NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

February 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 Tongan economy continued to expand by an estimated 0.7% in 2019/20, a similar growth rate to that of 2018/19, according to the latest National Accounts report from the Statistics Department. This indicates some resilience in the Tongan economy in the face of the global pandemic and Tropical Cyclone Harold. Tonga's ability to remain COVID free has also played a large role in maintaining this positive outturn.

The global economy expects to record positive growth in 2021 of 6.0%, driven by a strong recovery in advanced economies as a result of large fiscal stimulus and accommodative monetary policies. This is following a contraction of 3.3% in 2020 as reported in the Apri 2021 International Monetary Fund World Economic Outlook.

During the six months to February 2021, the NRBT has continued to maintain its accommodative monetary policy stance given the global pandemic's negative impacts on the economy. In reviewing the current monetary policy measures, the NRBT considers the monetary policy outcomes to be adequate.

The annual headline inflation remained relatively low over the six months to February 2021, averaging at 0.1%, below the Reserve Bank's reference rate of 5%. The fall in global oil prices and the excess supply of domestic food were the main drivers of the low inflation in 2020. However, due to the rebound in global oil and commodity prices, inflation has slowly crawled up in early 2021.

Gross official foreign reserves continued to grow strongly, reaching $692.4 million, equivalent to 11.7 months of imports cover, well above the minimum threshold of 3 months. Receipts of official budget support and relief funds from development partners and a loan from the IMF's Rapid Credit Facility were the main drivers of the strong growth in official reserves. This is in addition to higher private remittances from Tongan diaspora overseas.

The banking system remained sound and stable during the review period, supported by strong capital positions, excess liquidity, and low levels of non-performing loans. Broad money has expanded by $78.7 million to $703.4 million, largely corresponding to the strong growth in foreign reserves. Similarly, liquidity (reserve money) rose by $84.9 million to $421.2 million, mostly driven by higher commercial banks' exchange settlement account balances.

Commercial banks' lending slightly rose by 0.9% owing to a pick up in business lending mostly to the construction, services and forestry sectors. Deposits also increased by 11.2%, reflecting higher demand, time and saving deposits. Consequently, the banks' total loans to deposit ratio fell further to 68.2%, below the Reserve Bank's minimum threshold of 80% and reflecting the relatively higher growth in total deposits. The weighted average interest rate spread slightly widened as the decrease in deposit rates more than offset the fall in lending rates.

Outlook

The GDP growth outlook for the Tongan economy for 2020/21 is a contraction of 2.0% (revised up from -4.4% in the August 2020 MPS), owing mostly to the prolonged global pandemic and the extended border lockdown. A moderate recovery of 1.6% is expected for 20201/22 on the assumption that the international border would reopen in early 2022, with much stronger recovery projected for the outer years.

The inflation rate is expected to pick up close to the 5% reference rate in the near term, as oil prices continue to rise in line with economies reopening borders and resuming normal activities.

Foreign reserves will remain in comfortable levels above the minimum 3 months of import cover in the near term, despite an expected rise in imports of goods and services. More budget support and grants from development partners is expected for the end of the 2020/21 fiscal year, and the suspension of the EXIM principal loan repayments also supports this outlook.

Credit growth is anticipated to remain subdued in the coming months as borrowers remain cautious of the COVID-19 related uncertainties. Non-performing loans are also expected to be contained as some commercial banks extend their COVID-19 relief packages for their affected clients. However, the Reserve Bank continues to closely monitor banks' asset quality and ensure adequate provisions are in place to absorb shocks in the banking 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 will also boost consumer confidence and will likely lead to the safe reopening of the international border and the resumption of international travel.

Nevertheless, uncertainties remain on the evolution of the pandemic coupled with the outbreak of new variants in various countries tilting the outlook mostly to the downside. This is in addition to Tonga's vulnerability to natural disasters and other external shocks.

Given the above developments and outlook, 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

Global economic growth for 2021 is expected to rebound by 6.0% in 2021 from the estimated contraction of 3.3% in 2020 as reported by the IMF in its April 2021 World Economic Outlook (WEO). This is an upward revision from the estimated growth of 5.2% for 2021 in the IMF's October 2020 WEO.

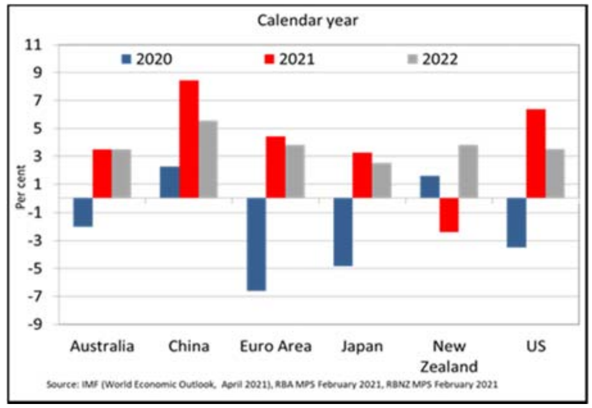
The revised forecast for 2021 reflects the impacts of additional fiscal support in large economies such as the US, Japan, and the European Union (EU) region, which stimulate investments, business activities, and employment opportunities. The launch of the COVID-19 vaccine across countries is expected to boost business confidence supported by accommodative monetary policy actions being key contributors to the positive outlook for 2021. Global economic growth for 2022 is projected to rise at a moderate pace of 4.4% (compared to 4.2% in the October 2020 WEO).

Global oil prices are projected to rebound by 30.0% in 2021 in line with the global economic recovery, coupled with the oil supply reductions in major producing countries. According to Reuters, global oil prices averaged at USD61.70 per barrel in February 2021, which is higher than an average of USD44.76 per barrel in August 2020, USD55.77 per barrel in February 2020 USD59.72 in August 2019. The IMF April 2021 WEO projects global oil prices to average at USD58.52 per barrel in 2021 and USD54.83 per barrel in 2022, compared to the projected average of USD41.69 per barrel in 2020.

Advanced Economies

In advanced economies, economic growth has shown positive signs of recovery in the second half of 2020 and is anticipated to pick up stronger by 5.1% in 2021 (upward revision to a forecast of 3.9% in the October 2020 WEO), from a contracted growth of 4.7% in 2020. Economic activities are expected to resume along with the rollout of vaccination programs supported by a recovery in demand on the back of substantial fiscal packages and accumulated savings in 2020. Economic activities in the US is anticipated to return to pre-COVID-19 level in the first half of 2021. Economic growth in the Euro Area for 2021 is projected to rise by 4.4%. However, this is slightly lower compared to the 5.2% growth in the October 2020 WEO largely due to the resurgence of COVID-19 cases during the last quarter of 2020, warranting extended lockdowns.

Figure 1: Growth Projection in the Advanced Economies



Emerging Market and Developing Economies (EMDE)

For EMDEs, economic growth is forecasted to expand by 6.6% in 2021 (revised from 6.2% in October 2020 WEO). The upgraded outlook is largely driven by strong growth recovery in Emerging and Developing Asia such as China, India and the ASEAN-5 countries[1]. This is attributed to continued efforts on containment measures, central bank liquidity support, and sizeable public investment initiatives. However, growth is expected to vary amongst countries based on the intensity of the pandemic, economic structure, and exposure to shocks. Overall, growth is forecasted to improve but at a slower pace of 4.9% in 2022, as restrictive containment measures is expected to be more frequent compared to advanced economies.

South Pacific Economies

The South Pacific region performed weaker than expected at a revised GDP growth of -7.0% for 2020 compared to the previous estimate of -5.7% in the August 2020 MPS. The economic downfall is attributed to the negative impact of the COVID-19 pandemic on the tourism, trade, and transportation sectors in the region. With the prolonged state of the COVID-19 pandemic coupled with the region's vulnerability to natural disasters, growth for 2021 is anticipated to remain subdued at a regional average of -0.4% before rebounding by 4.1% in 2022, as economic activities are expected to return to pre-COVID-19 levels. This hinges on several factors including the success of the vaccine rollout programs and the effectiveness of travel protocols for tourist destinations, as well as development in commodity and energy prices.

