NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

February 2020

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Contents

List of abbreviations

AUD	Australian Dollar
EXIM	Export-Import
FEDs	Foreign Exchange Dealers
GDP	Gross Domestic Product
IMF	International Monetary Fund
MAFF	Ministry of Agriculture, Food & Forests
MPS	Monetary Policy Statement
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
REER	Real Effective Exchange Rate
RFB	Retirement Fund Board
ROA	Return on Assets
ROE	Return on Equity
RSE	Regional Seasonal Employees
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 coronavirus pandemic (COVID-19) has shocked the world at an unprecedented speed and scale. It is first and foremost a health crisis, with many human lives being lost across many countries. It has also evolved quickly to becoming an economic crisis driving the global economy into a recession worse than the Great Depression. Financial markets have already felt a huge impact within the first few months of 2020, and could become a financial crisis should the economic fallouts intensifies.

Tonga is one of the few countries that has not yet contracted the virus, and it has quickly responded with measures to ensure it remains that way given the limited capacity of its health system. The Ministry of Health has taken the lead in recommending containment and precautionary measures to be implemented in the country. This led to the closing of the border from international travel since March 2020 and observing a 2 weeks national lockdown in April. Tonga continues to suffer from natural disasters such as Tropical Cyclone (TC) Harold in April 2020, leaving damages in its aftermath to businesses, dwellings, infrastructure, and agriculture.

Over the six months to February 2020, the Reserve Bank has maintained its current accommodative monetary policy stance to support its monetary policy objectives of maintaining internal and external stability, and promoting a sound and stable financial system. This monetary stance was also appropriate to support macroeconomic growth and stability given the negative impacts of COVID-19 and TC Harold on the economy.

The Tonga Statistics Department has released its preliminary real GDP growth for 2018/19 of 0.7%, a slight improvement from the 0.3% growth in 2017/18 reflecting a slow recovery from TC Gita. However, this is lower than the 3.2% growth forecasted by the Reserve Bank in the August 2019 MPS, reflecting a weaker than expected outturn for the secondary and tertiary sector, owing mostly to the deferral in the implementation of large infrastructure projects. The pace of domestic economic activity during these past six months was somewhat slower compared to the same period in the previous year. The measles outbreak in October and November 2019 prompted the cancellation of many of the end of year functions and celebrations contributing to the slower performances in domestic activities.

The annual headline inflation has been relatively low over the past six months, averaging at 0.7% over the year to February 2020. The annual headline inflation has remained below the Reserve Bank's reference rate of 5% since December 2018. Despite the gradual rise in import prices, the declining domestic prices have anchored inflation rates near zero during the review period.

Gross official foreign reserves has declined over the past six months by $12.0 million to $479.8 million, corresponding to lower foreign currency receipts. Nonetheless, official foreign reserves is still at adequate levels, sufficient to cover 7.4 months of import of merchandise goods and services[1] which is above the Reserve Bank's minimum level of 3 months of import cover.

Monetary conditions remained sound and stable since the last review in August 2019, supported by strong capital position, adequate profitability, high liquidity, and low levels of non-performing loans. The Reserve Bank maintained its policy rate at 0%, the Statutory Reserves Deposit Ratio at 10%, and the minimum loans to deposit ratio at 80% to encourage commercial banks to utilize the excess liquidity for further lending. Broad money fell by $10.4 million to $590.1 million over the six months to February 2020, while liquidity (reserve money) also declined by $13.4 million to $297.9 million. The lower broad money corresponds to the decline in net foreign assets, while the decline in liquidity was mostly driven by lower currency in circulation and commercial banks' exchange settlement account balances.

Commercial Banks' lending continued to rise since August 2019 by 0.6% ($3.2 million) to $499.7 million, as both business and household lending grew. It is

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

noted that this is a slower growth compared to the 2.7% growth over the six months to August 2019 coinciding with the slower pace of economic activities. Deposits, on the other hand, declined by $21.0 million. As a result, the banks' total loans to deposit ratio rose to 84.1%, from 79.0% in August 2019. This is also above the Reserve Bank's threshold of 80% minimum loan to deposit ratio. The weighted average interest rate spread continues to narrow during the six months as lending rates declined coupled with higher deposit rates.

Government deposits decreased by 3.4% over the past six months to February 2020 due to the payments of loan interests to the EXIM Bank of China. Accordingly, net credit to the Government rose by 3.9%. The continuing inflow of budgetary support, grants, and cyclone relief funds from development partners in addition to improved revenue collections continues to support the fiscal position.

Outlook

On the outlook, the Reserve Bank envisions a significant downturn for the Tongan economy due to the negative impacts of COVID-19 on tourism, travel, transport, and the trading sectors. Containment and precautionary measures such as national lockdown, social distancing, and curfews affect multiple sectors of the economy through limited operations and weak consumer demand. Some tourism businesses have come to a complete standstill while others are presented with a significant reduction in operations forcing some businesses to lay off its employees. The impacts of TC Harold is expected to exacerbate an already distressed economy. The Reserve Bank projects a contraction in Tonga's real GDP growth of -6.3% for 2019/20, and -2.7% for 2020/21 contrast to its previous forecast of positive growths in the August 2019 MPS.

Inflation rate is projected to gradually increase driven by higher import prices, yet remain below the 5% reference rate up to June 2021 as oil prices are projected to remain low offsetting the expected rises in other imported goods due to supply chain disruptions and additional surcharges for COVID-19.

Foreign reserves is still expected to remain at comfortable levels above the minimum of 3 months of import cover throughout 2020. The inflow of additional budget support, grants, and relief funds from development partners to assist with preparations for COVID-19 and TC Harold is expected to sustain foreign reserves at an adequate level. At the same time, it may offset a likely decline in remittances and travel receipts due to weaker growths experienced by our major remitting countries.

Credit growth is anticipated to be subdued in 2019/20 as borrowers remain cautious of the uncertainty on when will business returns back to normal after the pandemic. There is still excess liquidity in the banking system indicating a further capacity for lending. Meanwhile, commercial banks have taken initiatives to assist their customers who are affected by these events through moratoriums, deferrals of interests, and loan restructures. Nonetheless, non-performing loans are still expected to be at low levels through maintaining standards on monitoring asset quality and prudent lending practices.

Fiscal policy is likely to 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. However, because of these crises, the inflow of budgetary support and relief funds from donor partners is expected to be higher. The Reserve Bank will closely monitor the implications of the fiscal policy measures on its monetary policy objectives.

Nevertheless, COVID-19 is unlike any crisis the world has ever seen. Forecasting the full impact and magnitude of the pandemic is like navigating on uncharted waters. There is profound uncertainty on how deep and how long the scarring effects of the pandemic will have on the economy, especially with no cure being found yet. This is a downside risk to the forecast, in addition to Tonga's vulnerability to global shocks and natural disasters. The Reserve Bank will follow these developments closely and will revise its forecast regularly to assist with its monetary policy decisions.

