NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

August 2021

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List of abbreviations

AML	Anti-Money Laundering
APR	Annual Percentage Rate
AUD	Australian Dollar
CFT	Counter-Terrorist Financing
CNY	Chinese Yuan
COVID-19	2019 Novel Coronavirus
EXIM	Export-Import
FEC	Foreign Exchange Control
FEDs	Foreign Exchange Dealers
FJD	Fijian Dollar
GBP	Great Britain Pound
GDP	Gross Domestic Product
IMF	International Monetary Fund
MAFFF	Ministry of Agriculture, Food & Forests and Fisheries
MPS	Monetary Policy Statement
MSME	Micro Small and Medium Enterprises
NBFIs	Non-Bank Financial Institutions
NEER	Nominal Effective Exchange Rate
NRBT	National Reserve Bank of Tonga
NZD	New Zealand Dollar
OET	Overseas Exchange Transactions
OPEC	Organization of the Petroleum Exporting Countries
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
RCF	Rapid Credit Facility
REER	Real Effective Exchange Rate
RFB	Retirement Fund Board
ROA	Return on Assets
ROE	Return on Equity
RSE	Regional Seasonal Employees
SPBD	South Pacific Business Development
SWP	Seasonal Worker Program
TC	Tropical Cyclone
TOP	Tongan Pa’anga
UK	United Kingdom
US	United States
USD	United States Dollar
WEO	World Economic Outlook

Overview

Recent Development

The Reserve Bank reviewed Tonga's economic growth outlook based on the latest real sector indicators available. A deeper contraction of 2.5% is anticipated for FY2021 compared to the 2.0% official forecast in the February 2021 MPS. The downgrade is mainly due to weaker than expected outturns, mostly in the primary and industry sectors. Additionally, the recent outbreak of the Delta variant in neighbouring countries further affected logistics, travel, and trade, derailing recovery in tourism and trade activities.

The IMF, in its October 2021 WEO, slightly revised global growth down to 5.9% from 6.0% in the April 2021 WEO. The slight revision stems mostly from disruptions to global supply chains and trading performances. However, global economic growth is expected to moderate at 4.9% in FY2022 compared to 4.4% in the previous WEO.

The Reserve Bank continued to maintain its accommodative monetary policy stance throughout the six months to August 2021. Negative impacts of the global pandemic are considered in reviewing the Reserve Bank's stance to counter these adverse economic effects.

The annual headline inflation rose above the Reserve Bank's reference rate of 5.0% during the six months to August 2021. The rebound in global oil prices and the rising imported food prices were the main drivers of the higher inflation. Disruptions to shipping schedules and logistics will further affect inflation, which is evident in the latest annual headline inflation rate of 7.0% as of the end of August 2021.

Gross official foreign reserves reported a record high level of $751.7 million, equivalent to 13.1 months of imports cover, well above the minimum threshold of 3 months. Large inflows of donor funds, budget support, grant, remittances, and other financial assistance for the COVID-19 preparations and TC Harold assistance continue to buttress these significant movements.

The financial system remained sound during the six months to August 2021. This was reflected through banks' strong capital position, excess liquidity, and low levels of non-performing loans. Both broad money and liquidity (reserve money) rose to new high levels of $779.2 million and $515.0 million, respectively. Broad money rose on the back of strong growth in the foreign reserves, whilst the higher deposits made by commercial banks to the Reserve Bank vault supported the build-up in liquidity.

Loans extended by the commercial banks slowed in the six months to August 2021 as a result of lower business and household loans. Deposits, however, rose significantly in line with the higher remittance receipts, Government funds, and liquidity levels. All categories of deposits drove the overall increase, particularly demand and term deposits. As such, the banks' total loans to deposit ratio was at 59.0% below the Reserve Bank's minimum threshold of 80%. The weighted average interest rate spread widened as the deposit rates fell while lending rates rose.

Outlook

The Reserve Bank anticipates that GDP growth will recover moderately by 1.2% in FY2022, which is lower than the forecast of 1.6% in the February 2021 MPS. The slower recovery is underpinned by the resurgence of highly transmittable variants globally, further delaying the global exit from the pandemic.

The inflation rate is expected to remain above the 5% reference rate in the near term, as oil prices continue to rise in line with economies around the globe facing supply chain disruptions and other trade restrictions. These are external factors beyond the Reserve Bank's control. However, the Reserve Bank is of the view that this inflationary pressure is transitory, and headline inflation is expected to fall below the reference rate by the first quarter of 2022.

Foreign reserves will remain at comfortable levels above the minimum 3 months of import cover in the near term, despite an expected rise in imports of goods and services. The delayed receipt of budget support and grants from development partners, which are now scheduled for the end of FY2022, supports this outlook.

Credit growth is projected to remain subdued in the coming months as both borrowers, and the banks remain cautious of COVID-19 related uncertainties. However, a few Government projects in the pipeline may support a return to positive credit growth by the end of FY2022. Non-performing loans are expected to be contained as some commercial banks extend their COVID-19 relief packages for affected clients. The Reserve Bank continues to closely monitor banks' asset quality and ensure adequate provisions are in place to absorb any potential shocks in the financial system.

Fiscal policy remains expansionary with the Government's ongoing efforts to mitigate the economic impacts of COVID-19 on businesses and vulnerable groups. Vaccination rollouts are expected to further boost consumer confidence and will be considered for the safe re-opening of the international border.

In light of the above developments and projections, the Reserve Bank considers its current accommodative monetary policy stance to be appropriate in the medium term. The Reserve Bank will maintain its current monetary policy measures to support macroeconomic growth while maintaining financial stability. The Reserve Bank remains vigilant in closely monitoring economic and financial developments and stands ready to adjust its monetary policy settings to achieve its monetary policy objectives.

Sione Ngongo Kioa

Governor

1. Global Developments

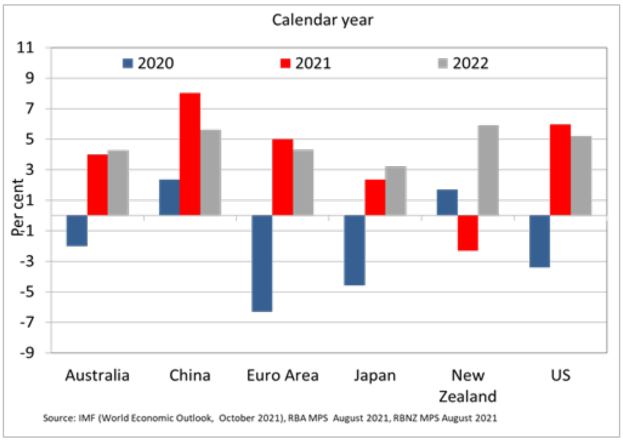
World Growth

In its October 2021 World Economic Outlook (WEO), the IMF revised its 2021 global growth projection down to 5.9%, slightly lower than the 6.0% growth estimated in the July and April 2021 WEO. The revision reflects in part a downgrade of economic growth for advanced economies from supply disruptions while worsening pandemic dynamics affect low-income developing economies. The slow rollout of the COVID-19 vaccines in low-income and developing countries also contributed to the downward revision. However, global economic growth for 2022 is projected to moderate at 4.9%, compared to a forecast of 4.4% in the April 2021 WEO.

Global oil prices are anticipated to increase in 2021 by close to 60% above their low base in 2020, while non-oil commodity prices are expected to rise by 30%. According to Reuters, global oil prices averaged at USD70.60 per barrel in August 2021, which is higher than an average of USD61.70 per barrel in February 2021, and USD44.76 per barrel in August 2020. As a result, inflationary pressures are observed in many economies for 2021, and projected to subside in 2022.

Advanced Economies

Figure 1: Growth Projection in the Advanced Economies



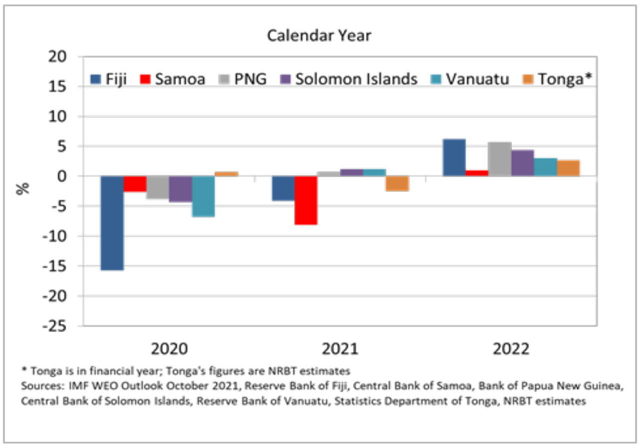
In advanced economies, growth prospects were revised down to 5.2% for 2021, compared to 5.6% in the July 2021 WEO Update. The spread of the delta variant and threats of new variants led to a downward revision of the forecasts. Consumer prices have risen substantially over the last couple of months leading up to August 2021, on the back of supply chain disruptions and higher commodity prices. The downward revision to growth largely reflects the United States' large inventory drawdowns due to supply disruptions. However, the US economy is projected to grow by 6.0% in 2021, driven by continued supportive financial conditions and policy support. For the Euro Area, economic growth is forecasted to grow by 5.0%, rebounding from the 6.3% contraction in 2020.

