NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

August 2020

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Contents

List of abbreviations

AML	Anti-Money Laundering
APR	Annual Percentage Rate
AUD	Australian Dollar
CFT	Counter-Terrorist Financing
COVID-19	2019 Novel Coronavirus
EXIM	Export-Import
FEC	Foreign Exchange Control
FEDs	Foreign Exchange Dealers
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 faced a double crisis in 2020 from the COVID-19 pandemic and TC Harold. Despite the remarkable effort to remain COVID free over the past six months to August 2020, the economy was not spared the global impacts of the pandemic. International border lockdowns, disruptions to supply chains, acute shocks to aggregate demand and consumption activities, and high uncertainties from the prolonged state of the pandemic has severely affected domestic activities and economic developments. Because of these extraordinary challenges, the Reserve Bank has maintained its accommodative monetary policy stance during the review period to support macro-economic fundamentals and growth.

The outlook for the economy still remains gloomy, with an expected contraction for the fiscal year 2020 of 2.7%. However, this is an upward revision from the -6.3% projected in February 2020. The upward revision was due to better than expected outturns in real indicators, especially from the primary sector partly offsetting the downturns in the tourism industry and other related sectors. A worse than expected outcome is predicted for the fiscal year 2021 on account of the extended lockdown of the international border, halting tourism activities and reducing private sector operations, resulting in higher unemployment and household indebtedness. Nevertheless, the monetary policy outcomes so far have been satisfactory and sound. The annual headline inflation remained relatively low over the past six months, averaging at 0.1% in August 2020 below the Reserve Bank's reference rate of 5%. The fall in global oil prices coupled with the strong recovery in domestic food supply were the main drivers of the low inflation.

Gross official foreign reserves grew strongly over the past six months by $76.2 million to $556.1 million, from inflows of additional budget support and relief funds for TC Harold and the preparations for COVID-19. This kept official foreign reserves at very comfortable levels, sufficient to cover 9.6 months of import of merchandise goods and services[1] which is above the Reserve Bank's minimum level of 3 months of import cover.

The Banking system remained sound and stable since the last review, supported by strong capital positions, adequate profitability, high liquidity, and low levels of nonperforming loans. Broad money has expanded by $34.6 million to $624.7 million over the six months to August 2020, as well as liquidity (reserve money) by $38.4 million to $336.3 million. The higher broad money corresponds to the growth in net foreign assets, while the growth in liquidity was mostly driven by higher currency in circulation and commercial 'banks' exchange settlement account balances.

Commercial Banks' lending slowed down in August 2020 by an annual growth rate of -1.8% to $487.6 million, as both business and household lending fell. On the other hand, deposits rose by $38.1 million, pushing the banks' total loans to deposit ratio down to 75.5%, which is below the Reserve Bank's minimum threshold of 80%. The weighted average interest rate spread continues to narrow over the past six months as lending rates declined coupled with higher deposit rates.

Government deposits rose by 28.6% over the past six months to August 2020 due to the inflow of budget support and relief funds. Consequently, net credit to the Government fell by 25.1%. The Government estimates a fiscal deficit for 2019/20 and 2020/21 of around $16.9 million and $37.4 million, respectively, given the expected loss of revenue streams from COVID-19. At the same time, Government expenditure is also projected to rise significantly in line with the preparations for COVID-19. The Government rolled out a $60 million stimulus package in April 2020 to assist economic and social sectors combat the adverse impacts of COVID-19.

Outlook

The Reserve Bank's forecast of an economic downturn in the Tongan economy still remains for the 2019/20 and 2020/21 fiscal years of -2.7% and -4.4%, respectively. This is largely based on the negative

[1] Method of calculation has changed in February 2017 to include both imports of goods & services (previous method used imports of goods only)

impacts of COVID-19 on various sectors of the economy, such as tourism, travel, transport and trade.

The inflation rate is projected to remain at low levels for the remainder of 2020 before gradually increasing in 2021 with the expected rebound in global oil prices. However, annual inflation is still expected to remain below the 5% reference rate up to June 2021.

Foreign reserves is likely to continue growing with more budget support and grants expected for the 2020/21 fiscal year. This will keep foreign reserves at very comfortable levels above the minimum of 3 months of import cover in the near term.

Credit growth is anticipated to be subdued in 2020/21 due to the uncertainties from COVID-19 discouraging borrowers from taking out credit while banks are becoming more risk-averse. Meanwhile, there is still excess liquidity in the banking system for further prudent lending. Commercial banks have extended their relief packages for their affected clients, which will help manage low levels of nonperforming loans.

Fiscal policy will also be expansionary over the medium term as the Government takes action to combat COVID-19, mitigate its economic impacts on the country, and provide relief for those affected by TC Harold. These efforts are also supported by donor funds and budget support from development partners. The Reserve Bank will closely monitor the implications of the fiscal policy measures on its monetary policy objectives.

Nevertheless, the outlook is largely precarious as high uncertainties surrounding the global pandemic still remains. Although there is some positive development on the vaccine, but having it available on a world wide scale remains a challenge. Emerging risks in cybersecurity, anti-money laundering and indebtedness threaten financial stability. Tonga's vulnerability to external shocks in the commodity markets and financial markets are also downside risks. At the same time, we are constantly battling climate change as part of our daily lives, with tropical cyclones expected to be more frequent and more severe, resulting in significant set-backs to domestic developments.

Given the recent 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 at the same time, maintain financial stability. The Reserve Bank remains vigilant by closely monitoring economic and financial developments and stands ready to provide corrective measures where necessary to achieve its monetary policy objectives.

Sione Ngongo Kioa

Governor

1. Global Developments

World Growth

The IMF's World Economic Outlook (WEO) in October 2020 projects that global economic growth is to contract by 4.4% in 2020. This is a downgrade from the forecast of -3.0% in the April 2020 WEO and a -5.2% in the June 2020 WEO. The revision for 2020 attributes to the sooner-than-expected recovery of economic activities in the second quarter. In particular, most advanced economies started easing COVID-19 restrictions, thus, allowing trade and business activities to slowly resume. Swift fiscal expansionary policies rolled out by governments and accommodative monetary policies by central banks also contributed to the upward revision. However, a 5.2% global economic growth recovery for 2021 is expected (compared to April 2020 WEO's 5.8% and the June 2020 WEO's 5.4%) with the prospect of a vaccine and more businesses recovering.

In advanced economies, overall economic growth is expected to remain subdued in 2020 given the uncertainties of COVID-19. Similarly, growth prospects for emerging markets and developing economies for 2020 continue to deteriorate owing to the pandemic's disruption in the tourism sector, trade, and the associated high costs of containing outbreaks. Commodity prices were volatile, as reflected by movements in the IMF's primary commodity price index since February 2020. The index fell by 24% (between February and April) as the pandemic escalated and then slowly recovered (between April and August) by around 31% as restrictions eased.

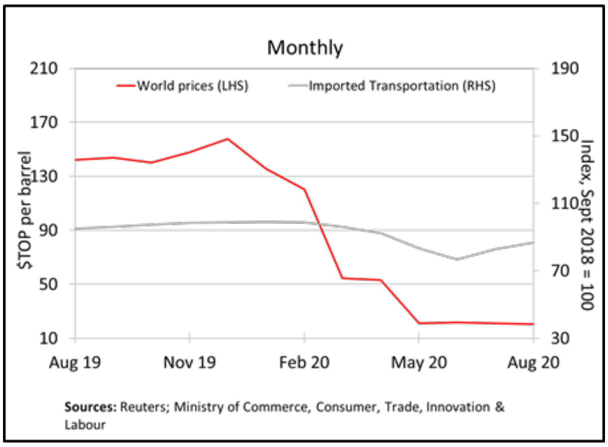
World Oil Prices

According to Reuters, world oil prices averaged around USD44.76 per barrel in August 2020. This is considerably lower compared to an average of USD55.77 per barrel in February 2020, and USD59.72 in August 2019.

The IMF October 2020 WEO projects oil prices to average at USD41.69 per barrel in 2020 and USD46.70 per barrel in 2021. This is higher than the forecast of USD35.60 per barrel for 2020 in the April 2020 (and USD36.20 per barrel in the June 2020 WEO), mainly as demand gradually recovers from eased restrictions.

The agreement amongst the Organization for the Petroleum Exporting Countries, including Russia (OPEC), to cut supply productions in June 2020 until December 2020 and again in April 2022, which also contributes to the projected rise in oil prices after it dropped to around USD20 per barrel in the first quarter of 2020.

Figure 1: World Oil prices



Advanced Economies

Economic growth in advanced economies is expected to contract by 5.8% in 2020 (revised upwards from the previous forecast of -6.1% projected in April 2020 WEO and -8.1% in the June 2020 WEO). This reflects better than anticipated outturn of business activities particularly in the US and Euro Area for the second quarter. However, growth is projected to gradually recover by 3.9% in 2021 as activity began to improve sooner than expected after lockdowns were scaled back.

In the US, the economy surged in the third quarter of 2020 at an annual growth rate of 33.1% this is according to the US Bureau of Economic Analysis. This is a significant turnaround amidst the COVID-19 pandemic following the 31.4% (annualized) contraction in the second quarter. The recovery reflected continued efforts by the Government and various sectors of the economy as they resumed operations. The government stimulus packages rolled out in March showed positive effects contributing to the rise in personal consumption spending, investments, and export activities in the third quarter. Nevertheless, the negative spillover effects of COVID-19 have taken its toll on the economy, and the prolonged impacts remain very uncertain. Therefore, overall growth for 2020 is forecasted to contract by

4.3% (compared to -5.9% in the April 2020 WEO and -8.0% in the June 2020 WEO) before rebounding by 3.1% in 2021 as business activities are expected to show further recovery. The US Federal Reserve in September 2020 maintained its federal funds rate at a target range of 0% - 0.25% and is expected to remain until labour market conditions improve.

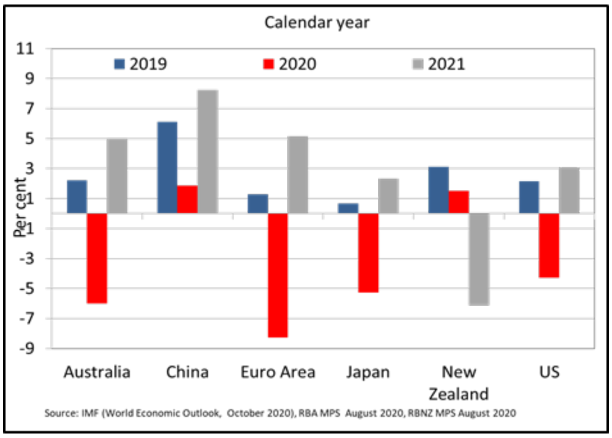
The Reserve Bank of Australia (RBA) reported in its August 2020 MPS that its economy has experienced its largest economic fallout since the Great Depression due to the COVID-19 pandemic. Economic growth for 2020 is projected to fall by 6.0% (unchanged since the May 2020 MPS), while growth for 2021 is forecasted to rise by 5.0% (compared to 6.0% in May 2020 MPS). The Government implemented expansionary targeted policies to support households. These policies included loan payment deferrals and early access to superannuation funds. The RBA maintained its cash rate target at 0.25% mainly to support the availability of credit to households and businesses. Meanwhile, the annual inflation rate fell by 0.3% in the June 2020 quarter, driven by lower fuel prices and discounted housing rent. The inflation rate is expected to remain below 2.0% until 2022.

The Reserve Bank of New Zealand (RBNZ) reported in its August 2020 MPS that it continues to maintain its Official Cash Rate (OCR) at 0.25%. This is targeted to support households and businesses access to credit, encourage investment, and consequently, more job opportunities. Firms responded positively as demand for credit and investments increased, according to the RBNZ's survey in June 2020. However, GDP growth still fell by 2.0% in the year to June 2020, largely driven by the fall in the services sector, specifically the retail and accommodation related services, as the country imposed strict restrictions and lockdown due to the COVID-19 outbreak. Overall, the growth outlook for 2020 is now projected at 1.5%, driven by some activity fueling recovery, and -6.1% for 2021 due mainly to the uncertainty surrounding the global pandemic. Annual headline inflation remained below the 2.0% target mid-point, at 1.5% in the June 2020 quarter. This is lower compared to the 2.5% inflation rate in March 2020 primarily driven by lower oil prices and weaker aggregate demand. Thus, annual inflation is estimated to remain low at 1.3% towards the end of 2020.

Economic activities in the United Kingdom (UK) were restrained due to the unprecedented shocks inflicted by COVID-19. Economic outlook for 2020 was revised down to -9.8% as reported by the IMF in its October 2020 WEO (compared to -6.5% in April 2020 WEO and -10.2% in June 2020 WEO), before regaining a 5.9% growth in 2021 (compared to 4.0% in April 2020 WEO and 6.3% in June 2020 WEO). Furthermore, the uncertainty of trade agreements with the European Union (EU) on the back of the disruptions of COVID-19 on the economy poses a downside risk to the outlook. The annual inflation rate is projected at 0.4% for 2020 and 1.5% for 2021.