Given the recent developments and outlook, the Reserve Bank considers its current accommodative monetary policy stance to be appropriate in the medium term. Therefore, the Reserve Bank will maintain its current monetary policy measures in the medium term to support macroeconomic growth. In March 2020, the Reserve Bank introduced additional monetary policy measures to support commercial banks' efforts in assisting its customers who are affected by COVID-19 and TC Harold. It also provided financial support to the Government in its effort to provide financial support to affected sectors of the economy. The Reserve Bank remains vigilant and alert by closely monitoring both 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

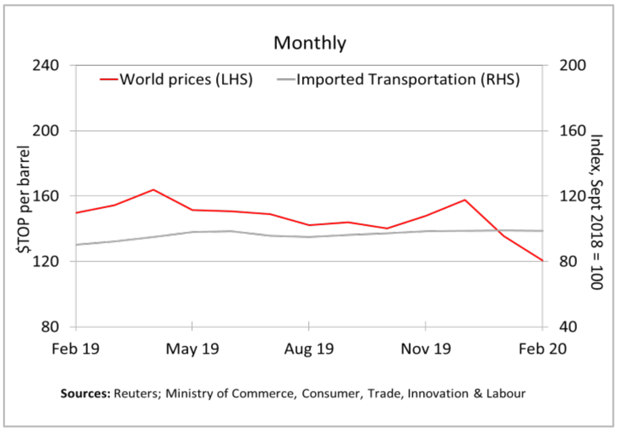
The IMF in its April 2020 World Economic Outlook (WEO) reported that global growth is projected to be worse than the Global Financial Crisis of 2008. As such, growth for 2020 was revised downwards significantly by 6.3% to -3.0%. This largely stems from the impacts of the COVID-19 pandemic resulting in lockdown and restrictions, disrupting business activities of economies around the globe. However, growth in 2021 is expected to rebound to 5.8% reflecting economic recovery provided the COVID-19 pandemic eases in the second half of 2020.

Growth for advanced economies is expected to contract in 2020 with most countries experiencing the severe outbreak of COVID-19. The slowdown in emerging markets and developing economies has been further intensified by the disruptions to various economic activities such as trade, tourism, and manufacturing as in the case of China. Commodity prices fell as reflected in the IMF's primary commodity price index by 1.5% since August 2019, largely driven by lower energy prices (particularly for oil) and base metals decreasing by 6.7% and 5.5% respectively.

World Oil Prices

According to Reuters, world oil prices averaged around USD$55.77 per barrel in February 2020. This is considerably lower compared to an average of USD$59.72 per barrel in August 2019, and US$64.19 in February 2019.

Figure 1: World Oil prices



The IMF April 2020 WEO stated that oil prices are expected to average at USD$35.60 per barrel in 2020 and USD$37.90 per barrel in 2021. This forecast reflects consistent weaker demands across large importing countries amid the COVID-19 pandemic restrictions and lockdown. The Organization for the Petroleum Exporting Countries (OPEC) including non-OPEC oil exporters agreed to reduce oil production commencing May 2020 till April 2022 in response to the drop in global demand for oil and to restore oil prices to sustainable levels.

Advanced Economies

The IMF April 2020 WEO significantly revised growth downwards for advanced economies in 2020 by 7.7% from the 1.6% forecasted in the January 2020 WEO. Therefore, forecasted growth is now -6.1% for 2020, before reverting in 2021 to a growth of 4.5% largely depending on whether the pandemic eases later in 2020. The forecasted contraction in 2020 stems from the lower growth of major economies such as the United States (US) and other European countries.

In the US, the economy recorded a 4.8% contraction in growth for the first quarter of 2020 compared to a 2.1% growth in the December quarter of 2019. This is the first time economic growth has contracted since 2014. Dampened personal consumption spending, investments, and lower exports as COVID-19 looms in drove the negative growth. Growth for the year 2020 is projected at -5.9% a downward revision of 8.0% from the 2.1% growth forecasted in the October 2019 WEO. However, a rebound of 4.7% growth is expected for 2021 as normal business activities are anticipated to resume. Unemployment rate rose by 4.4% in March 2020, noted as the highest monthly increase since January 1975. Unemployment is projected at 10.4% in 2020 and 9.1% in 2021. The US Federal Reserve had lowered its Federal Funds rate in March 2020 to ease financial difficulties during the pandemic. The target rate is currently at the 0% - 0.25% range being the lowest since 2015.

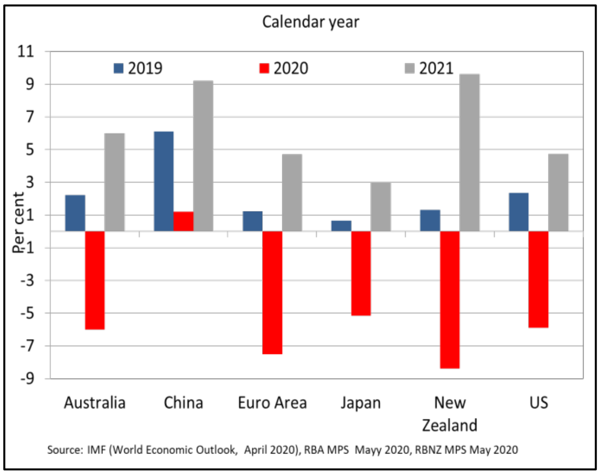
The Reserve Bank of Australia (RBA) in its May 2020 MPS shared that the Australian economy recorded growth of 2.2% in 2019 (lower than the 2.5% projected for 2019 in the August 2019 MPS). This largely stemmed from lower growth in household income and consumption coupled with the impacts of the recent bush fires. In response to the disruptions of COVID-19, the Reserve Bank has cut its cash rate target from 0.75% down to 0.25% in March 2020, the lowest recorded cash rate in history. This is to stimulate economic activities and strengthen the financial institutions' resilience amidst the on-going pandemic. This coupled with the government's fiscal response are expected to support the economy. GDP growth was initially projected by the RBA at 2.75% in 2020 and 3.0% in 2021, however, the revised projection is now expecting a negative growth of 6.0% in 2020 mainly due to the impacts of COVID-19, before returning to a 6.0% growth in 2021. Inflation remained low at 1.8% over the year to December 2019 and is expected to remain within the 2% – 3% target range supported by lower interest rates and lower oil prices.

The Reserve Bank of New Zealand (RBNZ) in its May 2020 MPS reported a reduction in its Official Cash Rate (OCR) to 0.25% from 1.0%. This is to support financial markets and to ensure the flow of liquidity to other sectors of the economy to help mitigate the impacts of COVID-19. The OCR is expected to remain at 0.25% for at least 12 months and is expected to boost consumer spending and investment. The latest GDP growth was recorded at 2.3% over the year to December 2019. Growth for 2020 is now projected to be 1.3%, with a negative growth of 8.4% forecasted for 2021. The downward revisions are attributed to the prolonged shutdown in business activities for many sectors of the economy due to the COVID-19 restrictions. Headline inflation remained at 1.9% slightly below the 2.0% mid-point target in December 2019. Inflation rose by 2.5% in the March quarter of 2020 largely due to tighter labour market conditions with rising wage inflation. Hence, it is expected to remain low at 0.3% by end of 2020 as wage and non-tradable inflation will likely ease as labour demand is projected to fall due to the impacts of COVID-19 on businesses and lower global oil prices.

The United Kingdom (UK) as reported in the IMF's WEO April 2020 recorded a growth of 1.4% in 2019. Growth is projected at -6.5% in 2020 and to recover to 4.0% in 2021. This downward revision stems from the COVID-19 outbreak shutting down businesses and further slowing down economic activities in the country. Inflation is forecasted at 1.0% for 2020 and 1.9% in 2021. Lower prices in 2020 is largely driven by lower oil prices and base metal commodities.

The IMF in its April WEO 2020 reported that growth for the Euro Area remains unchanged at 1.2% for 2019. The ongoing uncertainty with the Brexit negotiations along with Italy's poor economic growth contributed to the region's slow growth in 2019. Growth is forecasted at -7.5% for 2020 as production and manufacturing activities were disrupted due to the COVID-19 outbreak. However, they anticipate a recovery of 4.7% growth for 2021. Inflation in the Euro Area economies is expected to be as low as 0.2% largely driven by lower oil prices with spillover effects on other commodities' prices. However, prices are expected to increase by 1.3% in 2021.