Figure 2: Growth Projections in the Pacific

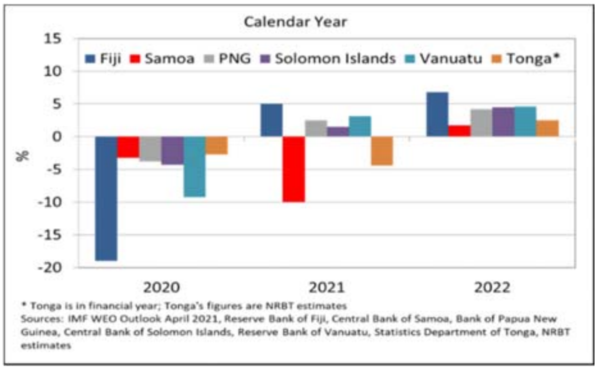


Table 1: World Data (Real GDP Growth, Inflation, and Unemployment)

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
World Growth	-3.3	6.0	4.4						
Australia	-2.0	3.5	3.5	0.9	1.5	1.5	6.8	6.0	5.5
China	2.3	8.4	5.6	-0.3	2.3	1.9	3.8	3.6	3.6
Euro Area	-6.6	4.4	3.8	-0.3	1.8	1.2	7.9	8.7	8.5
Japan	-4.8	3.3	2.5	-0.9	1.2	0.2	2.8	2.8	2.4
New Zealand	1.6	-2.4	3.8	1.4	2.2	1.6	4.2	5.0	5.1
United Kingdom	-9.9	5.3	5.1	0.5	2.1	1.9	4.5	6.1	6.1
United States	-3.5	6.4	3.5	1.4	2.3	2.5	8.1	5.8	4.2

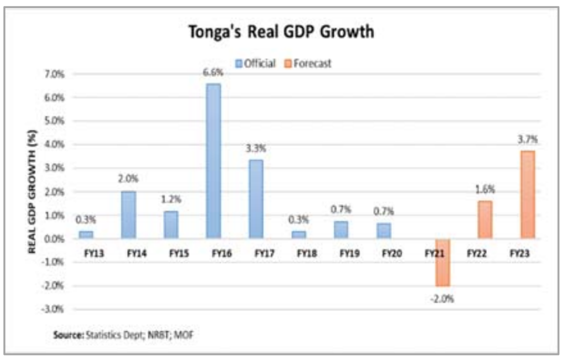
Note: f – forecast
Source: IMF (World Economic Outlook, April 2021), NRBT, RBA Feb 2021 MPS, RBNZ Feb 2021 MPS

2. Tonga's Economic Growth

Real GDP Growth

In its latest National Account Statistics report for 2019/20, the Statistics Department estimated real GDP growth to be 0.7%, similar to the previous year's growth rate. At factor cost (before net taxes), GDP grew at 0.2% compared to 2.0% in the previous year. This implies resilience in the Tongan economy despite the negative impacts of COVID-19 on the tourism industry starting early 2020, the closure of the international border since March 2020, and TC Harold in April 2020. As one of the very few remaining countries in the world that is still COVID free, Tonga has managed to continue domestic operations with less or no restrictions as compared to national lockdowns observed in many countries.

Figure 3: Real GDP Growth



The positive GDP growth for 2019/20 contrasts with the NRBT's estimated contraction of 2.7% in its August 2020 MPS. A later joint forecast by the Tongan authorities (NRBT and MOF) resulted in a more moderate projection of -0.8%, while the IMF projected a 0.5% contraction. According to the National Accounts report, the expansion in the Tongan economy was propped up by the positive growth in the primary sector (0.8%) and the services sector (0.9%) driven by expansions in agriculture, wholesale & retail trade, public administration, education and health. However, growth in the industry sector declined by 2.9%, reflecting a sharp drop in construction due to the completion of a few government construction projects in the previous fiscal year. Other sectors that reflected the impacts of the global pandemic and the border closure were the transport, accommodation & food services, real estate activities, and arts & entertainment sectors.

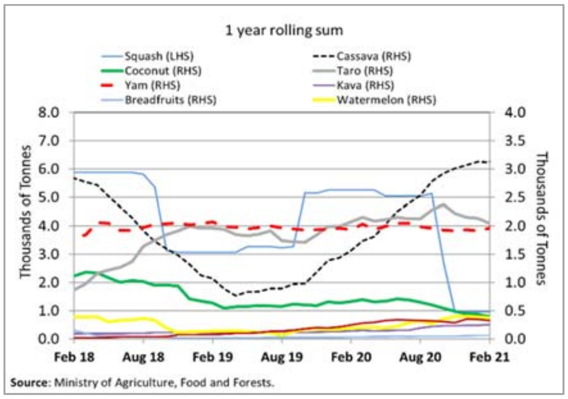
For the current fiscal year 2020/21, the authorities expect real GDP growth to contract by 2.0% due to the extended border closure bringing the tourism industry to a standstill, the weakening aggregate demand, and the deferral of some of the government infrastructure projects. The Tongan economy is expected to start recovering in 2021/22 by 1.6% on the back of successful vaccine rollouts and the anticipated reopening of the border for international travel. Stronger growth rates are also projected for the outer years. However, risks to the forecast are mostly on the downside as new variants of the virus emerge, and the evolution of the global pandemic still remains uncertain.

Primary Production

During the current global pandemic environment, some opportunities were realised in the primary sector, specifically in the agricultural sector. Favourable weather conditions and Government initiatives to ensure food security led to the excess food supply. At the same time, the reallocation of labour from the tourism industry and the seasonal working schemes also supported production. A trial shipment of watermelon exports to New Zealand also started in October to December 2020, even though it was temporarily halted after the first shipment when fruit fly larvae were detected at the border. The Ministry of Fisheries also lifted the ban on harvesting sea cucumbers for 3 months, July to September 2020, as part of their support to the fishermen in the sector.

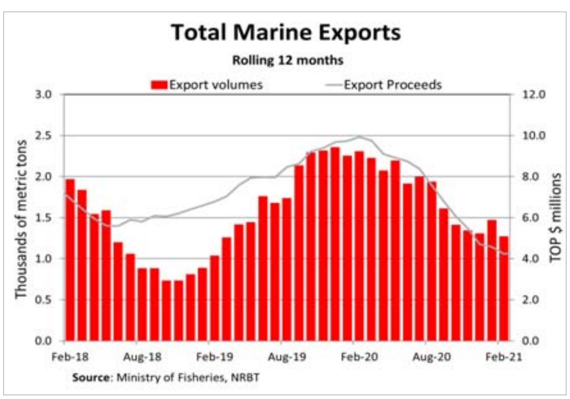
In the six months to February 2021, agricultural export volumes rose by 13.8% mostly in the export of cassava and taro. There were also some squash exports recorded during the squash harvesting season, however, this was significantly lower compared to last year's harvest. The sharp drop in squash production may offset the positive performance from root crops over the year. Kava production has improved and kava prices have dropped significantly owing to the higher supply. However, the export of kava, especially to Australia, is also affected by the border closure. Proceeds for agricultural exports also rose by 11.0% in the same period. The domestic market survey data shows that the volume of agricultural products sold domestically in the six months to February 2021 fell by 7.6% mostly from the decline in the volume of root crops (38.3%), reflecting the fall in demand from the tourism-related businesses and people's preference to export root crops to their families and relatives overseas. Vegetable products, however, rose in the same period by 174.4% due to the replanting initiatives from both the Government and non-profit organisations.

Figure 4: Major Agricultural Exports (tonnes)



On the other hand, the border closure adversely affected the fisheries sector, mainly the export of fresh fish via airfreight. Fisheries export volumes fell in the six months to February 2021 by 26.6%, largely due to lower tuna exports. Similarly, aquarium exports also fell by 16.3%. Export proceeds for fisheries and other marine exports however, slightly rose by 0.9%.

Figure 5: Marine Exports (metric tons)



Secondary Production

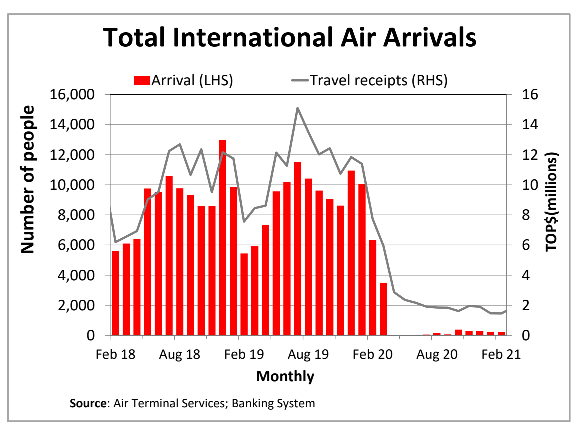
A few construction projects benefitted the secondary sector over the past six months to February 2021 such as the Pacific Resilience Program (PREP) completing a number of classrooms for schools that were damaged by TC Gita. The reconstruction projects for TC Gita and TC Harold also completed some private dwellings. The Nationwide Early Warning Systems (NEWS) project also contributed to the construction of several MEIDECC offices in the outer islands. Total lending to the construction sector also grew in February 2021 by 86.1% from August 2020. Payments for the import of construction materials also rose by 17.6% during the six-month period. These activities are expected to positively contribute to the sector with positive spillovers to the manufacturing, mining and quarrying sectors.

