.

Annex

Annex 1 – **Review of Monetary Policy**

Continue strengthening the monetary policy transmission mechanism through the modernisation of the Reserve Bank's operations, while closely monitoring internal and external stability.

1. **Monetary Policy Actions:** Since the last Monetary Policy Statement (MPS) – February 2025, the NRBT has progressed with the modernisation of its monetary policy operations through several technical assistance (TA) missions:

- Undertook two TA missions with the IMF MCM[1] to assess the state of the financial system and to work towards adopting a market-based operational framework that is aligned with international best practices.
- Completed its multi-year capacity building program on Forecasting and Policy Analysis System (FPAS) and has implemented the Nowcasting, Forecasting, and Quarterly Projection Models (QPM) into the monetary policy formulation process. As a result, the IMF has published in April 2025 a working paper co-authored with the NRBT on the QPM for Tonga.
- Conducted consultations with the Association of Banks on the need to collaborate in strengthening monetary policy transmission through the interest rate channel.
- Conducted consultations with the Ministry of Finance on how fiscal and monetary policy measures can be better aligned to address macroeconomic challenges such as the high cost of living, weak domestic growth, under-developed financial market, and constraints in access to finance. Supportive policy actions by the Government to date include the proposed consolidation of Government accounts, introduction of the electricity tariff to combat price surges, and continued investments in solar farms to reduce dependence on oil.
- Conducted wider stakeholder consultations with relevant counterparts including Government Ministries and the private sector to better align our respective policies and development strategies to support achieving our common objective of promoting sustainable macroeconomic growth.
- The NRBT participated in National Forums such as the Tourism Summit, National Development Framework Summit and the National Business Conference, raising awareness of the role of monetary policy.
- Launched Tonga's new FinTech Regulatory Sandbox Framework with the support of the Alliance for Financial Inclusion (AFI) to promote innovation of digital financial solutions.
- Maintained the accommodative stance by leaving the interest rate on ESA at zero percent and the Statutory Required Deposit rate at 15 percent.

[1] MCM – Monetary and Capital Markets Division of the International Monetary Fund (IMF)

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

- Headline inflation has eased and remained below the 5 percent reference rate since February 2025, recording 1.4 percent in June 2025. On a 12-month average basis, headline inflation has eased from 8.0 percent in the year to June 2024 to 3.0 percent in the year to June 2025. Meanwhile, core inflation is still persistently high reaching 9.8 percent (June 2025) reflecting sticky prices and excess demand for services.
- Foreign reserves has increased by 0.1 percent ($0.7 million) over the year to $925.1 million in June 2025, equivalent to 10.6 months of imports cover, due to an influx of foreign aid and budget support funds from donor partners. However, the effective exchange rates have slightly declined over the same period as our major foreign trading partner currencies continue to strengthen against the Tongan pa'anga.
- The stability of the financial system is maintained with adequate capital provisions and stable liquidity levels. Excess liquidity in the financial system as measured by commercial banks' balances with the NRBT is still very high, estimated at more than $309 million in June 2025, mostly due to expanding liquidity supply from ongoing inflows of Government receipts for projects and budget support, and remittances, amongst others. The sterilization of the excess liquidity would reactivate the interbank markets and support enhancing monetary policy transmission.
- Annual credit growth was healthy at 13.4 percent in the year to June 2025, in line with the economic recovery. This brings the loans to deposit ratio to 61.5 percent in June 2025 compared to 54.5 percent in the same period last year. However, the high ratio of non-performing loans (NPL) to total loans of 14.1 percent is still above internal benchmarks. Nonetheless, the commercial banks are actively engaging with their customers on workout strategies to return loans to performing status.
- The weighted average lending rate slightly declined from 7.57 percent to 7.55 percent, while the weighted average deposit rate increased from 1.44 percent to 1.49 percent, over the last six months to June 2025. This narrowed the interest rate spread by 20.4 basis points to 6.1 percent.
- The NRBT projects a real GDP growth of 1.8 percent for FY2023-24 (upgrade from 1.6 percent) and 2.6 percent for FY2024-25 (unchanged from February 2025 MPS).

3. **Outlook:**

- Inflation is projected to remain below the 5 percent reference rate in the near term, in line with the global disinflation and improved domestic food prices. Core inflation remains sticky and will take longer to adjust to market rates. The estimated fiscal budget deficit may induce some demand side inflationary pressures in addition to the tight labour conditions. However, subsidies aimed at reducing cost of living will also counter some of the inflationary pressure. Global trade tensions and supply chain disruptions continue to pose risks to the inflation forecast as core inflation remains high.

- Foreign reserves are projected to remain comfortably above the recommended level of 7.5 months of imports in the near term, supported by steady inflows of budget support, official grants, and remittances. Meanwhile, import payments are expected to rise in line with the economic recovery. New policies in the US on tariffs and remittance tax will have implications on the Tongan economy through the exchange rates, remittance receipts, and imported inflation. On the other hand, the depreciation of the USD may benefit importers and foreign exchange borrowers.
- Positive credit growth is anticipated in the short run, in line with the accommodative monetary policy and Government initiatives for private sector development and access to finance. Vulnerabilities to asset quality continue to be managed through effective oversight and prudent management measures.
- The anticipated issuance of NRBT notes is expected to mop up the excess liquidity in the financial system and revive the interbank market. Market indicates a pass through of the policy rate to deposit rates and thereby narrowing the interest rate spread, while lending rates are more stable.
- A stronger GDP growth is forecasted for FY2025-26, underpinned by construction projects and continued recovery in the agriculture and tourism sectors. The NRBT projects a real GDP growth of 2.5 percent for FY2025-26 (up from 2.0 percent in February 2025 MPS). The Government's focus on private sector development is also expected to boost investment and consumption. The Tongan economy is expected to lag behind the ADB's projection for the Pacific regional growth of 3.9 percent and 3.5 percent for 2025 and 2026, respectively.
- Despite the strong push from the Government for the roll out of infrastructure projects and private sector development, capacity constraints and tight labour conditions will continue to restrain project implementation and sectorial expansions. The weaker global growth, uncertain trade developments, and vulnerability to climate change are significant downside risks to the outlook. The weakening global growth may also have spillover effects on the economy due to our heavy reliance on foreign aid and imports.