Figure 2: Growth Projection in the Advanced Economies



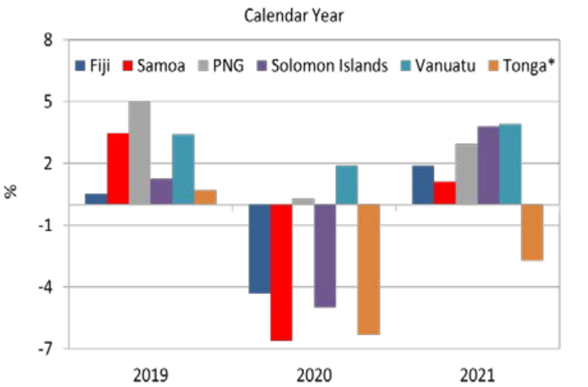
China experienced a growth of 6.1% in 2019. Relatively lower growth for 2019 (compared to a 6.7% growth in 2018) largely results from weaker demand from both the domestic and external markets, with softer investments further compounded by the impacts of the protectionism trade policies with the United States. Growth is expected to slow down significantly to 1.2% in 2020 (revised downward from 5.8% growth forecasted in the IMF October WEO 2019) before recovering to a forecasted 9.2% growth in 2021. Slower growth for 2020 arises due to the COVID-19 outbreak resulting in the lockdown and restrictions in travels. Shutting down businesses has caused disruptions in production, weakening sales, and investments in the country. Nevertheless, expansionary fiscal policies have been implemented along with accommodative monetary policies to support affected sectors of the economy. Inflation is projected at 3.0% for 2020 and to slow to 2.6% in 2021.

Japan experienced a slow growth of 0.7% in 2019 due to weaker export activities coupled with subdued consumer spending and investments. GDP growth has been revised downwards to -5.2% for 2020 (from a previous forecast of 0.7% in the October 2019 WEO). The downward revision owes to the impacts of COVID-19 which largely affected the tourism sector and manufacturing activities thus weakening domestic demand. Growth is anticipated to rise by 3.0% in 2021 as economic activities are expected to return to normal towards the end of 2020. Outlook for headline inflation in 2020 and 2021 is expected to be 0.2% and 0.4% respectively coinciding with slower movements in global energy, metal base, and food prices.

South Pacific Economies

The South Pacific region performed lower than expected at a regional average growth of 2.4% in 2019 compared to the forecasted 3.5% regional average growth in the previous MPS. The weaker than expected growth coincides with the slower global growth for 2019 on the back of subdued tourism arrivals later in the year (due to measles outbreak in Samoa), in addition to the impacts imposed by natural disasters in the region. Papua New Guinea (PNG) however, performed better than expected driven by the recovery in the resource sector particularly for gold and Liquefied Natural Gas (LNG) productions. Outlook for the future remains uncertain as the impacts of COVID-19 weigh down on global commodity prices which may impact PNG's export proceeds. Fiji reported slower growth in 2019 due to subdued consumer spending coupled with weaker business sentiments leading to a contraction on investments. Average growth in the Pacific region in 2020 is expected to fall to -3.3% with a growth recovery of 1.8% for 2021.

Figure 3: Growth Projections in the Pacific



* Tonga is in financial year; Tonga's figures are NRBT estimates
Sources: IMF WEO Outlook April 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	2.9	-3.0	5.8						
Australia	2.2	-6.0	6.0	1.8	0.3	1.3	5.2	9.0	7.5
China	6.1	1.2	9.2	4.5	1.0	3.0	3.6	4.3	3.8
Euro Area	1.2	-7.5	4.7	1.3	-0.1	1.3	7.6	10.4	8.9
Japan	0.7	-5.2	3.0	0.5	0.2	0.4	2.4	3.0	2.3
New Zealand	3.1	1.3	-8.4	1.9	0.3	0.8	4.1	4.2	7.4
United Kingdom	1.4	-6.5	4.0	1.4	1.0	1.9	3.8	4.8	4.4
United States	2.3	-5.9	4.7	1.9	0.8	2.4	3.7	10.4	9.1

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

2. Tonga's Economic Growth

Real GDP Growth

The Tongan Economy has expanded yet again in 2018/19 by 0.7%, according to the preliminary results released by the Statistics Department. This follows a 0.3% growth in 2017/18 and is the 10th consecutive year of growth for Tonga (estimated by the new 2016/17 base-year prices). The 0.7% growth for 2018/19 reflects a slight recovery in the Tongan economy mostly for the primary and secondary sectors, following the devastation from Tropical Cyclone Gita in February 2018.

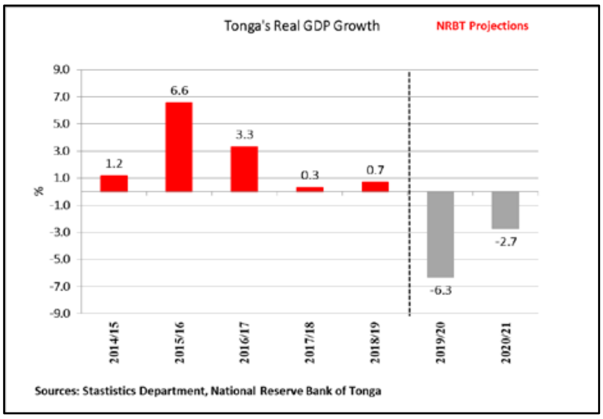
However, this 0.7% growth for 2018/19 is lower than the Reserve Bank forecast of 3.2% growth in its August 2019 MPS. The performance of the secondary and tertiary sector was weaker than expected owing mostly to the delays in the implementation of the reconstruction and donor-funded infrastructure projects that were estimated for the year. The primary sector, however, performed stronger than expected specifically the outturn for the agricultural sector.

Nevertheless, the Coronavirus (COVID-19) pandemic is an economic crisis unlike any that Tonga has ever come across. Despite not having any positive cases of the virus in the country yet, the containment and precautionary measures undertaken are taking its toll on economic activities. Locking down the border from international travel has crippled the tourism sector with rippling effects on transport and trading. Curfews and social distancing practices have reduced mobility and consumer spending for all sectors. Many businesses operate with reduced hours while some have laid off some of its workers, hence unemployment is on the rise.

Adding on to the economic distress was the arrival of TC Harold Category 4 in April 2020 leaving severe damages in its aftermath to businesses, households, and infrastructures in 'Eua and parts of Tongatapu. This is a stark reminder of Tonga's vulnerability to natural disasters and climate change, as Tonga has yet to fully recover from the devastation of TC Gita in 2018.

While COVID-19 continues to spread worldwide with no known cure to be found yet, it is hard to predict when this pandemic will end. Great uncertainties are surrounding the full impacts on the economy or how deep the implications are on the financial system. However, there is already a pattern of a synchronized slowdown in the global economy since the breakout of the virus, and Tonga is likely to follow suit. As such, the Reserve Bank has reviewed its GDP forecast for 2019/20 and 2020/21 given these latest developments. Contrast to its forecast of a recovery in the previous MPS (August 2019), the new forecast now projects a significant downturn in the economy's growth of -6.3% in 2019/20, and -2.7% in 2020/21. This is largely based on the assumption that the pandemic will ease by end of 2020.

Figure 4: Real GDP Growth



In the meantime, policies are being implemented rapidly to ensure that Tonga's health system is better prepared to combat any import of the virus, while other policies are being rolled out to mitigate the scarring effects on the economy. The Reserve Bank will review its forecasts regularly as new developments arise and new data are made available.