The ongoing Road Improvement projects funded by the Government continue to support the Mining & quarrying sector. Tonga Power Ltd is also undergoing several renewable energy projects alongside its network upgrade projects contributing to the Utility sector. During the six months to February 2021, electricity consumption and production rose by 6.8% and 4.7%, respectively. The number of electricity consumers also increased by 1.3%, coinciding with the positive outturn in construction projects. The rebound in fuel prices passed through to domestic electricity prices resulting in two electricity tariff increases in November 2020 and January 2021.

Tertiary Production

The halt in the Tourism industry continues to severely impact the tertiary sector, particularly the transport, accommodation, real estate, administrative & support services, and the arts and entertainment sectors. This also reduces aggregate demand, indirectly affecting other sectors such as wholesale & retail trade, agriculture, fisheries, and other services. However, many of Tonga's tourism businesses diversified to other business activities such as food and catering, hosting functions, agriculture and other services.

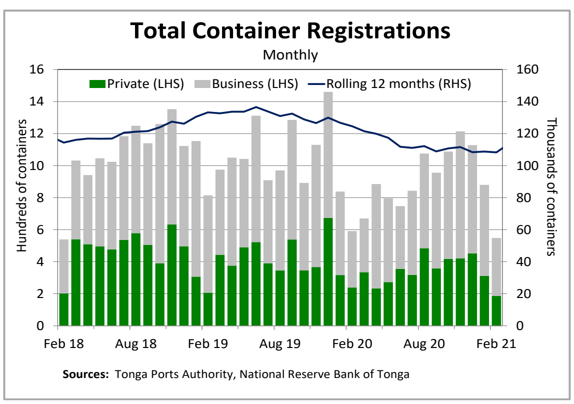
Figure 6: International Air Arrivals & Travel Receipts



International air arrivals fell in the six months to February 2021 by 59.4%, while international air departure fell by 685%. The number of international flights recorded also fell by 42.4% in the same period reflecting the extended border closure. Consequently, travel receipts also dropped by 40.3%, accentuating the impact on the tourism sector.

Container registrations rose over the six months to February 2021 by 15.9%, owing mostly to a 21.5% increase in business container registrations and a 7.4% increase in private container registrations. This largely relates to the Christmas holiday festivities and the back-to-school preparations. It also includes the delayed shipments from previous months that were due to port congestions and quarantine requirements in overseas ports. The pick-up in container registrations also coincides with the rise in payments for import of wholesale & retail goods, construction materials and motor vehicles, indicating a rebound in trading and consumption activities. The increase in private container registrations reflects the inflow of in-kind remittances and households taking advantage of the COVID-19 related CT and import duty exemptions.

Figure 7: Total Container Registrations



The information & communication sector, on the other hand, has promising prospects as technology plays a critical role in virtual communications during the Covid-19 lockdown. The financial sector is also advancing into digital products as online banking and money transfers offer more convenience and lower costs. Meanwhile, credit growth remains subdued as lenders and borrowers remain cautious given the uncertainties of the global pandemic.

The Government has received additional support to fund its stimulus package and other relief efforts to businesses, employees and vulnerable groups affected by the pandemic. These funds also support growth in public administration and education and health sectors as they make the necessary preparations for the eventual entry of COVID-19 into Tonga, in addition to the preparations for the vaccine rollout. Meanwhile, cash payouts provided needed support for businesses and employees' immediate financial obligations.

Unemployment

Higher unemployment is noted for the tourism sector as many businesses have either downsized or closed operations. Other business sectors, on the other hand, continued to maintain their staff where possible while coping with the impacts of COVID-19. Laid-off workers, however, are employed in the informal sector such as agriculture, fishing, arts & crafts, food & restaurants, and roadside trading.

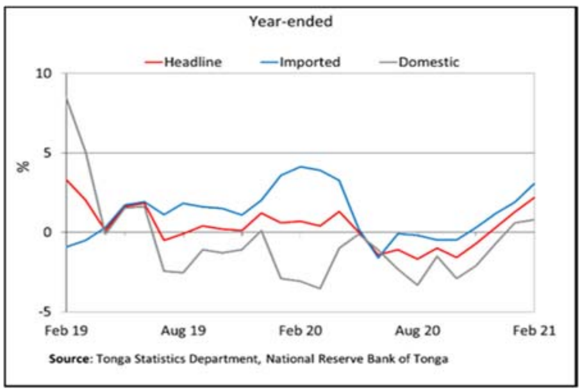
Tonga has continued its repatriation of seasonal workers under the Seasonal Working Scheme to Australia, as they faced labour shortages in the agricultural sector. Meanwhile, Tonga has temporarily ceased participation in the New Zealand Recognised Seasonal Employer scheme due to new travel restrictions and quarantine requirements from the New Zealand government.

3. Promoting Low and Stable Inflation

Recent Developments

In the year to February 2021, headline inflation for Tonga rose to 2.1% compared to 0.8% in February 2020 and -1.6% in August 2020. This is the highest inflation rate since the 3.2% recorded in February 2019. Tonga experienced low periods of inflation in 2020, recording six consecutive months of annual deflation from June to November 2020, before rising to 0.3% in December 2020. However, the higher prices for February 2021 is attributed to higher prices for imported and domestic items, particularly food items, tobacco, clothing and footwear.

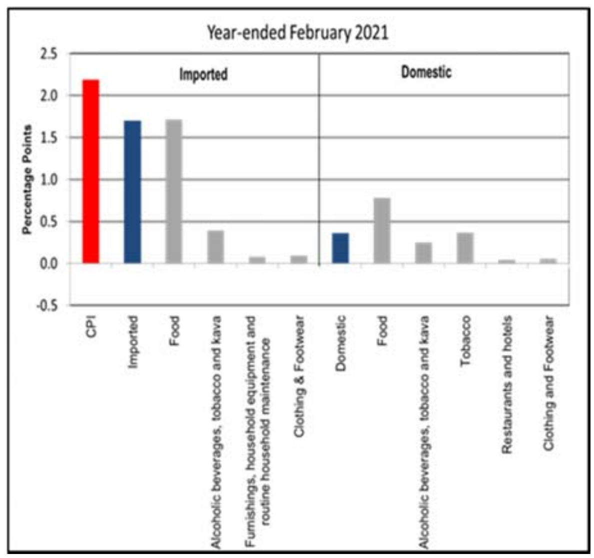
Figure 8: Inflation



Local prices returned to positive growth in 2021, increasing by 0.9% annually for February 2021, after recording negative growths all throughout 2020. This is largely due to the decline in fuel prices stemming from weakening global oil prices amidst the COVID-19 pandemic. The fall in prices of other local items such as root crops and kava Tonga were key contributors to the drop in domestic prices for 2020, reflecting excess supply. However, this is higher compared to the 3.4% decline in August 2020 but lower than the 8.5% rise in February 2019. The increase in prices of local food items (5.3%), tobacco (8.8%), and clothing & footwear (13.1%) were significant drivers of the higher annual domestic prices, outweighing the fall in electricity, gas & other fuels, and kava Tonga prices. The increase in local food prices, specifically for vegetables and some root crops largely reflected the seasonality of these produces, resulting in fewer supplies in the market. Additionally, the pick up in the general price level from previous months led to higher costs for growers and thus higher cost of production, further contributing to the increase in prices of local food items.

Imported prices also increased in the year to February 2021 by 3.1%. This is higher compared to the 0.2% decline in August 2020, and lower than the 4.1% rise recorded in February 2020. The higher imported prices for February 2021 are attributed to the increase in the price of food, tobacco & alcoholic beverages, and clothing & footwear. In particular, the increase in food prices was highest for turkey tails, oranges, and mutton flaps which may be due to the flow-through effect of higher food prices from Tonga's major trading partners, particularly in New Zealand and Australia.

Figure 9: Contributions to Inflation



The new excise taxes on tobacco effective in July 2020 significantly drove the higher tobacco prices. This amendment is part of the Government's policies to combat non-communicable diseases and encourage healthier lifestyles.

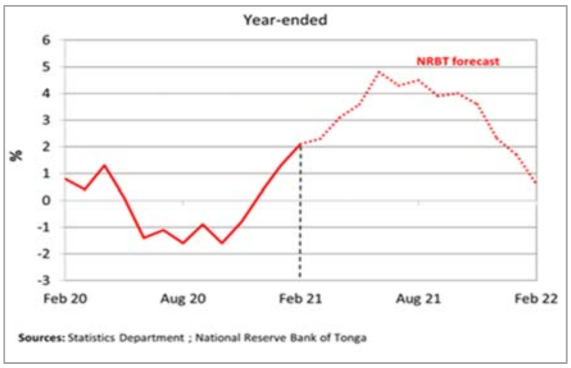
The strengthening of major trading currencies such as the Australian Dollar (AUD) and New Zealand Dollar (NZD) against the Tongan Pa'anga (TOP) also contributed to the rise of imported prices.

