MONETARY POLICY STATEMENT

February 2025

National Reserve Bank of Tonga

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Background

Inflation has eased moderately, but cost of living in Tonga remains elevated, higher than our neighbouring countries. Headline inflation has moderated to 1.2 percent in December 2024, down from 5.4 percent in June 2024. Imported inflation has eased due to lower energy prices, while domestic prices have declined due to improved agricultural harvests and lower electricity tariffs. Meanwhile, accumulated high inflation from previous years has solidified into domestic cost structures, lifting the overall cost of living higher. Tonga's accumulated inflation is much higher compared to Fiji and Samoa in the past 8 years by 25 percent and 15 percent, respectively. Over the past 4 years leading to 2024, domestic inflation outpaced imported inflation by 3 percent. This trend and elevated costs of living highlight the urgent need for supply-side fiscal intervention aimed at reducing base costs and increasing supply.

Headline inflation is expected to remain below the 5 percent reference rate in the near term, but risks to inflation remain high, including risks of another surge in domestic inflation. Global policy uncertainties and vulnerability to natural disasters may reignite inflationary pressure in the near term. The Reserve Bank will continue to monitor these risks and adjust monetary policy accordingly to ensure price stability.

Foreign reserves are currently above benchmark levels, but is on a declining trend. To deepen economic stability, it is essential to mobilize additional foreign reserve receipts. Foreign reserves remained at adequate levels, $878.0 million in January 2025, and is expected to remain above the recommended level of 7.5 months of imports in the near term. However, the expected increasing import expenditures and debt servicing will put pressure on the level of foreign reserves.

Financial stability is maintained, however, vulnerabilities to asset quality warrants stronger oversight. Non-performing loans have increased above the 10 percent threshold, but the NRBT is implementing enhanced risk-based tools to ensure further risks to banks' asset quality are mitigated. Though credit growth has improved, Tonga's interest rate spread have remained relatively wide at 6 to 7 percentage points for years. This is also indicative of market inefficiencies with lending interest rates driven more by external factors such as cost of doing business and country risk factors, while deposit rates remain low with the persistent excess liquidity.

Tonga's economic recovery is weak and volatile. The NRBT estimate remains at 2.6 percent growth for the Tongan economy in FY2024-25, stronger than the estimated 1.6 percent growth for FY2023-24. However, the outlook for FY2025-26 projects a slower growth of 2.0 percent.

Monetary policy transmission mechanism in Tonga has been weak. The persistent excess liquidity has largely limited the impact of monetary policy, coupled with an under-developed domestic financial market. Part of the excess liquidity is contributed by the Government. The inflationary trends were driven mainly by supply-side constraints, beyond the Reserve Bank's control.

The Reserve Bank looks to enhance its monetary policy tools so that it can have a greater influence on inflation in order to achieve its price stability mandate in the future. Coordination with fiscal policy is also needed to achieve this goal, in addition to more effective communication of the monetary policy to guide the market's expectations.

The Reserve Bank further considers that an **accommodative monetary policy stance** is appropriate for the next six months to support economic recovery while macroeconomic conditions are favourable. As inflation is expected to stay below the reference rate (assuming no external shocks), and with a comfortable outlook on foreign reserves, the Reserve Bank has the flexibility to adopt a more accommodative stance to support economic growth. However, achieving sustained growth and macro-economic stability requires addressing complex challenges through comprehensive strategies, and measures. These include reforms, financial sector development, prudent external sector management, vigilant inflation control, and proactive risk mitigation. Effective coordination with fiscal policy is essential to the success of these efforts.

Monetary Policy Decision

Strengthen the monetary policy transmission mechanism while safeguarding internal and external stability.

1. **Monetary Policy Actions and Other Efforts:** Since the last Monetary Policy Statement (MPS) – August 2024, the NRBT has continued to focus on price stability and external stability while ensuring financial stability and promoting economic growth by:

- Ensuring exchange rate stability is maintained and in line with fundamentals;
- Maintaining an accommodative stance by leaving the policy rate at zero percent and maintaining the Statutory Required Deposit rate at 15 percent;
- Conducting consultations with relevant stakeholders particularly the Ministry of Finance, international financial institutions, and domestic financial institutions on measures to address supply-side constraints that have impacted inflation. These included the possibility of establishing a concessional credit facility, partial credit guarantee, and a domestic credit registry. This aimed at improving access to finance for vulnerable sectors whose production were hindered by adverse weather conditions;
- Easing its exchange control requirements by establishing an Exemption List for consistently compliant customers;
- Initiating several research studies and engaged with international counterparts and expertise to revise and modernize its existing frameworks and strategies, that will enable the NRBT to better perform its roles and functions given the challenges that we are facing today;
- Implementing the National Financial Inclusion Strategy to facilitate financial deepening, promote innovation and inclusion, and further support access to finance.

2. **Monetary Outcomes:** Since the previous MPS, monetary outcomes are as follows:

- Headline inflation has moderated significantly during the second half of 2024, reaching 1.2 percent in December 2024. However, core inflation surged to 7.2 percent in December 2024, primarily driven by a sharp increase in international airfares during the Christmas holiday season, while the contribution from other goods and services remained relatively stable.
- Foreign reserves remained at adequate levels, $878.0 million in January 2025, which is sufficient to cover 10.1 months of imports, but lower compared to $894.7 million (11.6 months of imports) last year.
- Overall, the financial system in Tonga remains stable. However, the rising non-performing loans (NPL) ratio necessitates close monitoring of banks' performance to ensure resilience against potential risks.

- The weighted average lending rate declined from 7.79 percent to 7.57 percent, while weighted average deposit rate also declined from 1.52 percent to 1.43 percent, over the last six months.
- Excess liquidity in the banking system remains elevated and estimated at $331 million. The abundant excess liquidity continues to weaken the monetary policy transmission mechanism. Effective utilisation of this excess liquidity is crucial for enhancing monetary policy effectiveness, and fostering the development of Tonga's financial markets.

3. **Outlook:**

- Inflation is projected to gradually increase, but is expected to remain below the 5 percent reference rate. However, the volatility of food prices and the high demand during celebratory months (May-July) pose potential upside risks, which could temporarily push inflation higher. Furthermore, while the inflation rate may be moderating, the persistent high cost of living continues to erode household purchasing power, impacting consumption and overall demand. The current inflation rate provides an opportunity for the NRBT to maintain an accommodative stance. Nevertheless, the Reserve Bank remains vigilant regarding potential risks stemming from global commodity price volatility, trade wars, adverse weather events, supply side disruptions to the primary sectors, and persistent labour market shortages.
- Foreign reserves are projected to remain at comfortable levels and above the recommended level of 7.5 months of imports in the near term. However, the expected rise in import payments, offshore investments, and government debt repayments will exert pressure on foreign reserves.
- Rising vulnerabilities in the financial system pose risk to financial stability, therefore enhanced supervision of both banks and non-bank financial institutions remains crucial.
- Despite the strong credit growth of 10.2 percent over the year, a few growth sectors of the economy are still underserved such as agriculture, fishing, and construction.
- The interest rate spread has remained relatively stable, with weighted average lending rate around 8 percent and weighted average deposit rate around 2 percent, over the last 9 years. This may be indicative of the lending interest rates driven more by external factors such as cost of doing business and country risk factors, while bankable projects are limited. Low deposit rates also persist as excess liquidity contributes to the limited impact of monetary policy on market interest rates.
- Real GDP growth remains volatile and has been declining since 2016. Furthermore, potential growth has been gradually decreasing since 2012, now averaging around 1.2 percent. The lower average growth is driven mostly by the increased frequency of natural disasters damaging some of Tonga's

productive capital formations, and an increase in labour shortages, suggesting the need for a structural policy response.