Emerging Market and Developing Economies (EMDE)

For EMDEs, the economic growth projection for 2021 is marked up slightly to 6.4% in the October 2021 WEO from 6.3% in July 2021 WEO. The revised outlook partly reflects the improved assessments for some commodity exporters in certain regions such as Latin America and the Caribbean, the Middle East, and Central Asia. However, as the pandemic resurged, China and India's economic growth were slightly marked down due to stronger-than-anticipated scaling back of public investment and the overall fiscal support. Overall, growth is expected to slow down to 5.1% in 2022, due to tighter external financial conditions and the prolonged crises.

South Pacific Economies

Figure 2: Growth Projections in the Pacific



The Pacific region's GDP growth for 2020 was worse than previously projected, dropping lower to -8.5% compared to the forecasted -7.0% in the February 2021 MPS. The further slippage in economic growth reflects the ongoing pandemic related disruptions negatively impacting the tourism, trade, and transportation sectors in the region. However, due to the success of the vaccine rollout programs and the effectiveness of the travel protocols for tourist destinations, growth for 2021 is projected to rebound to a regional average of 2.0%, and further increase to 5.5% in 2022.

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

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
World Growth	-3.1	5.9	4.9						
Australia	-2.0	4.0	4.3	0.9	2.5	1.8	6.8	5.0	4.3
China	2.3	8.0	5.6	-0.3	1.2	1.8	4.2	3.8	3.7
Euro Area	-6.3	5.0	4.3	0.3	2.2	1.7	7.9	8.0	8.1
Japan	-4.6	2.4	3.2	-0.9	0.1	0.7	2.8	2.8	2.4
New Zealand	1.7	-2.3	5.9	2.5	1.5	3.7	4.2	4.6	3.9
United Kingdom	-9.8	6.8	5.0	0.5	1.5	2.0	4.5	5.0	5.0
United States	-3.4	6.0	5.2	1.6	5.1	2.4	8.1	5.4	3.5

Note: f – forecast

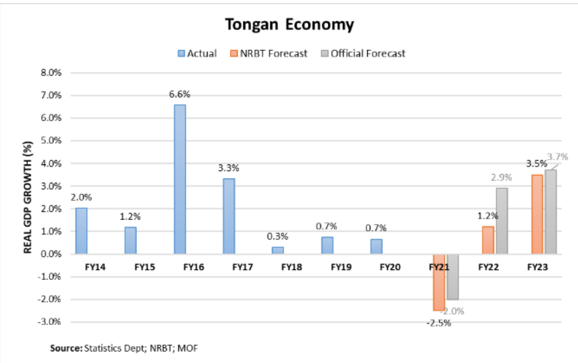
Source: IMF (World Economic Outlook, October **2021), NRBT, RBA August 2021 MPS, RBNZ August 2021 MPS**

2. Tonga's Economic Growth

Real GDP Growth

The Reserve Bank expects a deeper contraction of 2.5% for the Tongan economy for FY2021, compared to the official forecast of 2.0% in the February 2021 MPS. The worsening prospects reflect the continuous impact of the global pandemic on domestic activities over the 6 months to August 2021. The outbreak of the highly contagious delta variant in neighboring countries forced the extended lockdown of the border and imposed additional security measures on the shipping industry, further disrupting supply chains and trade. Although over the last six months a few major events supported the service sector, such as the annual church conferences, Tonga High School ex-student fundraising, and sports tournaments, the tourism sector still remains inactive. Private consumption and aggregate demand are still weaker than pre-covid levels, while hikes in prices may contribute to household indebtedness. The indicators for the primary sector also point to slower growth, whereas the scheduled implementation of infrastructure projects is further delayed.

Figure 3: Real GDP Growth

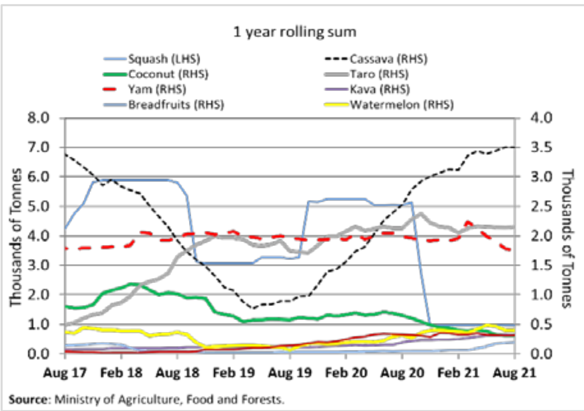


On the outlook, the Reserve Bank projects a 1.2% moderate recovery for the current FY2022 compared to the 1.6% growth forecast in February 2021. The previous expectation of the borders re-opening within the current fiscal year is now unlikely given the resurgence of new variants in our neighbouring countries such as Australia, New Zealand, and Fiji. This also means further delays in implementing large infrastructure projects funded by donor partners. Additionally, disruptions to global supply chains and the continuing rise in global oil prices put pressure on domestic inflation for most of the FY2022. The Government continues to push the rollout of COVID-19 vaccines with the assistance of foreign donors, while it slowly repatriates Tongan citizens who are stranded overseas. Meanwhile, there is still no firm expectation of when international travel will resume. Unfavourable weather outlooks such as tropical cyclones and droughts forecasted for 2022 also threatens primary sector production. Domestic economic recovery is expected to be stronger for the outer years provided that there are no more adverse shocks to the economy. However, risks to the outlook are tilted to the downside as uncertainties on pandemic dynamics remain.

Primary Production

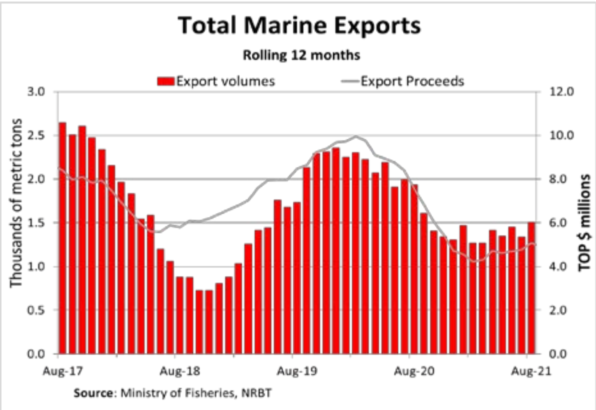
The primary sector indicators over the six months to August 2021 were mostly negative for both the agricultural and fisheries sectors. The agricultural export volumes fell by 16.6%, mostly from declines in volumes of squash and taro exports, offsetting the rise in cassava and yams exports. Over the year to August 2021, agricultural export volumes also fell by 22.6%, again driven by lower exports of squash, coconuts, and yams. Consequently, agricultural export receipts also decreased by 25.5% over the six months to August 2021, and 10.6% over the year. This largely reflect the fall in squash proceeds, whereas delays in shipping schedules put agricultural exports at higher risk of not meeting international standards.

Figure 4: Major Agricultural Exports (tonnes)



The fisheries sector showed some positive performance over the six months to August 2021 primarily driven by the increase in marine and aquarium export volumes by 80.8%, and 54.3%, respectively. As a result, marine export proceeds also rose by 39.4% in the same period. This is in stark contrast to the 22.1% decline in the export volume of marine products due to lower exports of tuna and snapper. Exports of aquarium products also decreased by 10.0%, coinciding with lower marine export receipts in the same period by 32.9%. These movements reflect the impact of the pandemic on the fisheries sector.

Figure 5: Marine Exports (metric tons)



Secondary Production

The secondary sector indicators also point to slower growth during the six months to August 2021, largely driven by a slowdown in construction activities. A few construction projects were completed over the six months to August 2021, including some of the TC Gita and Harold reconstructions, the new twin buildings for Queen Salote College, and the Fungalelea Business Complex.

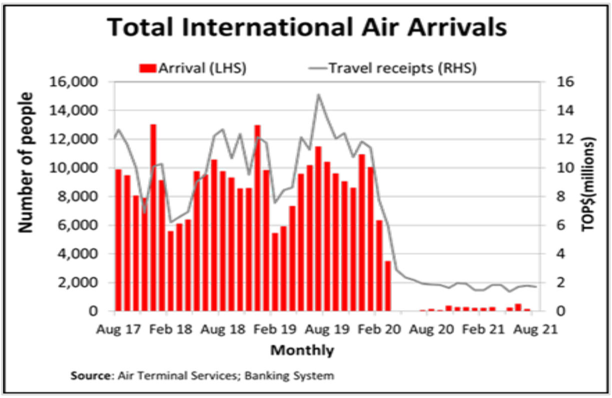
Lending to the construction sector fell by 11.1% over the six months to August 2021, coinciding with the 0.9% fall in payments for the import of construction materials. However, the performance over the year was mostly positive, with lending to the construction sector rising by 65.5%, and import payments for construction materials also increased by 7.1%. This may also have positive spill-over effects on the manufacturing, mining, and quarrying sectors.