Outlook

The Reserve Bank anticipates headline inflation to pick up in the upcoming months towards the Reserve Bank's inflation reference rate of 5.0% per annum in 2021. The upward projection revolves around the expected rise in food items and oil prices. Nevertheless, the prolonged impacts of the COVID-19 pandemic coupled with Tonga's vulnerability to natural disasters and external shocks remains a upside risk to the inflation forecast.

The Reserve Bank will continue to closely monitor the sources of inflation and the associated impacts on Tonga's economy.

Figure 10: Headline Inflation Forecast

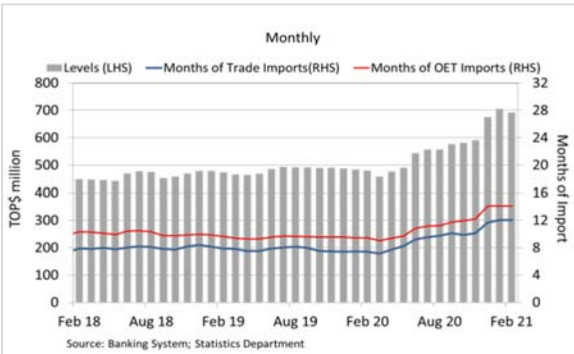


4. Maintaining an Adequate Level of Foreign Reserves

The Reserve Bank continues to carefully monitor the country's external monetary position to ensure that it maintains an adequate level of foreign reserves above 3 months of import cover. This is carried out 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 rose substantially in the six months to February 2021 by $136.3 million (24.5%) and $212.5 million (44.3%) over the year, to a record high of $692.4 million, equivalent to 11.7 months of imports of both goods and services. These significant movements resulted from an influx of donor funds and grants for budget support, official projects, and financial assistance for TC Harold and COVID-19. This is in addition to the inflow of private remittances, which has continued to hold up despite the impact of COVID-19 on our source remitting countries.

Overall OET Balance

In the past six months to February 2021, the overall OET balance recorded a surplus of $136.3 million, which is higher than the surplus of $76.2 million in the previous six months to August 2020. This is attributed to a higher surplus in the transfer account.

In the year to February 2021, the OET balance surplus rose substantially to $212.5 million, underpinned by a current account surplus reflecting higher official transfer receipts. Similarly, the capital account recorded a surplus balance stemming from both official and private capital net inflows. The financial account balance also improved over the year, driven mainly by lower interbank transfer payments.

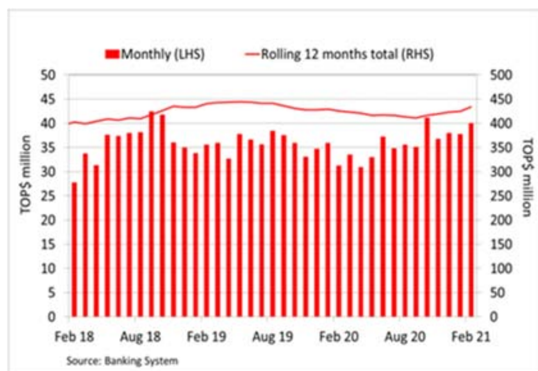
Figure 12: Balance of Overseas Exchange Transactions

OET Payments

Total OET payments rose in the six months to February 2021 by $11.9 million to $342.3 million compared to the $41.5 million decline in the last six months to August 2020. This was largely driven by an increase in payments for imports of goods and services.

In the year to February 2021, total OET payments fell by $83.4 million (11.0%) to $672.7 million. This was attributed mostly to a decline in payments for travel, primary income, portfolio investments, direct investments and official transfers.

Figure 13: Import Payments



Import payments over the six months to February 2021 rose by $23.8 million. Payments for imports of wholesale and retail goods increased the most by $22.7 million, followed by increases in motor vehicles and construction imports payments by $7.1 million and $3.4 million, respectively. These offset a decline in payments for oil and other imports, which fell by $8.7 million and $0.6 million, respectively. The strengthening of the major trading currencies against the Tongan Paánga during the same period has also contributed to higher import payments. Tonga continues to import wholesale and retail goods mainly from New Zealand, while the bulk of the import payments are denominated in US dollars due to oil import payments. Over the year, import payments increased by $8.3 million (2.0%) to $433.9 million. Payments for all import categories rose over the year except for oil imports. This was driven mostly by an increase in payment for construction materials which rose by $17.1 million (69.7%).

Total payments for services declined in the six months to February 2021 by $5.6 million (8.9%) due mostly to lower payments for transportation (air freight), computer services and professional and management services. This partially offset increases in payments mainly for insurance premiums, government services and telecommunication services. Services payments also fell over the year by $55.0 million (31.4%) to $120.3 million. This was largely underpinned by lower payments for travel, professional & management services, maintenance & repair services and, freight services.

Primary income payments also decreased by $6.2 million (61.6%) to $3.9 million during the six-month period, driven mostly by lower dividends paid out to non-resident shareholders and interest payments. Annually, income payments declined by $9.2 million (39.6%) to $14.0 million. This resulted mainly from lower dividends paid out to non-resident shareholders.

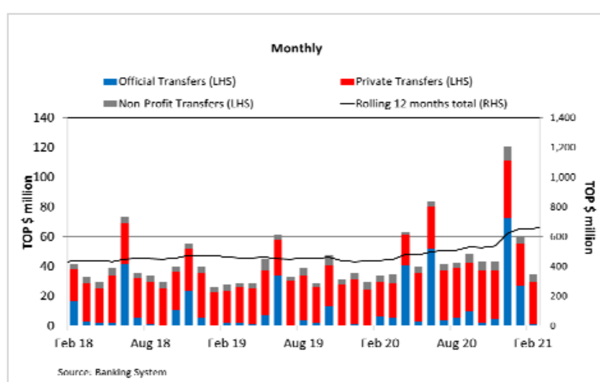
Capital payments rose marginally over the six months to February 2021 by $0.3 million as payments for both private and official capital investments increased during the same period. However, capital payments fell by $1.0 million over the year, attributed to a decline in private and official capital investment payments. In the past six months to February 2021, financial payments fell by $8.2 million (41.5%) due mostly to a decline in other financial payments, primarily payments of loans from non-resident banks. Similarly, financial payments declined over the year to February 2021 by $25.6 million (44.9%), reflecting lower payments for portfolio investments and direct investments.

OET Receipts

Total foreign exchange receipts also increased over the six months to February 2021 by $48.7 million (11.0%) to $492.4 million on the back of higher receipts in the transfer, capital and income accounts. This was partially offset by lower receipts mainly from services (insurance and travel), merchandise exports and other financial investments. In the year to February 2021, total foreign exchange receipts increased significantly by $125.0 million (15.4%) to $936.1 million. This stemmed mostly from higher transfer receipts ($214.9 million), primary income ($12 million) and official capital receipts ($10 million). This was partially offset by lower receipts mainly from services (travel), merchandise exports and direct investments. The substantial rise in transfer receipts reflected increases in official transfer receipts of $154.7 million, attributed mostly to receipts of budget support, official grants, and remittances of $51.0 million.

In the six months to February, total transfer receipts rose by $46.5 million (15.3%) to $351.1 million, underpinned by increases in all categories. Private transfer receipts rose by $25.9 million, followed by a $13.6 million increase in non-profit transfer receipts. The official transfer receipts also increased by $7 million (6.4%), supported by higher receipts of budget support, project funds, loan from the IMF's Rapid Credit Facility and financial assistance for TC Harold and preparations for COVID-19. In the year to February 2021, total transfer receipts rose significantly by $214.9 million (48.7%) to $655.7 million, supported by increases in all categories, mostly official transfer receipts. This stemmed mostly from receipts of budget support, project funds and relief for COVID-19 and TC Harold from donor partners.

Figure 14: Transfer Receipts



Total remittances increased over the six months to February 2021 by $30.1 million (15.8%) to $220.7 million and accounted for 44.8% of the total OET receipts for the same period. Receipts from all categories of remittances rose over the six months to February except for receipts for social benefits. The majority of the increase was for private transfers, approximately 90.0% 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 activities and church obligations

Despite the impact of COVID-19 on remitting countries, total remittances held up firmly over the year to February 2021, increasing by $60.5 million (17.3%) to its highest record level of $411.3 million. Remittances as a share of GDP was around 40% as at February 2021. Continued transfer of funds from families and friends abroad to support their families during COVID-19 and financing other domestic activities and church obligations are the main reasons for the surge in remittances over the year. Majority of remittance receipts were denominated in US Dollars, representing 38.5% of the total remittance receipts. Australian dollars followed with 31.5% and New Zealand Dollars with 25.1% share of total remittance receipts. The general appreciation of the trading partner currencies against the TOP also benefited the recipients of remittances.