- Current economic growth forecasts indicate lower than expected growth in key sectors, necessitating financial support for private sector development. Capital investments in resilient and sustainable infrastructure are vital to mitigate Tonga's climate-related risks.

4. **Monetary Policy Challenges:**

The NRBT also acknowledges that monetary policy does not influence inflation on its own as shown in the analysis in *Annex 1*. Fiscal policy also plays a role. The effectiveness of its monetary policy tools hinges on several factors outside of its control, highlighting the need for closer collaboration and effective communication. Such challenges include the following:

- **Excess liquidity in the financial system restricts monetary policy effectiveness.** Excess liquidity in the banking system from inflows of remittances and foreign aid, remains highly unutilized and weakens the NRBT's monetary policy transmission.
- **Persistent expansionary fiscal policy over the years has contributed to the excess liquidity.** Furthermore, the depositing of Government funds at the commercial banks has limited the Reserve Bank's ability to absorb and manage liquidity in the banking system.
- **Due to the excess liquidity, the interbank lending market has been inactive.** This, coupled with Tonga's underdeveloped capital market, have limited the Reserve Bank's ability to influence the short-term market interest rates.
- **Monetary Policy interest rate channel is typically used to influence aggregate demand.** However, inflation in recent years, has been driven by supply side constraints. The impact of global oil prices and adverse weather conditions on domestic production greatly impacts the trajectory of inflation in Tonga. In order to address supply side constraints, fiscal policy coordination is required.
- **The review of the Reserve Bank's policy rate has shown its weakness in supporting the monetary policy objectives**. The policy rate was set as the interest rate on the banks' Exchange Settlement Accounts, and has been kept at zero percent, the floor of the Reserve Bank's interest rate corridor. To enhance the effectiveness of the policy rate in influencing short-term interest rates, the policy rate is re-defined as the mid-rate. This would guide the market on the level of overnight interest rate, which the Reserve Bank expects to be passed through to the lending rates and borrowing costs, and ultimately inflation.
- **Impact of monetary policy on inflation is lagged.** Studies have shown that tools such as adjusting the Statutory Required Deposits (SRD) rate to influence

inflation through controlling money supply has a delayed impact of 12 months. Additionally, its impact has been shown to be minimal. Previous interventions by the Reserve Bank such as increasing the SRD, and offering investment options for the Government and retirement funds have not been able to absorb as much liquidity as intended, therefore have proven ineffective in impacting interest rates or influencing inflation.

- Reviews have also shown that the **communication of the Reserve Bank's monetary policy has not been very effective in influencing financial conditions and economic behaviour.**

5. **Monetary Policy Stance:** Given the above, the National Reserve Bank of Tonga (NRBT) remains committed to maintaining price stability, external stability, and financial stability, based on recent economic conditions and projections. However, the NRBT considers that an **accommodative monetary policy stance** is appropriate for the next six months to support economic recovery while macroeconomic conditions are favorable. Simultaneously, the NRBT will undertake actions to gradually modernize its monetary policy framework and strengthen the monetary policy transmission mechanism to optimize its impact on inflation in line with recommendations from the International Monetary Fund (IMF).

6. To achieve its objectives, the NRBT will implement the following:

I. **Gradually Strengthen Monetary Policy Transmission Mechanism**: In order for the monetary policy to have an impact on market interest rates, its monetary policy tools need to be modernized in order to strengthen the transmission mechanism which is weakened by excess liquidity. As such the following actions will be taken:
   1) Redefine the NRBT policy rate from a floor rate to a conventional mid-rate, providing a clearer signal for the overnight rate;
   2) In order to Mop-up excess liquidity
      i. Issue NRBT Notes (full allotment according to commercial banks' demands at policy rate);
      ii. Maintain the rate charged to banks demand deposits held with the Reserve Bank (ESA) at 0 percent;
      iii. Maintain the Statutory Reserve Deposit ratio at 15 percent.

II. **Review Exchange Rate Policy**: Review the current framework for calculating the currency basket composition to optimize its pass-through effect on inflation.

III. **Review its Communication Framework:** Enhance communication, policy transparency, and updates through regular policy reviews and greater outreach.

IV. **Strengthen Coordination between Monetary Policy and Sustainable Fiscal Policy:** With lower long-term economic growth and undiminished need for financial resources, coordination between monetary policy and sustainable fiscal policy of the Government to create important synergies needs to be strengthened.

7. The NRBT also identifies other developments which are outside of its control, but are necessary for the pursuit of its monetary policy objectives in maintaining internal, external, and financial stability. The Government also has a crucial part in the efforts to modernizing the NRBT's monetary policy tools. **Access to financing is uneven**. Promoting a more conducive credit environment requires coordination with relevant Government policies, as most barriers to access to finance fall outside the NRBT's control. The Government's presence in Tonga's economy is significant, therefore close consultation between NRBT and the Ministry of Finance (MOF) will coordinate monetary and fiscal policies, enhancing fiscal sustainability, supporting private sector investments, and strengthening economic recovery while addressing supply constraints. Specific initiatives include:

A. **Gradually Enhance the NRBT's Monetary Policy Tools:** We recommend MOF to consider the following:
   - Issuing regular shorter term Treasury bills at cheaper rates to establish market yield curve;
   - Setting up a Single Treasury Account framework to enhance liquidity management;
   - Relocating Government's time deposits from Commercial Banks to the NRBT thereby mopping up some of the excess liquidity;
   - Engaging in regular discussions and sharing of cash flow forecasts to assist liquidity and foreign reserves management.

B. **Addressing the Relative High Costs of Goods and Services**
   - Undertake reforms to reduce cost of doing business in Tonga such as petroleum downstream activities and labour skills development;
   - Develop measures to reduce high costs for basic utilities and necessities (energy, communication, transport, stable food items, and substitutes), with any Government subsidies to be time-bound, well-targeted, transparent, capped, and economically justified;
   - Address supply-side constraints and occasional instability in the agriculture, fisheries, and tourism sectors.

C. **Facilitating Access to Credit for productive sectors:**
   - Strengthen the credit environment to minimize risks for private sector financing, such as Government assistance to improve the land registry and support development of insurance coverage for the vulnerable productive sectors, to meet loan collateral requirements.
   - Provide support for funding sector-specific concessional lending facility;
   - Establish a partial credit guarantee scheme targeting growth sectors of tourism, agriculture, fisheries and manufacturing;

- Finalize the Credit Registry Bill to enable the establishment of a credit registry.

D. Promoting Private Sector Development and Investment:

- Develop a Macroeconomic Strategy to deliver the Government budget outcomes and be aligned with the NRBT Monetary Policy Tools to achieve fiscal sustainability especially the financing instruments in the short to medium term.
- Support private sector development initiatives and attracting Development Assistance for investments in Tonga;
- Incentivize foreign investment to support investment, employment and inflow of foreign reserves.

E. Developing the Domestic Financial Market for the modernization of Monetary Policy :

- Recommend the take-up of the ADB's Local Currency Bond Issue to fund solicited public and private sector development investments.
- Coordinate bond issuances to calibrate a term-structure sovereign yield curve.

The NRBT believes these coordinated efforts will contribute to a resilient and prosperous Tongan economy.