The utility sector benefitted from the Water, Sanitation, and Hygiene (WASH) facilities pilot projects, water system upgrade projects, and the ongoing renewable energy projects of Tonga Power Limited. The renewable energy projects continued to support effective supply and access to electricity, as reflected by the rise in both electricity consumption and production over the six months to August 2021, by 3.1% and 1.4%, respectively. The number of electricity consumers also rose by 1.6%. Over the year, similar trends were observed with electricity consumption rising by 4.8%, and production rising by 3.3%. Electricity consumers also rose by 3.0% over the year, supported by the Government's TC Gita and Harold housing recovery projects. However, electricity prices have been trending upwards in line with the rising fuel prices.

Tertiary Production

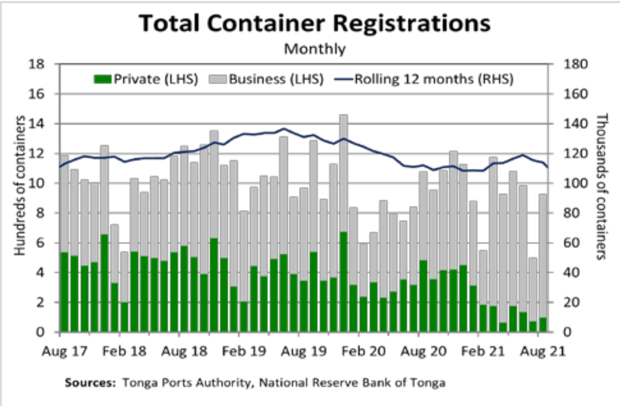
The pandemic continued to severely impact the services sector, particularly the inactive tourism industry, as the resurgence of COVID-19 further tightened travel restrictions. As such, economic activities in tourism-related businesses continued to remain stagnant, including accommodation and food service activities, transport and storage, arts, entertainment, and recreation activities. Over the six months to August 2021, both international passenger arrivals and departures fell by 18.5% and 32.8%, respectively. The number of international flights arriving in Tonga also fell by 18.4%. Over the year, total international passenger arrivals and departures significantly fell by 93.8% and 91.2%, respectively. This coincides with the 75.5% drop in travel receipts reflecting the extended closure of the international border.

Figure 6: International Air Arrivals & Travel Receipts



Container registrations also declined by 3.8% in the six months to August 2021, as Tonga imposed additional security measures leading to the rerouting of shipments that transit via Fiji to other ports before coming to Tonga. This led to further delays of several months in shipments resulting in supply shortages and higher freight charges. Over the year, container registrations increased by 1.7% owing to more business containers, coinciding with the higher import payment of wholesale and retail goods.

Figure 7: Total Container Registrations



The rollout of the Government's fiscal stimulus package provided financial support to businesses and employees affected by the fallout of COVID-19, particularly tourism and distribution businesses. The Government stimulus packages also supported economic recovery in the growth sectors such as agriculture and fisheries. Development partners have provided financial support for the stimulus package, in addition to other assistance to strengthen the health sector's preparedness and vaccine rollouts.

Unemployment

The Reserve Bank's survey on job vacancies showed a decline in advertised vacancies over the year to August 2021. The majority of the advertised vacancies were for health and social work activities.

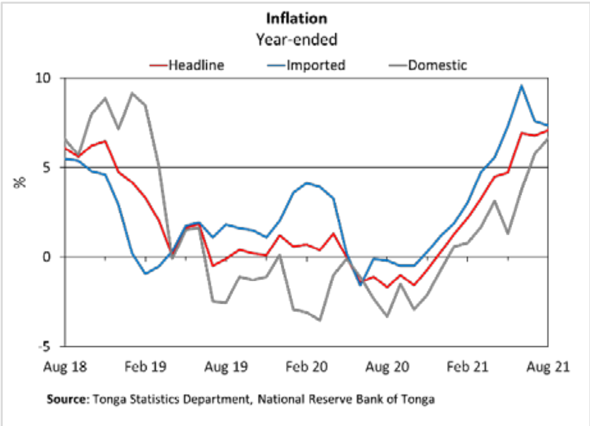
However, more and more Tongans are participating in the Seasonal Worker Programme (SWP) in Australia. The New Zealand Government is also intending to open its borders for quarantine free travel from Tonga, facilitating the travel of seasonal workers for the Regional Seasonal Employment (RSE) scheme. This however may put pressure on the domestic labour market affecting labour supply for domestic development activities.

3. Promoting Low and Stable Inflation

Recent Developments

As expected, Tonga's annual headline inflation surpassed the 5% reference rate for the first time since November 2018, rising by 6.9% in June 2021. In August 2021, annual headline inflation reached its highest level since the onset of the COVID-19 pandemic, of 7.0%. This is a significant rise compared to the 2.1% inflation in February 2021 and the 1.6% deflation in August 2020. Both imported and local prices contributed to this inflationary pressure, mainly from higher prices of fuels and food items.

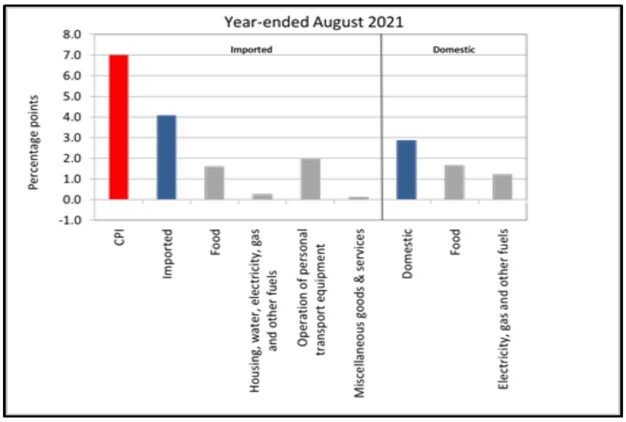
Figure 8: Inflation



Over the year to August 2021, domestic prices rose by 6.7% compared to the annual increase of 0.9% in February 2021. This stemmed from the increase in prices of electricity and food items. The price of electricity increased over the year to August 2021 by 32.3%, owing to the strong rebound in the global oil prices. In August 2021, with the electricity tariff reaching 80.71 seniti/kWh compared to 61.02 seniti/kWh in August 2020, this is the highest electricity tariff since February 2019 (81.20 seniti/kWh). Local food prices rose by 12.0% in the same period, due to higher prices of several root crops, few vegetable and marine products. These higher prices partially reflect the harvesting season and seasonality of some food items. Additionally, the higher local food prices reflect the higher input cost for farmers during the year from imported fertilisers and equipment.

Imported prices increased by 7.3% over the year to August 2021, compared to a 3.1% rise in February 2021. The higher imported prices were mainly attributed to the rebound in global oil prices, surging freight costs, and supply-demand mismatches pushing commodity prices higher. Additionally, higher prices were also noted for imported gas and other fuels, and food items. Despite the Government's effort to subsidise petroleum prices, it was not enough to offset the rise in global oil prices.

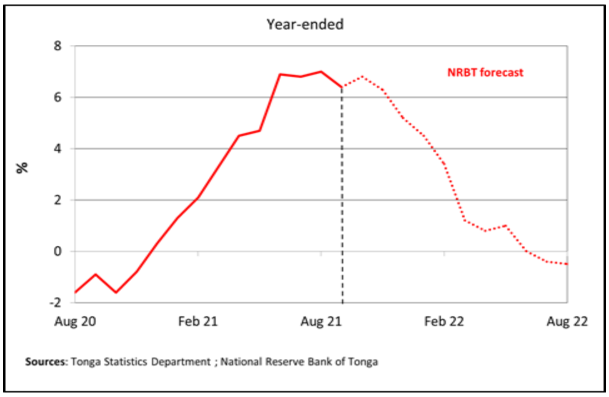
Figure 9: Contributions to Inflation



Outlook

The Reserve Bank anticipates inflationary pressure driven by higher global oil and commodity prices, rising freight costs, and supply chain disruptions will keep headline inflation above the 5% reference rate in the near term. However, the Reserve Bank views this pressure as transitory and inflation will return below the reference rate by the first quarter of 2022 as global supply and demand mismatches are smoothed out. However, this outlook is susceptible to the continued uncertainty on the evolution of the global pandemic. While corrective monetary policy actions may not be required at this stage, the Reserve Bank continues to closely monitor the sources of inflation and stands ready to adjust its monetary settings if necessary.