Primary Production

Figure 5: Major Agricultural Exports (tonnes)

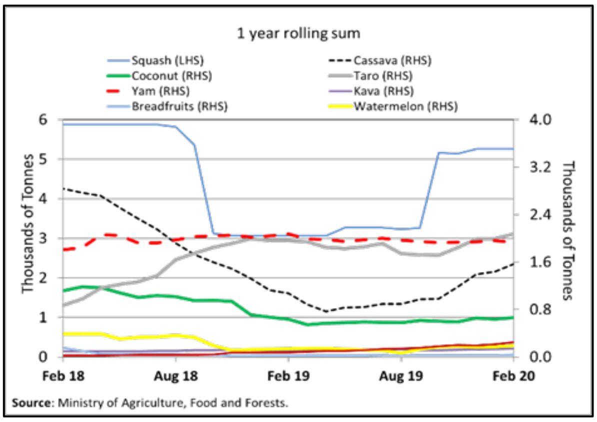


Table 2: Real GDP Forecast

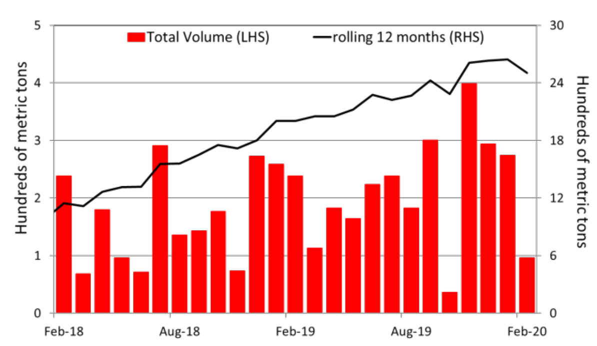
	Official 2016/17 %	Official (revised) 2017/18 %	Official (preliminary) 2018/19 %	FY 2019/20 (Aug-19 MPS) %	FY 2019/20 (Revised) %	FY 2020/21 %
GDP	3.3	0.3	0.7	3.0	-6.3	-2.7
Primary production	-2.5	0.4	3.6	1.6	1.1	-3.4
Agriculture and Forestry	1.7	2.3	2.0	2.0	1.0	-2.0
Fishing	-26.7	-14.6	18.6	3.0	2.0	-15.0
Secondary production	9.7	-14.4	4.6	4.4	-0.5	-3.2
Mining and quarrying	3.2	14.2	-23.0	8.0	2.0	-5.0
Manufacturing	1.5	-0.8	-4.8	3.0	-4.0	-5.0
Electricity, water and waste	9.9	0.0	11.0	6.0	1.0	-2.0
Construction	18.0	-32.4	16.2	7.0	2.0	-2.0
Tertiary production	1.8	3.3	0.8	2.6	-10.9	-2.2
Wholesale and retail trade	2.5	6.3	0.4	3.0	-12.0	-15.0
Transport and storage	19.6	1.8	2.2	4.0	-70.0	-60.0
Accommodation and food service activities	8.6	7.5	-3.3	2.0	-80.0	-70.0
Information and communication	-0.8	9.5	0.4	5.0	-2.0	1.0
Financial and insurance activities	-4.3	4.5	0.1	4.0	2.0	-2.0
Ownership of dwellings	1.5	-2.3	-0.6	2.0	-2.0	-3.0
Other real estate activities	0.0	1.0	2.7	2.0	-1.0	-3.0
Professional, scientific and technical activities	-15.0	25.2	11.0	2.0	2.0	-10.0
Administrative and support service activities	-8.2	1.2	2.5	2.0	-10.0	-15.0
Public administration and defense	-1.5	2.8	4.0	1.5	10.6	20.9
Education	-0.1	0.0	2.6	2.0	5.0	4.0
Human health and social work activities	8.6	5.4	-3.2	2.0	5.0	3.0
Arts, entertainment and recreation	2.1	-12.1	0.1	2.0	-70.0	-50.0
Other service activities	-3.4	3.5	-3.1	1.0	-2.5	-10.0
Other*	8.6	5.9	-5.4	1.0	-4.5	-3.0

* Includes taxes less subsidies
Source: Department of Statistics, NRBT

The primary sector recorded a growth of 3.6% in 2018/19 despite the damages from TC Gita. The agricultural and forestry sector recorded a growth of 2.0% owing to higher production of root crops, squash, and vanilla. The fishing sector also grew by 18.6% mainly from higher production of fresh and live fish, and yellowfin tuna.

The agricultural and forestry sector is projected to continue to grow but at a slower pace in 2019/20 of 1.0%. During the first eight months of 2019/20, the total volume of agricultural exports increased by 3,238.3 tonnes (46.8%) to a total 10,162.1 tonnes compared to the same period last year, driven by higher exports of squash, cassava, and taro. Improved harvests reflect favourable weather conditions during the year, and the replanting efforts from TC Gita. Comparing the agricultural export proceeds for the same eight-month period, however, declined by 23.2% ($1.8 million) indicating a time lag for receipt of proceeds, specifically for squash exports. It is expected that COVID-19 may slow down exports for the remaining months of 2019/20 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 from food and accommodation businesses who are no longer receiving 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. These negative impacts are projected to last longer in 2020/21 resulting in a negative growth outlook of 2.0%.

Figure 6: Fish Exports (metric tons)



Source: Ministry of Fisheries

The fisheries sector is also projected to grow in 2019/20 by 2.0%, lower than the 18.6% growth reported for 2018/19. The volume of marine exports rose during the first eight months of 2019/20, compared to the same period in the previous year by 61.6% (544.8 metric tonnes) attributing to the exports of tuna. Proceeds for exports of fish and marine products for the same period also rose by 37.6% ($2.0 million). However, the reduced number of international flights permitted to land in Tonga since March 2020 is expected to negatively impact the exports of fresh fish and aquamarine products resulting in a slower forecast. This condition is assumed to remain for the remainder of 2020 resulting in the negative growth projected for 2020/21 of 15.0%.

Secondary Production

Positive growths from construction and utility sectors were the main drivers for the rebound in the industrial sector in 2018/19 with a growth of 4.6% in contrast to the negative growth of 14.4% in the previous year. The Reserve Bank estimates the industry sector to contract by -0.5% in 2019/2020 and -3.2% in 2020/21. This largely attributes to further delays in the implementation of major infrastructure projects such as the Queen Salote Wharf, the Fanga'uta Bridge, and other construction projects due to the COVID-19 pandemic.

The on-going reconstruction works from TC Gita are expected to positively contribute to the construction sector in 2019/20 resulting in a growth of 2.0% compared to 7.0% in 2018/19. As mentioned above, the weaker forecast is mostly due to the delays in the implementation of large infrastructure projects. COVID-19 has prompted many countries to lock down its borders including Tonga. Many of the technical expertise for these projects are currently unable to enter the country. At the same time, imports of construction materials have declined by 34.8% ($8.0 million). These delays are expected to slow down the growth in this sector by -2.0% in 2020/21.

The upgrade of public roads continues to support the mining and quarrying sector in 2019/20. However, the impact of COVID-19 and TC Harold on normal business operations is likely to yield a negative growth for this sector by 5.0% in 2020/21. This is also in line with the forecasts for construction activities.