Receipts for services in the six months to February 2021 declined by $17.6 million (29.0%) to $42.9 million as receipts for most services fell, especially insurance. Insurance receipts declined by $11.5 million following the insurance payout from the Pacific Catastrophe Risk Assessment and Financing Initiative for TC Harold in May 2020. Travel receipts from tourism-related earnings fell by $6.9 million (40.3%) as the tourism sector continued to be impacted by the international border lockdown and TC Harold. Receipts for construction & installation related services also declined by $2.8 million (71.9%). In year ended terms, the total service receipts declined significantly by $104.4 million (50.2%) to $103.4million. This stemmed mainly from travel receipts declining by $107.8 million (79.8%) due to the international border closure since March 2020. This is in line with the 46.8% decrease in international air arrivals. The decline in travel receipts outweighed the increase in other services by $3.4 million (4.7%), reflecting receipts from telecommunication services and insurance claims following TC Harold in April 2020.

In the six months to February 2021, total export proceeds rose by $0.6 million (10.2%) to $6.4 million, owing to higher proceeds from agricultural and marine exports of $0.6 million and $0.02 million, respectively. This partially offset the slight decline in receipts from other marine exports. The higher agricultural proceeds resulted mostly from squash products and mixed crops. However, the decline in other marine exports coincided with the lower exported volume of fish and aquamarine products during the same period. This resulted mostly from reduced airfreight services and flights due to the COVID-19 travel restrictions.

Conversely, total export proceeds fell over the year to February 2021 by $7.2 million (37.3%) to a total of $12.1 million. All export categories declined, with marine exports decreasing the most. This coincided with the declines in the total exported volume of agricultural and marine exports over the year. Receipts from agricultural exports accounted for 56.0% of the total export proceeds, while fisheries and marine exports accounted for 34.8%, and the remaining 8.4% were from other exports.

Capital receipts rose over the six months to February 2021 by $21.3 million (180.4%) to $33.2 million. This resulted from increases in official and private capital receipts by $17.4 million and $3.9 million, respectively. The increase in official capital receipts reflected receipts from donor partners for capital expenditures and investment projects. Over the year to February 2021, the capital receipts was also higher by $11.7 million, rising to $45.0 million. Both official and private capital accounts contributed to this increase by $10.0 million and $1.7 million, respectively.

Over the six months to February 2021, total financial receipts declined by $7.0 million (15.7%) to $37.6 million. This was mainly underpinned by lower receipts from other investments, particularly interbank transfer receipts. Over the year to February 2021, the total financial receipts fell to $82.3 million from $84.3 million in February 2020. This was driven mainly by lower transfers for direct investments offshore during the year.

The balance of unclassified transactions recorded an average outflow of $4.2 million per month over the year to February 2021, compared to $4.0 million in the previous year. This was due to higher financial claims by non-residents, which involved foreign exchange dealings between commercial banks and their overseas correspondent banks.

Exchange Rates

In the six months to February 2021, the Nominal Effective Exchange Rate (NEER) index fell by 5.7% due to the NZD, AUD, FJD, CNY, and GBP appreciation against the TOP. Most of these trading currencies have strengthened against the TOP since April 2020. This followed the heightened financial market volatility at the onset of the global pandemic, which peaked in March 2020. Similarly, the Real Effective Exchange Rate (REER) index fell by 2.7% during these six months reflecting Tonga's low inflation rate relative to its major trading partners.

In year ended terms, both the NEER and REER index fell by 8.2% and 7.1%, respectively. Tonga's major trading currencies, such as the AUD, NZD, FJD, Euro, GBP, and CNY, strengthened against the TOP. The decline in the REER reflected the deflation recorded during the same period. This implies an improvement in Tonga's trade competitiveness and benefits recipients of foreign currencies. However, the lower NEER may cause inflation to increase through higher import prices.

Outlook

The Reserve Bank has reviewed its outlook for foreign reserves based on the latest developments. Despite the expected negative economic impacts from the COVID-19 pandemic, the Reserve Banks still projects foreign reserves to remain at comfortable levels in the medium term, above the minimum level of 3 months of import cover. This projection is based on the following key factors:

- The expected influx of additional budget support and relief funds from development partners to support the Government's efforts in mitigating the economic and financial impacts of the global pandemic.
- Expected receipt of Government grants and project funds for earmarked infrastructure projects such as the upgrade of the Queen Salote Wharf and the Fanga'uta Lagoon Bridge.
- Remittance receipts continue to hold up reflecting the impact of monetary and fiscal policy stimulus in source remitting countries. Receipts of support from families abroad for the Kava Idol and Tonga High School Ex-student's Concert have also contributed to the increase in remittances.
- The continuation of the Seasonal Workers Programme (SWP) scheme to Australia to facilitate high demand from Australian farmers is expected to support remittance receipts in the near term. More than 500 seasonal workers have joined the SWP's scheme since the repatriation programme started in November 2020.

However, risks to the outlook are mostly on the downside such as:

- Extended border lockdown resulting in an inactive tourism sector with sharp declines in travel receipts and other tourism activities.
- Fragile financial markets affecting returns on foreign investments and exchange rates.
- Strong rebound in global commodity prices and oil prices.
- Ongoing trade tensions and political unrest in advanced economies.
- High uncertainty remains on the global exit from the COVID-19 pandemic.
- De-risking issues may impact the flow of remittances to Tonga.
- High vulnerability to natural disasters and external shocks.

5. Promoting a Stable Financial System

Despite the negative effects of COVID-19 on the global and domestic economy, the banking system remained sound during the six months to February 2021. This was reflected in strong capital positions, adequate profits, high liquidity, and low non-performing loans. The loans to deposit ratio declined and remained below the minimum 80% threshold. However, both the total deposits and total banks' lending increased. Weighted average interest rate spread widened as the deposits rates fell more than the lending rates.

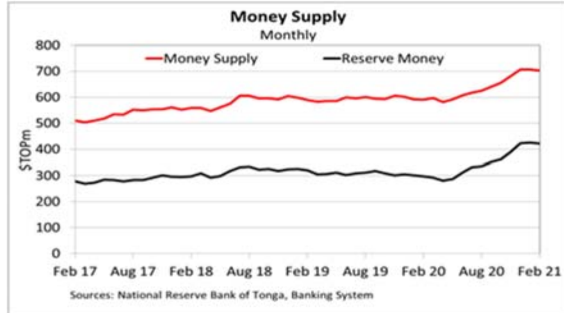
Money Supply

During the six months to February 2021, broad money expanded by $78.7 million (12.6%) to a total of $703.4 million peaking in December 2020 at $707.5 million. The increase in broad money was attributed mainly to the higher foreign reserves.

Over the year to February 2021, broad money increased again by $113.3 million (19.2%), underpinned by a $227.1 million (45.9%) rise in net foreign assets which outweighed the $113.4 million (118.4%) decline in net domestic assets. The higher foreign reserves drove the increase in net foreign assets yet again, whilst higher government deposits lowered the net domestic assets.

Liquidity in the banking system (reserve money) rose in the six months and in the year to February 2021 by $84.9 million (25.3%) and $123.3 million, respectively, to $421.2 million. These increases resulted from a rise in all the three categories, with the Bank's Exchange Settlement Accounts (ESA) rising the most over the month by $69.8 million (38.8%) and over the year by $85.0 million (51.7%). This coincided with the increase in commercial banks' deposits to the Reserve Bank vault. Currency in circulation followed with a $7.9 million (8.1%) monthly rise and an annual increase of $28.9 million (37.6%), in line with the festivities such as the churches' annual donations, Christmas, and New Year festivities. Required reserves also increased by $7.3 million (12.4%) over the month and $9.4 million (16.6%) over the year, corresponding to the rise in total deposits.

Figure 15: Broad Money and Liquidity



Lending

The banks' total lending (including Government Development Loans (GDL) increased in the six months to February 2021 by $4.6 million (0.9%) to a total of $492.2 million. This was solely driven by higher business loans, mainly construction, professional & other services, and forestry loans reflecting more activities in these sectors during the period. GDL accounted for 1.7% of total loans in February 2021, similar to its share in August 2020 but slightly lower than the 1.8% share recorded in February 2020. An additional fund of $5 million was added to the GDL scheme in November 2020, which assisted businesses directly affected by COVID-19 and further contributed to the increase in total Government Development Loans.