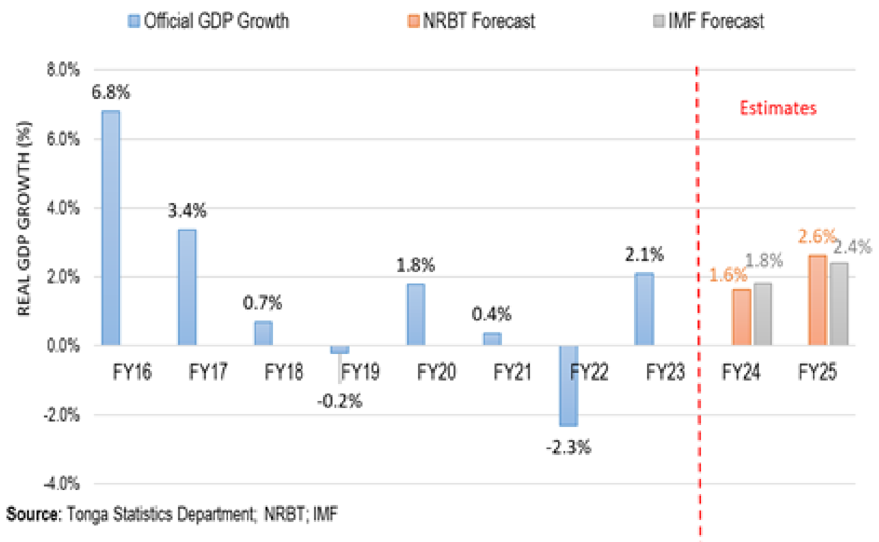
Annex

Annex 1 - **Economic and Financial Developments**

a. GDP Growth

Tonga's economic recovery is lacking traction. Real GDP growth on average is low and has been declining since 2016. Consequently, potential growth is also trending downwards now averages around 1.7 percent. The latest official release by the Statistics Department is for FY2022-23 with a 2.1 percent growth, slightly lower than the NRBT estimate of 2.4 percent. The NRBT GDP growth estimates for FY2023-24 and FY2024-25 remain unchanged since the August 2024 MPS, at 1.6 percent and 2.6 percent, respectively. Large events such as the Pacific Islands Forum (PIF) Leaders' meeting, support these estimates as they positively contribute to the industry and services sectorial performance, specifically for construction, trade, and tourism activities. On the other hand, labour constraints, elevated costs, and adverse weather conditions are key impediments to the primary sector performance.

Figure 1: **Tonga's GDP Growth**



Source: Tonga Statistics Department; NRBT; IMF

The services sector indicators were mostly upbeat during the review period. The Government and relevant private entities were actively preparing for the 53rd PIFs Meeting in August 2024. New accommodations were constructed, and existing hotels and accommodations were refurbished to accommodate visiting leaders and officials. The Government also imported approximately 200 container houses, and vehicles for the event. Several international rugby games were hosted locally in Teufaiva stadium, and various local communities organized Christmas light events. Total travel receipts rose by 25.2% ($19.2 million) over the six-months to December 2024, relative to the same period in the previous year. Vehicle registrations also increased by 13.8% (212 vehicles) in the same period. The restaurant, wholesale & retail trade, and recreational services sectors also benefited from major private events such as weddings birthdays, and family reunions. Between July and November 2024, total container registrations increased by 10.3% (553 containers), of which majority are business containers. Similarly, total wholesale & retail import payments increased by 3.6% ($6.9 million) during the six-month to December 2024, compared to the same period in 2023.

Industry sector indicators were generally positive, despite some delays in project implementation. The construction sector remains active, supported by private projects such as the construction of private dwellings, businesses, and churches. Between July and November 2024, the value of construction applications increased by 37.9% ($20.5 million) compared to the same period in the previous year. Construction import payments also rose by 27.9% ($4.1 million) in the six-months to December 2024 compared to the same period in 2023. Nonetheless, the country was in some state of limbo for several weeks due to the shift in political power resulting in the appointment of a new Government. This may have caused some delays in the progress of several public infrastructure projects, while other projects are faced with resource constraints. However, the new Government administration remains committed to continuing key projects such as the ongoing HTHH reconstruction efforts, the construction of a new bridge, and upgrades of public road infrastructure. Activities in the utilities sector also reflect some positive spillovers from the vibrant domestic activities. During the six-months to December 2024, electricity consumption rose by 7.9% (2.8 million kWh) relative to the same period in 2023, plus an additional 121 electricity consumers by December 2024.

High production costs, labour shortage, and unfavourable weather conditions dampened primary sector performance. The agricultural sector suffered the adverse effects of the El Nino season, while the continuing outflow of low and semi-skilled workers to the Australian and New Zealand seasonal working schemes constrained production capacity. Previous hikes in import prices and tariffs have been factored into higher production costs, and competing demand for exports keeps food prices high and sticky since the informal market dominates the sector. Over the six-months to December 2024, total agricultural export volumes fell by 22.8% (1,027.1 tonnes) compared to the same period in 2023. This decline is attributed to lower exports of squash, taro, and kava. Marine exports also declined by 26.5% (228.7 metric tonnes), along with lower aquarium exports of 22.0% (7,855 pieces).

Strong demand from both local and international markets puts pressure on labour supply. The Pacific Tourism Organization's (SPTO) 2024 Business Confidence Index Report shows that 64% of business respondents were experiencing problems with hiring new staff due to labour migration, resulting in loss of skills. While some employers look to hiring workers from abroad, additional costs for travel and visas are discouraging. Between July 2024 and January 2025, the Reserve Bank's survey on job advertisements recorded a total of 520 job vacancies, 5.5% lower than the same period in the previous year, mostly due to the political disruptions over the past few months. Majority of the advertised vacancies were in public administration, transport and communications, financial intermediation, forestry, and business services. Unemployment rate was recorded at 2.2% in 2023, declining from 3.1% in 2018, according to the 2023 Labour Force Survey. Data from the Ministry of Internal affairs showed that in 2024, Recognized Seasonal Employment (RSE) workers increased by

301 compared to 2023, while Pacific Australia Labour Mobility (PALM) workers increased by 864, contributing to more outflow of workers abroad.

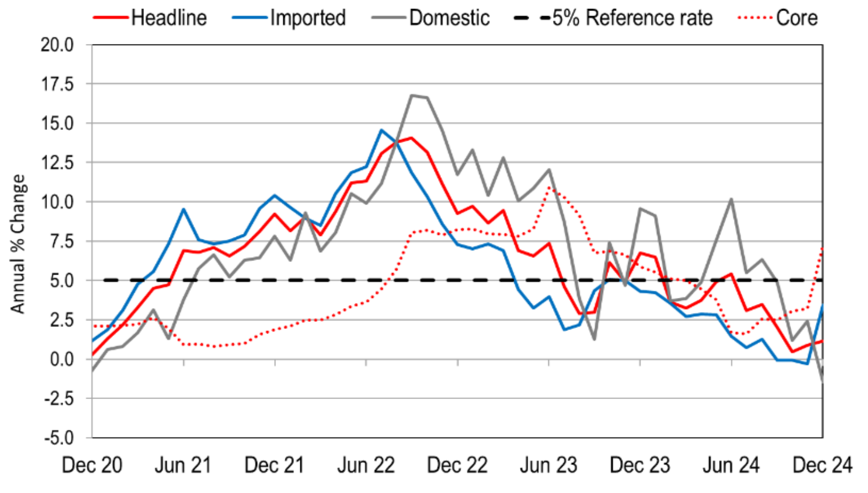
The NRBT project a positive but slower growth of 2.0 percent for FY2025-26, underpinned by the anticipated implementation of infrastructure projects and the recovery of the primary sector. Despite initial resource constraints and political transitions that led to project delays in FY2023-24 and FY2024-25, the new Government is committed to expediting development projects such as the Fanga'uta Lagoon Bridge, crucial for enhancing connectivity in Tongatapu. Key risks to the outlook includes any further political instability that may induce additional delays to these projects, such as the upcoming general election in November 2025. Unfavourable weather conditions, including the ongoing cyclone season, and global geopolitical tensions are also downside risks to the forecast.