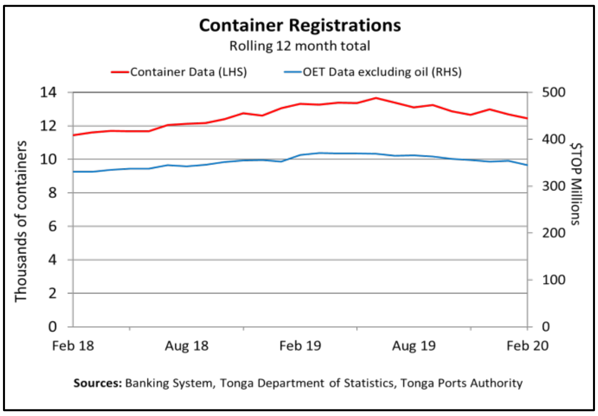
Similar results are also expected for the Utility sector, with a slight growth of 1.0% in 2019/20 and a negative growth of 2.0% in 2020/21. Both electricity production and consumption increased in the first eight months of 2019/20 by 4.3% and 5.4% respectively, compared to the same months of the previous year. The Nuku'alofa Network upgrade project continues to support the Electricity sector. The rolling out of the smart metering project for the Tonga Water Board strengthens its bill collections. Waste Authority Ltd also benefits from keeping Tonga clean campaigns and other green initiatives. However, the impacts of COVID-19 on other related sectors coupled with the damages from TC Harold are the main drivers of the negative growth forecasted for 2020/21.

Manufacturing of Tongan handicrafts is projected to cease as there are no more tourists visiting Tonga. This is in addition to the projected slowdown in the construction sector. The manufacturing sector is projected to continue to contract by negative 4.0% and 5.0% respectively in 2019/20 and 2020/21.

Tertiary Production

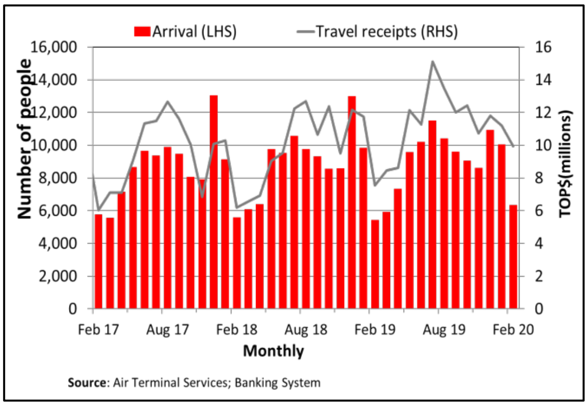
Following a modest growth of 4.6% in 2018/19, the tertiary sector is expected to significantly contract by -10.2% in 2019/20, and will continue to decline in 2020/21 by another 2.2%. This is mostly in line with the expected impact of COVID-19 and TC Harold on the Tourism sector with repercussions across multiple sectors of the economy such as transport, accommodation and food services, real estate activities, and entertainment businesses to name a few.

Figure 7: Import Indicators



International trade has suffered disruptions to supply chains, weak consumer demand, and business sentiment since the outbreak of COVID-19 from China and spreading out to other advanced economies. Signs of imports slowing down are evident in container registrations which have decreased during the first eight months of 2019/20 by 12.9% (1,200 registrations) for both business and private containers. Similarly, vehicle registrations also declined by 8.8% (215 registrations). Payment for imports of goods for the same period also declined by 6.2% ($18.6 million) for wholesale and retail goods, construction materials, and motor vehicles. The cancellation of local celebrations and events such as funerals, weddings, birthdays, and church conferences further contributed to slower trading activities. Consequently, the wholesale and retail sector expects a negative growth of -12.0% and -15.0% respectively for 2019/20 and 2020/21.

Figure 8: International Air Arrivals & Travel Receipts



Tourism activities are expected to be at a standstill starting from late March 2020 as international travel ceased, and it is unclear when things will return to normal. During the first eight months of 2019/20, international air arrivals rose by 1,435 passengers (1.9%) reflecting a strong start for this sector as it recovers from the damages of TC Gita. Travel receipts for the same period also rose by 8.8% ($7.8 million). However, there is very minimal activity expected for the remainder of the year. The transport sector is expected to contract significantly in 2019/20 and 2020/21 by 70.0% and 60.0% respectively, in line with the restrictions on travel. Similar trends for the fiscal year 2020 and 2021, are also projected for the accommodation and food service activities (-80.0% and -70.0%), and the arts, entertainment and recreation businesses (-70.0% and -50%). Travel and tour operators will also cease operations contributing negatively to other real estate activities of -1.0% and –

3.0%. Properties for rent now attract fewer customers as many of our foreign expatriates have been repatriated back to their home countries. Some of the beach resorts and major tourist attractions also suffered severe damages from TC Harold hence it will take some time for them to rebuild and resume operations. This will be reflected as -2.0% and -3.0% for ownership of dwellings.

Higher lending and increasing appetite for insurance covers support the expected growth for the financial and insurance activities in 2019/20. Meanwhile, moratoriums and loan restructure for affected customers from COVID-19 and TC Harold may hamper the growth of this sector in 2020/21.

Public and administration services is forecasted to rise as the Government implement measures to secure the country from COVID-19 and provide additional relief for those affected by TC Harold. Other services such as communication and information, professional and technical, and administrative and support services are expected to either slow down or contract in the current and upcoming fiscal years.

Unemployment

The 2018 Labour Force Survey estimated unemployment to be at 3.1%. Tonga's Labour Force is around 63.4% of its total population and its participation rate is at 46.7%. The share of employment by economic sector accounts for 4.8% in the service sector, 30.4% in the industry sector and the remaining 19.8% in the primary sector.

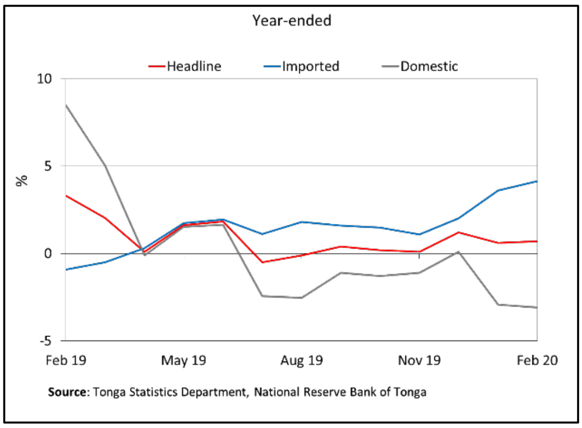
The informal sector accounts for 46.8% of the total employment which is mostly the workers in the primary sector. About 77.9% of the labour force are informally employed or are not provided with any formal requirements. Unemployment is expected to rise due to the impacts of COVID-19 on businesses. Many of the seasonal workers who were about to travel out on the seasonal schemes are now unable to as the border remains closed. However, the Reserve Bank anticipates that this temporary unemployment especially from the services sector will shift to the primary sector such as fishing and agriculture as their new source of livelihoods.

3. Promoting Low and Stable Inflation

Recent Developments

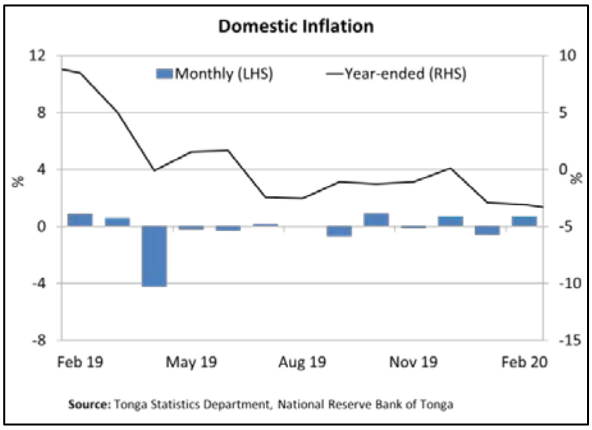
Tonga recorded an annual headline inflation of 0.8% in February 2020, well below the NRBT's 5% reference rate. This results from lower domestic prices (-3.1%) partially offsetting the higher import prices (4.1%) and is considerably lower than the relatively high inflation rate of 3.2% in February 2019. The main drivers of the decline included lower prices for kava Tonga, local food items, and imported fuel.