Table 2: Total Lending

	Monthly			Annual	
Lending	Feb-21	Aug-20	% Growth	Feb-20	% Growth
Total Lending ($ in million)	492.2	487.6	0.9	499.7	-1.5
Business lending	234.0	229.0	2.20	237.8	-1.6
Household lending	258.2	258.7	-0.17	261.9	-1.4
Other lending	0.0	0.0	0.0	0.0	0.0

Source: Banking System, National Reserve Bank of Tonga

In the year to February 2021, the total banks' lending declined by $7.5 million (1.5%), compared to a credit growth of $16.0 million (3.3%) in the year to February 2020. Both business and household loans declined due to loan run-offs, mainly loans to public enterprises and businesses in the manufacturing and professional & other services, as well as households' other personal loans. However, the construction loans increased annually, reflecting businesses and households reconstruction work after TCs Gita and Harold . Non-performing loans over the six months to February 2021 improved from $4.8 million to $2.4 million mainly driven by upgrades of loans in the agricultural and fishing sectors, the partial loan settlements in the transport sector and repayments of housing loans and business loans. However, the negative effects of COVID-19 on various sectors of the economy continues to raise concerns over a potential hike in non-performing loans and household indebtedness.

The banks' total deposits rose in the six months to February 2021 by $70.6 million (11.2%) and over the year by $108.7 million (18.3%). This was due mainly to higher demand deposits made by public enterprises, more time deposits from churches and schools' ex-students, and higher saving deposits from private individuals.

Interest Rates

In the six months to February 2021, the banks' weighted average interest rate spread widened by 4.4 basis points to 5.69%. The weighted average deposit rates decreased and outweighed the decline in the weighted average lending rates. Time deposit rates decreased the most over the six-month period, followed by lower savings and demand deposit rates. Similarly, lending rates declined mainly for businesses in the construction, utilities, and agricultural sectors as well as households' other personal loans. In the year to February 2021, the weighted average interest rate spread narrowed as the weighted average lending rates declined more than the weighted average deposit rates. The lower lending rates was attributed mainly to a decrease in rates offered to businesses in the mining/quarrying, construction, and utilities sectors as well as households' other personal loans. The lower deposit rates annually resulted from lower time and saving deposit rates.

Table 3: Weighted average interest rates

Weighted average of all banks					
	Month ended			Change over 6 months to	Change over 12 months to
	Feb 21 %p.a.	Aug 20 %p.a.	Feb 20 %p.a.	Aug 20 Bps	Feb 21 Bps
Deposits all	2.00	2.13	2.04	-13.20	-3.82
Demand	0.34	0.38	0.32	-4.28	1.63
Savings	2.54	2.60	2.58	-6.29	-4.30
Term	3.32	3.45	3.48	-13.40	-16.29
Loans all	7.69	7.78	8.01	-8.85	-32.03
Housing	8.08	8.04	8.05	4.16	2.36
Other personal	11.33	11.35	11.36	-2.38	-3.11
Business*	7.11	7.50	7.84	-39.61	-73.41
Other	0.00	0.00	0.00	0.00	0.00

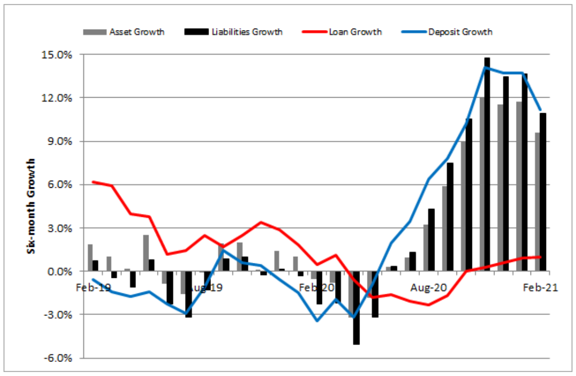
*Included Statutory Non-financial Corporation and Other Financial Corporations

Banking System Performance

The banking system remained sound during the six months to February 2021. Total assets increased by 9.6% to $993.2 million over the six months to February 2021. The asset growth reflected the increase in banks' ESA by $69.3 million (38.5%) followed by a rise in demand deposits due from depository institutions abroad of $9 million (31.4%). There was also a credit growth of $4.7 million (1.0%), mainly private business loans. Accrued Interest receivable also grew by $2.4 million (29.9%) due mainly to accrued interest on individuals' loans and advances. Cash holdings, on the other hand, fell by $5.9 million (20.4%) followed by holdings of debt securities (Government bonds) decreasing by $1.7 million (4.9%) over the six months to February 2021. Total liabilities also recorded an increase over the six months to February 2021 of $77.8 million (10.9%) to $791.3 million. This was attributed mainly to a growth in deposits of $70.6 million (11.2%) as all categories of deposits rose over the period. Demand deposits rose by $42.6 million (16.9%) mainly due to higher deposits by private businesses of $14.6 million followed by a rise in deposits by public enterprises of $13.8 million, and deposits by Government and private non-banks of $5.0 million and $2.3 million respectively. Time deposits increased by $16.7 million (6.3%) while savings deposits rose by $11.3 million (9.7%) over the six months to February 2021 mainly due to deposits by non-profit organisations (churches) followed by the Retirement Funds deposits. Other liabilities also rose over the month by $4.9 million (19.7%) due mainly to other miscellaneous liabilities rising by $3.8 million (16.5%). This was attributed mainly to other banks' cheques that were settled during the period.

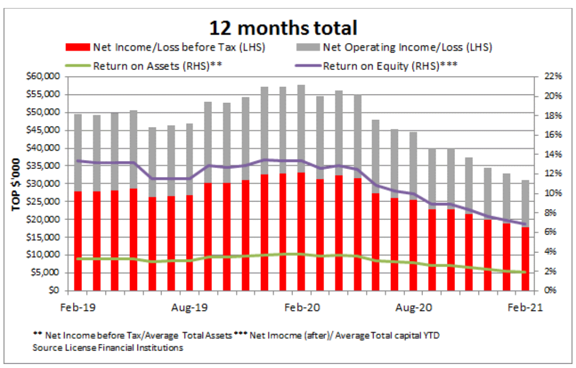
The total banking system remained profitable over the six months to February 2021. The Net Profit after Tax (NPAT) was $13.4 million, which was lower than the $19.0 million NPAT in the previous six months to August 2020 and $24.6 million NPAT in the same period last year. The lower profitability was attributed mainly to higher loan loss provision expenses of $3.7 million (61.8%). This was coupled with lower interest and non-interest income of $2.6 million (10.6%) and $2.3 million (4.6%), respectively.

Figure 16: Total Banking System Balance Sheet Development



Interest income fell by $2.3 million (4.6%), reflecting the moratorium on the principal and interest repayments on loans offered by the commercial banks since April 2020 to cushion the impacts of the COVID-19 pandemic. Non-interest income also declined mainly due to lower foreign exchange revaluation as the Tongan pa'anga appreciated against the US dollar over the six-month period.

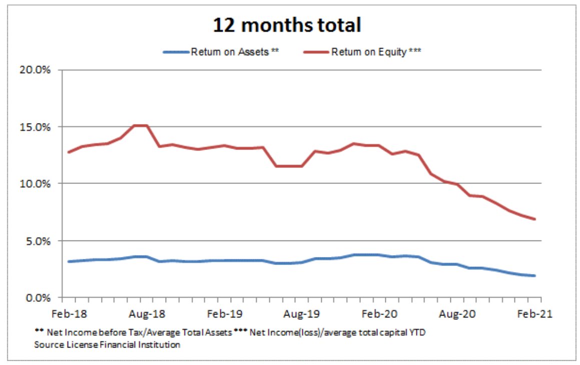
Figure 17: Total Banking System's Profitability



Return on Assets (ROA) and Return on Equity (ROE) decreased over the past six months to February 2021. ROA fell to 1.9% from 2.9% in August 2020. Similarly, ROE decreased to 6.9% from 10.0% in August 2020. The lower profitability reflects the banks raising loan loss provisions due to the COVID-19 pandemic's prolonged impact on the majority of their customers. The banking system's capital position remained strong and well above the Reserve Bank's minimum requirement of 15% at 33.7% in February 2021. This increase in the capital position to 31.6% in August 2020 largely reflects the increase in the eligible capital due to the FY2019/20 profits transfer to retained earnings in January 2021. Banks' net interest margin slightly declined to 3.4% in February 2021 from 3.9% in August 2020, due mainly to a decrease in the return on funds while the cost of funds remained relatively stable.

The overall quality of the banks' assets improved over the six months to February 2021. Total non-performing loans fell by $3.2 million (16.8%) to $15.9 million, representing 3.4% of total loans compared to 4.0% in August 2020. The lower impaired loans were driven mainly by the settlement of loans in the transport sector, particularly shipping companies, housing loans, and some restructured loans. The COVID-19 relief package for one of the banks is extended up to 2022 for their top tourism customers.