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

b. Inflation

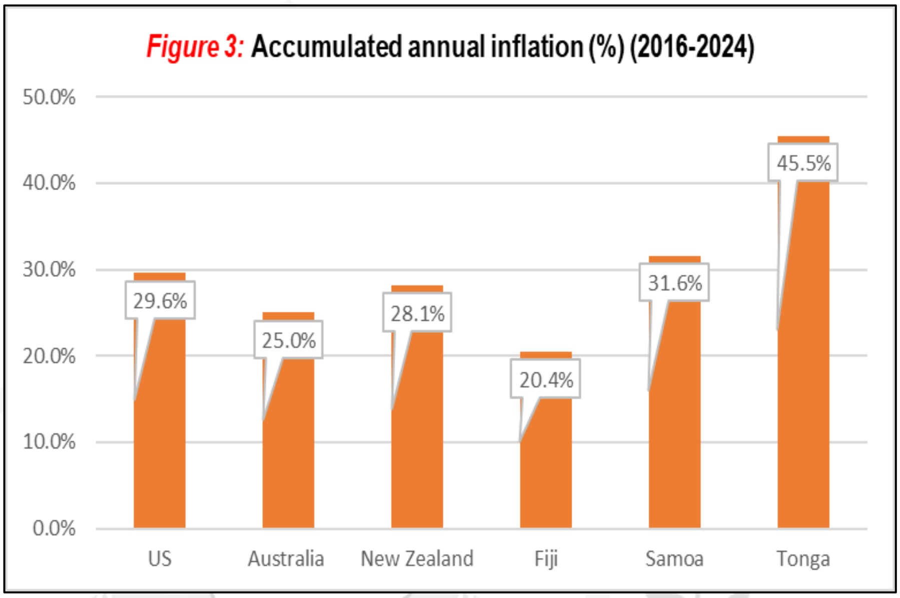
As anticipated, Tonga's headline inflation has remained below the 5 percent reference rate for six consecutive months since July 2024. Inflation dropped as low as 0.5 percent in October 2024, and settled at 1.2 percent in December 2024. Energy prices continued to improve in comparison to 2022 and 2023, along with a slowdown in food prices. Although headline inflation eased substantially, the cost of living remains elevated due to the prolonged impacts of accumulated inflation over the years. Tonga's

Figure 2: **Inflation**
Year-ended

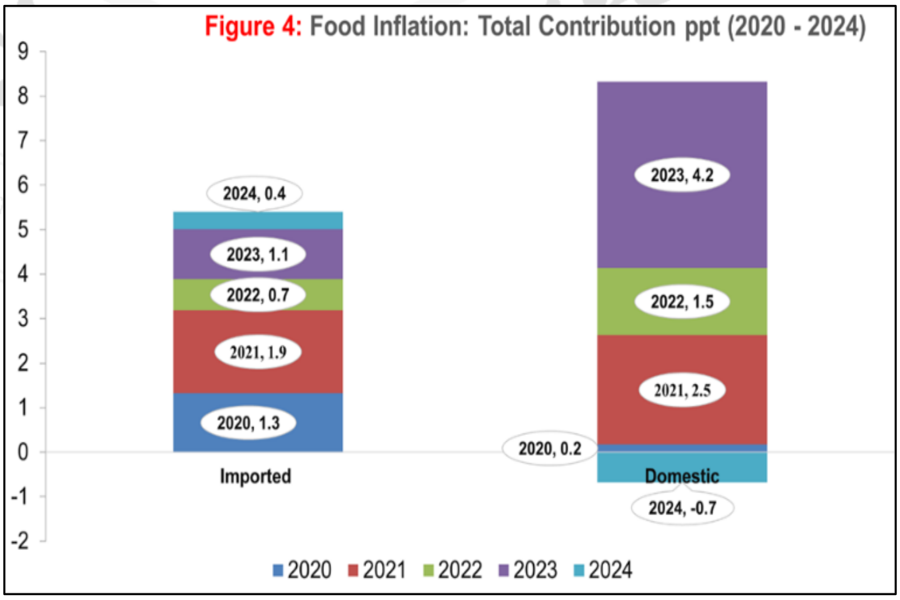


Source: Tonga Statistics Department; National Reserve Bank of Tonga accumulated inflation over the last 9 years in comparison to regional peers, Fiji and Samoa, is much higher at 45.5 percent as shown in Figure 3.

High inflation over the years has resulted in high cost of living. In the past five (5) years, domestic food inflation has outpaced imported inflation. An NRBT analytical working paper found that more competition and improvement in logistics have reduced prices of imported food. Meanwhile, labour shortages are driving labour costs up which are pushing up producer costs for domestic food, and are then passed on to consumers. The shortage of supply is also contributing to higher domestic food prices. However, wage adjustments for consumers lag behind inflation reducing real purchasing power and increasing indebtedness of households. On this regard, remittances have played a key role in cushioning the impacts of higher inflation and alleviating poverty.



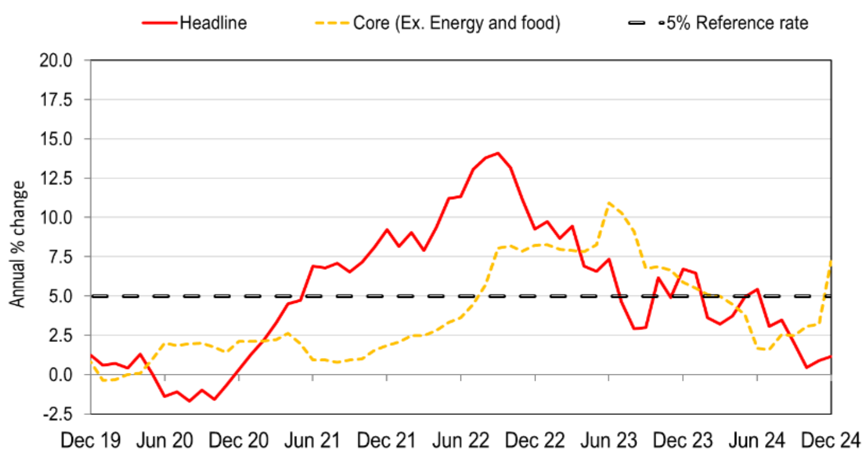
Imported prices have eased moderately, as global prices cool down. Imported prices rose by 3.4 percent in December 2024, lower than the 4.3 percent rise in December 2023. Overall, imported inflation contributed around 1.8 percentage points (pps) to the headline inflation in December 2024. The decline in imported inflation is attributed largely to lower energy prices. As of February 2025, the local retail price of petrol has decreased by 25 seniti/litre, while diesel has fallen by 32 seniti/litre compared to February 2024. The improvement in local petroleum prices was mainly due to a combination of lower global prices and favourable exchange rate movement against the US dollar. Despite lower energy



prices in December 2024, they were offset by increases in international airfares, imported food items, goods for personal care, household items, and clothing & footwear. Imported inflation recorded an average of 2.0 percent in 2024 compared to 4.6 percent in 2023.

Domestic prices also declined in response to lower energy prices. Domestic prices recorded a negative growth of 1.5 percent in December 2024, due to lower prices for local food items, electricity, catering services, clothing, and tertiary education fees. Local food items (including non-alcoholic beverages) declined by 4.4 percent over the year, contributing around negative 0.9 pps to the headline inflation. The lower electricity tariff reflects the improvement in diesel prices and the ongoing Government Lifeline Subsidy to address high cost of living. On the other hand, prices for kava Tonga, alcoholic beverages, and tobacco increased over the year, partially offsetting some of the declines. Overall, domestic prices contributed around -0.7 pps to the headline inflation in December 2024. On average, domestic prices rose by 4.9 percent in 2024, a significant decrease from the 8.7 percent recorded in 2023.