4. Monetary Policy Challenges:

As mentioned in the February 2025 MPS, the non-responsiveness of the market to monetary policy has been a long-standing challenge for the NRBT due to the underdeveloped domestic market and the persistent excess liquidity in the financial system. As a result, the interest rate channel for monetary policy is ineffective. However, addressing the impact of market non-responsiveness on the monetary policy transmission mechanism is not an easy task and will require effective collaboration with fiscal policy. Some of the challenges for monetary policy are:

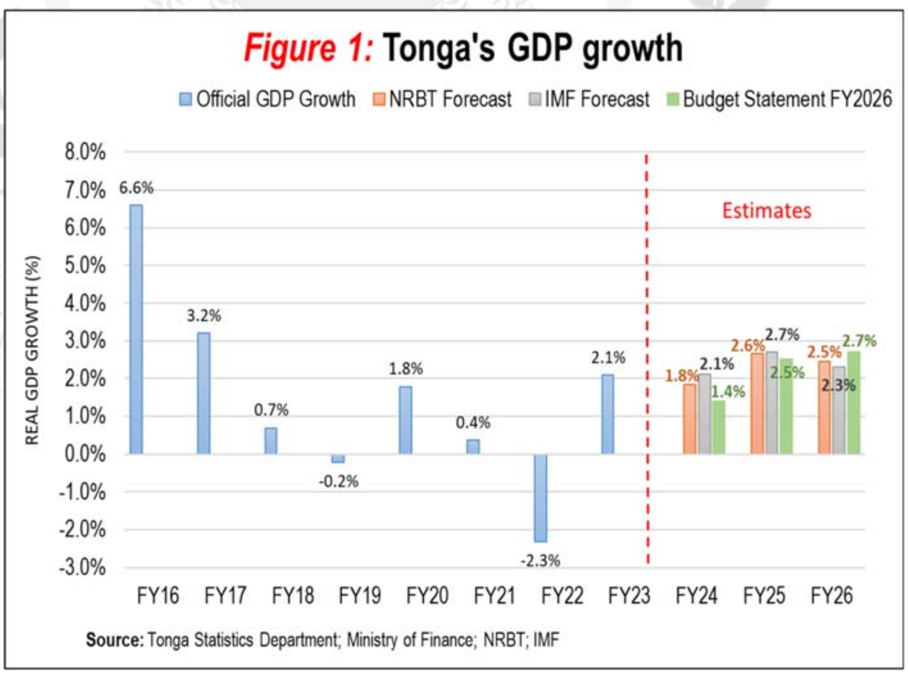
- **Large influx of official project funds and a track record of slow implementation contributes to the excess liquidity.** Some of the donor funds earmarked for Government infrastructure projects deposited at the commercial banks contributes to the excess liquidity in the financial system. It also adds on to the banks' funding costs resulting in lower deposit rates.
- **The underdeveloped domestic market and lack of investment opportunities are the main reasons for capital outflows.** Government bonds is the only fixed income investment instrument available other than bank deposits. However, these bonds are issued only at the primary market and at irregular intervals. These bond issues are usually over-subscribed reflecting the excess demand in the market.
- **Monetary Policy instrument adopted such as adjusting of the Statutory Reserve Deposit (SRD) requirement, is blunt and has limited impact on the level of interest rates in the economy and ultimately price stability.** Tonga is a net importer and a price taker, leaving little room for monetary policy to impact prices through the exchange rate channel, while the interest rate channel is inactive. The impact of monetary policy on inflation is lagged and cannot address supply side constraints which often is the driver of inflation in Tonga.
- **Fiscal dominance in the Tongan economy emphasize the need for policy coordination.** Although the autonomy of the NRBT in the design and implementation of monetary policy must be upheld, the context of the Tongan economy does require coordination with fiscal policy for its success. Fiscal policy is more effective in addressing supply side drivers of inflation, and the development of the domestic market requires active participation and collaboration with Government authorities.
- **The conduct of monetary policy is complex and often misunderstood.** The fast-evolving financial landscape is complex and requires effective communication across different levels of stakeholders to prevent policy misalignment and ensure effective implementation. Monetary policy also has an important role in signaling market behavior and providing forward guidance.
- **The cost of monetary policy.** Accumulated excess liquidity in the financial system over the years is high, at more than $300 million. Issuing NRBT notes to mop up the banks' excess liquidity will be costly, but is necessary for the interbank market to be reactivated and the interest rate corridor to be more effective in aligning short-term rates with the NRBT policy rate.

Annex 2 - Economic and Financial Developments

a. GDP Growth

Tonga's economic performance is gaining momentum, fueled primarily by Government-led development efforts and expected growth across both formal and informal segments of the private sector. The NRBT GDP growth estimate for FY2024 was slightly revised to 1.8%, while the growth forecast for FY2025 remains largely unchanged at 2.6% since the Monetary Policy Statement (MPS) February 2025. Although major public projects faced delays due to resource constraints and changes in the Government administration, some were successfully completed in FY2025, including the Tonga High School Sports Complex, the wind power project, Tonga Climate Resilient Project, to name a few. At the same time, spillover effects from major events hosted locally have stimulated activity across other sectors, while household demand and consumption remained strong, supported by rising remittance inflows.

Key indicators in the services sector mostly trended upward in FY2025. Both the public and private sectors hosted events throughout the year, generating spillover effects that extended to trade, transport, accommodation & restaurants, entertainment, communication, and recreational sectors. These events include the Pacific Islands Forum (PIF) Leaders' meeting, Pacific Week of Agriculture and Forestry, church annual conferences, among others. Evidently, container registrations rose by 110 containers (0.9%) in FY2025 due to higher business containers, highlighting strong momentum in the services sector alongside positive developments in the construction sector. Coincidently, total import payments excluding oil rose by $40.8 million (7.6%), along with higher wholesale & retail import payments of $8.0 million (2.1%). Consequently, these major events also induced travel-related income for the economy, reflected in higher travel receipts recorded in FY2025 by $31.4 million (21.5%).