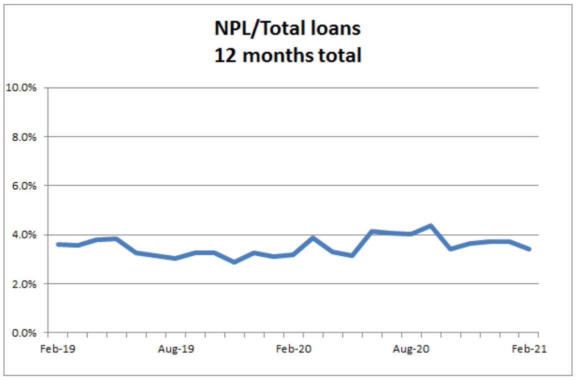
Figure 18: Total Banking System's ROE & ROA



The share of non-performing private individual loans to total non-performing loans increased to 73.3% ($11.6 million) from 68.9% ($13.1 million) six months ago, however, lower than 75.9% ($12.0 million) in February last year. Non-performing private individual loans comprised mainly of housing loans representing 57.9% of total non-performing loans, increasing from 55.9% in August 2020 and 57.4% in February 2020.

Non-performing business loans accounted for the remaining 26.7% ($4.2 million) of the total non-performing loans, improving from 31.1% ($5.9 million) in August 2020, but still higher than 24.1% ($3.8 million) in February 2020. Non-performing loans for the transport sector decreased as the healthy business cashflows of shipping companies enabled the repayments of their loan arrears. Shipping is currently a major means of cargo of all goods due to the international border restrictions. The restructure in one of the fisheries loans contributed to the lower non-performing business loans over the six months to February 2021.

Figure 20: Total Banking System Asset Quality Indicators



Provisions against loan losses continue to be sufficient with additional provisions raised over the last six months. Total provisions, therefore, rose to $23.8 million compared with $22.6 million in August 2020 following the ongoing quarterly review of the banks' provisions to ensure it remains conservative 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. The automated national payment system is to be deployed to the banks, this system aims to improve the efficiency of the settlement of banks' transactions.

Supervision of Non-Bank Financial Institutions (NBFIs)

The need for effective supervision of non-bank financial institutions continues to be a priority for the Reserve Bank. Thus the Reserve Bank continued to develop an adequate legal framework for regulating and supervising NBFIs. This will assist in fulfilling its objective in promoting a sound and efficient financial system as well as protecting the financial system and consumers from financial loss, fraud and money laundering. NBFIs account for only a small portion of the total financial system, but it plays an essential role in driving inclusive economic growth. The COVID-19 pandemic influences consumer behaviour in terms of demand for the use of digital financial services and platforms such as more direct deposits to bank accounts of remittances and fewer over-the-counter transactions. However, this also poses other types of risks such as cyber risks, agency risks, and additional operational risks. The establishment of a robust supervisory framework would mitigate such potential risks.

The Reserve Bank continues to monitor and oversee the conformity and operations of all the fifteen (15) authorised foreign exchange dealers as required by the Foreign Exchange Control Act 2018. The global banks' de-risking policy continued to affect the banks in Tonga in terms of retaining US dollar bank accounts with a correspondent bank overseas. However, the Reserve Bank continued to closely monitor and supervise authorised foreign exchange dealers to strengthen their AML/CFT policies and systems to ensure that they comply with the AML/CFT requirements and international standards. Technical meetings, quarterly spot checks, annual compliance check visits, trainings and guidance were provided during the year.The Reserve Bank is also developing a National KYC system to centralise and digitise KYC and Customer Due Diligence (CDD) processes. This may assist banks with their negotiation with correspondent banks in maintaining their bank accounts to facilitate the flow of remittances

The Microfinance Act 2018 gives the Reserve Bank the authority to license microfinance institutions. South Pacific Business Development (SPBD) is the only microfinance institution in Tonga that was licensed on 24th February 2020 and has operated for 11 years since its inception in July 2009. The Reserve Bank continues to act under its overarching supervisory role to consistently assess and monitor SPBD's performance through the collection of financial reports. This will complement quarterly compliance spot checks that the Reserve Bank plans to undertake to start in early 2021. Maintaining the financial soundness of microfinance institutions is crucial to ensure their business continuity and provide essential micro-financial services to the public. This will also enable the NRBT to assess the level of accessibility and availability of financial services to households for policy formulation to promote financial inclusion.

The Reserve Bank commenced implementing the Moneylenders Act 2018 since it was proclaimed to be effective on the 30th of September 2020 by registering and licensing moneylenders in Tonga. The Reserve Bank registered over 120 moneylenders currently in operation to determine their eligibility for licensing under the Moneylenders Act. Around 90% of the total moneylenders are from Tongatapu, and the remaining

10% are from the Vava'u, Ha'apai, and 'Eua. However, some of the moneylenders who have registered are exempted from being licenced as a moneylender as the financial services they provide do not fully meet the definition of money lending business. These exempted moneylenders will be licensed under the relevant NBFI legislation. About 113 moneylenders out of the total 120 registered moneylenders have met the definition of money lending business of which about 10% have been granted with a Moneylender Licence certificate and 41% have submitted applications for a moneylender's licence which are currently being assessed. Meanwhile, about 49% have yet to submit their licence applications. The Reserve Bank is working closely with them to ensure that they submit a license applications.

The regulating of Insurance Companies is a work in progress following consultation and the drafting of an Insurance Bill. The purpose of this Insurance Bill is to license and supervise insurance companies. The supervision of insurance companies supports financial stability, given that insurance companies safeguard banks' financial stability by insuring the assets held as collateral against bank loans and the financial stability of its policy holders by insuring against risk.

The Retirement Funds are key players in the financial system. They are significant investors in the banking system, and the size of the funds and their projected growth would have an impact on financial stability. As such, there is a need to regulate and supervise these key players in the financial system. The Pension Fund Bill has been issued to stakeholders for comments in December 2020 before a consultation meeting is scheduled. In addition, the Credit Union Bill has been approved by the Board of Directors and has been submitted to the Attorney General's Office for processing. Meanwhile, the Reserve Bank continues to collect monthly reports from the two (2) retirement funds, and quarterly reports from the four (4) insurance companies to monitor and enhance the understanding of their operations.

Outlook

The Reserve Bank forecast a positive annual credit growth of 0.3% for June 2021 as some local credit opportunities over the year relating to Government projects are expected to resume in the first half of 2021. This is coupled with some expected growth in personal and housing loans, given that the majority of the banks' customer base for personal loans are civil servants. COVID-19 vaccination in early 2021 indicates a possible opening of the borders and rebound of economic activities in tourism-related sectors. 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 March 2021 and 2022. This will result in a change of profitability projection for all banks with expected lower income over the near to medium term.
  - Ensure banks closely monitor likely impacts of COVID-19 on the local businesses such as the tourism sector and other private businesses and their financial capability 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.
  - Complete the processing of the Insurance and Pension Funds Bills through public consultations with relevant stakeholders and related businesses.
- 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.
  - A Fair Report of Credit Bill is being circulated for comments.
  - Support structural reforms to improve the credit environment, such as improvement to the land administration system and the

development of a bankruptcy law would further improve banks' confidence to continue their lending activities in a prudent manner.
  - Facilitate the dialogue with the banks on strengthening the credit process of security, mainly for housing loans in line with the recent Ministerial Directive.
  - Continue to license and supervise the existing credit bureau (Data Bureau (Tonga) Limited)
- Modernise and improve the efficiency of the payments system by automating the daily cheque settlement system for banks. This initiative is at its final stage of industry consultations for the payment system to be launched in later 2021.
- Develop a National Know Your Customers System within the Reserve Bank. This will enhance the AML/CFT risk tool for the Reserve Bank 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 status for the global banks to retain their correspondent bank accounts.
- 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 such as the TDB 'Ave Pa'anga Pau product and its expansion to Australia
- Continue to ensure compliance with the disclosure requirements under the 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, also impact the risk appetite and fear of sanctions relating to money-laundering and terrorist financing risks.
- The economy's vulnerability to further natural disasters and other external shocks.

6. Fiscal Indicators

Over the six months and year to February 2021, the uncertainties caused by the COVID-19 pandemic has impacted the fiscal position. Banking system data shows the net credit to the Government declined by $42.3 million (18.8%) and $87.6 million (48.6%), respectively. Both declines are attributed to a rise in Government deposits of $40.9 million (16.3%) over the six-month period and $96.7 million (49.5%) annually. These were mainly receipts of budget support and official funds from Tonga’s major donor partners such as New Zealand, Australia, European Union, Asia Development Bank and World Bank for the preparations for COVID-19 and other grants for TC Harold recovery, as well as the loan proceeds from the IMF Rapid Credit Facility (RCF).