The IMF October 2020 WEO stated that growth projections for the Euro Area is revised to -8.3%, compared to -7.5% in April 2020 WEO and -10.2% in June 2020 WEO. The revision is due to better than anticipated economic fallout in the Euro Area and the support from government transfer supporting household incomes. Economic activities are expected to gradually pick up as restriction measures ease with a 5.2% growth estimated for 2021 (compared to 4.7% and 6.0% growth in the April 2020 WEO and June 2020 WEO, respectively). Moreover, annual inflation is to remain relatively low at 0.1% in 2020 due to weaker consumption spending and falling global oil prices before rising by 1.1% in 2021.

Figure 2: Growth Projection in the Advanced Economies



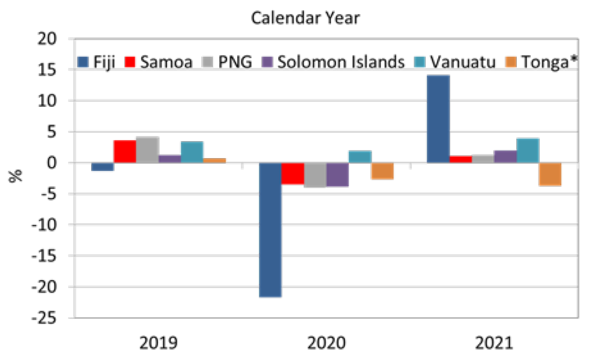
Despite being the epicenter of the COVID-19 pandemic, economic growth has rebounded in China. The June 2020 quarter showed a recovery of 3.2% (annual growth) after plunging by 6.1% in the March 2020 quarter. The pace of positive recovery continued on to the third quarter of 2020 increasing by 4.9% (annual growth) as reported by the National Bureau of Statistics of China. This is attributed to the swift policy measures and regulatory responses being rolled out, and targeted containment of the COVID-19 outbreak. Exports also picked up as most of the country reopened in early April allowing business activities to resume. Exports growth is further supported by the high external demand for medical equipment and related technological items required for remote working. In light of this, a growth of 1.9% is projected for 2020 (compared to 1.2% in April 2020 WEO and 1.0% in June 2020 WEO) before surging by 8.2% in 2021. Inflation forecast for 2020 is expected at 1.4%, and 2.5% in 2021.

Japan's economy recorded a decline in economic growth of 28.1% (annual) in the June 2020 quarter (compared to the -2.2% annual growth in March 2020 quarter) as reported by Japan's Cabinet Office. The contraction stemmed from declining capital expenditure, fall in real wages, and consequently, a drop in consumer spending. Therefore, projected growth for 2020 has been slightly revised down to -5.3% (compared to -5.2% in April 2020 WEO and -5.8% in June 2020 WEO), before slowly recovering by 2.3% growth in 2021 (compared to the 3.0% and 2.4% growth projected in the April 2020 WEO and June 2020 WEO respectively). The inflation rate will remain low at -0.6% and 0.7% for 2020 and 2021, respectively, moving in line with weaker domestic demand and low oil prices.

South Pacific Economies

Revised GDP estimates for the South Pacific region in 2019 showed that it performed lower than expected at 1.9% growth, compared to the previous estimate of 2.4% regional average growth in the February 2020 MPS. Regional average growth is now expected to decline by 5.7% in 2020. The impacts of COVID-19 imposed varying economic fallouts across the region. Significant disruptions were evident, particularly for the tourism sector due to the lockdown of borders. Consequently, this affected the flow of revenue into the region. International trade and remittance inflows are also expected to deteriorate given the economic downturn of economies abroad coupled with weaker commodity prices. Fiji is expected to be the hardest hit economy in the region (-21.7% growth for 2020) driven by severe downfall in tourism, investments, negative production output and weaker consumer spending. In PNG, the shutdown of the Porgera Mine along with the slowdown in other sectors of the economy contributed to negative growth. Nevertheless, expansionary fiscal stance implemented by respective governments with continued efforts to curb the COVID-19 outbreak has provided some relief to affected sectors. The South Pacific region is expected to recover by 3.1% in 2021 as impacts of the pandemic is anticipated to slowly fade away.

Figure 3: Growth Projections in the Pacific



* Tonga is in financial year; Tonga's figures are NRBT estimates
Sources: IMF WEO Outlook October 2020, Reserve Bank of Fiji, Central Bank of Samoa, Bank of Papua New Guinea, Central Bank of Solomon Islands, Reserve Bank of Vanuatu, Statistics Department of Tonga, NRBT estimates

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

	Real GDP Growth (%)			Inflation (%)			Unemployment* (%)		
	2019	2020f	2021f	2019	2020f	2021f	2019	2020f	2021f
World Growth	2.8	-4.4	5.2						
Australia	2.2	-6.0	5.0	1.8	1.3	1.0	5.2	10.0	8.5
China	6.1	1.9	8.2	4.5	1.4	2.5	3.6	3.8	3.6
Euro Area	1.3	-8.3	5.2	1.3	0.1	1.1	7.6	8.9	9.1
Japan	0.7	-5.3	2.3	0.5	-0.6	0.7	2.4	3.3	2.8
New Zealand	3.1	1.5	-6.1	1.9	1.3	0.3	4.1	4.2	8.0
United Kingdom	1.5	-9.8	5.9	1.4	0.4	1.5	3.8	5.4	7.4
United States	2.2	-4.3	3.1	2.1	2.1	2.2	3.7	8.9	7.3

Note: f – forecast
Source: IMF (World Economic Outlook, October 2020), NRBT , RBA August 2020 MPS, RBNZ August 2020 MPS)

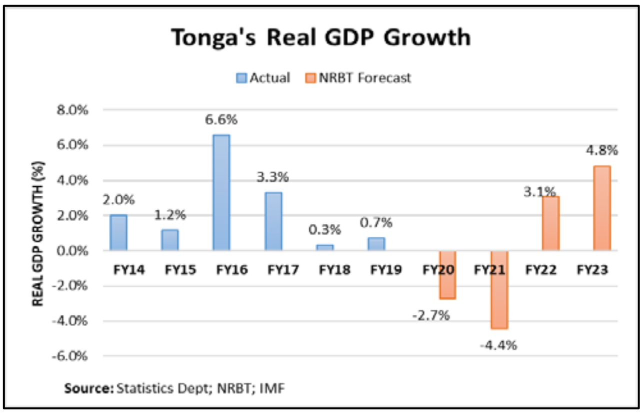
2. Tonga's Economic Growth

Real GDP Growth

Tonga, like many countries in the world, navigates through the global pandemic with great uncertainty. Extreme measures were taken to ensure the security of the country and its people through extended border lockdowns, strict quarantines, night curfews, and social distancing has weighed heavily on the economy, driving many countries into economic recession.

At the time of this review, Tonga remains one of seven countries in the Pacific region that is still COVID-19 free. Nevertheless, border restrictions continue to heavily limit international tourism and migration. This has immediate impacts on the tourism-related sectors such as accommodation & food services, transport and trade activities. More broadly, domestic economic activity is being subdued due to lower household and firm incomes, the uncertain economic outlook, and lower external demand from our trading-partner economies. While the race for developing a vaccine continues and shows promising results, the question remains of when it will be available and accessible for small countries like Tonga. As such, border restrictions are likely to be in place for some time.

Figure 4: Real GDP Growth



Since the February 2020 MPS, the NRBT has been collecting new data and information, thus reviewing its forecasts more regularly. Although the NRBT still projects an economic downturn for FY2020 and FY2021, it is now estimating a smaller drop in real GDP growth for FY2020 than previously anticipated (revised up from -6.3% to -2.7%). In comparison, a sharper economic downturn is expected for FY2021 (revised down from -2.7% to -4.4%). Better than expected outcomes, especially from the primary sector at the end of June 2020, led to the upward revision, while the extended duration of the pandemic affecting tourism contributes to the downgrade in FY 2021 forecast.

Primary Production

The primary sector is expected to continue to grow by 3.2% (revised up from 1.1% in February 2020 MPS) in 2019/20 on account of the strong performance in the agricultural sector. The primary sector was least affected by the impacts of COVID-19. The strong performance is also attributed to many of the businesses affected by COVID-19 in the tourism sector diversifying to the primary sector. Looking ahead, the primary sector is anticipated to continue trending positively although not as strongly as pre-COVID levels.

Growth in the agricultural and forestry sector has been revised upward for 2019/20 to 3.0% from the previous forecast of 1.0%. Favorable weather conditions supported the stronger growth during the year which resulted in an increase in both domestic production and export volumes. The total volume of agricultural exports increased by 4,105.8 tonnes (45.1%) at the end of June 2020, driven by higher exports of squash and root crops. Replanting and recovery efforts from TC Gita and TC Harold and other initiatives to ensure food security during the global pandemic also supports the growth in this sector. However, compared to export proceeds for the same period, it declined by $1.9 million (19.8%) reflecting an unsuccessful squash season and a time lag in receipt of proceeds. Small non-commercial exporters may also be receiving their proceeds as remittance instead.

Figure 5: Major Agricultural Exports (tonnes)

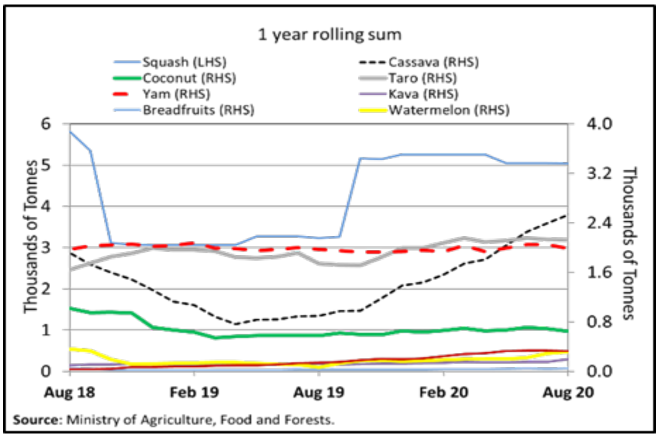


Table 2: Real GDP Forecast

	Official 2017/18 %	Official (preliminary) 2018/19 %	FY 2019/20 (Feb-20 MPS) %	FY 2019/20 (Revised) %	FY 2020/21 (Feb-20 MPS) %	FY 2020/21 (Revised) %	FY 2021/22 %	FY 2022/23 %
GDP	0.3	0.7	-6.3	-2.7	-2.7	-4.4	3.1	4.8
Primary production	0.4	3.6	1.1	3.2	-3.4	2.4	1.3	2.7
Agriculture and Forestry	2.3	2.0	1.0	3.0	-2.0	0.5	1.0	2.0
Fishing	-14.6	18.6	2.0	5.0	-15.0	-32.0	5.0	10.0
Secondary production	-14.4	4.6	-0.5	-0.8	-3.2	1.9	2.1	4.5
Mining and quarrying	14.2	-23.0	2.0	-2.0	-5.0	6.0	5.0	5.0
Manufacturing	-0.8	-4.8	-4.0	-4.0	-5.0	-2.0	2.0	5.0
Electricity, water and waste	0.0	11.0	1.0	2.0	-2.0	-5.0	2.0	2.0
Construction	-32.4	16.2	2.0	1.0	-2.0	1.0	2.0	5.0
Tertiary production	3.3	0.8	-10.9	-5.2	-2.2	-5.6	5.6	6.1
Wholesale and retail trade	6.3	0.4	-12.0	-6.0	-15.0	-10.0	5.0	7.0
Transport and storage	1.8	2.2	-70.0	-40.0	-60.0	-40.0	40.0	60.0
Accommodation and food service activities	7.5	-3.3	-80.0	-40.0	-70.0	-80.0	200.0	100.0
Information and communication	9.5	0.4	-2.0	3.0	1.0	3.0	2.0	2.0
Financial and insurance activities	4.5	0.1	2.0	-1.0	-2.0	-2.0	2.0	2.0
Ownership of dwellings	-2.3	-0.6	-2.0	-1.8	-3.0	1.0	1.0	2.0
Other real estate activities	1.0	2.7	-1.0	-2.0	-3.0	-3.0	1.0	2.0
Professional, scientific and technical activities	25.2	11.0	2.0	-1.0	-10.0	-21.0	2.0	5..0
Administrative and support service activities	1.2	2.5	-10.0	-5.0	-15.0	-15.0	5.0	5.0
Public administration and defense	2.8	4.0	10.6	10.6	20.9	10.9	5.0	-3.0
Education	0.0	2.6	5.0	4.0	4.0	4.0	-2.0	-1.0
Human health and social work activities	5.4	-3.2	5.0	5.0	3.0	6.0	3.0	-2.0
Arts, entertainment and recreation	-12.1	0.1	-70.0	-50.0	-50.0	-40.0	80.0	30.0
Other service activities	3.5	-3.1	-2.5	-2.5	-10.0	-30.0	2.0	5.0
Other*	5.9	-5.4	-4.5	-2.7	-3.0	-5.0	-2.0	3.0

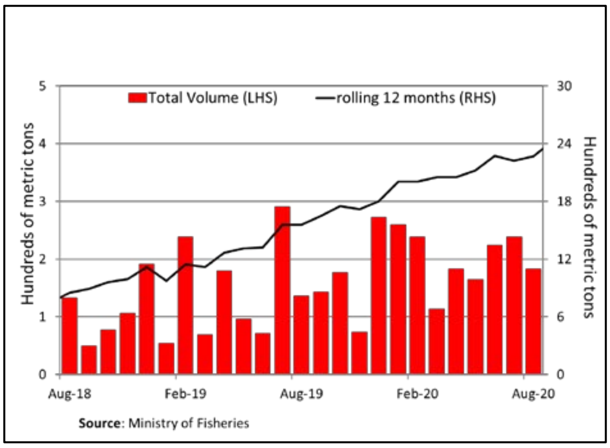
* Includes taxes less subsidies

Source: Department of Statistics, NRBT

It is expected that COVID-19 may slow down agricultural exports in 2020/21 due to new trade regulations imposed at our main exporting countries such as New Zealand and the United States. Reduced local demand is also expected, especially for the food and accommodation businesses that are no longer accommodating guests or hosting any large gatherings. This is coupled with the damages caused by TC Harold in April 2020 to some of the agricultural products.