Activities in the industrial sector trended favorably during FY2025. Construction sector indicators have improved compared to FY2024, demonstrating progress in existing projects alongside new major ones. Construction import payments rose by $12.1 million (32.9%) in FY2025, aligning with the increased construction permit applications of $72.6 million (45.8%). Meanwhile, lending to the construction sector rose by $0.2 million (1.2%), while credit for individual housing rose by $9.4 million (4.6%). The utilities sector also showed favorable trends. Between July 2024 and April 2025, electricity consumption rose by 4.6 million kWh (7.3%) compared to the same period in FY2024, along with increased consumers of 120 (0.4%). Total electricity production also rose by 5.1 million kWh (7.6%). The rise in electricity metrics may also be attributed to the Tapanekale Housing programs, the HTHH reconstructions efforts, and the individual housing projects.

Outcomes in the primary sector showed improvement in FY2025 compared to FY2024. This may indicate the combined effect of recovery and development efforts implemented throughout the year, supported by favorable weather conditions. Total agricultural export volumes increased by 675.5 tonnes (9.8%) in FY2025, while total agricultural export receipts increased by $0.6 million (10.3%). Agricultural product volumes in domestic markets rose between July 2024 and March 2025 compared to the same period in FY2024, aligning with an annual decline in local food prices. In June 2025, local food prices declined by 0.6% compared to June 2024. This also indicates increased marine products surveyed in domestic markets, despite a 35.6% (608.7 metric tonnes) drop in exports compared to FY2024. Squash exports, which used to be one of Tonga's major commercial exports, is notably absent from the sector. Nonetheless, growth in the primary sector remains prone to natural hazards, labour shortage, and accumulated high costs of production.

Skill mismatches remain a concern in Tonga, alongside labour shortages from labour mobility schemes. While more emigration opportunities are being rolled out, domestic workers continue to be drawn to the labour mobility schemes due to the significantly higher earnings they offer compared to local wages in Tonga. In the meantime, the Government is committed to investing in education and training programs to bridge the gap between workforce skills and labour market demands. According to the Reserve Bank's survey on job advertisement, total vacancies of 855 were advertised during FY2025. Majority of the job vacancies advertised were from public administration, transport & communications, financial intermediation, and business services. This figure does not capture labour demand within the informal sector, which could be a substantial share of the workforce.

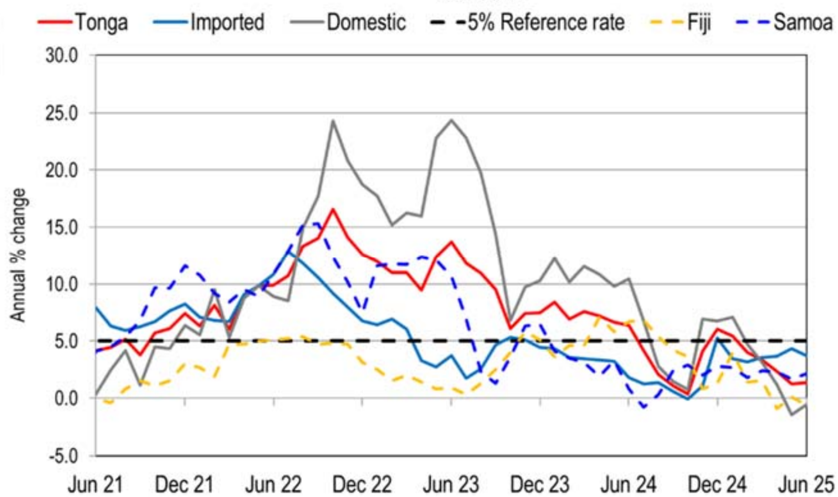
The NRBT is projecting a growth of 2.5% for FY2025-2026, an upward revision from 2.0% in the MPS February 2025. The Government emphasized its strong commitment to development in the FY2026 Budget Statement, with about 39% allocation to development initiatives. Key initiatives include the Fanga'uta Lagoon Bridge, Tonga Resilience Climate Project II, Fua'amotu Airport Upgrade, the bio-gas production project, among others. Key risks to the outlook include any further political changes that may cause delays to these projects, such as the upcoming general election in November 2025. Unfavourable weather conditions including the upcoming cyclone season, weak global growth, and geopolitical trade tensions are also downside risks to the forecast.

Key structural reforms to unlock growth potential are critical to reverse the economy's growth trajectory. Both fiscal and monetary policy need coordinated efforts to address the high cost of living, stabilize prices, remove restrictive barriers to investment, and manage the availability of resources for production. Institutions must be equipped with the necessary tools and means to deal with Tonga's geographical barriers, impacts from climate change, modernization, and uncertainties that come with globalization. Fostering an environment that is stable and resilient, with effective risk management, while conducive to investment is crucial for boosting of economic growth towards a stronger development path.