Figure 5: **Core Inflation vs. Headline Inflation**
Year-ended



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

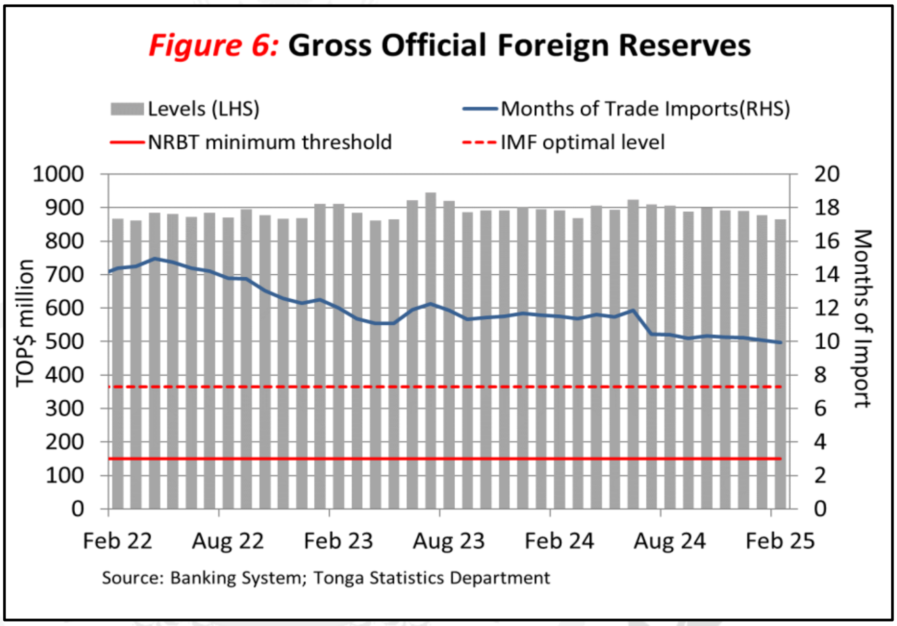
Core inflation (excluding food & energy prices) on the other hand, is trending upwards. Core inflation surged to 7.2 percent in December 2024, fueled by a one-off increase in international airfares during peak season, while the contribution from other goods and services remained relatively stable.

On the outlook, inflation is projected to gradually increase in 2025, but still remain below the 5 percent reference rate. Policy uncertainties and geo-political tensions risk reigniting inflationary pressures that will pass through import prices movements to Tonga's inflation. While local food supply and prices have shown signs of recovery, production and harvests remain vulnerable to the current cyclone season and other natural hazards. A resurgence in demand in the near term (i.e. during the celebratory season (May-July)) is expected to further contribute to the upward inflationary trend in 2025, though this impact is seasonal and therefore transitory in nature.

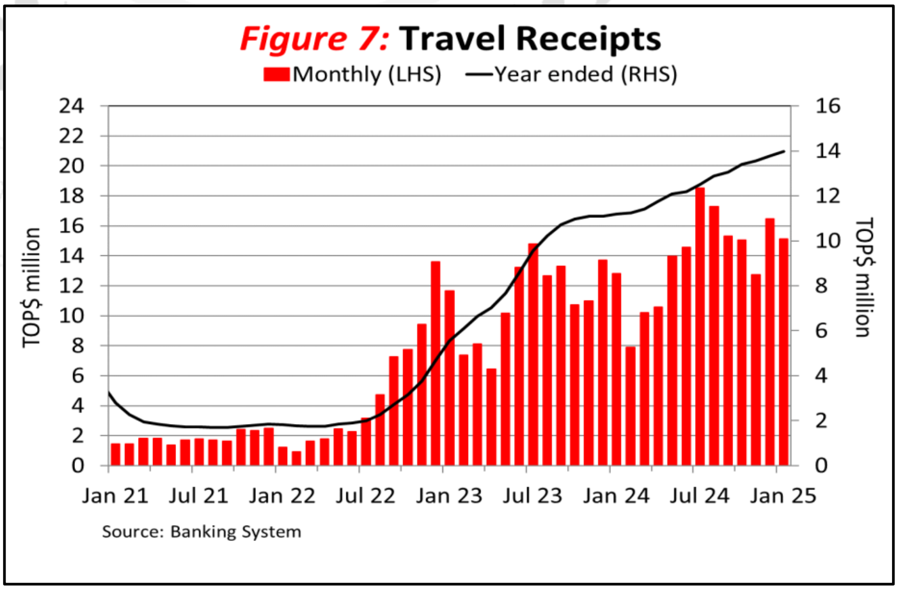
The Reserve Bank is currently undertaking initiatives to modernize its monetary policy tools to strengthen its monetary policy transmission in pursuit of its price stability objective. Concurrently, monitoring the development in both the international and domestic economies will continue, to ensure that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

c. Foreign Reserves

Foreign reserves is declining, but still at comfortable levels. Tonga's official foreign reserves remained sufficient in December 2024, with an equivalent of 10.2 months of imports, well above the IMF's recommended minimum of 7.5 months. Foreign reserves were 3.8 percent (T$35.3 million) lower than in June 2024 and, last year by 1.4 percent (T$12.7 million) amounting to $889.1 million. This reflects the increased outflows for imports and debt repayments, along with offshore investments, despite the continued inflows from development partners for Government budget support, development projects and remittances.

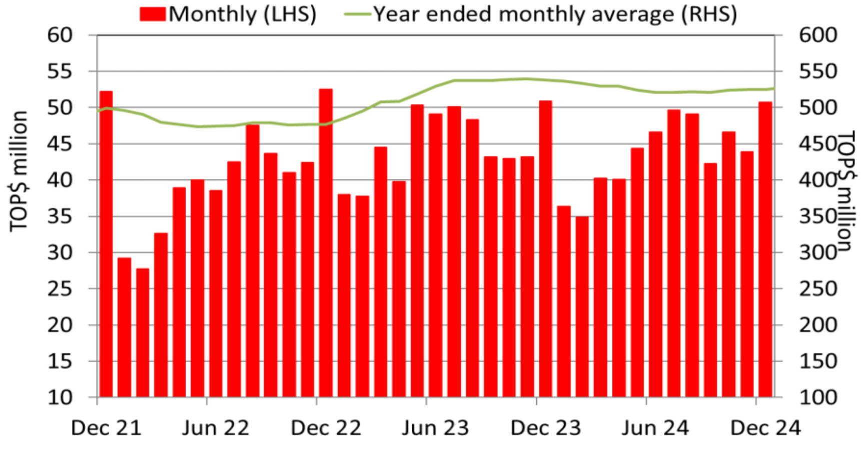


Foreign exchange inflows rose by 13.6 percent over the year to December 2024, owing to higher travel receipts and foreign aid. Travel receipts bounced back strongly with a 24.2 percent increase over the year to December 2024, in line with the main events such as the PIFs meeting and the holiday festivities. Inflow of foreign aid from donor partners for development projects continue to support foreign exchange inflows. Remittances however, is slowing down by 2.5 percent over the year to December 2024. This



indicates a return to normal levels following the previous natural disasters and border closures. Export receipts for agriculture and marine products also declined over the year by 38.3 percent and 20.9 percent, respectively, reflecting the weak sectorial performances during the year. Furthermore, the lack of repatriation of export proceeds is indicative of a large proportion of exports from Tonga not being sold to formal markets, but rather are sent to families overseas in the informal sector. Setting up of pack-houses, certification, and formalizing these exports may help improve export receipts.