Figure 9: Inflation



Domestic prices fell by 3.1% in the year to February 2020, recording two consecutive months of local price deflation and the lowest level recorded in the past two years. The fall in domestic prices partially offsets the higher imported prices. Prices of kava Tonga drove the lower domestic prices contributing a negative 0.7% with local food and tobacco both weighing in negative 0.1% to the annual movement.

Figure 10: Domestic Inflation

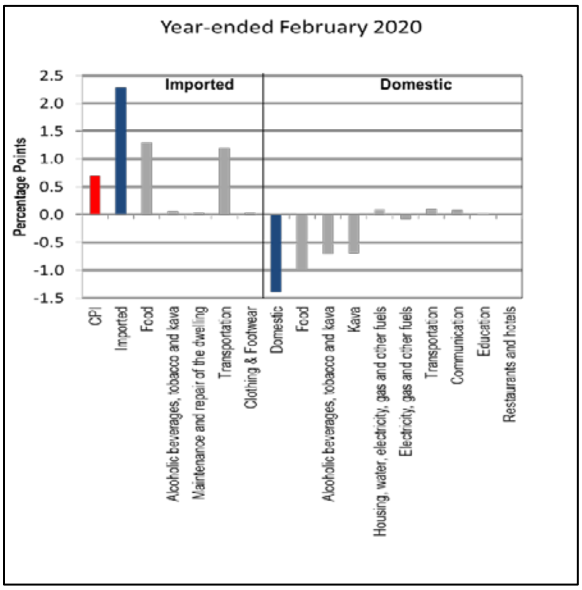


Local food prices fell by 6.8% in the year to February 2020 attributed to the decline in prices for local root crops, seafood, and vegetables as shown in Table 3. This reflects a recovery in the agricultural sector following the aftermath of Tropical Cyclone Gita. Additionally, the price of kava Tonga fell by 41.1% in the year to February and has significantly dropped after spiking in August 2018 as supply increases in the market. Tongan tobacco also fell by 1.4% while electricity, gas and other fuels also decreased by 1.6%. This outweighed the increase in prices for water supply services, transportation services, and furnishing and household items. Prices for communication services also increased by 1.6% over the year in line with the imposing of CT on international calls starting in March in 2019.

Table 3: Food items contributing to domestic inflation

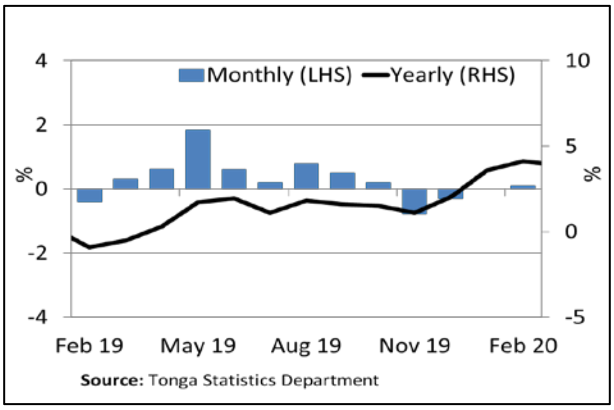
		($ per kg)		YOY	
Domestic	Unit	Feb 20	Feb 19	Annual changes $	% growth
Kava	1kg	72.50	140.00	-67.50	-48.21
Carrots	1kg	2.45	4.72	-2.27	-48.09
Manioke	1kg	0.87	1.61	-0.74	-45.96
Kumala	1kg	1.28	2.23	-0.95	-42.60
Talo - Tonga	1kg	1.28	2.23	-0.95	-42.60
Talo - Futuna	1kg	1.35	1.91	-0.56	-29.32
Cockles (to'o)	1kg	4.53	5.14	-0.61	-11.87
Octopus	1kg	19.71	22.10	-2.39	-10.81
Yams - early	1kg	4.85	5.13	-0.28	-5.46
Yams - late	1kg	3.07	3.17	-0.10	-3.15
Sausages	1kg	8.40	8.30	0.10	1.20
Lu	1kg	4.96	4.90	0.06	1.22
H/Cabbage	1kg	5.57	5.34	0.23	4.31
Tuna	1kg	17.00	16.00	1.00	6.25
Tomatoes	1kg	15.23	14.19	1.04	7.33
Eggs	1 tray	16.08	14.92	1.16	7.77
Stringed fish (mixed)	1kg	9.00	8.00	1.00	12.50
Capsicum	1kg	17.46	11.27	6.19	54.92

Figure 11: Contributions to Inflation



Imported prices recorded an annual inflation of 4.1% in February 2020, the highest since November 2018. Higher imported prices resulted from the increase in prices for food, transport services, and alcoholic beverages. More specifically, food prices were highest for sugar, mutton flaps, and chicken pieces. Global oil prices decreased by 21.6% in the year to February 2020 which has a flow-through effect on domestic fuel prices with a 1-2 months lag. Brent crude oil was lower at US$52.03 per barrel in February 2020 compared to the US$66.37 per barrel in February 2019. The weaker demand across the globe leading to excess supply in the global market largely contributes to the falling oil prices.

Figure 12: Imported Inflation

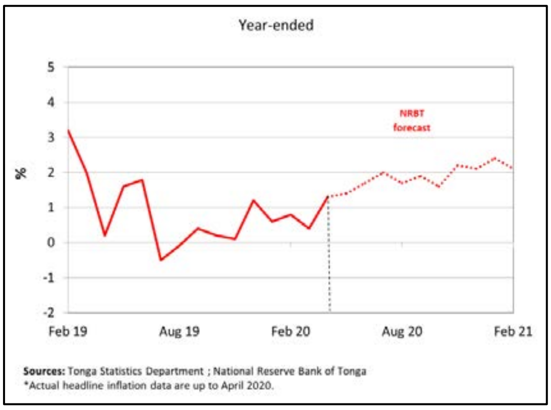


The price of imported tobacco such as Pall Mall cigarettes remained the same in the year to February 2020. Meanwhile, alcoholic beverages increased by 2.1% in the year to February 2020. Transport services also increased by 2.6% contributing to the annual movement of imported items. The appreciation of the USD currency against the TOP also contributed to the higher imported prices.

Outlook

The Reserve Bank projects the yearly headline inflation to gradually increase but will remain below the 5% reference rate in the medium term. The vulnerability of Tonga to natural disasters and the fluctuations in global food and oil prices poses a risk to the inflation outlook. The Reserve Bank will continuously monitor the sources of higher inflation and its impacts on the economy, including the movements in exchange rates, COVID-19, and any new taxes on goods and services.

Figure 13: Headline Inflation Forecast

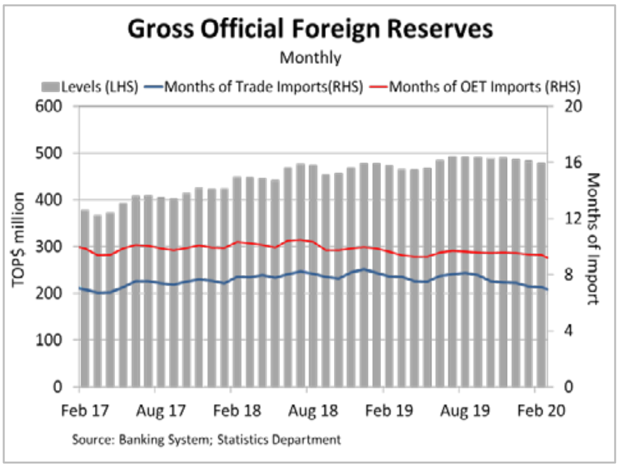


4. Maintaining an Adequate Level of Foreign Reserves

The Reserve Bank continued to monitor the country's external monetary position and to ensure that it maintains an adequate level of foreign reserves above 3 months of import cover. To monitor the external monetary position, estimates of the balance of payments position are derived from Overseas Exchange Transactions (OET) data collected from banks and authorized foreign exchange dealers (FEDs).