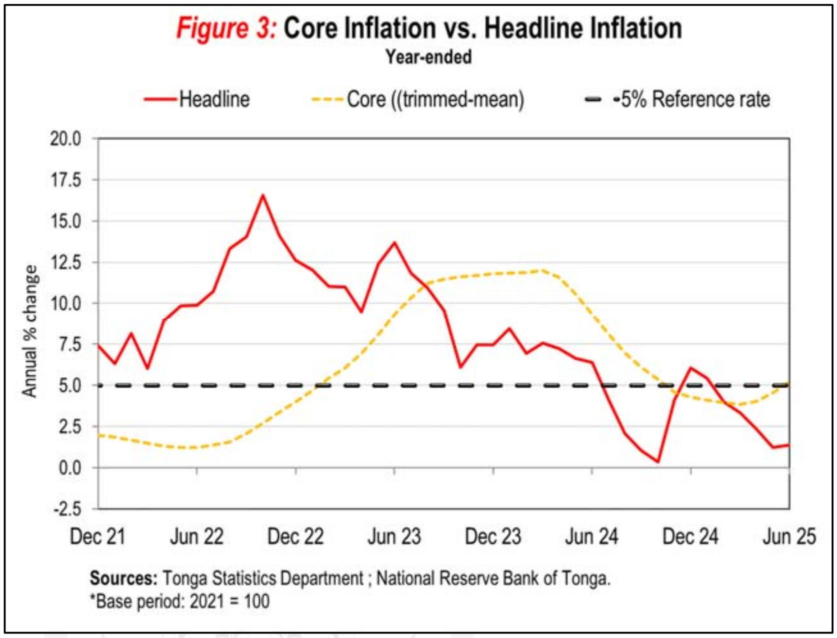
b. Inflation

Tonga's new-base-year headline inflation remained below the 5% reference rate since the February 2025 MPS. Headline inflation reached a low of 1.2% in May 2025 and settled at 1.4% in June 2025. The moderation in headline inflation is due to favourable energy and local food prices which comprise about 29% of the new CPI basket. Nonetheless, cost of living remains persistently high, reflecting the cumulative impact of past inflation hikes and the heightened volatility of global commodity prices amid ongoing geopolitical tensions among major developed economies. In the meantime, Tonga's geographical remoteness and vulnerability to uncertain global conditions, have contributed to prices being sustained at high levels. On the other hand, the increasing inflow of remittances also helped to maintain strong levels of spending and consumption. Headline inflation averaged at 3.0% by the end of FY2025, a substantial decline from 8.0% in FY2024. However, this is slightly higher than the 2.6% and 2.3% averages in Fiji and Samoa, respectively.

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



Source: Tonga Statistics Department
* Base period: 2021 = 100



Imported inflation now exceed domestic inflation, reflecting the increased market volatility amid geopolitical and trade tensions. Imported inflation is now at 3.7% in June 2025, higher than the 1.8% recorded in June 2024. The annual rise in imported prices was largely driven by increases in food and non-alcoholic beverages, goods for personal care, clothing & footwear, furnishings & household items, and purchase of vehicles. These increases were partially offset by lower prices for fuel, and gas & other fuels, reflecting favorable movements in international prices and exchange rate against the US dollar. In July 2025, Brent Crude Oil prices averaged at US$69.27/barrel, compared to US$83.93/barrel in July 2024. Despite the ongoing wars, global oil supply remained relatively favourable, and softened global demand as a result of the US tariff retaliations, have helped ease pressure on oil prices. However, Tonga's imported inflation remains highly prone to potential impacts from US tariffs on commodity prices and freight costs. On an annual average basis, imported inflation was 2.6% in June 2025, down from 3.6% in June 2024.

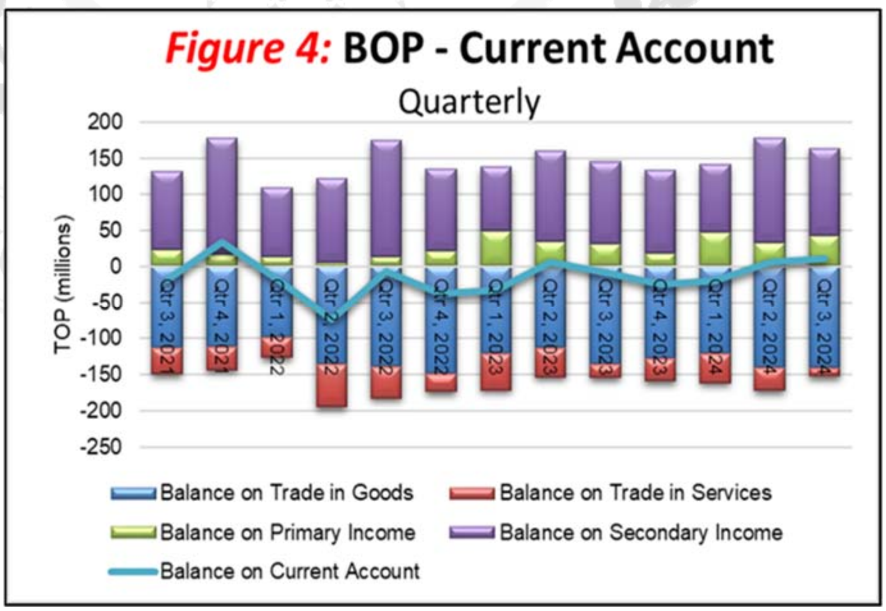
Domestic prices continue to ease, reflecting improved local food supply and pass-through of favorable energy prices. In May 2025, domestic prices recorded its lowest growth of -1.4% since the -1.3% in May 2021. Domestic prices was at -0.6% in June 2025, supported predominantly by lower local food prices. Most prices of root crops, vegetables, and fruits have declined compared to June 2024, reflecting improved harvests in addition to recovery and development efforts in the sector, and favourable weather conditions. Under the new rebase, prices of food and beverage serving services now have the second highest weight among domestic items and are expected to move in line with local food prices provided that local supply conditions remain favourable over time. Meanwhile, prices of other goods and services are more persistent, indicating their susceptibility to global inflation trends. On average, domestic prices increased by 3.3% in June 2025 lower than 12.4% in June 2024.

On the outlook, the baseline forecast projects inflation to rise at times during the second half of 2025, while remaining below the 5% reference rate. Potential risks to the outlook exist, however the extent of their impact is uncertain. Policy uncertainties and geo-political tensions risk reigniting inflationary pressures that will pass through import prices to Tonga's inflation. While local food supply and prices have shown signs of recovery, production and harvests remain vulnerable to natural hazards (i.e. upcoming cyclone season in November). A resurgence in demand in the near term (i.e. Christmas holiday season and fiscal expansion) is expected to further contribute to the upward inflationary trend in 2025, though this impact is seasonal and therefore transitory in nature.