Nevertheless, there is still an excess food supply in the market, especially for root crops, reflected in the declining domestic food prices. Many locals are shipping bags of root crops to their family and relatives overseas. The New Zealand market is also open for the export of watermelon, although issues with non-compliance with biosecurity requirements may dampen this opportunity. Over the year to August 2020, the total volume of agricultural exports rose by 50.2% (4,510.6 tonnes) largely driven by exports of squash and root crops. As such, the agricultural sector is expected to continue to record a 0.5% growth in 2020/21.

Figure 6: Fish Exports (metric tons)



The fisheries sector is anticipated to continue growing in 2019/20 albeit at a slower rate of 5.0%. Despite the set-back on the last quarter of 2019/20 prompted by the border lockdown, the volume of marine exports still rose over the year to June 2020 by 152.1 metric tons (8.6%) mainly from tuna exports. The volume of aquarium exports, however, declined by 93,371 pieces (37.2%). Proceeds for exports of fish and marine products for the same period also rose by $0.8 million (9.7%).

The ban on harvesting sea cucumbers was lifted temporarily in July - September 2020 as part of the COVID-19 assistance to the sector, whereby an estimated 15 tonnes was exported. Other assistance also involved the Ministry of Fisheries buying fish from fishing companies and selling it to the public at a cheaper price. However, the set-back on air freight exports due to the COVID-19 border lockdown is likely to persist for 2020/21 and to negatively impact the fisheries sector, resulting in a sharp negative growth projected of 32.0%.

Secondary Production

The industrial sector is expected to slow down to a 0.8% growth in 2019/20 following a 4.6% growth in 2018/19. This slowdown owes mostly to the sharp drop in the construction sector's projected growth by 15.2%, in line with the completion of major construction projects in the previous year. In the year to June 2020, lending to the Manufacturing and Utility sectors declined by 17.1% and 46.8%. In contrast, lending to Construction and Mining & Quarrying businesses grew by 10.2% and 17.2%, respectively. Individual housing loans also rose slightly by 1.7%. However, imports of construction materials fell by 19.9%.

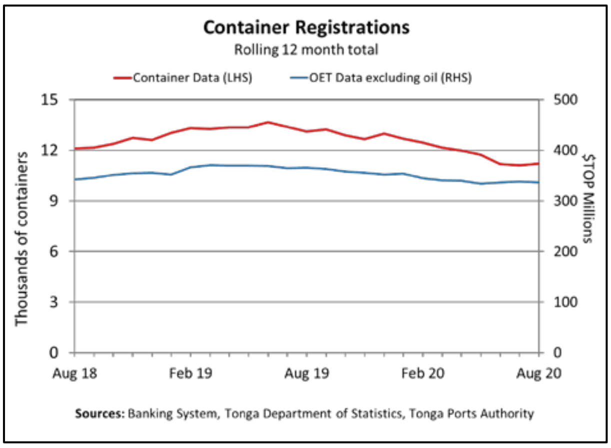
COVID-19 has interrupted the implementation of major infrastructure and construction projects, including the Fanga'uta Bridge, and the Queen Salote Wharf, to name a few. Many of the technical and professional expertise required to implement these projects have either been repatriated to their home countries or unable to enter Tonga due to the border lockdown. However, the reconstruction for TC Gita and TC Harold contributes to some growth in the construction sector for 2020/21. Additionally, the Road Improvement Project supports the mining and quarrying sector. Tonga Power Ltd reduced its electricity tariff in July 2020 as a result of declining of global prices.

Meanwhile, their Network upgrade projects and Renewable energy projects are still on-going. Both electricity production and consumption rose consistently over the year to August 2020, along with the number of electricity consumers. As such the secondary sector is expected to rebound in the current fiscal year by 1.9%.

Tertiary Production

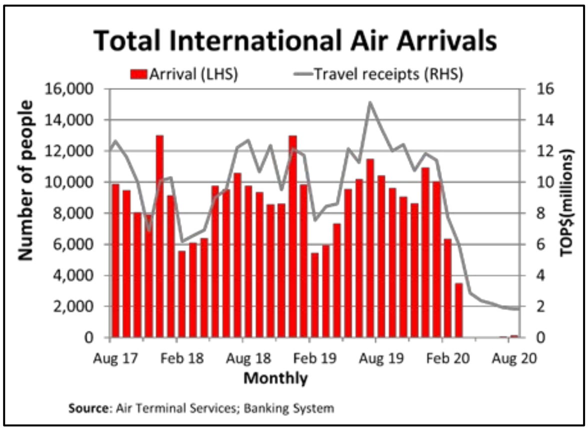
The tertiary sector is expected to weaken the most from the impacts of COVID-19 with a projected contraction of 5.2% in 2019/20. This largely stems from the international border lockdown severely impacting the tourism sector and other related sectors, further exacerbated by TC Harold. Restricted mobility, social distancing and night curfews affected other sectors of the economy such as transport, trade, accommodation and food services, real estate activities, and entertainment businesses. The wholesale and retail sector is expected to decline by 6.0%. International merchandise imports declined in the year to June 2020 by 3.8%, coinciding with the 6.0% drop in OET payments mostly for wholesale and retail goods, motor vehicles and construction materials. Similarly, container registrations also dropped by 18.2% from both Business and Private containers reflecting disruptions to supply chains and trade. Vehicle registrations also declined by 16.0%.

Figure 7: Import Indicators



The tertiary sector is to contract further by 5.6% in 2020/21 with the extended border lockdown and the pandemic's prolonged state heavily curtailing tourism activities. Although some businesses have diversified from the tourism sector, aggregate demand and consumption are still weak with the downsizing and cancellation of local celebrations and events. International travel is minimal with the repatriation flights only. At the same time, transport faces delays with port congestions, additional quarantine measures and difficulty in rotating crew members. Domestic travel has picked up the pace with operation of the Lulutai Airlines, however, customers are only local residents. The financial sector is experiencing subdued credit growth, with banks becoming more risk-averse while borrowers are not confident due to the uncertainties of the global pandemic. Banks have also extended their COVID-19 relief packages for their affected customers into early 2021.

Figure 8: International Air Arrivals & Travel Receipts



The Government continues with the roll out of its fiscal stimulus package with funding support from donor partners. The Governments priorities are to support the Health system in their preparation for the pandemic and mitigate the pandemic's economic impact on businesses, employees, and the vulnerable groups. Exemption of import duties for private households supported in-kind remittances, while deferrals of CT payments helps businesses with their cash flows. The Government also extended the Government Development Loan (GDL) in October 2020 with an additional $5 million to support affected sectors of the economy such as tourism and fisheries.

A moderate recovery in all sectors are expected for the outer years 2021/22 and 2022/23, given the rollout of the COVID-19 vaccines, which can ease travel restrictions and border lockdowns. However, there is still tremendous uncertainties given the development of new virus strains. Tonga's vulnerability to natural disasters and external shocks also remains a downside risk to the forecasts.

Unemployment

Unemployment is on the rise due to the financial hardship faced by businesses in the private sector from reduced operations and loss of profit. Although there is an evident decline in the number of formal vacancies being advertised, people are venturing out for new livelihoods, with many falling back to the primary sector and home production such as farming, flea markets, roadside food stalls, and domestic labourers. Consequently, the informal sector gained significance from the impacts of COVID-19, which was estimated at46.8% of the total labour force in 2018.

The border closure also affected the deployment of seasonal workers to New Zealand and Australia. Many of the workers deployed before the border lockdown remained overseas and continued work, and were rotated to other sectors or new farms. The repatriation of seasonal workers commenced in August 2020, at the same time, more workers were deployed to Australia to meet labour demands from Australian Farmers. In February 2021, Tonga has temporarily pulled out of the Recognized Seasonal Employer (RSE) scheme with New Zealand due to difficulties in meeting new criteria such as providing a guaranteed return flight home at the end of the season.

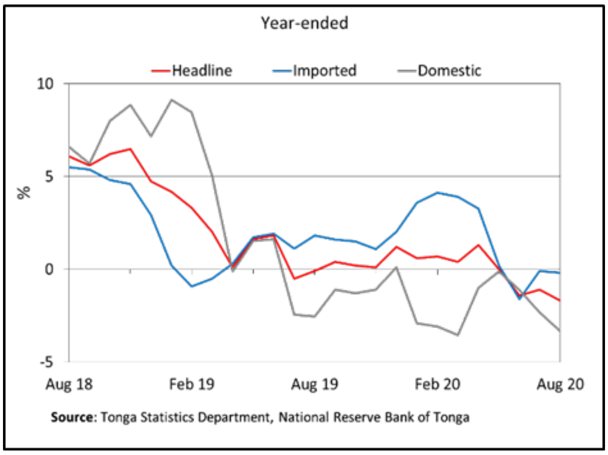
However, part of the Government's fiscal stimulus package includes employee support for those affected by the pandemic. The Pension funds also offered relief funds for their members who applied for their financial difficulty packages. Unemployment will likely remain high given the estimated economic downturn and the uncertainties of the COVID-19 pandemic.

3. Promoting Low and Stable Inflation

Recent Developments

The annual headline inflation for Tonga continued to remain below the NRBT's 5% reference rate since February 2020 and dipped into negative inflation since June 2020. In August 2020, annual inflation declined by 1.6% (deflation), stemming from lower domestic and imported prices. This is lower compared to August 2019 (-0.1%) and February 2020 (0.8%). Lower prices were largely driven by the falling prices for local food, kava Tonga, and oil prices.

Figure 9: Inflation



Domestic prices declined by 3.4% over the year to August 2020. The decreasing local prices for electricity, gas and other fuels (-23.7%) were significant drivers of the annual price movements, which contributed by -1.2%. This, largely reflects the reduction of electricity tariffs in April and July 2020, coinciding with the lower oil prices.

Additionally, local food prices also declined by 4.2% over the year to August 2020. This attributes to lower prices for vegetables, root crops, and seafood. Similarly, kava Tonga prices consistently declined (since January 2019), dropping by 39.8% annually in August 2020. These movements reflect the general recovery in the agricultural sector from previous cyclones and the favourable weather conditions. The Government's replanting efforts from TC Harold and the initiative to ensure food security during the pandemic contribute to the domestic market's ample food supply. On the other hand, the cancellation of major events such as the annual church conferences and the inactive tourism sector reduced food demand, further driving prices lower.