Figure 10: Headline Inflation Forecast

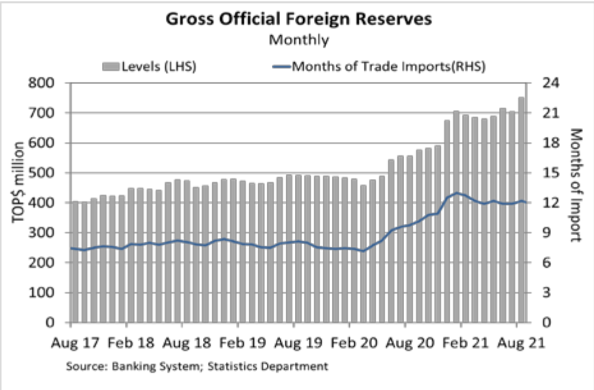


4. Maintaining an Adequate Level of Foreign Reserves

The Reserve Bank continues to monitor the country's external monetary position to ensure that an adequate foreign reserves level is maintained above 3 months of import cover. This is monitored by analysing Overseas Exchange Transactions (OET) data collected from the commercial banks and authorised foreign exchange dealers (FEDs).

Official Foreign Reserves

Figure 11: Gross Official Foreign Reserves



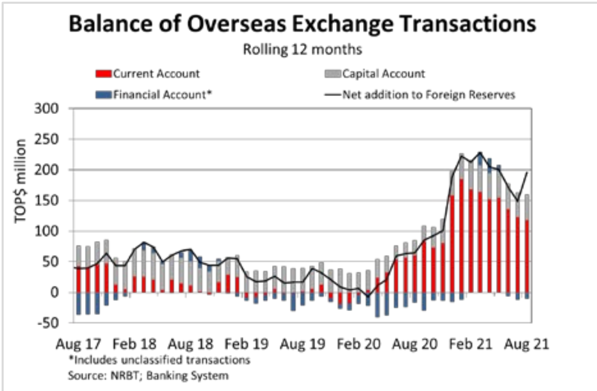
Gross official foreign reserves grew strongly in the six months and in the year to August 2021 by $59.3 million (8.6%) and $195.6 million (35.2%), respectively. Foreign reserves was at $751.7 million in August 2021, equivalent to 13.1 months of imports of both goods and services. The higher foreign reserve levels stemmed from an influx of donor funds and grants for budget support, official projects, and financial assistance for TC Harold recovery and COVID-19. The inflow of private remittances remained high and also contributed to the higher reserves.

Overall OET Balance

In the six months to August 2021, the overall OET balance recorded a surplus of $59.3 million, which is lower than the surplus of $136.3 million in the previous six months to February 2021. This resulted from a lower surplus in all major accounts, especially the current account.

In the year to August 2021, the overall balance still recorded a surplus of $195.6 million, the majority of which is from the current account reflecting the inflow of official and private transfer receipts during the year. The capital account also recorded a surplus underpinned by both official and private capital net inflows. The financial account balance also increased over the year, driven mainly by lower interbank transfer payments.

Figure 12: Balance of Overseas Exchange Transactions

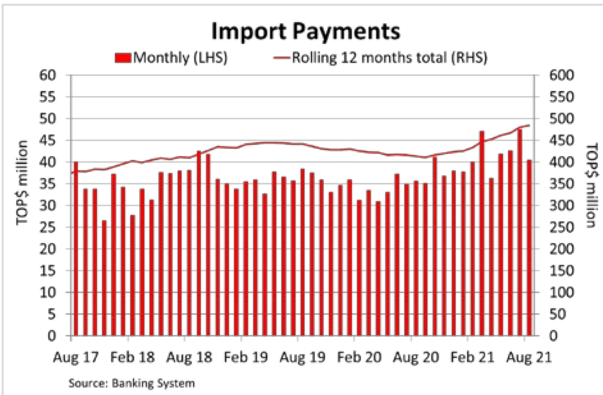


OET Payments

Total OET payments rose in the six months to August 2021 by $48.2 million to $390.5 million compared to the $11.9 million increase in the last six months to February 2021. This was mainly driven by an increase in payments for imports of goods and services. Higher imported inflation and shipping costs may have also contributed to the higher import payments.

In the year to August 2021, total OET payments rose by $30.5 million (4.3%) to $732.8 million. This stemmed mostly from an increase in payments for imports, private transfers, primary income, and non-profit transfers.

Figure 13: Import Payments



Import payments increased over the six months to August 2021 by $27.1 million. Payments for imports of wholesale and retail goods increased the most by $122.7 million, followed by an increase in other imports, mainly Government imports by $10.8 million. These increases were partially offset by declines in payments for import of oil, construction materials, and motor vehicles, which fell by $188.5 million, $119.4 million, and $3.3 million, respectively. Annually, import payments increased by $71.3 million (17.2%) to $484.8 million. This was due mainly to a $46.1 million (19.1%) increase in payment for import of wholesale and retail goods.

Total payments for services rose in the six months to August 2021 by $4.8 million (8.4%), due mostly to higher payments for transportation (sea freight), computer services, and personal travel. This offset declines in payments for insurance premiums, professional & management services, and telecommunication services. However, services payments fell over the year by $32.2 million (21.2%) to $119.5 million. This was largely driven by lower payments for travel, professional & management services, and postal services.

Primary income payments increased by $13.9 million to $17.8 million during the six months, driven mostly by higher dividends paid out to non-resident shareholders and interest on external loans. Income payments also increased over the year by $2.3 million (12.0%) to $21.6 million, reflecting higher dividends paid out to non-resident shareholders during the year.

Capital payments fell slightly over the six months and year to August 2021 by $0.5 million, respectively, as payments for both private and official capital investments declined. Financial payments rose in the past six months to August 2021 by $6.5 million (56.0%) due mostly to higher payments for portfolio investments offshore. However, financial payments declined over the year to August 2021 by $17.8 million (37.4%), reflecting lower payments for other investments and portfolio investments.

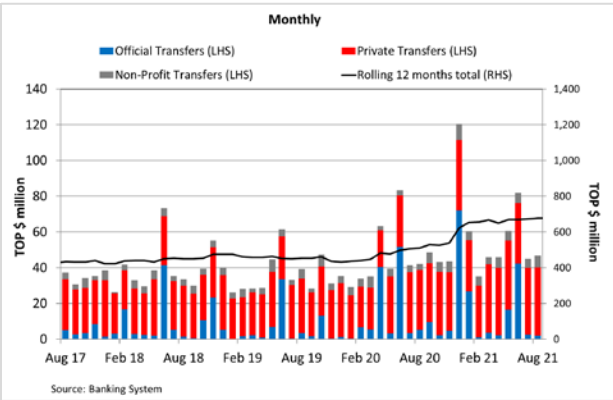
OET Receipts

Total foreign exchange receipts declined over the six months to August 2021 by $28.1 million (5.7%) to $464.3 million. This was attributed to lower receipts from the current account, mainly from transfers and services receipts (travel, Government, and telecommunication services). The receipts in the capital account were also lower due to declines in both official and private capital receipts. These were partially offset by higher receipts mainly from other financial investments (interbank transfer receipts), and primary income.

In the year to August 2021, total foreign exchange receipts increased substantially by $132.0 million (16.0%) to $956.6 million. This resulted mostly from higher transfer receipts ($167.2 million), primary income ($19.9 million), and official capital receipts ($14.0 million). This was partly offset by the decline in receipts mainly from services (travel), direct investments, and merchandise exports.

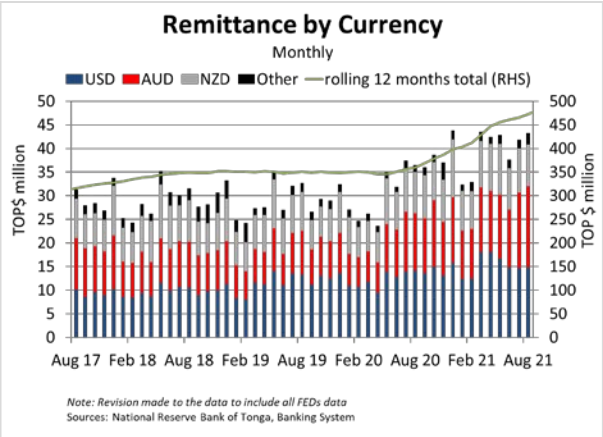
In the six months to August 2021, current transfer receipts fell by $25.5 million (7.2%) to $325.9 million, attributed mostly to a decline in official transfer receipts by $47.5 million. This followed the influx of budget support, project funds, loan from the IMF's Rapid Credit Facility and financial assistance for TC Harold, and the preparations for COVID-19 in the previous six months. Non-profit transfer receipts also declined by $4.0 million. This was partially offset by higher private transfer receipts, which rose by $26.3 million. In year ended terms, total current transfer receipts increased substantially by $167.2 million (32.8%) to $677.0 million, supported by increases in both private and official transfer receipts.