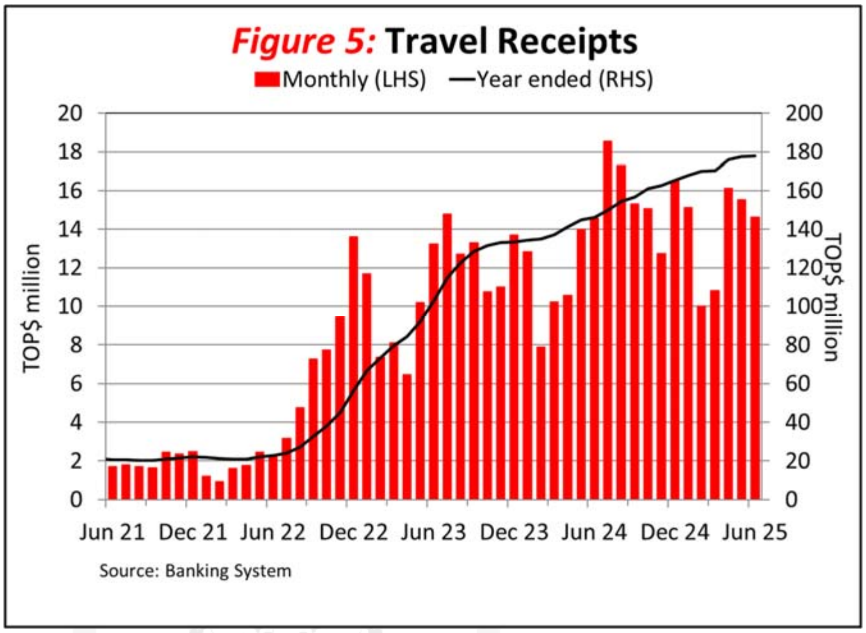
The Reserve Bank is currently undertaking initiatives to modernise its monetary policy tools to strengthen transmission in pursuit of its price stability objective. Concurrently, monitoring the development in both the international and domestic economies will continue, to ensure that any potential pass-through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

c. External sector

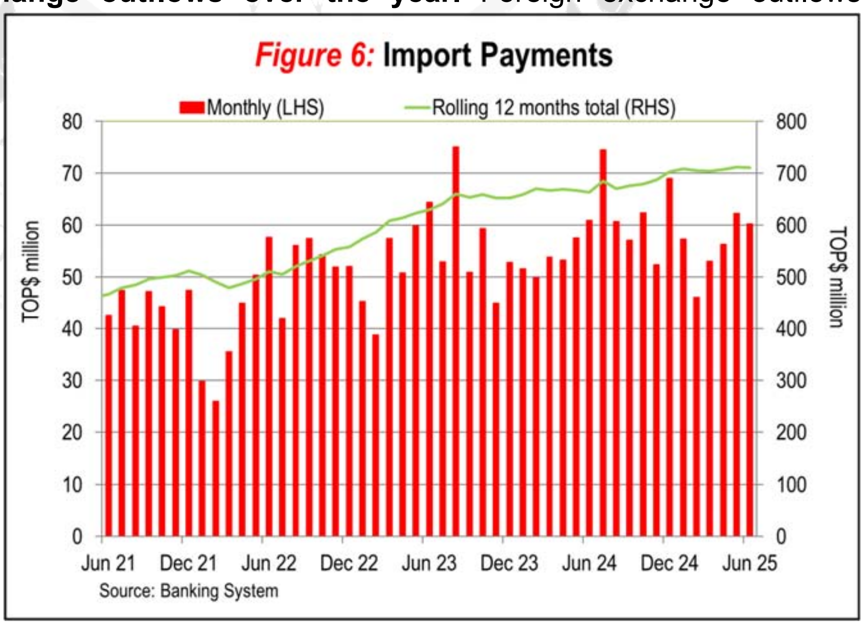
According to the latest Balance of Payment report released by the Statistics Department – Quarter 3 2024, Tonga's current account deficit has narrowed substantially by 61.7% to $27.9 million over the year to September 2024. This improvement was mainly due to the higher positive balances in the primary and secondary income accounts of 4.4% and 7.1%, respectively. This reflects higher inflows of foreign aid and remittances over the year. Additionally, the trade deficit declined over the year (1.1%), contributing to the reduced current account deficit. This stems from the strong rise in service credits (23.5 percent), particularly travel receipts, which outweighed the rising imports (1.0%). Tonga's Balance of Payment position continues to be defined by the country's reliance on imports relative to a narrow export base, remittance, and foreign aid. Consequently, these are also the key sources of vulnerability to external shocks that can significantly impact inflation and economic growth.



The NRBT also monitors the following high-frequency performance indicators sourced from its Overseas Exchange Transactions (OET) data, to assist with the assessment of the external sector.



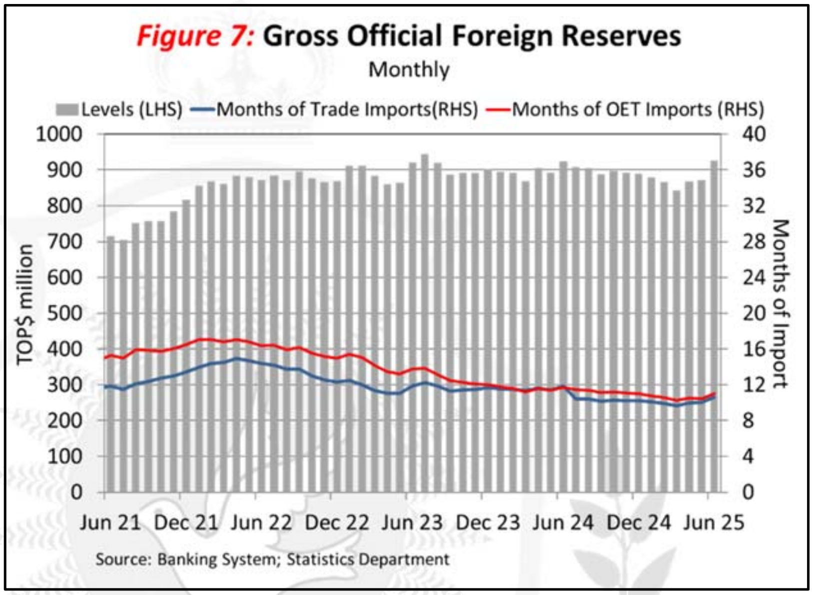
Foreign exchange inflows increased by 14.9% over the year to June 2025, attributed to higher receipts from financial transfers, travel and services. Inflows of financial transfers increased by 54.6% to $188.9 million over the year to June 2025, attributed mostly to interbank transfers and foreign investments. Travel remained upbeat, with receipts increasing firmly by 21.5% over the year to June 2025, supported by annual church events and holiday festivities. Inflow of receipts from services increased also underpinned by higher receipts specifically from professional & management, computer and telecommunication services. Inflow of development fund for non-profit organizations also continued to support foreign exchange inflows. Remittances rose 3.7% over the year, reflecting higher receipts for the annual church events and holiday festivities. Export receipts increased also over the year by 1.2% largely from agriculture and other exports, reflecting favourable performances in the sector during the year.