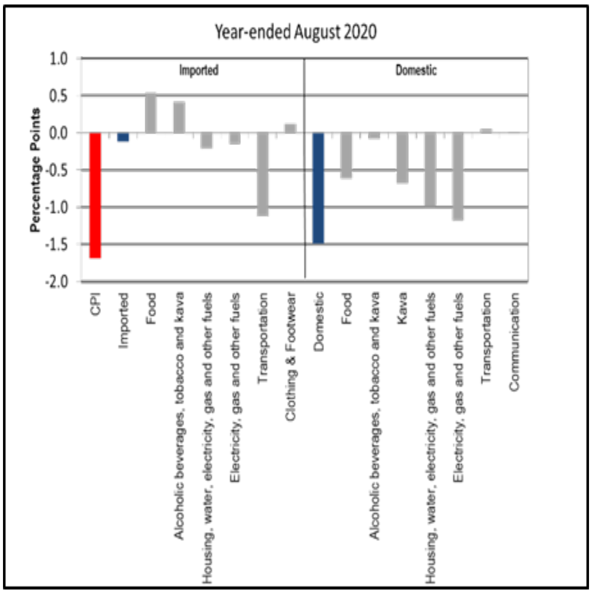
Table 3: Food items contributing to domestic inflation

		($ per kg)		YOY	
Domestic	Unit	Aug 20	Aug 19	Annual changes $	% growth
Kava	1kg	$60.00	$112.50	-$52.50	-46.67
Capsicum	1kg	$11.68	$15.45	-$3.77	-24.40
Octopus	1kg	$11.66	$15.29	-$3.63	-23.74
Tomatoes	1kg	$5.23	$6.55	-$1.32	-20.15
H/Cabbage	1kg	$1.35	$2.09	-$0.74	-35.41
Lu	1kg	$3.78	$4.34	-$0.56	-12.90
Tuna	1kg	$17.00	$17.56	-$0.56	-3.19
Yams - early	1kg	$5.99	$6.33	-$0.34	-5.37
Manioke	1kg	$0.95	$1.03	-$0.08	-7.77
Yams - late	1kg	$2.50	$2.47	$0.03	1.21
Talo - Futuna	1kg	$1.57	$1.52	$0.05	3.29
Carrots	1kg	$2.57	$2.45	$0.12	4.90
Kumala	1kg	$2.15	$1.96	$0.19	9.69
Talo - Tonga	1kg	$1.88	$1.68	$0.20	11.90
Sausages	1kg	$8.67	$8.19	$0.48	5.86
Eggs	1 tray	$18.30	$17.33	$0.97	5.60
Stringed fish (mixed)	1kg	$12.00	$9.00	$3.00	33.33
Cockles (to'o)	1kg	$10.37	$5.81	$4.56	78.49

Source: Tonga Statistics Department

Imported prices also declined by 0.2% in the year to August 2020 compared to a 4.1% increase in February 2020. This owes mostly to the fall in transportation items, particularly for fuel prices, electricity, gas & other fuels, and household maintenance and repair. Fuel prices reflected the 25.1% drop in global oil prices over the year to August 2020. The subdued global demand for oil from the COVID-19 restrictions led to excess supply hence, crude oil prices were significantly lower in August 2020 at US$45.81 compared to US$61.12 per barrel in August 2019.

Figure 10: Contributions to Inflation

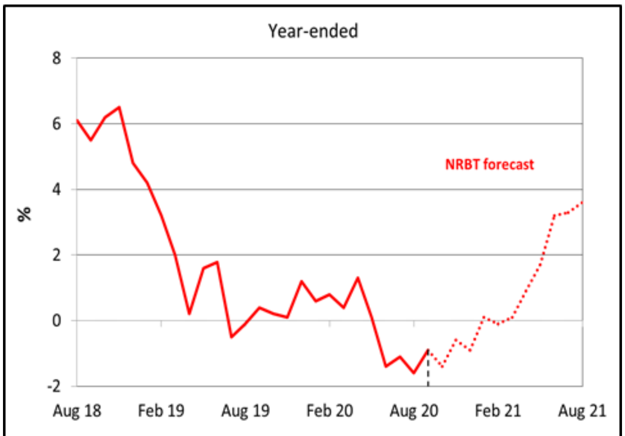


However, imported prices for food and tobacco rose over the year to August 2020, partly driven by the new tax amendment effective since June 2020 as part of the Government's initiative to promote healthy living. The general appreciation of major trading currencies against the TOP also contributed to the higher imported prices.

Outlook

The Reserve Bank projects headline inflation to remain relatively low for the remainder of 2020 before gradually rising in 2021, however, it will remain below the 5% reference rate. Nevertheless, the associated uncertainties of the COVID-19 pandemic on global food and oil prices coupled with Tonga's vulnerability to natural disasters poses a risk to the inflation forecast. The Reserve Bank will continue to closely monitor the sources of inflation and its impacts on the economy.

Figure 11: Headline Inflation Forecast



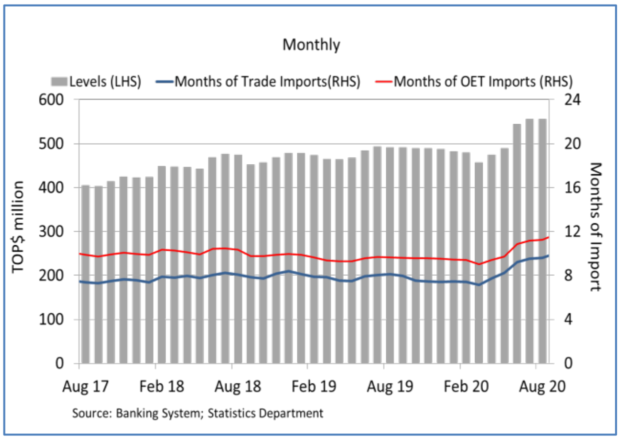
Sources: Statistics Department ; National Reserve Bank of Tonga
* The actual headline inflation data are up to September 2020.

4. Maintaining an Adequate Level of Foreign Reserves

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

Official Foreign Reserves

Figure 12: Gross Official Foreign Reserves



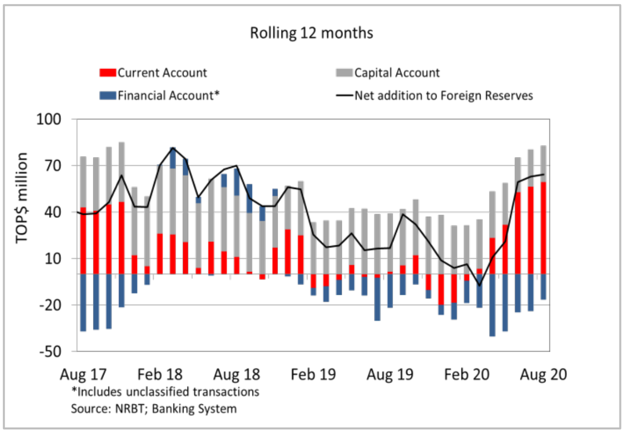
Gross official foreign reserves increased in the six months to August 2020 by $76.2 million and over the year by $64.3 million (0.1%) to a record high of $556.1 million, equivalent to 8.5 months of imports of both goods and services. These movements were due to higher receipts of funds for budget support, project funds from development partners, and financial assistance grants for TC Harold and COVID-19 preparations. Additionally, the inflow of remittances despite the impact of COVID-19 on remitting countries also supports the higher foreign reserves.

Balance of Overseas Exchange Transactions

In the past six months to August 2020, the overall OET balance recorded a surplus of $76.2 million following a deficit of $12.0 million in the previous six months to February 2020. The expanding surplus in the current account was the main contributor to the overall balance surplus.

Annually, the overall OET balance recorded its highest year on year surplus of $64.3 million in August 2020 compared to a $16.8 million surplus in August 2019, driven by the higher current account surplus.

Figure 13: Balance of Overseas Exchange Transactions



Current Account

The balance of the current account over the six months to August 2020 was a $76.9 million surplus compared to a deficit of $15.7 million in the last six months to February 2020. This surplus was driven by higher transfer and income receipts. Improvements in the merchandise trade account also contributed to the current account surplus. Similarly, the current account surplus further improved to $61.2 million in the year to August 2020 from a $1.8 million surplus recorded in the previous year.

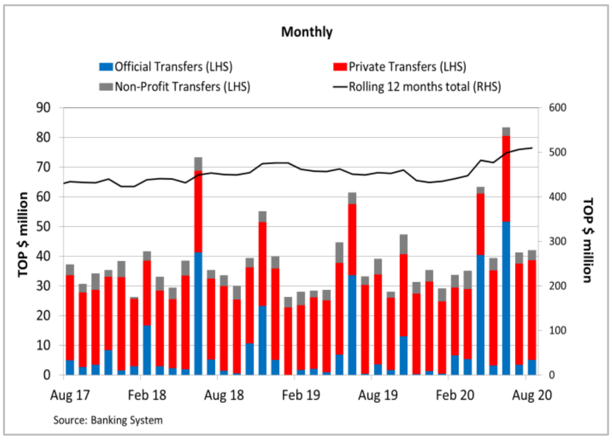
i. Current Account Receipts

a. *Transfer receipts*

Transfer receipts continued to account for the largest share in the current account receipts at 78.9% during the six months to August 2020. In the past six months to August 2020, the transfer receipts rose significantly by $99.7 million (48.6%), underpinned by increases in official and private transfer receipts. The official transfer receipts rose by $85.8 million to $109.3 million, supported by higher receipts of budget support, project funds, financial assistance for TC Harold, and preparations for COVID-19. Private transfer receipts also increased by $16.0 million (10.3%) to $172.4 million attributed to remittances, particularly family support and gifts. Contrastingly, the non-profit transfer receipts fell by $2.5 million (9.8%) to $22.8 million, mainly due to lower inflows of grants received by non-profit organizations, mostly technical assistance for churches and schools and other current expenditures.

In year ended terms, total transfer receipts increased by $55.0 million (12.1%) to $509.4 million. Both official transfer receipts and private transfer receipts rose over the year by $44.1 million (47.9%) and $11.6 million (3.7%), respectively. This outweighed the $0.5 million (0.9%) decline in non-profit transfer receipts.

Figure 14: Transfer Receipts



Total remittances increased over the six months to August 2020 by $21.6 million (12.8%) to $190.6 million, and accounted for 43.1% of the total OET receipts for the same period. All categories of remittance receipts rose over the six-month period to August 2020 with receipts from private transfers increasing the most. Approximately 90.5% of the total remittance receipts were private transfer receipts with a total of $172.4 million, which are mostly gifts and family support from families and relatives abroad. The receipts for compensation of employees (seasonal employees and other wages and salaries) followed with a total of $15.4 million (8.1%). Private transfers by individuals for capital investments totaled $1.9 million (1.0%), and social benefits were $0.8 million (0.4%).

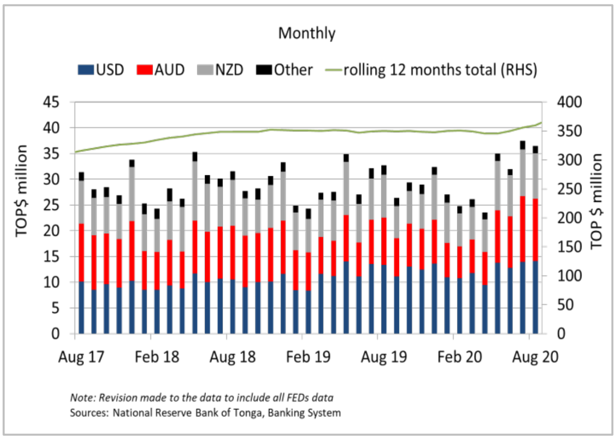
Total remittances in the year to August 2020 rose by $9.3 million (2.7%) to a total of $359.8 million. Remittance as a share of GDP was around 40% as at August 2020. The increase in total remittances over the year stemmed from continued transfer of funds from families and friends abroad to support their families during COVID-19 as well as financing other home and church obligations over the year. Compensation for employees also contributed to the increase in remittances over the year.

Majority of remittance receipts were denominated in US Dollars, representing 41.1% of the total remittance receipts. Australian dollars followed with 28.6% and New Zealand Dollars with 25.2% share of total remittance receipts.

The general appreciation of the trading partner currencies against the TOP supported this increase and also benefited the recipients of remittances.

FEDs remained the preferred channel for remittances, increasing from 86.0% share in February 2020 to 87.7% share in August 2020. However, the share of remittances transferred through the banks declined to 12.3% in August 2020 from 14.0% in February 2020. The impact of COVID-19 disruptions and the resulting temporary closure of some of the FEDs were muted by digital financial products' developments. Digital financial products enabled many people to transfer funds using online apps such as Money Gram and Áve Paánga Pau, helping to maintain the consistent flow of remittances to Tonga.

Figure 15: Remittances by Currency



b. *Export proceeds*

Over the six months to August 2020, total export proceeds fell by $4.6 million (44.1%) to $5.8 million, owing to declines in receipts from all categories. The proceeds from exported fisheries products (fish & aquarium) decreased the most by $2.5 million followed by about $0.9 million decline in agricultural exports. Export proceeds from other exported goods also fell by $0.2 million. The lower agricultural proceeds resulted from an unsuccessful squash season, whereas the decline in fisheries exports reflects the impact of the COVID-19 restrictions on exports of fish via airfreight.

Similarly, total export proceeds also declined in the year to August 2020 by $4.5 million (21.7%) to a total of $16.1 million. All export categories declined with agricultural exports decreasing the most. However, this decline in proceeds contradicts the increase in total volume of agricultural and marine exports over the year, due to a damaged squash shipment during the year and a possible lag in the receipt of proceeds. It is also presumed that proceeds for non-commercial farmers may be contributing to remittances both cash and in-kind. Receipts from fisheries and marine exports accounted for 47.0% of the total proceeds, while agricultural exports account for 44.0%. The remaining 8.0% are from other exported goods.

c. *Service receipts*

Receipts for services in the six months to August 2020 decreased significantly by $42.2 million (41.5%) to $59.3 million as receipts for most services fell especially travel. Travel receipts from tourism-related earnings declined by $49.0 million as the tourism sector was severely impacted by the international border lockdown and TC Harold. Receipts for construction and installation related services also fell by $3.2 million (45.4%), followed by receipts for professional & management by $1.8 million (28.0%), and transport services fell by $1.8 million (17.2%). Other services receipts which also decreased included personal, cultural & recreational services, computer & information, and maintenance & repair services.