Official Foreign Reserves

Figure 14: Gross Official Foreign Reserves

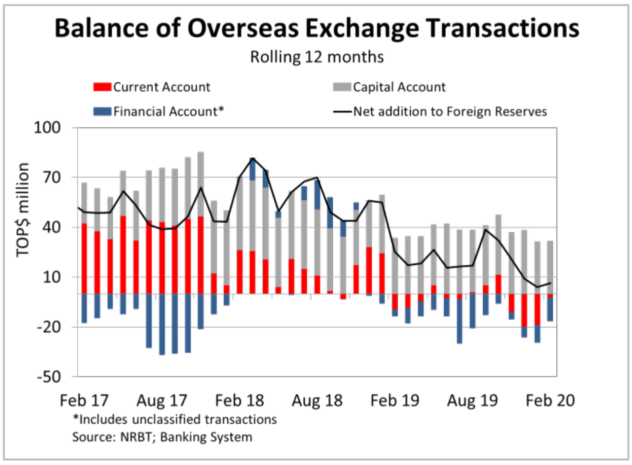


Gross official foreign reserves rose over the year to February 2020 by $6.4 million (1.3%) to $479.8 million, equivalent to 7.4 months of imports of both goods and services. This is lower than the level of $491.8 million in August 2019. The decline was due mainly to import payments by businesses for oil and other various goods. However, it is well above the minimum threshold of import cover and the desirable levels recommended by the International Monetary Fund. The annual growth resulted largely from receipt of budget support, grants, and project funds from development partners. During the year, the foreign reserves peaked at $492.9 million in July 2019.

Balance of Overseas Exchange Transactions

In the past six months to February 2020, the overall OET balance recorded a deficit of $12.0 million compared to a surplus of $18.3 million in the previous six months to August 2019. The overall deficit corresponds to a decline in the foreign reserves from $491.8 million in August 2019 to $479.8 million in February 2020. This decline was due to the widening of the current account deficit, and lower surpluses in both the financial and capital accounts.

Figure 15: Balance of Overseas Exchange Transactions



The overall OET balance recorded a lower surplus of $6.4 million in the year to February 2020 compared to a surplus of $25.5 million in the year to February 2019. The lower surplus was due mainly to a net outflow in the financial account this year compared to a net inflow in the previous year. The capital account surplus also lowered over the year, while the current account deficit improved.

Current Account

The balance of the current account over the six months to February 2020 was a $14.0 million deficit, compared to an $11.8 million surplus in the last six months to August 2019. This was largely attributed to a decline in the transfer and services receipts which consequently lowered the surpluses of these accounts.

The current account deficit improved from a $9.6 million deficit recorded in the year to February 2019 to a $2.0 million deficit in February 2020. The deficit balance stems from the merchandise trade deficit outweighing the surpluses in transfers, services, and income accounts.

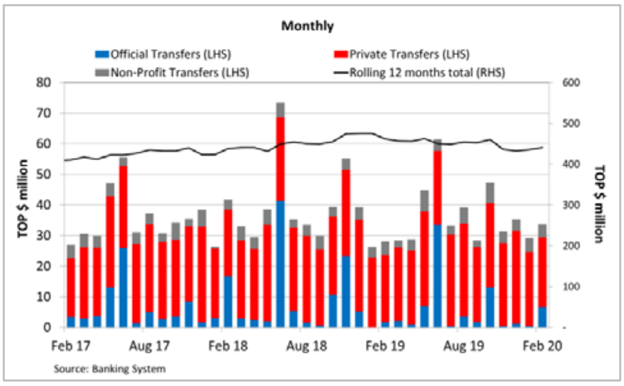
i. Current Account Receipts

a. *Transfer receipts*

Transfer receipts continued to account for the largest share in the current account receipts, at 62.3% during the six months to February 2020. In the past six months to February 2020, the transfer receipts fell by $30.5 million due to decreases in official and private transfer receipts. The official transfer receipts fell by $23.9 million (50.3%) to $23.5 million stemming from lower receipts of budgetary support and project funds from development partners over the past six months. Private transfer receipts decreased by $6.9 million (4.4%) to $156.4 million due to the decline in receipts for family support and gifts. The non-profit transfer receipts rose by $0.3 million (1.1%) to $25.2 million, mainly due to higher inflows of grants received by non-profit organizations mostly churches and schools for technical assistance and other current expenditures.

In year ended terms, the total transfer receipts declined by $21.2 million (4.6%) to $440.8 million. Official transfer receipts fell by $25.8 million (26.6%) and outweighed the $3.2 million (1.0%) and $2.0 million (4.2%) rise in private transfers and non-profit transfers respectively.

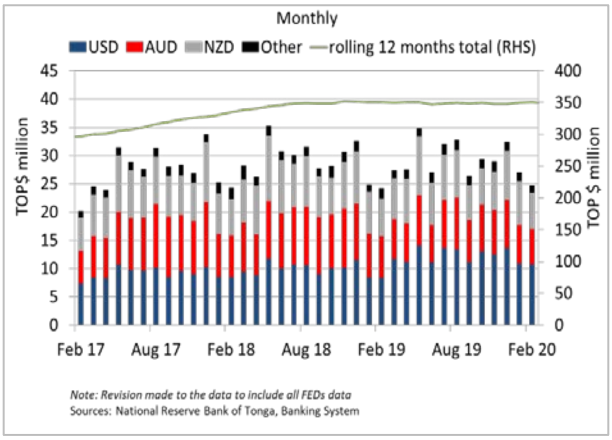
Figure 16: Transfer Receipts



Total remittances fell over the six months to February 2020 by $12.6 million (6.9%) to $169.0 million and accounted for 44.2% of the total OET receipts in the same period. Lower remittances were mainly due to fewer receipts during the six months to February 2020 from all categories of remittance. Approximately 92.6% of the total remittance receipts were private transfer receipts with a total of $156.4 million, mostly gifts and family support funds from families and relatives abroad. The receipts for compensation of employees (seasonal employees and other wages and salaries) followed with a total of $9.7 million (5.8%). Private transfers by individuals for capital investments totaled to $2.2 million (1.3%), and social benefits were $0.7 million (0.4%).

Total remittances in the year to February 2020 slightly fell by 0.1% to a total of $350.5 million. Remittances as a share of GDP is around 34%. Total remittances over the year is attributed to the continued transfer of funds from families and friends abroad to support their families, as well as funding major celebrations and events throughout the year. Compensation for employees also contributed to the rise in remittances over the year. Majority of remittance receipts were denominated in US Dollars, representing 41.9% of the total remittance receipts. Australian dollars followed with 26.3% and New Zealand Dollars with 26.2% share of total remittance receipts. FEDs remained as the preferred channel for remittances, of which approximately 86.1% of total remittances are transferred through.

Figure 17: Remittances by Currency



b. Export proceeds

Over the six months to February 2020, total export proceeds increased by $1.5 million (16.7%) to $10.3 million. The proceeds from exported fisheries products (fish & aquarium) rose by $1.0 million. Agricultural export proceeds slightly increased by $0.1 million with the remaining amount of export proceeds from other exported goods. The favorable weather conditions increased the exported volume of fish and aquamarine products. Agricultural proceeds, on the other hand, is lower compared to the same period last year.