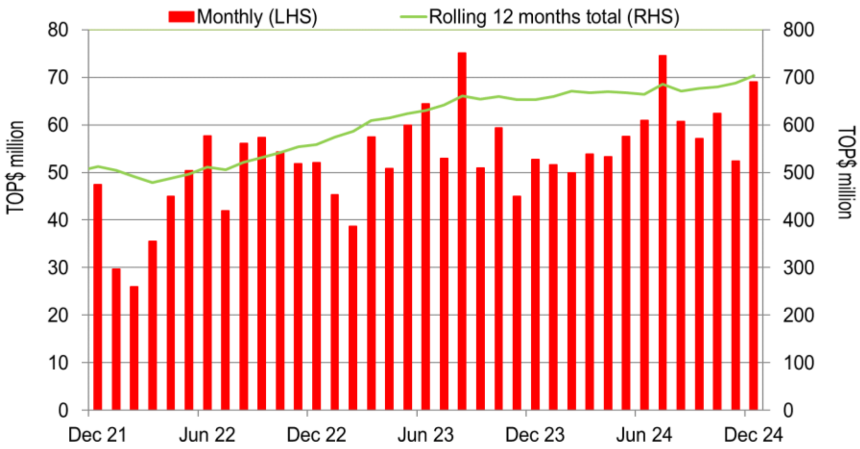
Figure 8: **Remittances Receipts**



Source: Banking System

Payments for imports of goods and services, and debt repayments led to higher foreign exchange outflows over the year. Foreign exchange outflows increased by 11.3 percent in the year ended December 2024, resulting from the constant increase in payments for the imports of goods and services coupled with the rise in outflows for portfolio investments. Import payments grew by 7.8 percent, mostly for wholesale and retail goods and other imports (mostly Government).

Figure 9: **Import Payments**



Source: Banking System

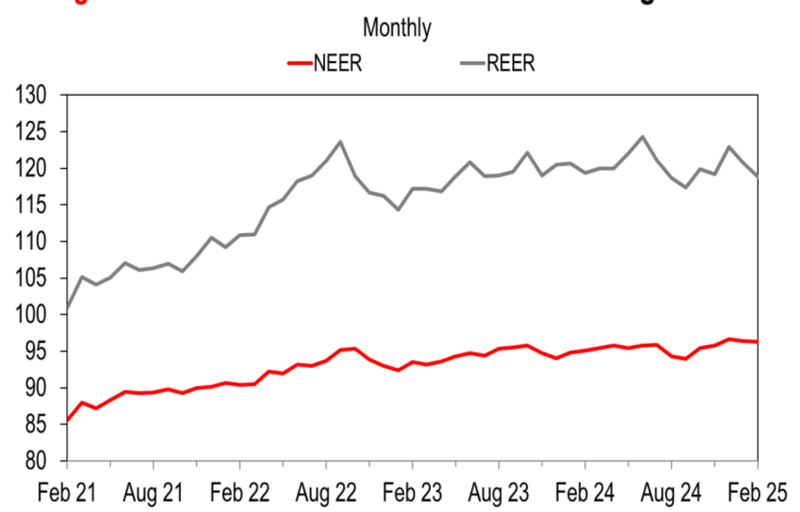
Foreign reserves is expected to slowly decline as debt repayments and increasing import payments continues, but still remain at adequate levels above the minimum thresholds. Safeguarding of foreign reserves remains a top priority for the Reserve Bank for maintaining external stability and supporting international trade. Higher import expenditure for the ongoing infrastructure projects, offshore investments, and debt servicing obligations, including the repayment of the Export – Import Bank of China (EXIM) loan may exert pressure on foreign reserves in the near to medium term.

Remittances is expected to ease in the near term following the end of the celebratory months and local celebration, partially offset by the increase in travel receipts as the recovery in the tourism industry continues. Cost of living pressures and policy uncertainty in major source remitting economies may also weaken remittance flows. One of the key supporting measures for the modernization of the monetary operational framework involves the design of short-term liquidity monitoring and forecasting framework that will assist with foreign reserves management.

Tonga's nominal effective exchange rates strengthened during the review period. The Nominal Effective Exchange Rate (NEER) rose by 0.8% over the last six months to December 2024 as the TOP strengthened against some of its major trading partners' currencies such as the NZD, AUD, FJD and EUR. This helps ease some of the imported inflationary pressures. The Real Effective Exchange Rate (REER), however, declined by 1.4% during the same period, in line with Tonga's relatively lower inflation rate. This may indicate a gain in Tonga's trade competitiveness.

Over the year, both the NEER and REER increased by 2.7% and 2.0%, respectively. The NRBT in collaboration with the IMF will revisit the design of its currency basket to ensure it aligns with market fundamentals.

Figure 10: **Nominal and Real Effective Exchange Rates**



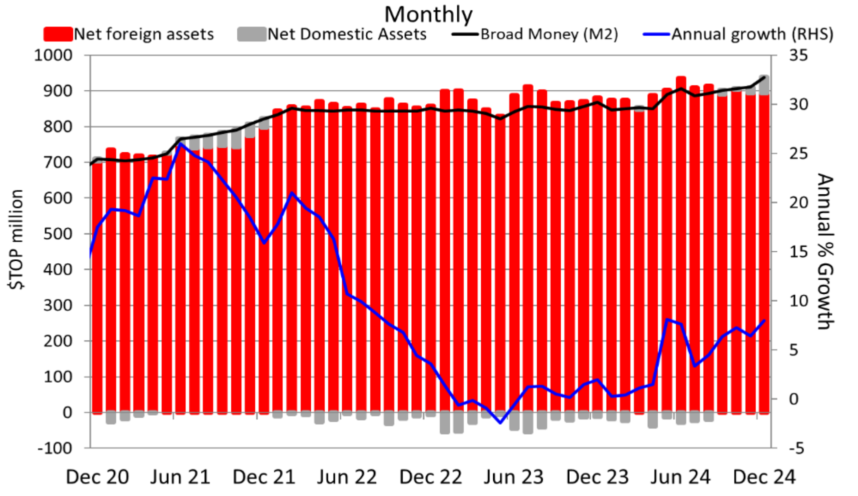
Source: NRBT

d. Monetary Sector

The banking system remained sound over the six-months to December 2024, supported by high liquidity and capital position. The banks are still profitable and well capitalized, with excess liquidity to meet demand for credit. However, the rise in non-performing loans is a concern for the Reserve Bank. Enhanced supervision of banks is crucial while also stepping up the supervision of non-bank financial institutions to ensure risks to financial stability are moderated. The return on equity was estimated at 8.8 percent in December 2024 (compared to 10.4 percent in June 2024 and 13.6 percent in December 2023), and the return on assets was 2.2 percent (compared to 2.6 percent in June 2024 and 3.4 percent in December 2023).

Money supply continued to expand on the back of higher net domestic and foreign assets. Money supply peaked in December 2024, at $937.5 million, rising by $31.4 million (3.5 percent) from June 2024, and $69.3 million (8.0 percent) from December 2023. The annual rise was attributed mainly to an increase in net domestic assets, underpinned by higher credit to private sectors and net credit to non-financial corporations. Similarly, the net foreign assets increased, as a result of higher liabilities over the year. Reserve Money also increased in December 2024, rising from June by $0.2 million (0.04 percent) and annually by $20.1 million (3.3 percent) to $632.0 million. Both the Exchange Settlement Accounts and Statutory Reserve Deposits grew over the year and outweighed the lower Currency in Circulation. The higher deposits to the Reserve Bank vault and Reserve Bank net foreign currency purchases from the commercial banks supported the overall growth.