In year-end terms, the total service receipts also fell by $43.0 million (21.1%) to $160.8 million. This is attributed mainly to travel receipts declining by $49.8 million (37.4%) due to the international border lockdown since March 2020. This is in line with the 46.8% decrease in international air arrivals. The fall in travel receipts outweighed the increase in other services by $6.7 million (9.5%), reflecting receipts from insurance claims following TC Harold in April 2020 and telecommunication services.

ii. Current Account Payments

Total current account payments declined over the six months to August 2020 by $42.0 million to a total of $330.4 million. This resulted from lower payments for services and imports payments whilst income payments increased.

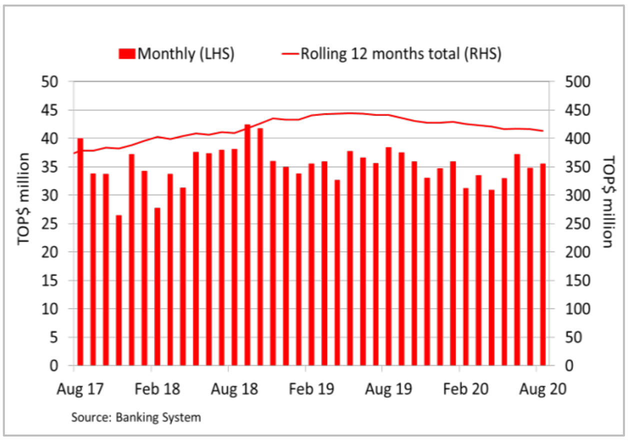
Current account payments also fell in the year to August 2020 by $49.1 million (7.0%) to a total of $653.8 million. This resulted mainly from lower import, services, and transfer payments, which offset the rise in income payments.

a. *Import payments*

Merchandise import payments declined by $3.5 million to $205.0 million in the six months to August 2020. Oil import payments declined the most by $12.9 million in line with the lower global oil prices, followed by a decrease in wholesale & retail goods by $4.5 million. This offset increases in payments for construction materials and motor vehicles, which rose by $9.4 million and $4.4 million, respectively. Payments for other imported goods, which are mostly for public enterprises, also increased by $1.6 million.

In the year to August 2020, import payments fell by $28.1 million (6.4%) to $413.5 million, coinciding with the 14.4% decline in container registrations for the same period. Payments for all import categories declined over the year except for oil imports. Oil import payments rose by $1.1 million (1.5%) and accounted for about 19% of total import payments. Tonga continued to import mainly from New Zealand while the bulk of the payments are denominated in US Dollars.

Figure 16: Import payments



b. *Services & Transfer payments*

Payments for both service and transfer accounts fell over the six months to August 2020 with services declining by $25.8 million, and transfers by $4.8 million. Service payments decreased to $63.0 million underpinned mainly by lower payments for travel, professional & management, insurance premiums, postal & courier, telecommunication, maintenance & repair services. However, payments for air freight increased over the six months despite the travel restrictions. Contributions and payments of subscriptions to international organizations by non-profit organizations also increased.

In year ended terms, both services and transfer payments declined. Services payments fell by $20.3 million (11.8%) to $151.7 million for airfares, professional & management, and construction & installation services. Transfer payments decreased by $1.1 million (1.5%) to $69.2 million mostly from a $1.4 million decline in individual transfers abroad for family support and transfers to their bank accounts overseas. This offset increases in payments for official donations, contributions, and subscription payments to professional associations by non-profit organizations.

c. Primary Income payments

Over the six months to August 2020, primary income payments increased by $0.9 million (9.8%) to $10.1 million, mainly attributed to higher dividends paid out to non-resident shareholders. Payments for pension & social benefit, and taxes & rent also increased during this period.

Annually, income payments increased by $0.5 million (2.5%) to $19.3 million, underpinned by rises in dividends paid out to non-resident shareholders and wages and salaries to expatriates overseas.

Capital Account

A net inflow of $11.6 million was recorded in the capital account for the six months to August 2020, which is slightly higher than the $11.5 million surplus in the six months to February 2020. This stemmed from an increase in official capital transfers by $0.3 million offsetting the decline in private capital transfers by $0.2 million.

Over the year to August 2020, the capital account surplus fell by $14.2 million (38.1%) to $23.1 million. This resulted from lower surpluses in both the private and official capital accounts due to lower receipts over the year. Both the private capital and official capital surpluses declined by $7.3 million and $6.9 million, respectively. Official capital receipts in the capital account dropped following an influx of receipts from donor partners for capital expenditures and investment projects in the previous year, such as the 'Nuku'alofa Network Upgrade and the Fua'amotu International Airport Upgrade.

Financial Account

The deficit in the financial account balance widened to $11.0 million during the six months to August 2020, lower than a deficit of $7.5 million in the previous six months to February 2020. This was mainly underpinned by higher payments for direct investments offshore and inter-bank lending funds.

Over the year to August 2020, the financial account deficit narrowed by $2.3 million to $20.0 million. This reflects an increase in the return from direct investments.

The balance of unclassified transactions recorded an average outflow of $4.7 million per month over the year to August 2020, compared to $4.5 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 August 2020, the Nominal Effective Exchange Rate (NEER) index fell by 2.6% due to an appreciation of the AUD, NZD, FJD, and JPY against the TOP. Most of these trading currencies remained strong against the TOP since April 2020. This followed the financial panic surrounding the global pandemic, which peaked in March 2020. Similarly, the Real Effective Exchange Rate (REER) index also fell by 4.0% 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 1.8% and 4.0%, respectively. Tonga's major trading currencies, such as the AUD, NZD, FJD, Euro, GBP and CNY, strengthened against the Tongan Pa'anga. The decline in REER coincided with the deflation during the same period. This implies an improvement in Tonga's trade competitiveness and benefits recipients of foreign currencies.

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 range 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 assist with ' 'Government's efforts in mitigating the economic and financial impacts of the global pandemic;
- Temporary suspension of external loan repayments to EXIM Bank of China;
- the drawdown of additional funds from the IMF Rapid Credit Facility;
  Receipt of Government grants and project funds 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;
- The continuation of the Seasonal workers schemes to Australia to facilitate high demand from Australian farmers is expected to support remittance receipts in the near term. A total of 300 seasonal workers have signed up for this repatriation program that they are expected to be in Australia by the end of this year
- Positive outcomes from the rollout of COVID-19 vaccines and the corresponding economic recovery in our major trading partners may help boost interest rates for investments.

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

- Extended border lockdown warrants an inactive tourism sector with sharp declines in travel receipts and other tourism activities;
- Resumption of scheduled repayment of external public debt to EXIM Bank of China;
- Fragile financial markets affecting returns on foreign investments and exchange rates;
- Strong rebounds in global commodity prices and oil prices;
- On-going 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;
- Climate change and unfavourable weather conditions;
- High vulnerability to natural disasters and external shocks.

5. Promoting a Stable Financial System

Despite the adverse effects of COVID-19 on the global economy as well as Tonga's economy, the banking system remained sound during the six months to August 2020. This was reflected through strong capital positions, adequate profits, high liquidity, and low nonperforming loans. Total banks' lending fell whilst deposits rose, contributing to the loans to deposit ratio falling below the minimum 80% threshold. Weighted average interest rate spread narrowed, mainly a result of lower lending rates.

Money Supply

Despite the impact of COVID-19, negative economic growth and deflation, Broad money increased to high levels during the past six months to August 2020, driven by official receipts associated with COVID-19 preparations and TC Harold recovery. Broad money rose by $34.6 million (5.9%) to a total $624.7 million. Net foreign assets increased by $87.5 million (17.7%) supported by the $76.2 million (15.9%) rise in official foreign reserves. This was partially offset by the lower net domestic assets falling by $52.8 million (55.2%) as the higher receipts of official funds from overseas contributed to higher government deposits, thus lowering the net credit to Government.

The same movement is also depicted in the annual trend where broad money expanded by $24.2 million (4.0%). Net foreign assets rose by $71.5 million (14.0%) driven by higher foreign reserves, which more than offset a $47.1 million (52.3%) decline in net domestic assets.

In the six months to August 2020, liquidity in the banking system (reserve money) rose by $38.4 million (12.9%) to $336.3 million. Currency in circulation increased the most by $21.0 million (27.3%) reflecting higher demand for cash uncertainties arising from the COVID-19 national lockdown, curfews, and the COVID-19 relief assistance by the pension funds, insurance companies and banks, as well as financial packages extended by the Government to affected businesses and individuals. The cancellation of family and church functions also contributed to the rise. The low inflation rate and the increase in remittances also contributed to higher income and may have also contributed to the demand for cash. The commercial banks' Exchange Settlement Account (ESA) increased by $15.3 million (9.3%) which coincided with higher deposits from the Government, and individuals. Furthermore, the Statutory Required Deposits (SRD) also increased by $2.1 million (3.7%) in line with the higher deposits.

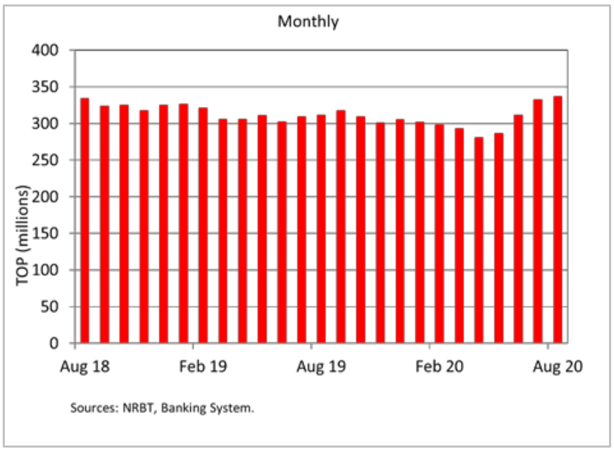
Liquidity in the banking system also rose in the year to August 2020 by $25.0 million (8.0%) as a result of higher currency in circulation which rose by $13.5 million (15.9%), followed by increases in ESA and SRD of $10.2 million (6.0%) and $1.3 million (2.2%) respectively.

Table 4: Consolidated Balance Sheet of Depository Corporations

	Level			YoY Change	
	August 2020	February 20	August 19	August 20	
	$TOPm	$TOPm	$TOPm	$TOPm	%
Broad money liabilities	**624.7**	**590.1**	**600.5**	**-24.2**	-3.9
Currency in circulation	74.5	63.2	67.1	-7.3	-9.9
Demand deposits	214.7	210.3	209.0	-5.8	-2.7
Savings and term deposits*	335.5	316.6	324.4	-11.1	-3.3
equals					
Net foreign assets	**582.4**	**494.9**	**510.9**	**-71.5**	-12.3
plus					
Net domestic assets	**43.0**	**95.8**	**90.0**	**47.1**	109.6
Gross bank lending**	487.2	499.7	497.8	10.6	2.2
Public enterprises	59.2	61.7	65.0	5.7	9.7
Private Sector	425.6	435.6	429.5	3.8	0.9
Other financial corporations	2.3	2.4	3.3	1.0	43.6
Other***	-444.2	-403.9	-407.8	36.5	-8.2

* Also includes very minor amounts for securities other than shares.
** Differs slightly from standard measures of bank lending by amounts classified as accrued interest.
*** Includes mostly capital accounts of the banks and NRBT, and their net claims on the central government.
Sources: Banking system; NRBT

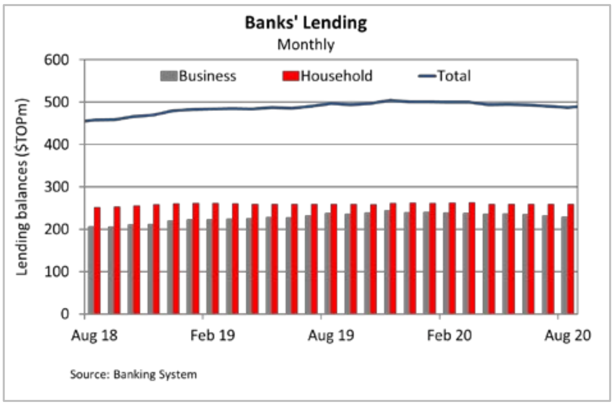
Figure 17: Banking System Liquidity



Lending

Banks' lending (including Government Development Loans - GDL) slowed down in the six months to August 2020, falling by $12.1 million (2.4) to a total $487.6 million. This was driven by both declining individual and business loans. The uncertainties associated with COVID-19 weakened investment appetite, while banks are also becoming more risk averse. GDL accounted for 1.7% of total loans in August 2020, remaining unchanged from the 1.7% share in August 2019, although lower than the 1.8% in February 2020.