Figure 14: Transfer Receipts



Total remittances increased over the six months to August 2021 by $30.7 million (13.9%) to $251.5 million and accounted for 54.2% of the total OET receipts for the same period. Receipts from all categories of remittances increased over the six months to August 2021. The majority of the increase was for private transfers, approximately 89.3% of the total remittance receipts. These are mostly gifts from families and friends abroad to support their families during COVID-19, and to finance other domestic fundraising activities such as the Tonga High School Ex-students fund raising concert and church obligations. Over the year to August 2021, remittances rose by $112.4 million (31.2%) to a record level of $472.2 million. In August 2021, remittance receipt was estimated to be around 46% of GDP. Consistent financial support from families and friends abroad during times of crisis was the main driver for the higher remittances over the year, in addition to funding domestic festivities and receipts from seasonal workers. The majority of remittance receipts were denominated in US Dollars, representing 38.0% of the total remittance receipts. Receipts in Australian Dollars followed with a 33.3% share, and New Zealand Dollars with a 23.8% share.

Figure 15: Remittances



Receipts for services in the six months to August 2021 declined by $1.8 million (4.3%) to $41.1 million as receipts for most services fell. Receipts for Government services fell by $1.5 million, followed by a decline in receipts for the transport services by $0.8 million, mostly from postal services. Receipts for telecommunication services also fell by $1.4 million. In year ended terms, the total service receipts declined significantly by $78.0 million (48.1%) to $84.0 million, underpinned by the drop in travel receipts by $62.9 million (75.5%) due to the border closure. Receipts from services other than travel also declined over the year by $15.1 million (19.2%), reflecting lower receipts from insurance, construction, and professional & management services.

In the six months to August 2021, total export proceeds rose marginally by $0.1 million (1.1%) to $6.4 million, owing to a slight pick-up in marine export proceeds. Conversely, total export proceeds fell over the year to August 2021 by $3.3 million (20.6%) to a total of $12.8 million. All export categories declined, with marine exports decreasing the most. This coincided with the declines in the total marine and agricultural export volumes over the year. Receipts from agricultural exports accounted for 50.3% of the total export proceeds, while fisheries and marine exports accounted for 39.7%, and the remaining 10% were from other exports.

Capital receipts declined over the six months to August 2021 by $25.2 million (75.9%) to $8.0 million. Official and private capital receipts decreased by $20.8 million and $4.4 million, respectively. This reflected lower receipts from donor partners for capital expenditures and investment projects. Conversely, capital receipts increased by $17.0 million over the year to August 2021, rising to $41.2 million. Both official and private capital receipts contributed to this increase by $14.0 million and $3.0 million, respectively.

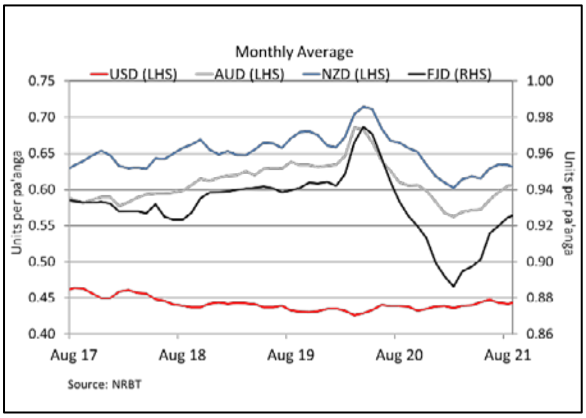
Over the six months to August 2021, total financial receipts increased by $19.4 million (51.6%) to $57.1 million. This was mainly due to higher receipts from other investments, particularly interbank transfer receipts. Over the year to August 2021, the total financial receipts also increased to $94.7 million from $85.5 million in August 2020. This was driven mainly by higher receipts from other investments, mostly interbank transfer receipts.

The balance of unclassified transactions recorded an average outflow of $2.3 million per month over the year to August 2021, which is lower than the average outflow of $4.8 million in the previous year. This was due to higher financial claims by non-residents, mostly from interbank transfers.

Exchange Rates

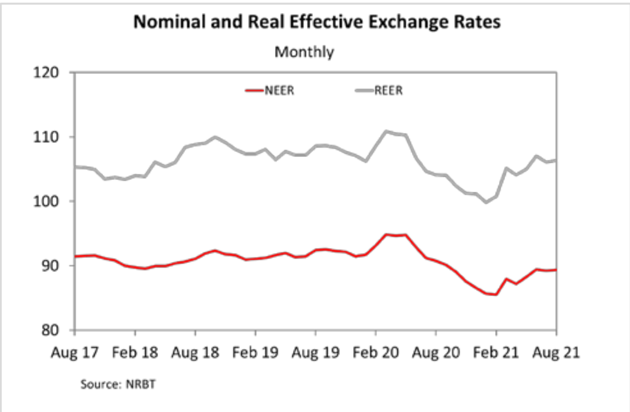
In the six months to August 2021, the Nominal Effective Exchange Rate (NEER) index rose by 4.5% reflecting a general weakening of the trading partner currencies against the TOP. The Real Effective Exchange Rate (REER) index also increased by 6.6% during this six-month period reflecting Tonga's high inflation rate relative to its major trading partners.

Figure 16: Foreign currency Exchange Rates



In year ended terms, the NEER index fell by 1.5% as Tonga's major trading currencies, such as the NZD, AUD, CNY, GBP, and FJD strengthened against the TOP. This benefits recipients of foreign currency such as foreign aid and remittance receipts. However, the REER increased by 3.2%, reflecting Tonga's higher inflation rate compared to its major trading partners. This also implies a loss in Tonga's trade competitiveness.

Figure 17: Effective Exchange rates



Outlook

The Reserve Bank projects the foreign reserves to remain at comfortable levels in the near to medium term, well above the minimum level of 3 months of import cover, despite the COVID-19 pandemic continuing to set back both the global and domestic economic recovery. This projection is based on the following key factors:

- Expected financial assistance from development partners to support economic recovery.
- Expected receipt of budget support and Government grants for earmarked infrastructure projects such as the upgrade of the Queen Salote Wharf and the Fanga'uta Lagoon Bridge that are yet to be implemented.
- Increasing demand for Tongan seasonal workers from Australia and New Zealand which will support a steady inflow of remittance receipts.
- Suspension of the EXIM principal loan repayments under the Debt Service Suspension Initiative agreement.

Risks to the outlook are mostly on the downside, such as:

- High uncertainty remains on the global exit from the COVID-19 pandemic. The consequential extended border lockdown would impact foreign receipts for the tourism industry.
- Volatile financial markets affect returns on foreign investments and exchange rates.
- Higher import bill stemming from elevated imported inflation puts pressure on foreign reserves.
- De-risking and de-banking issues impact the flow of remittances to Tonga and competition in foreign exchange dealings.
- High vulnerability to natural disasters and external shocks.

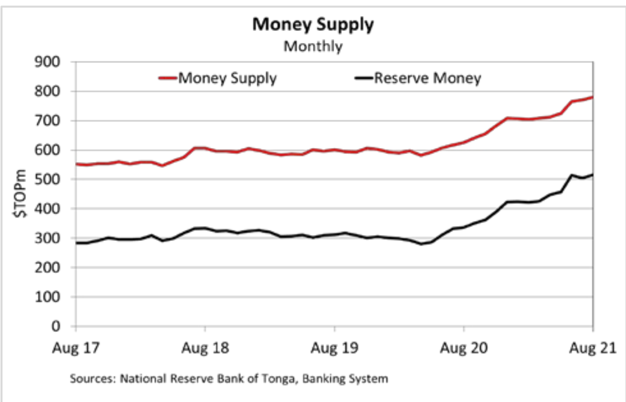
5. Maintaining a Stable Financial System

The financial system remained sound during the six months to August 2021, despite the ongoing impact of the global pandemic. This was supported by banks' strong capital positions, adequate profitability, and high liquidity. As anticipated, the loans to deposit ratio remained below the minimum 80% threshold as total lending declined, whilst total deposits increased. The weighted average interest rate spread widened as weighted average deposit rates continued to decline, coupled with the rise in the weighted average lending rates.

Money Supply

In the six months to August 2021, broad money rose by $75.8 million (10.8%) to a new high level of $779.2 million. This is attributed mainly to both higher net domestic assets and net foreign assets. Net domestic assets rose on the back of higher net credit to the Government, while net foreign assets rose in line with the higher foreign reserves. Broad money also rose over the year by $154.5 million (24.7%). Net foreign assets increased by $160.0 million (2.8%), while net domestic assets declined by $5.6 million (13.0%). The higher foreign reserves drove the increase in net foreign assets yet again, whilst higher Government deposits lowered the net domestic assets. The inflow of official funds for the COVID-19 preparations, Government projects, cyclones relief funds, external debt proceeds, and budget support were the main drivers of the higher foreign reserves and Government deposits.