The 2020/21 Government revised budget estimates expect receipt of $38.5 million in budget support from development partners, whereby an estimated outturn of only $27.2 million is now anticipated due to the deferral of the remaining amount to be received in the next financial year. Despite this delay, a total of $75.0 million has been received to date, which is higher than the budget by $36.5 million as more funds were received as financial assistance for the COVID-19 preparations and TC Harold recovery. The total budget support estimated for 2021/22 is $45.5 million.

Tonga is assessed as a high risk of debt distress country with a preference for donor support to be in the form of grants and debt relief to help build fiscal buffers to meet priority spending needs. The total public debt position for June 2021 is estimated at $514.4 million representing 41.5% of GDP, an increase of 5.3% from June 2020 due to the new loan received from the IMF. Total external debt accounts for 87% of the total public debt and 13% is domestic debt mostly government bonds. The Reserve Bank as the Registrar of government bonds continues to facilitate the issuance of government bonds. Government bonds of $20.0 million is expected to be issued in 2020/21, of which a total of $6.0 million government bonds have been rolled over to date. The Export-Import Bank of China (EXIM) still remains as the largest external creditor of the Government, holding around 67.7% of the total external debt. While the Government is putting strategies in place to prepare for the servicing of the EXIM loans, it has also requested a restructure of both loans. Meanwhile, the EXIM Bank has deferred the principal loan repayments due on both the Tonga National Road Improvement Projects Loan and the Nuku’alofa CBD Reconstruction Project Loan from FY2020-21 to FY2021-22 under the G20’s Debt Service Suspension Initiative (DSSI).

On the outlook, Government receipts are expected to increase in the near term due to receipts of committed and deferred budget support funds. These funds will continue to assist the Government with their stimulus packages provided to businesses and individuals directly affected by COVID-19.

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

7. Monetary Policy Stance

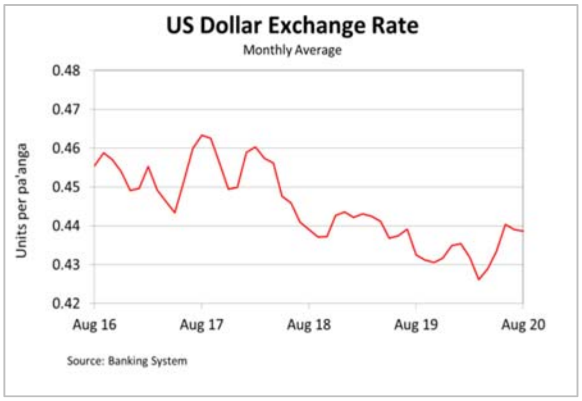
In light of the extraordinary challenges brought by the global pandemic and further exacerbated by the impact of TC Harold, the Reserve Bank continues to maintain its accommodative monetary policy stance throughout the review period. This is to encourage utilisation of the excess liquidity in the banking system through further lending to growth sectors to support the economy in addressing the fallout from the impacts of COVID-19.

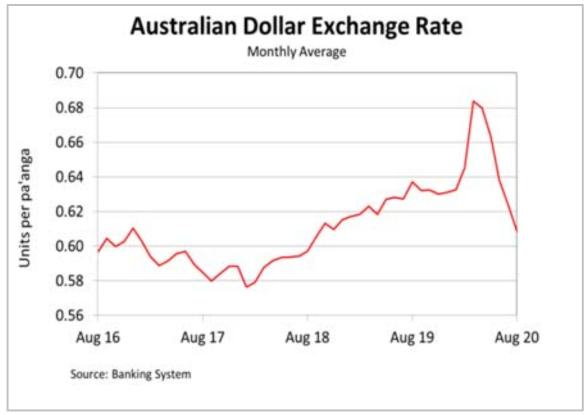
The Reserve Bank's Board of Directors approved to maintain the current monetary policy measures outlined below:

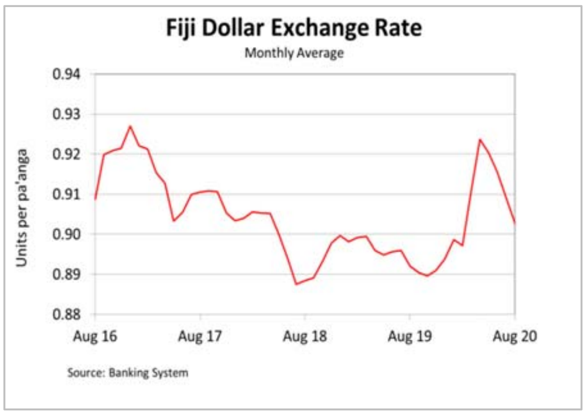
a. Maintain the monetary policy rate at 0% (zero interest rate policy).
b. Maintain the minimum loans/deposit ratio of 80%.
c. Maintain the Statutory Reserve Deposit (SRD) ratio at 10%.
d. Maintain the inflation reference rate at 5%.
e. Monitor the commercial banks' liquidity and adjust the SRD ratio if needed.
f. Monitoring 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.

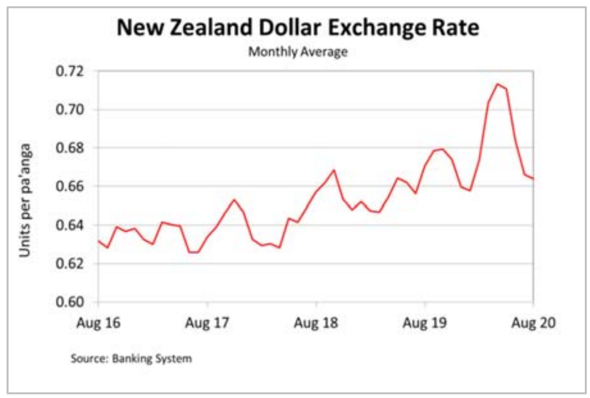
The Reserve Bank continues to be vigilant in closely monitoring its economic and financial indicators and stands ready to adjust its monetary policy settings if needed to maintain internal and external stability and support macroeconomic growth.

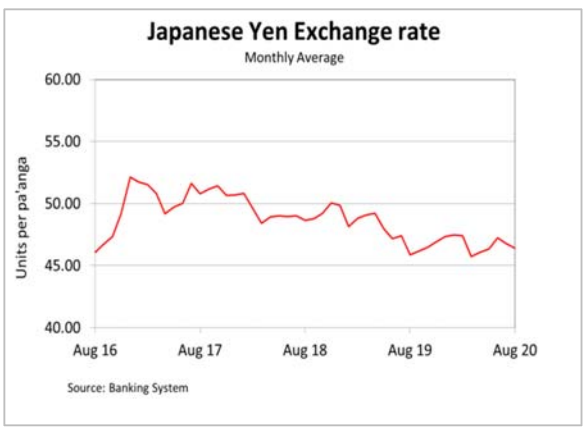
Appendix 1: Tongan Pa'anga Exchange Rates

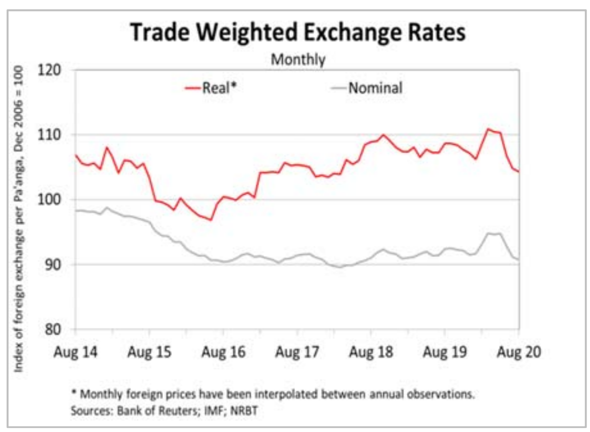












Appendix 2: Monetary Policy Objectives

The NRBT's obligations with respect to monetary policy are laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, which state 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 (Amendment) Act, states the Bank shall exclusively hold and manage the official international reserves of the Kingdom and maintaining an adequate level of foreign exchange reserves. Under the Act, the NRBT 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 dependent on imports for the supply of most of its goods, which needs to be paid for in foreign currency. Given Tonga's vulnerability to external shocks and natural disasters, its small size, narrow export base, and dependence on imports, it is imperative that foreign reserves are maintained at an adequate level to meet individuals' needs for basic 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 are able to meet their foreign currency obligations. The Reserve Bank targets a level of foreign reserves equivalent to 3 to 4 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 NRBT through its conduct of monetary policy can most effectively contribute towards macroeconomic stability, sustained economic growth, and raised prosperity for Tonga.