Figure 18: Bank's lending

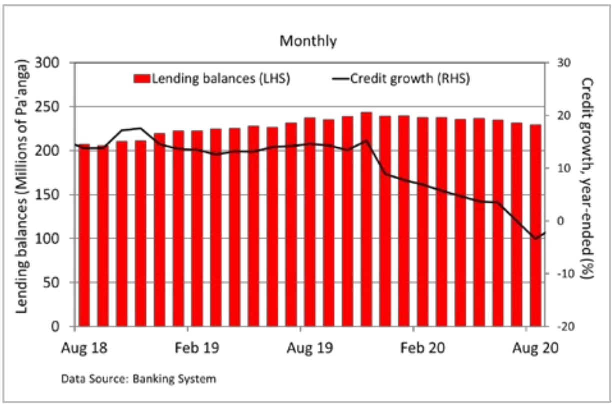


In the year to August 2020, the total banks' lending also fell by $8.9 million (1.8%). This is in contrast to a $39.0 million (8.5%) credit growth recorded in the year to August 2019. Negative growth in the reporting period is mainly attributed to the negative effects of COVID-19 on various sectors of the economy. COVID-19 continues to pose risks to financial stability through financial difficulties expected by both households and the private sector with regards to business operations and performances, and consequently, loan repayments. This raises concerns over a potential hike in nonperforming loans and household indebtedness.

Lending to businesses declined by $8.9 million (3.7%) in the past six months to August 2020. This reflected declining loans to both businesses and households. Majority of lending to various sectors of the economy declined, led by lower lending to the professional & other services, followed by the manufacturing, transportation, and utilities sector. Despite the negative growth in lending to these sectors, lending to the construction, agriculture, and tourism sectors increased during these six months.

Annually, business loans fell by $8.1 million (3.4%) to $229.0 million. Lending to the wholesale & retail, manufacturing, public enterprises, and transportation sectors declined and offset the rise in loans to the professional & other services, tourism, and agriculture sectors. This is indicative of the subdued economic activity throughout these sectors during the year partially attributed to COVID-19. Nonetheless, the lower interest rate from the GDL scheme is supportive of these sectors' developments such as agriculture and tourism.

Figure 19: Business Lending

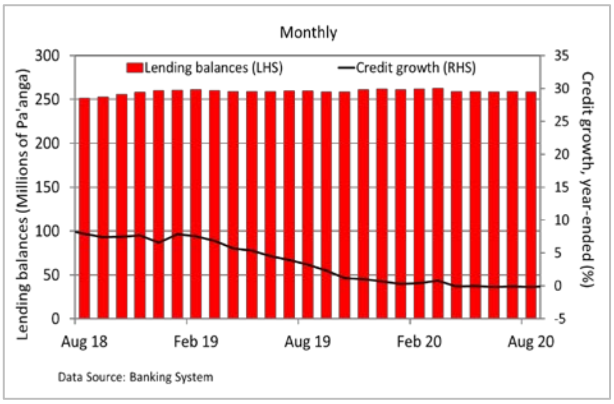


In addition, lending to households fell by $3.2 million (1.2%) over the six months to August 2020, and over the year by $0.5 million (0.2%) to $258.7 million. Other personal loans declined over the six months and in the year to August 2020 by $3.7 million (6.5%) and 3.3 million (5.8%), respectively. This outweighed the increase recorded for housing and vehicles loans.

The banks' new loan commitments rose over the six months to August 2020 by $0.7 million (12.5%) driven by reconstruction works during this period. However, it fell over the year by $7.3 million (53.6%), indicating fewer prospective investments for the future considering rising uncertainties amidst the global COVID-19 pandemic.

The banks' total deposits rose in the six months to August 2020 by $38.1 million (6.4%) and over the year by $17.0 million (2.8%). This was mainly attributed to higher investments by the central Government in time deposits. Private individual saving deposits also contributed to the rise in deposits.

Figure 20: Household Lending



Therefore, the banks' total loans to deposit ratio declined from 79.0% in August 2019, and 82.2% in February 2020 to 75.5% in August 2020. These are the results of the rise in total deposits whilst total loans declined. The loans to deposit is below the 80% minimum threshold, indicating that excess liquidity remains in the banking system available for further lending.

Interest Rates

The banks' weighted average interest rate spread narrowed by 30.8 basis points to 5.67% over the six months to August 2020. This was driven by a 21.6 basis points decline in weighted average lending rates coupled with an increase in weighted average deposit rates by 9.2 basis points. Lower lending rates drove the lower weighted average lending rate to the private sector, particularly for the tourism, construction, transport, and professional and other services sectors. These were partially due to the lower interest rates offered to businesses affected by the COVID-19 pandemic. Average interest rates for households' housing, and other personal loans also declined. Meanwhile, the higher demand and savings deposit rates drove the increase in weighted average deposit rates. This outweighed the lower time deposit interest rates.

Figure 21: Weighted Average Interest Rates Spread

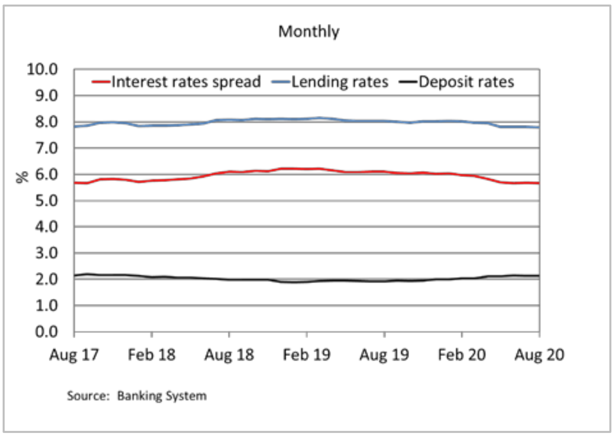


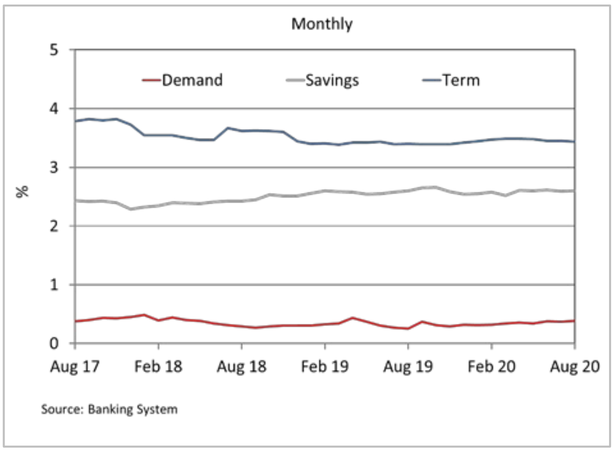
Table 5: Lending Rates
Weighted average of all banks

	Month ended			Change over 6 months to	Change over 12 months to	Loan Share
	August 2020 %p.a.	February 20 %p.a.	August 19 %p.a.	August 2020 Bps	August 2020 Bps	August 2020 %
Loans all	7.80	8.01	8.04	-21.59	-23.68	100
Housing	8.03	8.05	8.20	-1.89	-16.15	41
Other personal	10.49	11.27	11.43	-77.55	-93.78	11
Business*	7.54	7.84	7.69	-30.01	-14.89	29
Other	0.00	0.00	6.53	0.00	-653.09	18

*Included Statutory Non-financial Corporation and Other Financial Corporations

In the year to August 2020, the weighted average interest rate spread narrowed by 44.24 basis points. This resulted from the lower weighted average lending rates by 23.68 basis points coupled with a 20.57 basis points rise in weighted average deposit rates. The weighted average lending rates declined mainly on household loans and business loans for the mining & quarrying, tourism, fisheries, transport, and construction sectors. However, average deposit rates for demand and time deposits increased in line with the increase in the volume of time deposits.

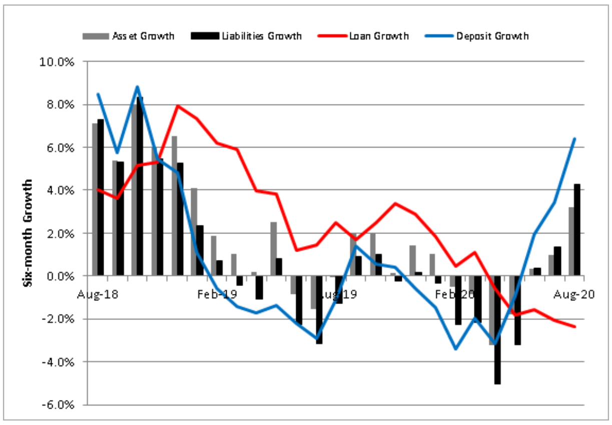
Figure 22: Deposit Rates



Banking System Performance

The banking system remained sound during the six months to August 2020. Total assets increased by 3.2% to $906.5 million over the six months from February 2020. The asset growth reflected the increase in Exchange Settlement Account by $16.6 million (10.2%) followed by Debt Securities (Government bonds) rising by $10.0 million (39.1%) over the six months to August 2020. Demand Balances at Depository Institutions abroad also grew by $3.9 million (15.7%). Loans and Advances on the other hand, partially offset the trend as it fell by $11.4 million (2.3%), mainly private sector business and individual loans, which fell by $5.7 million (3.4%) and $3.2 million (1.2%), respectively. Total liabilities also recorded an increase in August 2020 by $29.2 million (4.3%) to $713.4 million. This was attributed mainly to the rise in deposits by $38.1 million (6.4%) driven by increases in time and savings deposits by $21.2 million (8.8%) and $15.8 million (15.6%), respectively. The higher deposits were due to increases in Government (Time deposits) and Individuals' (Savings deposits) deposits. Provisions for Losses also increased by $7.9 million (51.5%) over the six months to August 2020.This is attributed to the quarterly review of provisioning by one of the big banks to incorporate the probability of default for the customers impacted by COVID-19 and TC Harold. On the other hand, borrowings from the Head offices partially offset the rise in total liabilities as it fell by $10.7 million. The settlement of a foreign currency loan by one of the big banks funded by the head office was the reason for this decline in borrowings.

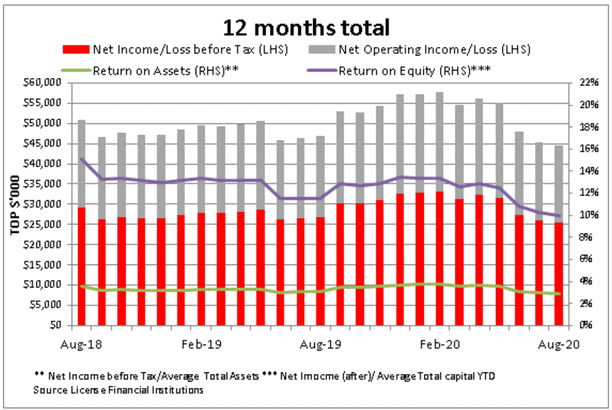
Figure 23: Total Banking System Balance Sheet Development



The total banking system remained profitable from February to August 2020. The Net Profit after Tax was $19.0 million, lower than $24.6 million in February 2020 and the $20.0 million during the same period last year. The lower profitability was attributed mainly to $4.3 million (95.1%) increase in loan loss provision expenses. This was coupled with lower non-interest income as it fell by $3.3 million (12%) driven mainly by the fall in foreign exchange revaluation by $1.6 million (11.1%). This was due to the settlement of a $9 million foreign currency loan over the year, coupled with the appreciation of the USD currency against the TOP since February 2020. Hence, operating income declined over the six months to August 2020 by $4.1 million (6.2%).

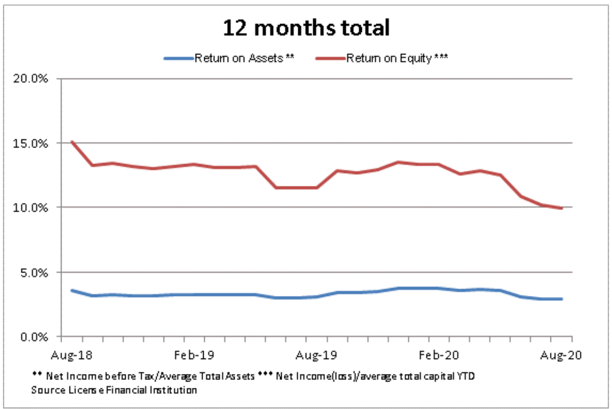
Return on Assets (ROA) and Return on Equity (ROE) decreased over the past six months. ROA fell to 2.9% from 3.7% in February 2020. Similarly, ROE decreased to 10.0% from 13.4% in February 2020 driven by lower profitability reflecting bank's raising provisions, due to the prolonged COVID-19 pandemic's impact on their customers over the six months to August 2020. The banking system's capital position remained strong and well above the Reserve Bank's minimum requirement of 15% at 31.6% in August 2020. Nevertheless, this was a lower ratio than in February 2020 of 33% due to capital repatriation by one of the banks. The banks' net interest margin slightly declined to 3.9% in August 2020 from 4% in February 2020, reflecting the increase in the cost of funds while the return on funds remained relatively stable.