Figure 18: Broad Money and Liquidity



Liquidity in the banking system (reserve money) rose over the six months and year to August 2021 by $93.8 million (22.3%) and $178.7 million (53.1%), respectively, to a new high level of $515.0 million. This rise was mostly driven by the strong growth in the bank's Exchange Settlement Accounts (ESA) over the six months to August 2021 by $78.8 million (31.6%), and over the year by $148.6 million (82.6%). This coincided with the increase in commercial banks' deposits to the Reserve Bank vault. Currency in circulation (CIC) also contributed to the rise in reserve money with an increase in the six-month period by $7.6 million (7.1%). In the year to August 2021, CIC rose by $15.5 million (15.8%) in line with the domestic festivities that took place during the year. Required reserves also increased by $7.4 million (11.3%) in the six months, and $14.7 million (25.0%) over the year to August 2021, corresponding to the rise in total deposits and contributing to the higher reserve money level.

Lending

Table 2: Total Lending

	Monthly			Annual	
Lending	**Aug-21**	**Feb 21**	**% Growth**	**Aug-20**	**% Growth**
Total Lending ($ in million)	478.8	481.6	-0.6	487.6	-1.8
Business lending	221.6	223.2	-0.7	229.0	-3.2
Household lending	256.9	258.1	-0.4	258.7	-0.7
Other lending	0.3	0.4	-24.4	0.0	0.0

Source: Banking System, National Reserve Bank of Tonga

Over the six months and year to August 2021, the banks' total lending (including Government Development Loans (GDL) fell by $2.8 million (0.6%) and $8.8 million (1.8%), respectively. These were driven by lower lending to both businesses and households. The ongoing loan repayments by both the private sector and public enterprises contributed to the decline over the six-month period. Lending to businesses in the distribution, professional and other services, and construction sectors also decreased. Over the year, the loan repayments from the public enterprises offset new lending to the private sector. Loans for manufacturing, professional and other businesses, as well as the agricultural sectors, fell and contributed to the annual decline. These declines also reflect sectors that were mostly affected by COVID-19. Construction loans, on the other hand, continued to increase annually, reflecting the progression of the TC Gita and Harold reconstruction projects.

Household loans declined over the six months to August 2021, driven solely by lower housing loans. Annually, household loans also decreased, due mostly to lower housing loans, followed by declines in other personal and vehicle loans.

GDL accounted for 2.0% of total loans in August 2021, compared to a 1.7% share in February 2021, and 1.1% share in August 2020. The rise in the GDL's share reflects the utilisation of this loan scheme by businesses affected by the COVID-19 pandemic.

Over the six months and year to August 2021, the banks' total deposits increased significantly by $89.9 million (12.8%) and $160.6 million (25.4%), respectively. All categories of deposits rose, mostly driven by higher demand deposits, reflecting fund receipts by Government ministries for the COVID-19 preparations. Savings and time deposits also increased, contributed mainly by deposits from retirement funds and private businesses. Churches also made time deposits from their annual donations.

The significant rise in deposits coupled with the decline in lending in the six months and in the year to August 2021, resulted in a lower loans to deposit ratio of 59.0%. This is compared to 68.2% in February 2021 and 75.5% in August 2020, and continues to remain well below the 80% minimum threshold.

Interest Rates

Table 3: Weighted average interest rates

	Month ended			Change over 6 months to	Change over 12 months to
	Aug 21	Feb 21	Aug 20	Feb 21	Aug 20
	%p.a.	%p.a.	%p.a.	Bps	Bps
Deposits all	1.87	2.00	2.13	-13.00	-26.19
Demand	0.36	0.34	0.38	2.38	-1.90
Savings	2.46	2.54	2.60	-8.01	-14.30
Term	3.21	3.32	3.45	-10.62	-24.02
Loans all	7.76	7.69	7.78	7.00	-1.84
Housing	8.09	8.08	8.04	1.35	5.51
Other personal	11.32	11.33	11.35	-0.74	-3.12
Business	7.17	7.11	7.50	6.62	-32.99
Other*	8.78	0.00	0.00	878.37	878.37

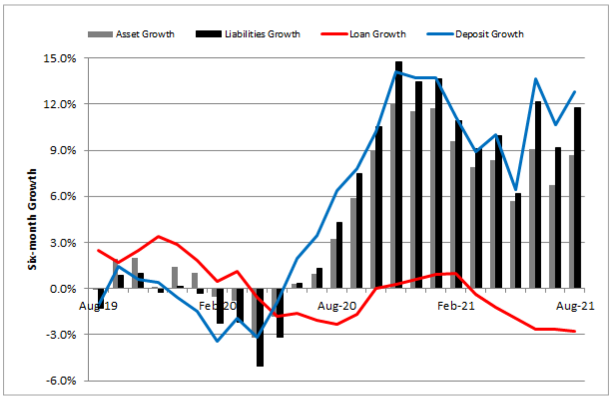
* Refers to Other commercial loans/overdraft loans
Sources: Banks; NRBT

The banks' weighted average interest rate spread widened over the six months to August 2021 by 20.0 basis points, and over the year by 24.4 basis points to 5.89%. The rise over the six-month period was due to lower weighted average deposit rates coupled with higher weighted average lending rates. Both saving and time deposit rates decreased which offset the higher demand deposit rates. On the other hand, lending rates increased mainly for loans to businesses in the fisheries, agricultural, and transport sectors as well as households for vehicle and other personal loans.

Over the year, the weighted average deposit rates declined more than the fall in weighted average lending rates. All deposit rates decreased, led by lower time deposit rates, followed by declines in saving and demand deposit rates. Similarly, lending rates decreased mostly for loans to businesses in the utilities, construction, and agricultural sectors as well as households' other personal loans.

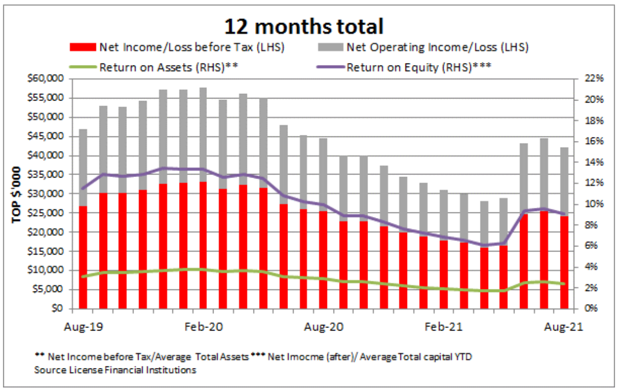
Banking System Performance

Figure 19: Total Banking System Balance Sheet Development



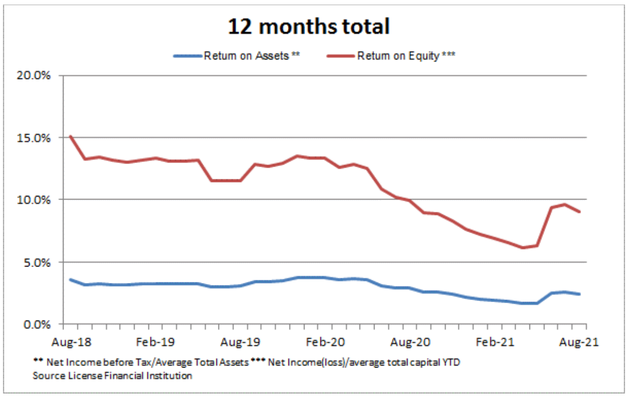
The banking system remained sound during the six months to August 2021. Total assets increased by 8.7% to $1.1 billion over the six-month period. This reflected the increase in banks' Exchange Settlement Accounts (ESA) by $79.3 million (31.8%) followed by a rise in banks' time deposits with their head offices and branches of $4.2 million (41.2%). In addition, items in transit increased by $5.3 million (76.9%). This was due mainly to a rise in banks' cheques that were yet to be settled by the end of August 2021. Holdings of debt securities (Government bonds) also rose by $3.6 million (10.7%), followed by an increase in banks' cash holdings by $3.1 million (13.3%). On the other hand, total loans declined by $13.4 million (2.8%), reflecting ongoing loan run-offs by the private businesses and public enterprises. This also reflected the ongoing rollout of the Government's stimulus package to pandemic-affected businesses and limited lending opportunities during the pandemic. Total liabilities also recorded an increase over the six months to August 2021 of $92.8 million (11.7%) to $884.1 million. This was mainly based on deposit growth of $89.9 million (12.8%), as all categories of deposits increased over the period. Demand deposits rose by $45.4 million (15.4%), mainly attributed to Government deposits rising by $19.0 million (51.8%) on the back of donor/grant funds for projects and COVID-19 assistance receipts. Private sector deposits grew by $17.4 million (9.3%), which were mainly for businesses, increasing by $8.1 million, followed by non-profit organisations and individuals of $5.6 million (20.1%) and $3.7 million (7.9%) respectively. Saving deposits also increased by $41.8 million (32.5%), mainly due to the deposit build-up for the private sector of $11 million (38.6%), mostly non-profit organisations, reflecting churches' annual donations. This was followed by an increase in Retirement Funds' deposits of $18 million. Term deposits also rose by $2.8 million (1.0%) over the six months to August 2021 largely reflecting higher private businesses deposits. Accumulated depreciation also increased by $1.5 million (7.0%) over six months to August 2021. The general loan loss provisions raised over the six months to August 2021 increased by $1.5 million (8.3%), reflecting the banks' continued effort to ensure adequate provisioning amid the ongoing uncertainties of COVID-19.