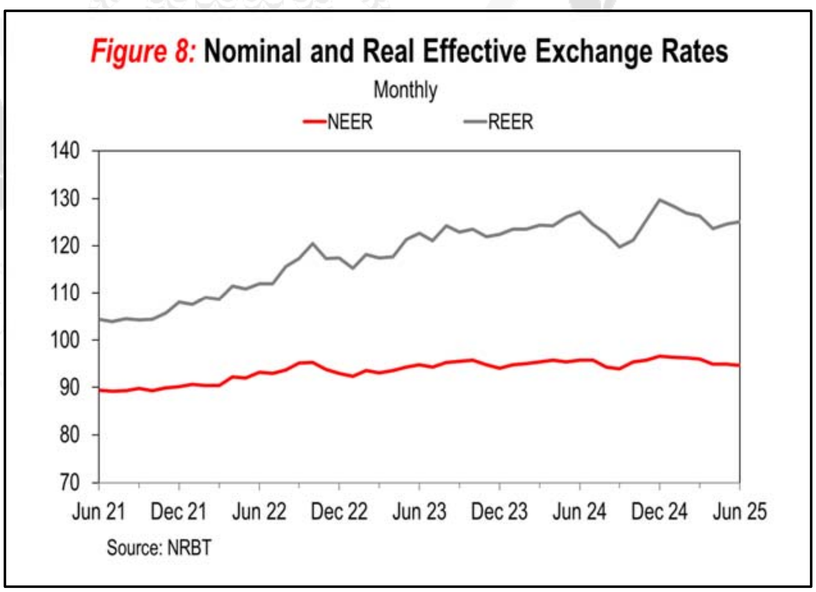
Payments for imports of goods and services, and portfolio investments drove the higher foreign exchange outflows over the year. Foreign exchange outflows increased by 10.3% in the year ended June 2025, predominantly due to consistent increases in payments for the imports of goods and services coupled with the rise in outflows for portfolio investments (offshore investments). Import payments increased by 7.2%, mostly for construction materials and other imports (mostly Government).

d. Foreign Reserves

Foreign reserves level has remained above adequacy thresholds, supporting Tonga's external stability. Nonetheless, signs of increasing capital flight are emerging as reflected in the rising offshore investments. Tonga's official foreign reserves remained sufficient in June 2025, with an equivalent of 10.6 months of imports, well above the IMF prescribed level of 7.5 months of imports, and the NRBT's minimum threshold of 3 months of imports cover. Foreign reserves were 0.1% (T$0.7 million) higher than in June 2024, recording $925.1 million. This owes to the substantial inflow of budgetary support and official grants over the year.



Tonga's effective exchange rates have weakened against most of it its major trading currencies during the review period. The Nominal Effective Exchange Rate (NEER) depreciated by 2.0% over the last six months to June 2025 as the TOP weakened against some of its major trading partners' currencies such as the NZD, AUD, FJD, JPY, EUR and CNY. The Real Effective Exchange Rate (REER) declined by 3.6% during the same period, in line with Tonga's relatively lower inflation rate. This may indicate a gain in Tonga's trade competitiveness. Similarly over the year, both the NEER and REER decreased by 1.2% and 1.6%, respectively.



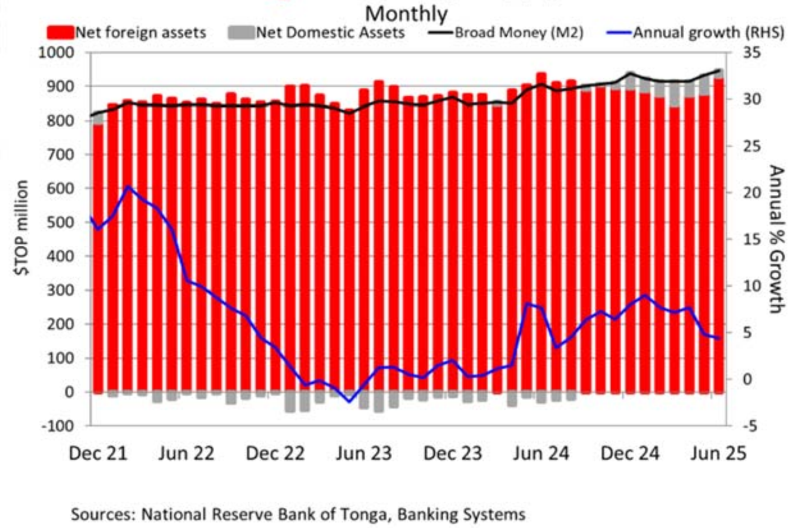
Foreign reserves is expected to gradually decline as import payments and scheduled debt repayments eventuate, but still remain at adequate levels. The Reserve Bank continues to prioritise safeguarding of foreign reserves to maintain external stability and facilitate international trade. Import payments is expected to increase for the ongoing public infrastructure projects, offshore investments, and debt servicing obligations, including the repayment of the Export – Import Bank of China (EXIM) loan. This may continue to exert pressure on foreign reserves in the near to medium term. Remittances is expected to ease in the near term following the end of the celebratory months and local celebration, partially offset by the anticipated increase in travel receipts as the recovery in the tourism industry continues. Cost of living pressures, weak global growth, and policy uncertainty in major source remitting economies, such as the proposed US tax on remittances, may also weaken remittance flows.