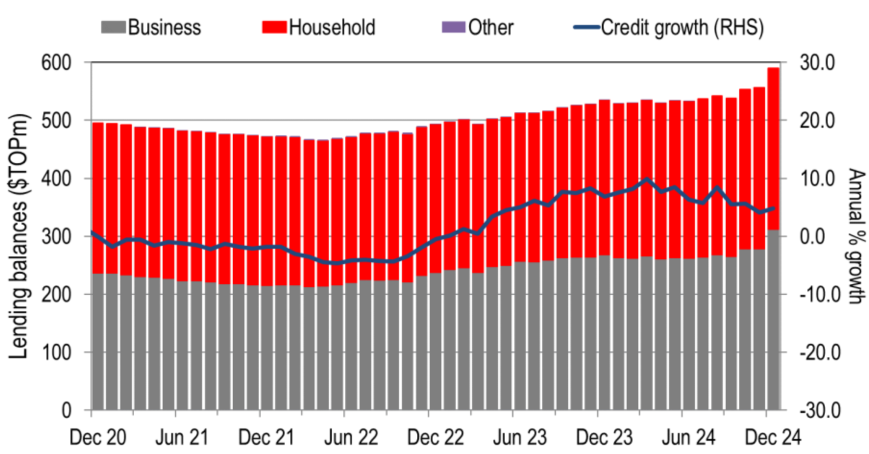
Figure 11: **Money Supply**



Sources: National Reserve Bank of Tonga, Banking Systems

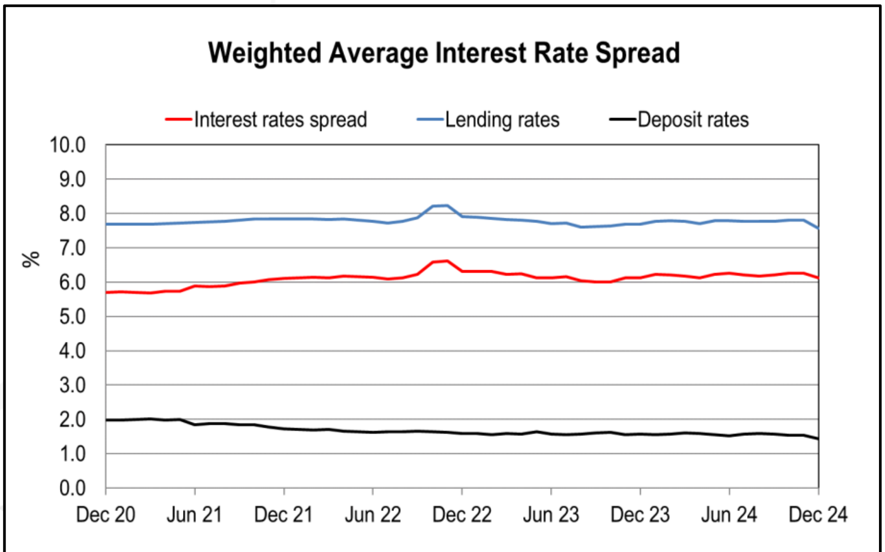
Unutilized excess liquidity in the banking system weakens monetary policy transmission The Reserve Bank estimates excess liquidity of $331 million in the banking system in January 2025, higher than $308 million reported in the August 2024 MPS. Lack of investment opportunities results in excessive term deposits in the banking system, while uptakes for new credit is slow. In addition to the inactive interbank market, the persistently high level of excess liquidity undermines the effectiveness of the monetary policy transmission and the ability of the Reserve Bank to influence interest rate and thereby inflation through the demand-side.

Figure 12: **Banks' Lending**



Source: Banking System

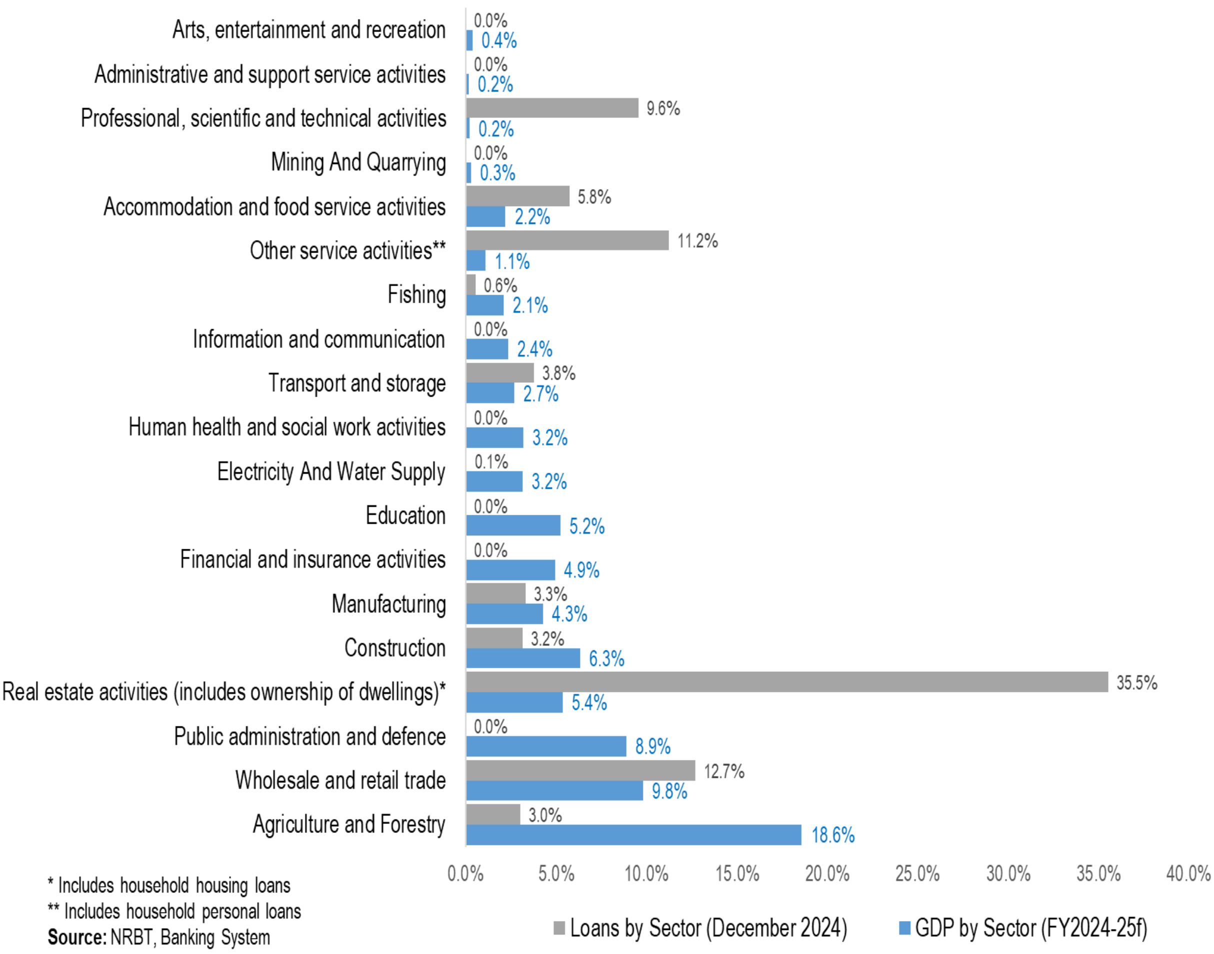
The excess liquidity in the banking system also drives the weighted average deposit rate lower. The weighted average interest rate spread narrowed over the past six months to December 2024 by 13.1 basis points, but widened annually by 0.8 basis points to 6.1%. The annual rise is attributed to a 13.1% decline in the weighted average deposit rate by 12.3 basis points, offsetting the fall in the weighted average lending rate. The persistent low deposit rates encourages the increased offshore investments by private entities. The increased volume of demand deposits over the year also contributed to the lower demand deposit rates. Meanwhile, loan rates offered to businesses within the mining/quarrying, utilities and the distribution sectors decreased, as well as households' other personal and housing loan rates. Additionally, loan rates offered to non-profit organizations and statutory non-financial corporations also decreased over the year.