Figure 20: Total Banking System's Profitability



The total banking system remained profitable over the six months to August 2021. The Net Profit after Tax (NPAT) was $18.0 million, which was higher than the $13.4 million NPAT in the previous six months to February 2021. This was attributed mainly to lower loan loss provision expenses of $2.4 million compared to $9.7 million in the past 6 months. Some of COVID-19 impacted customers have now managed to meet the conditions of their restructured loan agreements. This was coupled with an improvement in the non-interest income of $0.9 million (4.3%), specifically other incomes, resulting from the commission received from the 'Ave Pa'anga Pau and the MoneyGram remittance services undertaken by the banks. Interest income fell by $1.4 million (2.9%), reflecting the current moratorium on the loan principal and interest repayments since April 2020 to cushion the impacts of the COVID-19 pandemic.

Figure 21: Total Banking System's ROE & ROA



Both the Return on Assets (ROA) and Return on Equity (ROE) increased over the past six months to August 2021. ROA rose to 2.4% from 1.9% in February 2021, while ROE was also higher at 9.1% compared with 6.9% in February 2021.

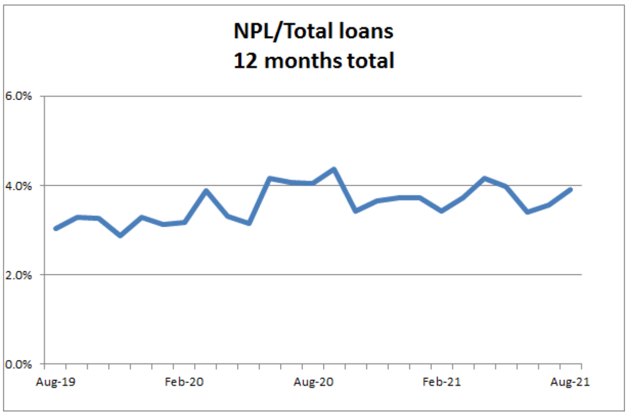
The banking system's capital position remained strong as the risk-weighted capital ratio continued to be maintained well above the Reserve Bank's minimum requirement of 15% at 31.8% in August 2021. This was lower than 33.7% in February 2021, owing to the decrease in the eligible capital as banks repatriated dividends to their shareholders. Banks' net interest margin slightly declined to 3.0% in August 2021 from 3.4% in February 2021 due to the decrease in the return on funds exceeding the decline in the cost of funds.

The overall quality of the banks' assets deteriorated over the six months to August 2021. Total non-performing loans (NPLs) increased by $1.8 million (11.1%) to $18.4 million, representing 3.9% of total loans compared to 3.4% in February 2021. The effect of unfavourable squash seasons in recent years (i.e. 2019-20) affected the growers' proceeds, resulting in higher non-performing loans for the agricultural sector. Furthermore, the delay in repayments of housing and wholesale & retail loans, reflecting the spill-over effects of duty-free policies on domestic demand for consumption goods, also contributed to the higher NPLs. The Banks COVID-19 relief packages for impacted customers were extended to early 2022 and continued to be applied on a case-by-case basis.

The non-performing private individual loans' share of total NPLs was 67.6%, which fell from 73.3% six months ago and 68.9% in August last year. Non-performing private individual loans comprised mainly of housing loans representing 54.1% of the total NPLs, decreasing from 57.9% in February 2021.

Non-performing business loans accounted for the remaining 32.4% of the total NPLs, deteriorating from 26.7% in February 2021 and 31.1% in August 2020. This increase reflects the impact of COVID-19 on businesses mainly in the tourism sector, and gradually more in the distribution sector.

Figure 22: Total Banking System Asset Quality Indicators



Specific provisions against loan losses continue to be adequate in accordance with the Reserve Bank's prudential requirements. Furthermore, general provisions had been raised over the last six months as banks align with the IFRS 9 provisioning requirements. Total provisions, therefore, rose to $24.9 million compared with $23.8 million in February 2021. Quarterly review of some banks' provisions are ongoing given the uncertainties associated with the prolonged COVID-19 pandemic.

The Reserve Bank continued to monitor and manage the payment and settlement system to ensure it is functioning in an efficient, sound, and safe manner. To improve the efficiency of the settlement of banks' transactions, an automated national payment system and architecture is to be launched in late 2021.

Supervision of Non-Bank Financial Institutions (NBFIs)

The Reserve Bank continues to implement supervision and oversight over the non-bank financial institutions and their operations in Tonga. The development of regulations and regulatory framework for the effective supervision of NBFIs remains a priority. NBFIs provide essential financial services to the public, particularly those that do not access banks' services. The effective supervision of NBFIs, therefore, is key to ensuring they operate in a safe and sound manner to support financial stability while also protecting the interests of their customers.

The Reserve Bank continues to monitor and oversee the operations of all fifteen (15) authorised foreign exchange dealers (FEDs) in Tonga to ensure they comply with their licensing conditions. This is through conducting of technical meetings, quarterly spot checks, annual compliance check visits, training, and providing guidance for the FEDs throughout the year. Enhanced supervision of FEDs is also critical for supporting efforts to combat banks' de-risking policies. Moreover, a stronger focus is warranted on the mitigation of cyber and other related risks stemming from the increased utilisation of digitalised channels by the FEDs during the pandemic.

In terms of the regulation and supervision of Microfinance Institutions, relevant Prudential Statements are being drafted to ensure the effective implementation of the Microfinance Act 2018.

The implementation of the Moneylenders Act 2018 through the licensing of moneylenders in Tonga continues. Currently, about 73 moneylender applicants have submitted their license applications of which 59 have been licensed, and 14 are still on hold awaiting submission of all required information. To fully implement the Moneylender's Act, Prudential Statements will also be drafted. An upcoming consultation is being scheduled to clarify the prudential requirements to current and potential moneylenders.

On the regulation and supervision of the insurance industry, the drafting of the Insurance Bill is still underway. Meanwhile, the Reserve Bank continues to collect quarterly reports from four (4) insurance companies. This would enable the Reserve Bank to better understand and monitor the insurance businesses' financial positions and performance to ensure their solvency.

On the regulation and supervision of the pension funds, the Pension Fund Bill was issued to stakeholders for comments in December 2020. A consultation meeting on the Bill was conducted in August 2021. The Pension Fund Bill is now on its second round of consultation. In the interim, the Reserve Bank continues to collect monthly reports from the two (2) pension funds. This is to monitor their operations to ensure their viability and solvency.

The Credit Union Bill was approved by the Board of Directors and has been submitted to the Attorney General's Office for processing. Public consultation on the Bill was also conducted in August 2021 via radio talkback programs.

Financial Inclusion Initiatives

The Reserve Bank continues to promote financial inclusion in Tonga through the ongoing monitoring of the access and usage of financial products by individuals and Micro, Small and Medium Enterprises (MSMEs). Over the year ended June 2021, the number of cash in and cash out access point indicators was lower compared to the previous year. This was due to the fall in the number of banks' EFTPOS terminals and branches. The decrease in EFTPOS terminals was mainly driven by lack of activities in these terminals, especially due to the border closure during the pandemic. The lower number of branches reflected the closing down of the ANZ branch in Vava'u in late 2020.

The usage of financial services in banks reflected a higher outcome over the year ending June 2021, with an increase in both the total number of individual deposit accounts and the number of individual loan accounts. The COVID-19 pandemic has changed financial consumers' behaviour. This is reflected in the increase in usage of digital services (internet/online banking). which were mostly facilitated by banks given their global outreach advantage. The increase in the total number of individual loan accounts was due to the banks' continuous loan campaign activities, including the lowering of interest rates and expansion of loans to two additional sectors (Government Development Loan).

Access to financial services over the year ended June 2021 also reflected the impact of COVID-19. The convenience associated with the digital financial services, particularly for sending remittances to Tonga, amid the COVID-19's social distancing and lockdowns, supported the increased usage of digital financial services. The higher remittance receipts have also supported the increase in deposit accounts.