Figure 24: Total Banking System's Profitability



The overall quality of the banks' assets weakened over the past six months to August 2020. Total nonperforming loans rose to $19.3 million from $15.6 million, representing 4.0% of total loans compared to 3.2% in February 2020. Loan downgrades over the past six months derived the higher impaired loans. However, the banks' relief packages offered to COVID-19 impacted customers in April 2020, was extended up to 3 months until March 2021 for some banks due to the prolonged impact of the pandemic.

Figure 25: Total Banking System's ROE & ROA

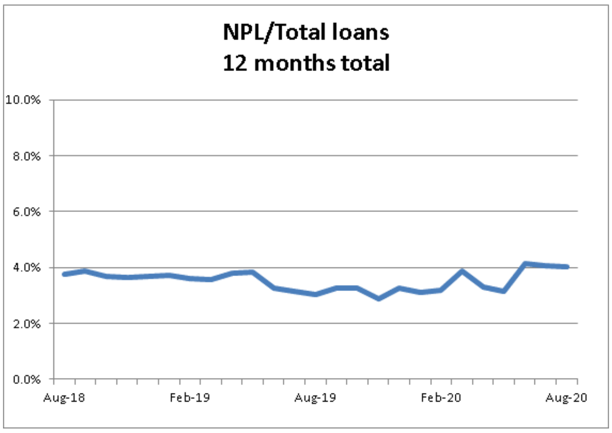


Non-performing private individual loans to total non-performing loans, fell to 68.9% ($13.1 million) compared to 75.9% ($12.0 million), six months ago, and 71.6% ($10.1 million) during the same time last year. Non-performing private individual loans comprised mainly of housing loans representing 55.9% of total nonperforming loans. a decrease from 57.4% in February 2020 but higher than 51.7% in August 2019.

Non-performing business loans accounted for the remaining 31.1% ($5.9 million), higher than 24.1% ($3.8 million) in February 2020, and 28.4% ($4.0 million) in August 2019. The poor squash season contributed to the rise in the Agriculture sector impaired loans and contributed to the increase in non-performing business loans, coupled with delinquent housing loans over the 6 months to August 2020.

Provisions against loan losses are sufficient over the last six months, at $22.6 million higher than $14.9 million in February 2020, due mainly to the on-going quarterly review of the banks' provisions given the prolonged COVID-19 pandemic.

Figure 26: Total Banking System Asset Quality Indicators



The Reserve Bank continued monitoring and managing the payment and settlement system to ensure it is functioning in an efficient, sound, and safe manner. The automated national payment system is being finalized to improve the efficiency of the settlement of banks' transactions.

Supervision of Non-Bank Financial Institutions (NBFIs)

The Reserve Bank continues to develop an adequate legal framework for regulating and supervising non-bank financial institutions, to promote a sound and efficient financial system and protect the financial consumers. Although non-bank institutions account for only a small portion, they may pose a risk to the overall financial system. The establishment of a robust supervisory framework would mitigate such potential risks.

The supervision and regulation of Foreign Exchange Dealers continue under the Foreign Exchange Control Act 2018. The Reserve Bank has licensed eleven (11) foreign exchange dealers under the Foreign Exchange Control Act 2018. However, in April & May 2020, two new foreign exchange dealers were licensed as license type A (inward & outward remittances) and type B (inward remittances only), resulting in a total of thirteen (13) licensed foreign exchange dealer. Since de-risking issues, the money transfer services industry in Tonga were directly affected in terms of keeping their overseas bank accounts. The Reserve Bank has considered possible solutions to assist local foreign exchange dealers in sustaining its business. There is an on-going collaboration with authorized foreign exchange dealers such as technical meetings, quarterly spot checks, training, and advisories on the importance of improving and strengthening their Anti-Money Laundering/ Counter-Terrorist Financing (AML/CTF) compliance status.

Under Section 3 of the Microfinance Act 2018 the National Reserve Bank of Tonga licensed the South Pacific Business Development Microfinance Tonga Limited (SPBD) to manage and operate a microfinance business in Tonga on the 24th February 2020. SPBD is expected to adhere to the conditions of the license set by the Reserve Bank. Additionally, the Reserve Bank issued the finalized the Annual Percentage Rate (APR) calculator for SPBD to use. The Reserve Bank will be undertaking quarterly spot checks as part of supervising SPBD's prudent performance and its contribution to a sound financial system.

Moneylenders Act 2018 was proclaimed effective on the 30th September 2020. The Reserve Bank is currently working to implement the Act by licensing of the existing Moneylenders. Additionally, work is still underway for the drafting of Bills for the supervision of the Retirement Funds and Insurance Companies which is expected to be submitted to Parliament in 2021. The Insurance Bill was issued to four (4) insurance companies for their comments prior to the proposed consultation set for the beginning of next year. At the same time, the Reserve Bank continues to collect monthly reports from two (2) retirement funds and quarterly monthly reports from four (4) insurance companies. The collating of these reports would strengthen the Reserve Bank’s understanding of the NBFI's business in monitoring their financial positions and performance to ensure their solvency.

The Reserve Bank continued to develop an enabling financial infrastructure to license and supervise the existing credit bureau (Data Bureau (Tonga) Limited) under the Reserve Bank's Credit Bureau Licensing Guideline that was issued in July 2017. The credit bureau will contribute to the mandate of maintaining financial stability through monitoring the level of household indebtedness. It would also assist with prudential supervision to monitor systemic risks and the quality of 'banks' assets and enhance access to loans.

Financial Inclusion Initiatives

The Reserve Bank continued to carry out its function in promoting financial inclusion in Tonga through attaining objectives which include enhancing the access to finance for individuals and Micro, Small and Medium Enterprises (MSMEs). The channeling of access to finance by these relevant stakeholders through various financial products and services play an important role in allowing potential economic benefits by expanding the outreach of financial services across the country. This will support the Reserve Bank's objectives of inclusive economic growth as well as promoting financial stability.

Tonga's access to finance indicators showed a slight decline compared to the same period of last year. The slight decrease in access to finance was mainly due to the fall in the number of banks' EFTPOS terminals being recalled from inactive merchants to

minimise operational costs for both the bank and the inactive merchants. Despite the decline in the number of EFTPOS terminals, the number of

Table 6: Summary of Banks' Access Points in Tonga by Constituency

Constituency	June 20					June 19[2]				
	Total Access Points	No. of Branches	No. of Agents	No. of EFTPOS	No. of ATMs	Total Access Points	No. of Branches	No. of Agents[3]	No. of EFTPOS	No. of ATMs
Tongatapu 1	59	1	22	34	2	65	1	18	44	2
Tongatapu 2	206	22	24	147	13	192	21	23	139	9
Tongatapu 3	54	1	15	37	1	55	1	15	35	4
Tongatapu 4	214	4	22	184	4	204	4	22	173	5
Tongatapu 5	40	2	24	14	0	36	1	24	11	0
Tongatapu 6	37	1	33	3	0	37	1	29	7	0
Tongatapu 7	36	1	23	12	0	39	1	23	14	1
Tongatapu 8	38	0	24	14	0	39	1	21	17	0
Tongatapu 9	45	6	21	17	1	51	4	25	21	1
Tongatapu 10	34	0	31	3	0	31	2	27	2	0
'Eua 11	37	8	23	5	1	39	9	25	4	1
Ha'apai 12	28	9	7	11	1	31	9	8	13	1
Ha'apai 13	17	0	15	2	0	15	0	15	0	0
Vava'u 14	17	0	17	0	0	23	0	20	3	0
Vava'u 15	85	13	14	54	4	98	12	17	65	4
Vava'u 16	16	0	15	1	0	18	0	16	2	0
Ongo Niuas 17	7	5	2	0	0	4	4	0	0	0
TOTAL	969	73	332	537	27	977	71	328	550	28

Source: Banks & Non-Banks Department

branches and agents increased. The rise in the number of agents reflected the banks' efforts to achieve their corporate targets on increasing their footprint in remote and rural areas. Non-Banks access points slightly increased, owing to a rise in the number of branches. This reflected the entrance of a new foreign exchange dealer into the market, who also opened access points in the outer islands. SPBD remained the Non-Bank financial institution with the highest access points compared to other non-bank financial institutions over the year. This is consistent with the on-going activities and services carried out by SPBD to their members in all the islands except the two Niuas.

On the other hand, the usage of financial services increased over the year, mainly driven by a rise in the total number of individual deposits and individual loan accounts. Bank customers primarily drove the increase, with customers preferring direct deposits of remittances to their bank account to access the ATMs or EFTPOS machines. This preference may also be driven by the COVID-19 social distancing requirements. Furthermore, new customer's accounts were opened to receive government financial assistance through the COVID-19 Economic Stimulus package. The rise in the total individual number of loan accounts was due to one of the banks' loan campaigns called "Toutai Campaign", which offered customers a 50% discount on the loan establishment fees.

Table 7: Usage of financial services indicators - Banks

Indicators	2020	2019	2016[4]	2015[5]
Number of regulated deposit accounts per 10,000 adults	14,096	13,353	10,916	5,604
Number of regulated credit accounts per 10,000 adults	1,342	1,258	1,588	521

Source: Banks

Local Money Transfer refers to money that is sent or transferred by the Money Transfer Operators (MTOs) to another party within Tonga. There are 3 MTOs currently providing local money transfer services, namely Fexco, S.A.V Transfer, and Island Flexi Transfer. Over the year ended August 2020, the local money transfer declined by T$5.2 (by 52%) to T$8.9 million compared to a year ago. The decline was mainly due to a fall in inward transfers for family support, gifts, and local kava proceeds. This reflects the effect of the COVID19 curfew restrictions and social distancing requirements on the kava clubs. The decline in the in the kava price over the year also contributed to the fall in the local kava proceeds.

[2] Commence collecting Non-Banks access points
[3] Including SPBD Village Centres
[4] Adult population (15 years old +) - 64,076 - Census Report 2016
[5] Tonga's financial inclusion benchmark

Furthermore, the COVID-19 pandemic also reduces household spending and consumption.

Table 8: Summary of Local Inward Transfer

To	Local Inwards Transfers (T$m)				
	Month-ended			Year-ended	
	Aug-20	Jul-20	Aug-19	Aug-20	Aug-19
Tongatapu	0.28	0.19	0.49	3.00	4.50
Vava'u	0.23	0.19	0.46	3.54	5.99
Ha'apai	0.07	0.06	0.28	1.35	1.98
Eua	0.08	0.05	0.16	0.94	1.46
Niuatoputapu	0.005	0.004	0.004	0.06	0.10
Niuafo'ou	0.001	0.001	0.01	0.03	0.06
Total Inwards	0.66	0.50	1.41	8.92	14.10

Source: Banks and Non-banks Department

The MSMEs' outstanding loan fell by $3.0 million (11%) to T$25.4 million over the year to June 2020. This was mainly due to a decline in outstanding loans to other services, agriculture, and tourism sector. The decline was predominantly driven by banks outweighing the rise in the MSMEs outstanding loan for Non-Banks financial institutions. This reflects the impact of COVID19 pandemic resulting in cancelled events. This may lead to a decline in aggregate demand and fewer income-generating activities for the MSME sector. On the other hand, the number of MSMEs loans rose by 341 (16%) to 2,467 MSMEs due to a considerable increase in MSME loans in the manufacturing, wholesale, retail, and agriculture sector. The increase in the number of MSME loans was attributed to loans extended by Non-Banks Financial Institutions as part of their COVID-19 and TC Harold relief packages. Loans by Banks to MSMEs fell at the end of 2019/20. The main bulk of the number of MSME loans is in the agriculture sector and mainly to men, this is due to the land being used as collateral for agriculture loans. In contrast, the increase in number of loans to the manufacturing sector was driven by female-owned MSMEs, particularly for weaving mats and handicrafts.

Tonga's access to financial service showed a mixed outcome indicating a change in financial consumer behavior opting for greater flexibility and options for selecting access points and financial services that best meet their needs', due to the impact of COVID-19. Furthermore, there is a shift to using digital means by direct transfers to accounts and usage of ATMs instead of over the counter transactions. However, despite the mixed outcomes, the Reserve Bank is concerned with the termination of agent agreement between one of the MTOs and a commercial bank in the outer island, particularly Ongo Niuas, as well as the upcoming close down of a commercial bank's branch in Vava'u as it will limit the individual's access to financial services. The close down of the financial services in the outer islands may affect the daily accessibility of the people to financial services that is available and affordable. This may harm local money transfers. In this regard, the Reserve Bank will continue to liaise with the banks and non-banks in terms of monitoring and encouraging the access to finance for both individuals and MSMEs through enhancement in coordination efforts as well as supporting available bankable projects & business plans for MSMEs including those in the rural and remote areas..