Source: Banking System

Credit growth bounced back strongly at the end of 2024, but critical growth sectors are still underserved. Total lending reached a new high level of $589.8 million in December 2024, an increase of $56.3 million (10.6 percent) from June 2024, and $54.6 million (10.2 percent) from December 2023. Lending to both businesses and households grew over the year by 16.2% and 4.1 percent respectively. Lending to businesses within the professional & other services, distribution and tourism experienced growth, along with all categories of household borrowing. These movements reflect greater demand for credit and improved capacity for more loans. Despite the strong credit growth, few growth sectors of the economy are still underserved such as agriculture, fishing, and construction. Land administration delays, limited eligible collateral, lack of credit history, and high risk premiums are the main barriers for access to finance by these sectors, but they are outside of the Reserve Bank's control. Nonetheless, the Reserve Bank continues to advocate for collaboration with responsible Government agencies to undertake these structural reforms that will facilitate greater access to credit, lower the cost of borrowing, and encourage investment both locally and from abroad. Some of these initiatives includes the establishment of a sector-specific concessional lending facility, partial credit guarantee scheme, finalizing the Credit Registry Bill, and promoting private sector development.

Figure 14: **GDP vs Credit by Sector**



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

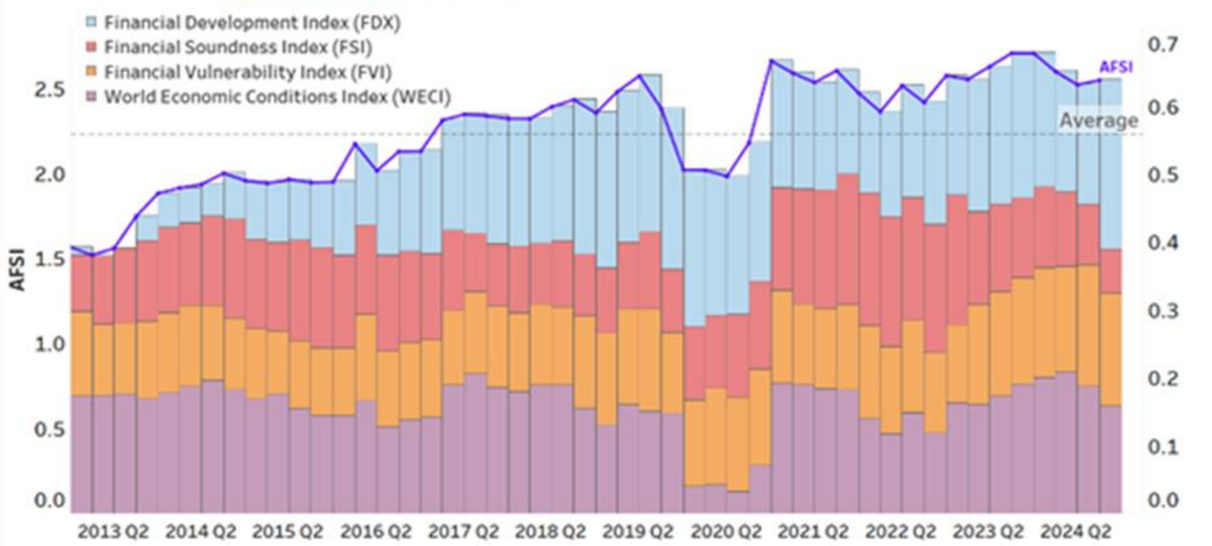
Elevated vulnerabilities to asset quality warrant enhanced supervision of financial institutions. Non-performing loans to total loans has increased above the 10 percent threshold to 14.1 percent in December 2024, from 11.8 percent in December last year. The higher non-performing loans were mainly in the construction sector as banks roll back their loan moratoriums for Covid-19 and HTHH.

Positive credit growth is expected in the near term. Credit growth is expected to remain high in the first quarter of FY2025. Stronger demand for credit is anticipated as the economy continues to recover, improving business confidence and investment appetite, thereby creating more employment opportunities. There were a number of loan campaigns in the second half of 2024, which is expected to improve competition and help to maintain lower interest rates.

e. Financial Stability

Financial stability is still maintained, but upside risks from policy uncertainties require caution. Tonga's Aggregate Financial Stability Index[1] has deteriorated by 1.3 index points over the six month period from June to December 2024. Moderate gains across the Financial Development (FDX) and Financial Vulnerability Index (FVI) were outweighed by a weakening of both the Financial Soundness (FSI) and World Economic Conditions Index (WECI). Shifts in variables of note include a significant increase in the banks' NPL ratio (up to 14.1% from 11.2% in June 2024) as well as the contraction of the banks' capital-to-RWA and liquid-assets-to-total-assets ratios. Globally, the World Uncertainty Index surged by 61% over the same period, reflecting concerns over potential trade disruptions following the re-election of the Trump administration in the United States.

Figure 15: Aggregate Financial Stability Index



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

f. Key Challenges

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

[1] The AFSI consists of 4 sub-indexes, 3 of which are related Tonga's domestic economy, the Financial Development Index (FDX), Financial Soundness Index (FSI), and Financial Vulnerability Index (FVI) with the final relevant to international conditions, the World Economic Climate Index (WECI). The sub-indexes are calculated on the weighted approach by multiplying each indicator by pre-determined weights. The value components of each sub-indexes are normalized over the analyzed period (Dec 2013 – Dec 2024). An overall average of all weighted indicators is then computed to determine the AFSI (a score between 0 - 1).

- Escalating geo-political tensions and policy uncertainties leading to increasing tariffs, mass deportation, and lower foreign aid that could have significant spillover effects on small vulnerable states like Tonga, through the exchange rates and imported inflation.
- Climate change impacts and extreme weather conditions resulting in poor outcomes for the primary sector.
- Domestic political instability from the change in Government and the upcoming general election could divert current development projects and government priorities. This does not help lower our country risk profile and discourages foreign investment.
- Delays in structural reforms required for private sector development risks trapping the economy in low growth trajectory.
- Lack of coordination and structural reform to address supply-side bottlenecks in domestic production and bring down core inflation will leave cost of living at very high levels. Persistently high cost of living pressures not compensated with wage growth reduces households' purchasing power and overall standard of living.
- Lack of collaboration from fiscal policy for the effective mop up of excess liquidity, and the development of the domestic market threatens the effectiveness of monetary policy tools in achieving price stability.
- Tonga is data impoverished. Lack of available and regular data on key economic indicators such as labour, wages, tourism, and fiscal data restrains quality analysis and thereby policy recommendations and evaluation.

Annex 2 - **Monetary Policy Objectives**

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

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

Safeguarding macroeconomic stability requires addressing the imbalances in key macroeconomic variables in a sustainable manner, such as the foreign reserves and current account deficit, inflation, fiscal deficit and debt levels, and risks to employment, economic growth, and financial stability. This warrants policy trade-offs that must be carefully weighed to ensure the imbalances are manageable.

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

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

In accordance with Section 50A of the National Reserve Bank of Tonga Act;

1) The Bank shall, at least every six months, publish a Monetary Policy Statement and submit a copy to the Minister.
2) The Statement in subsection (1) shall contain -
   a) a review of economic developments and the conduct of monetary policy in the period since the previous Statement;
   b) a statement of how the Bank intends to conduct monetary policy over the coming six months to achieve its objectives specified under this Act; and
   c) a statement of any other development outside its control, which are adversely affecting, or may adversely affect in future, the successful pursuit of the Bank's objectives under the Act.
3) The Minister shall submit this monetary policy statement to the Legislative Assembly and Cabinet as soon as practicable.