The MSMEs sector could only partially reach its full potential during the pandemic with the ongoing closed borders impacting their operations, particularly the tourism-related businesses. The MSMEs sector have showed a negative outcome with both the number of MSME loans and MSMEs outstanding loans declining over the year to June 2021. MSMEs loans to the agricultural and manufacturing sectors contributed to the decline.

Outlook

The Reserve Bank forecast a positive annual credit growth of 0.9% for the year ended June 2022. This stems from the expectation that some local credit opportunities over the year relating to Government projects would resume in the last part of 2021. The stability of the financial system will be maintained going forward through the close monitoring and supervision of banks and non-bank financial institutions and implementing of various policy measures as outlined below:

- Ensure banks maintain prudent lending practices and monitor asset quality and profitability while continuing to roll out COVID-19-related assistance to customers.
    - ✓ Banks have extended COVID-19 loan packages up to early 2022.
    - ✓ Closely monitor likely impacts of COVID-19 on the local businesses such as the tourism sector and other private businesses and their capacity to service their debt.
- Implement and develop the legislations for the licencing and supervision of non-bank financial institutions
    - ✓ Ongoing implementation of the Moneylenders Act and Microfinance Act.

  - ✓ Complete the review and public consultations on the Insurance Bill, Pension Fund Bill and Credit Union Bill.
- Establish a Financial Stability Unit to develop and implement a macroprudential and financial stability policy. This would support the Reserve Bank's primary function of promoting financial stability.
- Continue to develop an enabling financial infrastructure to support prudent credit growth.
  - ✓ Complete the Credit Registry Project that is to be effective in 2022.
  - ✓ Support structural reforms to improve the credit environment, such as working closely with the Ministry of Land and Natural Resources to strengthen the land administration system; and following up with the Ministry of Trade and Economic Development on the development of a bankruptcy law.
- Modernise and improve the efficiency of the payments system by completing the rollout of the Domestic Electronic Payment System for the automation of the daily cheque settlement system for banks. This initiative is at its final stage of industry consultations with the aim to launch in late 2021.
- Continue the development of the National Know Your Customers System within the Reserve Bank. This will enhance the Reserve Bank's AML/CFT risk tool to effectively vet customers in the financial system.
- Continue to work together with Pacific central banks and other stakeholders as well as the authorised foreign exchange dealers to strengthen their AML/CFT compliance for the global banks to retain their correspondent bank accounts e.g. application of the Wolfsberg questionnaire
- Address the recommended actions in Tonga's Mutual Evaluation report in relation to AML/CFT supervision, by strengthening the reporting entities' (financial institutions and cash dealers) understanding of AML/CFT obligations, introducing comprehensive AML/CFT supervisory programs, and promoting risk-based implementation of AML/CFT requirements.
- Encourage the development of technological solutions (FinTech) that would facilitate low-cost remittance of funds while still complying with the AML/CFT requirements.
  - ✓ Ensure that there is an enabling regulatory environment that will support these initiatives within the applicable legal and regulatory requirements and protect the interest of financial consumers.
  - ✓ Support new digital and innovative products in the financial system.
- Build capacity of the supervision team in new areas such as FinTech and cyber related risks, and AML/CFT supervision.
- Continue to ensure compliance of banks with all Prudential Statement requirements.

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

- The development in credit growth and non-performing loans, which will depend on the severity and evolution of the COVID-19 pandemic.
- The global banks' de-risking decisions, mostly headquarter decisions, which coupled with fear of sanctions relating to money-laundering and terrorist financing risks, impact the risk appetite for provision of financial services.
- The economy's vulnerability to further natural disasters and other external shocks.
- The rising cyberattacks and cyber risks posed by increased usage of digital financial services.

6. Fiscal Indicators

The Government in its Budget Statement for FY2022 continues to prioritise 'health' given the ongoing global pandemic and spill-over effects on Tonga. It also includes efforts to augment economic recovery. The estimated budget outturn for FY2021 was a fiscal deficit of $11.2 million, following a fiscal surplus of $59.7 million in the previous fiscal year. The fiscal deficit reflects the impact of COVID-19 in reducing Government revenues while giving rise to higher Government spending. A higher fiscal deficit of $18.8 million is estimated for FY2022 underpinned by higher Government expenditures in support of the Government's efforts to enhance the public health system's COVID-19 preparedness. The Government also relies on the assistance of development partners to finance its budget deficit, in addition to improved revenue collection.

The banking system data shows that the net credit to the Government increased by $40.1 million (15.0%) in the six months to August 2021 due mainly to lower Government deposits. Large payments were made during this period mainly for imports, Government operations, COVID-19 preparations, and reconstruction projects from previous cyclones. However, the net credit to the Government decreased over the year by $2.2 million (1.0%), mainly on higher Government deposits. These were mainly due to receipts of budget support and official funds from Tonga's major donor partners for COVID-19 preparations, TC Harold recovery, as well as external financing from the IMF Rapid Credit Facility (RCF).

The Government's revised budget for FY2022 expects a total receipt of $45.5 million as budget support from development partners, however, only $7.0 million has been received to date. Therefore, the remaining budget support for this fiscal year is $38.5 million. The deferred budget support of $11.3 million from FY2021 is also expected to be received in this fiscal year. Furthermore, more funds are expected during this fiscal year to assist with the COVID-19 preparations.

The estimated total public debt as at the end of June 2021 was $514.4 million, which is 5.3% higher than June 2020 and represented 41.5% of GDP. Total external debt accounts for around 87% of the total public debt, and 12% is attributed to domestic debt which is mostly Government bonds. Nearly two-thirds of the total external debt is owed to the Export-Import Bank of China (EXIM). Public debt is anticipated to decrease over the medium term, due to the ongoing repayment of World Bank and Asia Development Bank loans, and the commencement of the EXIM loan principal repayments. Tonga has been approved to be part of the Debt Service Suspension Initiative (DSSI) whereby its interest and principal payments due to the EXIM over the next 4 years will be re-profiled. It is estimated that around $14.6 million will be suspended under the DSSI agreement which is then diverted to supporting the Government's preparation for the arrival of COVID-19 in Tonga.

As the Registrar of Government bonds, the Reserve Bank continued to facilitate the issuance of Government bonds. Three Government bonds totaled $14.0 million matured in FY 2021, however only $12.4 million was rolled over due to one bond issue being undersubscribed. Similarly, four Government bonds totaling $10.7 million will mature in FY2022, whereby two bonds have been rolled over, with a total amount of $5.0 million.

The rollout of the Government's fiscal stimulus package continues to provide in-kind and cash assistance to households and businesses. Some of the programs that were rolled out include an Employee Wage support scheme, grants to the tourism sector, and conditional cash transfer programs for households with disabilities and elderlies, and subsidising of high school tuition for one term. More than 80% of the $60 million stimulus package are funded by development partners.

The Ministry of Health continues its vaccination rollout targeting to fully vaccinate 70% of the total population by the end of 2021. Those eligible for vaccination start from the ages of 12 years old and above.

On the outlook, the Government is likely to maintain its expansionary fiscal policy in support of economic recovery with wider fiscal deficits estimated for the outer years. The Reserve Bank will closely monitor the developments in fiscal policies and their implications on the monetary policy objectives.

7. Monetary Policy Stance

Given recent developments in the domestic economy, the external sector, the monetary sector, and the outlook on the monetary policy targets, the Reserve Bank considers the current accommodative monetary policy stance appropriate for the medium term. This is to support economic recovery from the global pandemic while maintaining the stability of the financial system. It also encourages the utilisation of the excess liquidity in the banking system through further lending to growth sectors to support the economy in addressing the fallout from the impacts of COVID-19.

The Reserve Bank's Board of Directors approved to maintain the current monetary policy measures outlined below:

a. Maintain the monetary policy rate at 0% (zero interest rate policy).
b. Maintain the minimum loans/deposit ratio of 80%.
c. Maintain the Statutory Reserve Deposit (SRD) ratio at 10%.
d. Maintain the inflation reference rate at 5%.
e. Monitor the commercial banks' liquidity and adjust the SRD ratio if needed.
f. Monitor the commercial banks' capital reserves and adjust further when required.
g. Ease the exchange control requirements when required.
h. Continue to assist the Government during Covid-19 with issuing Government bonds.
i. Maintain clear channels of effective communications with the financial institutions to ensure adequate preparedness.
j. Continue to be transparent and raise awareness of monetary policy decisions through press releases to the public.
k. Closely monitor the impacts of the pandemic on the financial system for early detection of any signs of vulnerability.
l. Continue to ensure both commercial banks and non-bank financial institutions adhere to all Government declarations regarding COVID-19 in the workplace while delivering essential financial services to the public.

The Reserve Bank continues to be vigilant in closely monitoring its economic and financial indicators and stands ready to adjust its monetary policy settings if needed to maintain internal and external stability and support macroeconomic growth.

Appendix 1: Monetary Policy Objectives

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

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

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

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

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

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

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

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

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