e. Monetary Sector

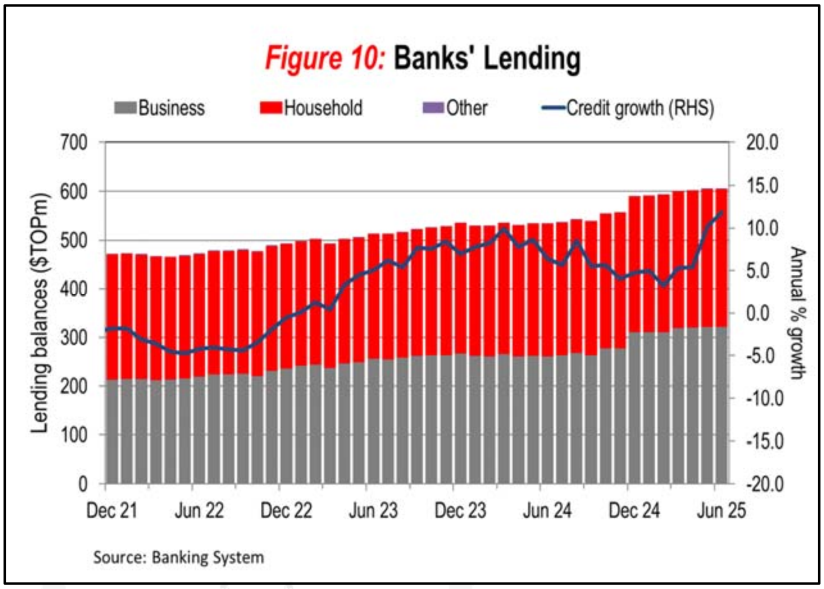
The banking system remained sound, supported by high liquidity and adequate capital positions. Over the 12-month period to June 2025, the banks remained profitable and well capitalized, with excess liquidity to meet demand for credit. However, the persistently high level of non-performing loans remains a concern for the Reserve Bank. However, systemic risks are contained, while commercial banks are actively engaging in workout strategies with their customers to return non-performing loans to performing status. The return on equity for banks was estimated at 9.1% in June 2025 (compared to 9.8% in June 2024), and the return on assets was 2.2% (compared to 2.5% in June 2024).

Money supply continued to expand on the back of higher net domestic and foreign assets. In June 2025, money supply rose by $8.4 million (0.9%) from December 2024, and $39.8 million (4.4%) from June 2024, to a new peak of $945.8 million. The annual rise was a result of higher net domestic assets, mainly on increased credit to private sectors, as well as net credit to both non-financial corporations and central government. On the other hand, the net foreign assets decreased, as a result of lower liabilities over the year. Reserve Money however, declined in June 2025, decreasing by $1.0 million (0.2%) from December 2024 and annually by $0.8 million (0.1%) to $631.0 million. The Exchange Settlement Accounts fell over the

***Figure 9:* Money Supply**

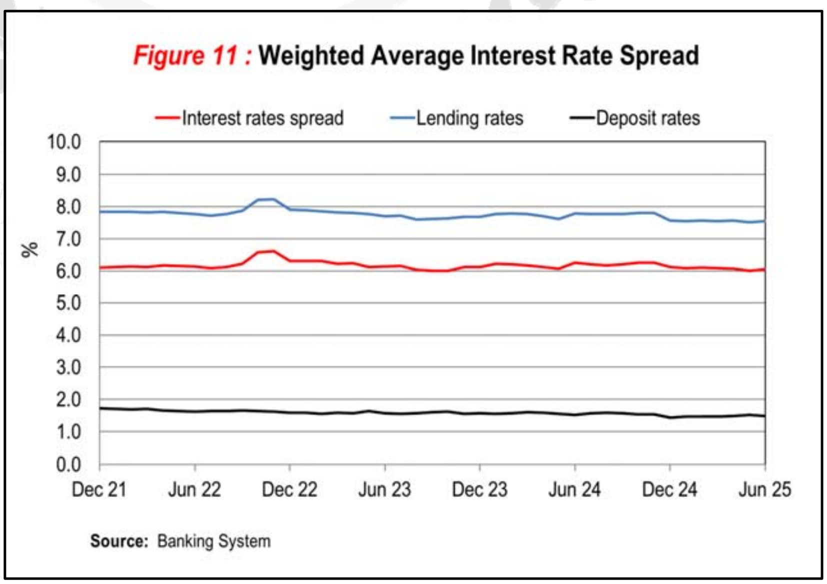


Sources: National Reserve Bank of Tonga, Banking Systems year and outweighed the increases in Statutory Required Deposits (SRD) and Currency in Circulation. The higher withdrawals from the Reserve Bank vault contributed to the lower ESA whilst the rising deposits and higher demand for local currency supported the increases in SRD and CIC.



Credit growth rebounded strongly in June 2025, increasing by 2.6% from December 2024 and 13.4% from June 2024. The higher loans over the year were mainly for public enterprises and private businesses within the professional & other services, distribution and tourism sectors. All categories of household loans also increased over the year, led by higher housing loans. Despite the strong credit growth, excess liquidity in the banking system remained high in June 2025, estimated at $309 million. Lack of investment opportunities resulted in excessive term deposits in the banking system relative to the uptakes of new credit. In addition to the inactive interbank market, the persistently high level of excess liquidity continued to affect the effectiveness of the monetary policy transmission and the ability of the Reserve Bank to influence interest rate and thereby inflation.