Table 9: Banks & Non-Banks MSMEs Sector Growth

Type of Sectors	June 2020		June 2019		Change over the year			
					No. of MSMEs		MSMEs Outstanding Balance	
	No. of MSMEs	MSMEs Outstanding Balance *(T$m)*	No. of MSMEs	MSMEs Outstanding Balance *(T$m)*	Change	% Change	Change *(T$m)*	% Change
Overall Total	2,467	25.4	2,126	28.4	341	16.0%	(3.0)	-10.6%
Agriculture	1,137	8.4	1,082	10.3	55	5.1%	-1.8	-17.6%
Construction	17	0.6	16	1.2	1	6.3%	-0.6	-52.2%
Fisheries	121	1.8	108	2.2	13	12.0%	-0.3	-16.1%
Forestry	4	0.02	2	0.01	2	100.0%	0.01	102.7%
Manufacturing	881	6.7	682	5.4	199	29.2%	1.3	25.1%
Other services	65	1.5	66	4.1	-1	-1.5%	-2.6	-63.2%
Tourism	26	1.7	36	2.6	-10	-27.8%	-0.9	-34.0%

Source: Banks & Non-Banks Department

Outlook

The stability of the financial system will be maintained going forward on the close monitoring and supervision of banks and non-bank financial institutions through various policy measures outlined below:

- The Reserve Bank forecast a negative annual credit growth of -1.6% for December 2020 given the downward trend since the beginning of 2020 will continue. However, for June 2020/21 the estimated loan growth will be subdued at 0.0%.
- Non-performing loans are expected to remain at low levels until the first quarter of 2021. This is owing to the extended COVID-19 loan relief packages for most of the banks up to early 2021. On this note, the Reserve Bank continues to ensure banks maintain their prudential standards and continue to monitor asset quality and prudent lending practices during this time.
- Continue to closely monitor likely impacts of COVID-19 on the local businesses such as the tourism sector and other private businesses and their ability to service their debt. At the same time, banks are expected to assist these impacted businesses. This will result in a change of profitability projection for ALL banks as they will see lower income over the near to medium term. Recoveries to business and bank losses will depend on when the COVID-19 impact will ease off.
- On-going implementation of the non-bank financial institutions Acts such as Moneylenders and Microfinance Act. This will be through consultation with the public and related businesses for public awareness on the legal framework in place.
- Formalizing the non-bank financial institutions and the informal financial sector by developing the legal framework to supervise insurance companies and retirement funds.
- The Reserve Bank's initiatives to develop an enabling financial infrastructure would further support credit growth. However, structural reforms to improve the credit environment, such as improvement to the land administration system and a bankruptcy law, would further improve the banks' confidence level, would further improve the banks' confidence level to continue lending out prudently.
- Ensure compliance with the disclosure requirements under prudential and regulatory requirements for banks and foreign exchange dealer's customers. The Reserve Bank also requires that the Annual Percentage Rates (APR) be stated in the loan agreement. This loan agreement is to be translated into Tongan. This will enhance transparency and the disclosure of fees & charges, Annual Percentage Rates (APR) on loan products, and foreign exchange rates.
- Continue to develop an enabling financial infrastructure to license and supervise the existing credit bureau (Data Bureau (Tonga) Limited) under the Reserve Bank's Credit Bureau Licensing Guideline that was issued in July 2017. The credit bureau will contribute to the mandate of maintaining financial stability. It would also assist with prudential supervision to monitor systemic risks and the quality of banks assets and enhance access to loans.
- Modernize the payments system by automating the daily bank's cheque settlement system to improve the efficiency of the financial system further.
- Continue to work together with Pacific Central banks and other stakeholders and the authorized restricted foreign exchange dealers to strengthen their Anti-Money Laundering / Counter Financing Terrorist (AML/CFT) compliance status for the banks to retain their accounts.
- Support new digital and innovative products in the financial system, such as the TDB 'Ave Pa'anga Pau product and its expansion to Australia.
- Encourage the development of technological solutions (FinTech) that would facilitate the low-cost remittance of funds and, at the same time, still comply with the AML/CFT requirements.

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

- The growth rate in credit and non-performing loans will depend on the severity of the arising COVID-19 pandemic.
- The banks' de-risking decisions which have resulted in the closing of some of the foreign exchange dealers' accounts as well as the termination of correspondent banking relationships of some of the banks.
- Any natural disaster will have an impact on the financial system.

6. Fiscal Indicators

The Government Budget Statement 2020/21 expects COVID-19 to significantly impact fiscal position. The 2019/20 estimated outturn showed large declines in expected revenue collection, leading to an expected fiscal deficit of $16.9 million. This is in contrast to the $10.2 million surplus estimated last year. The outlook for 2020/21 is expected to be much worse as the fiscal deficit is expected to widen to $37.4 million as the rise in Government Expenditure is estimated to be higher than the rise in Revenues.

The Government's first priority now is strengthening the health sector given the current global pandemic. In April 2020, the Government approved a $60 million Economic and Social Stimulus package aiming to provide immediate relief support to those affected by COVID-19.

Development partners have generously contributed to the Government's efforts to prepare for COVID-19 through additional budget support, grants, and project funds. Additional relief funds were also mobilized to assist with the recovery from TC Harold. As a result, government deposits rose by $55.8 million (28.6%) in the six months and $49.0 million (24.3%) in the year to August 2020. Consequently, net credit to Government in the banking system decreased by $45.3 million (25.1%) and $38.1 million (20.3%), respectively for the same period. The influx of these funds contributes to the strong growth of foreign reserves during the past 6 months.

Tonga still ranks as a high debt distress country with a preference for budget support and donors to be in the form of grants only. The total public debt position for June 2020 is estimated to represent 46.1% of GDP, of which 85% is external debt and 15% is domestic debt, mostly Government Bonds. The Reserve Bank as the Registrar of Government Bonds continues to facilitate the issuance of Government Bonds. The Export-Import Bank of China (EXIM) still remains as the largest external creditor of the Government, holding around 58.4% of the total external debt. While the Government forms strategies to service the EXIM loans, it has also requested a restructure of both the Tonga Road Improvement Project (TNRIP) and the Nukuálofa CBD Reconstruction Project loans.

On the outlook, Government receipts are expected to rise in the near term due to on-going receipts of budget support for COVID-19 preparations and TC Harold recovery which will further support foreign reserves.

Public debt is also expected to increase as the Government ventures into accessing funds from the IMF Rapid Credit Facility (RCF) which is available at 0% interest rate, to meet its Balance of Payments needs. Moreover, new government bonds of $20.9 million is expected to be issued in 2020/21, which would reduce the excess liquidity in the banking system. The EXIM Bank of China deferred the principal loan repayment due on the TNRIP loan from FY2020-21 to FY2021-22. This frees up some space in the Government Budget for its immediate financial needs.

The Government Stimulus package rollout will also ease pressure on unemployment, private sector cash flows, and household indebtedness.

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

7. Monetary Policy Stance

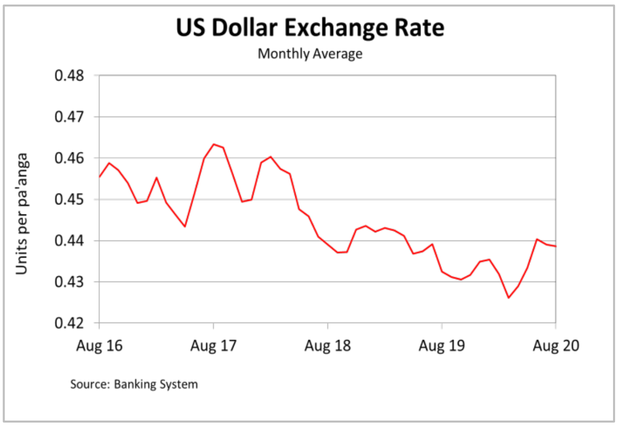
In light of the extraordinary challenges brought by the global pandemic further exacerbated by TC Harold, the Reserve Bank continues to maintain its accommodative monetary policy stance throughout the review period. This is to encourage utilization of the excess liquidity in the banking system through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

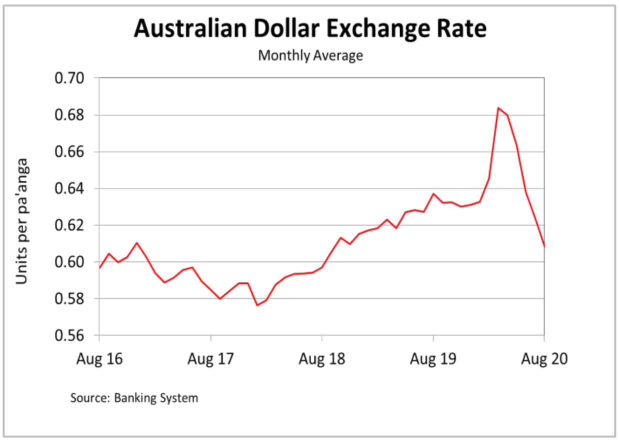
The Reserve Bank since April 2020 approved the current monetary policy measures outlined below:

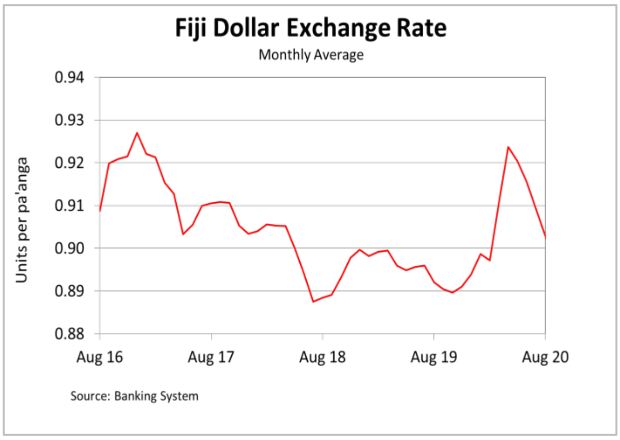
a. Maintain the monetary policy rate at 0% (zero interest rate policy).
b. Maintain the minimum loans/deposit ratio of 80%.
c. Maintain the Statutory Reserve Deposit ratio at 10%.
d. Maintain the inflation reference rate at 5%.
e. Monitor the commercial banks' liquidity and adjust the SRD ratio if needed.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

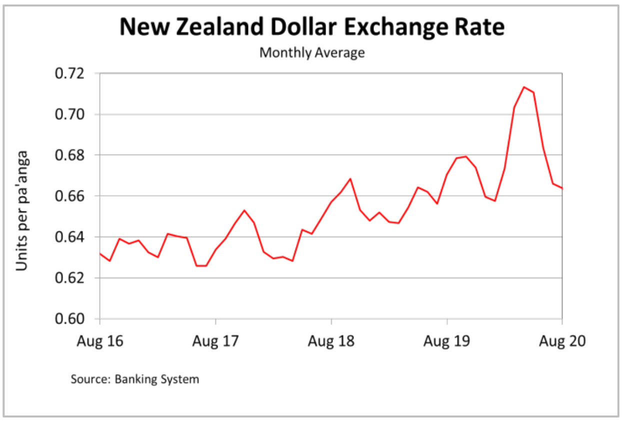
The Reserve Bank continues to be vigilant in closely monitoring its economic and financial indicators and stands ready to adjust its monetary policy settings if needed to maintain internal and external stability and support macroeconomic growth.

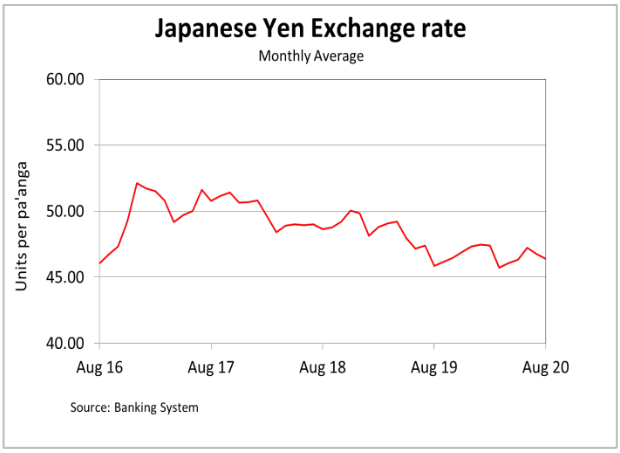
Appendix 1: Tongan Pa'anga Exchange Rates

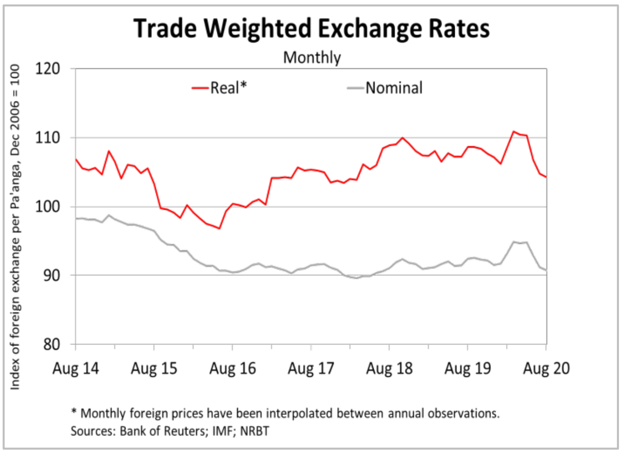












Appendix 2: Monetary Policy Objectives

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 minimizes 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.