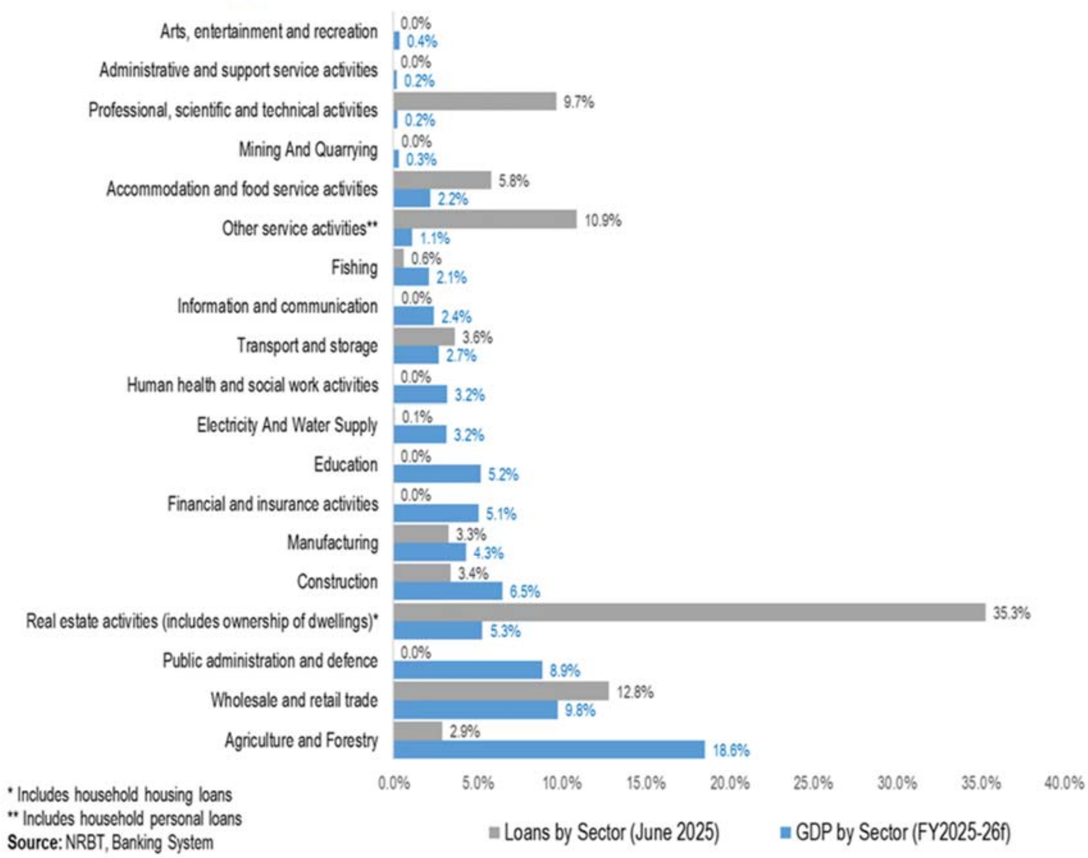
The weighted average interest rate spread narrowed, supported by lower lending rates for non-profit organisations and households. The weighted average interest rate spread declined over the past six months to June 2025 by 7.3 basis points, and over the year by 20.4 basis points to 6.1%. The annual decrease was underpinned by a 24.1 basis points decline in the weighted average lending rate offsetting the 3.7 basis points fall in the weighted average deposit rate. Lower lending rates were



offered primarily to non-profit organizations and all sectors of household loan rates. In addition, the loan rates offered to public enterprises and businesses such as utilities, fisheries and tourism sectors also declined. On the other hand, the time deposit rates solely declined and outweighed the increases in both saving and demand deposit rates.

Despite the strong credit growth, critical growth sectors are still underserved. Few growth sectors of the economy are still underserved such as agriculture, fishing, construction and manufacturing. Land administration delays, limited eligible collateral, lack of credit history, and high risk premiums are the main barriers for access to finance by these sectors, most of which are outside of the Reserve Bank's control. Nonetheless, the Reserve Bank continues to advocate for collaboration with responsible Government agencies to undertake these structural reforms that will facilitate greater access to credit, lower the cost of borrowing, and encourage investment both locally and from abroad. Some of these initiatives include the establishment of a sector-specific concessional lending facility, partial credit guarantee scheme, enactment of the Credit Registry Bill and development of the in-house credit registry, and promoting private sector development.

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



Elevated vulnerabilities to asset quality warrant enhanced supervision of financial institutions. Non-performing loans to total loans ratio has increased to 14.7%

in June 2025, from 11.5% in June last year. The higher non-performing loans were mainly in the construction sector as banks roll back their loan moratoriums for Covid-19 and HTHH.

Positive credit growth is expected to continue in the near term. Positive credit growth is expected to continue in FY2026. This is in line with the projected economic recovery and the improved business confidence and investment appetite, thereby creating more employment opportunities. Government initiatives for private sector development such as the increased allocation for the Government Development Loans and the ADB Local Bond issuance also support the positive credit growth outlook. This could also assist with the absorption of excess liquidity in the financial system, and maintaining stable lending interest rates.

f. Key Challenges

The Reserve Bank will prioritize its primary objective of maintaining internal and external stability, through the strengthening of its monetary policy transmission. Nonetheless, the NRBT identifies the following key challenges that are outside of its control, but could potentially deter its efforts over the next six months:

- Weakening global growth and escalating uncertainties from geopolitical tensions trade developments, and migration can have significant spillover effects on small vulnerable states like Tonga, through the exchange rates, imported inflation, foreign aid inflows, and remittances.
- Climate change impacts and extreme weather conditions resulting in poor outcomes for the primary sector.
- Potential changes in Government administration and the upcoming general election can affect implementation of scheduled development projects and government priorities. Such delays or uncertainties could increase our country risk profile and discourage foreign investment.
- Delays in structural reforms required for private sector development risks trapping the economy in low growth trajectory.
- Lack of coordination and structural reform to address supply-side bottlenecks in domestic production and bring down core inflation will leave cost of living at very high levels. Persistently high cost of living pressures not compensated with wage growth reduces households' purchasing power and overall standard of living.
- Limited collaboration from fiscal policy for the effective mop up of excess liquidity, and the development of the domestic market threatens the effectiveness of monetary policy tools in achieving price stability.
- Tonga is data impoverished. Lack of available and regular data on key economic indicators such as labour, wages, tourism, and fiscal data restrains quality analysis and thereby policy recommendations and evaluation.

Annex 3 - **Monetary Policy Objectives**

The Reserve Bank's principal objectives as laid out in Section 4 of the National Reserve Bank of Tonga Act, shall be to:

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

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 promote price stability and maintain an adequate level of foreign exchange reserves 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 and foreign aid, narrow export base, its small size, remoteness, 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 50A of the National Reserve Bank of Tonga Act;

1) The Bank shall, at least every six months, publish a Monetary Policy Statement and submit a copy to the Minister.
2) The Statement in subsection (1) shall contain -
   a) 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 this 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.
3) The Minister shall submit this monetary policy statement to the Legislative Assembly and Cabinet as soon as practicable.