In the year ended February 2020, total export proceeds declined by $1.1 million (5.4%) to a total of $19.4 million. Despite the increase in the volume of agricultural exports over the year by 3,009.1 tonnes (32.2%) mostly for squash exports, the agricultural export receipts declined by 30.1% ($3.4 million) indicating a possible lag in the receipt of proceeds. This was partially offset by the rise in marine export proceeds of $3.1 million (46.4%) coinciding with the rise in the volume of marine exports over the year.

Receipts from fisheries and marine exports accounted for 51.3% of the total proceeds, while agricultural exports account for 40.3%. The remaining 8.3% are from various other exports.

c. Service receipts

Receipts for services in the six months to February 2020 declined by $2.8 million (2.6%) to $103.5 million as receipts for most services fell. Receipts for construction and installation related services fell by $1.9 million (21.0%), followed by receipts for telecommunication services by $1.3 million (50.5%). Travel receipts from tourism-related earnings declined by $0.9 million as the tourism sector starts to shrink due to travel restrictions relating to the COVID-19 outbreak. Receipts from personal and business travel fell by $2.6 million and were partially offset by a $1.6 million increase in unclassified credit card transactions. Other services receipts which also decreased included freight, computer & information, and professional & management services.

However, the total service receipts increased over the year to February 2020 by $15.7 million (8.1%) to $209.8 million. Travel receipts rose by $16.3 million (13.4%) to a total of $137.2 million over the year, in line with the 6.0% increase in international air arrivals. This outweighed a decline in various other services by 0.7% due to lower receipts from insurance claims following TC Gita in 2018, and telecommunication services.

ii. Current Account Payments

Total current account payments declined over the six months to February 2020 by $10.4 million to a total of $343.5 million, due to lower payments for imports and income payments. This outweighed the rise in services and transfer payments.

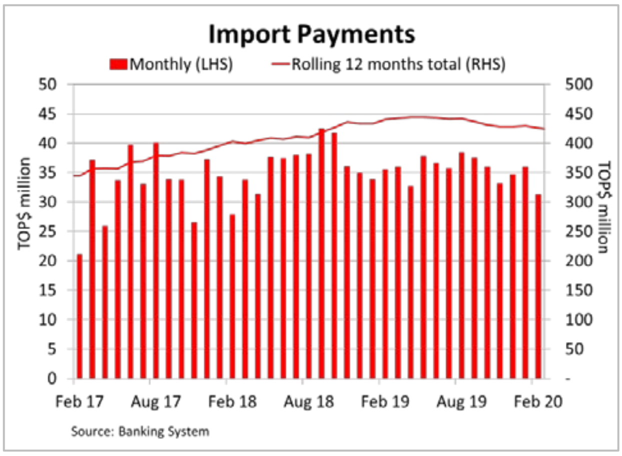
Similarly, current account payments fell in the year to February 2020 by $13.3 million (1.9%) to a total of $697.4 million driven mainly by lower import and services payments, which offset the rise in payments for income and transfers.

a. Import payments

Although merchandise import payments is the largest outflow from the current account, it declined by $8.6 million to $208.5 million in the six months to February 2020. All categories of import payments fell (except for oil imports) led by an $8.1 million decrease in wholesale & retail goods, followed by respective declines of $5.0 million each in construction materials and motor vehicle payments. Other imported goods which are mostly for the Government (public enterprises) also fell by $0.4 million.

Import payments also declined in the year to February 2020 by $15.2 million (3.4%) to $425.6 million. This reflects slower economic activities. Payments for most of the import categories decreased except for oil imports. Oil import payments rose by $6.8 million (9.2%) over the year and account for almost 20% of total import payments. Majority of the imports originated from New Zealand while the bulk of the payments were denominated in US Dollars.

Figure 18: Import payments



b. Services & Transfer payments

Payments from both the service and transfer accounts rose over the six months to February 2020 with services increasing by $2.1 million and transfers by $0.9 million. Service payments increased to $88.8 million due to more payments for government services, postal & courier, professional & management, insurance premiums, and recreational services. The rise in transfer payments over the six months to February 2020 was mainly driven by a $1.6 million increase in transfers to own accounts offshore. Contributions and subscriptions to international organizations by non-profit organizations also increased. These outweighed the decline in official transfer payments during these six months.

In year ended terms, services payments declined while transfer payments increased. Services payments fell by $7.8 million (4.3%) to $175.4 million for services such as airfares, professional & management, and construction & installation services. Transfer payments however, increased by $4.0 million (5.8%) to $73.2 million mainly from a $3.5 million increase in individual transfers abroad for family support and transfers to their own bank accounts overseas. Payments for official donations, contributions, and subscription payments to professional associations by non-profit organizations also slightly increased over the year.

c. Primary Income payments

During the six months to February 2020, primary income payments fell by $4.8 million (34.1%) to $9.2 million mainly due to lower dividends paid out to non-resident shareholders. Pension and social benefit payments also declined during this period. However, income payments increased over the year by $5.5 million (31.1%) to $23.2 million as a result of an increase in dividends being paid out to non-resident shareholders, and wages and salaries to expatriates overseas.

Capital Account

A net inflow of $11.5 million was recorded in the capital account for the six months to February 2020 although it is lower compared to the $20.1 million surplus in the six months to August 2019, and the $17.2 million surplus in the six months to February 2019. Both official and private capital transfers declined by $7.5 million and 1.0 million respectively in the six months to February 2020.

In the year to February 2020, the capital account surplus was lowered by $1.8 million (5.4%) to $31.6 million. This was due mainly to a lower surplus in the private capital accounts from lower receipts for individuals. The private capital account surplus declined by $5.7 million and outweighed a $3.9 million rise in the official capital account. Higher receipts in the capital account were Government receipts from donor partners for capital expenditures and investment projects such as the Nuku'alofa Network Upgrade and the Fua'amotu International Airport Upgrade.

Financial Account

In the past six months to February 2020, the financial account balance recorded a $12.3 million surplus, lower than a surplus of $14.1 million in the previous six months to August 2019. This surplus was underpinned by higher receipts for direct investments and was partly offset by offshore investments and inter-bank lending funds. Over the year to February 2020, the financial account surplus declined by $43.0 million to $26.6 million. This reflects an increase in offshore investments and lower inter-bank receipts.

The balance of unclassified transactions recorded an average inflow of $0.5 million per month over the year to February 2020, compared to $2.1 million in the previous year. This was due to lower financial claims by non-residents which involves foreign exchange dealings between commercial banks and their overseas correspondent banks.

Exchange Rates

In the six months to February 2020, the Nominal Effective Exchange Rate (NEER) index rose by 0.6% due to a depreciation of the AUD, USD, FJD, & JPY against the TOP. The Real Effective Exchange Rate (REER) index on the other hand slightly fell by 0.1% during this six months period reflecting Tonga's low inflation rate relative to its major trading partners.

In year ended terms, both the NEER and REER index increased by 2.3% and 1.1% respectively. Tonga's major trading currencies, such as the AUD, NZD, FJD, GBP, and EUR, weakened against the Tongan Pa'anga. This may also indicate a loss in Tonga's international competitiveness.

Outlook

In the August 2019 MPS, the Reserve Bank's outlook for foreign reserves remained at comfortable levels above 3 months of imports cover up to June 2020 based on the expected receipts of budget support and donor funds for infrastructure projects budgeted for the current fiscal year. However, the COVID-19 outbreak has changed the setting for many things that the Government, businesses, and households have set out to do at the beginning of the year. This is in addition to the unexpected arrival of TC Harold.

The Reserve Bank has reviewed its outlook for foreign reserves based on the latest developments and despite the expected negative economic impacts, 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:

- Expected receipt of remaining budget support for the current financial year.
- The expected influx of additional budget support and relief funds from development partners to strengthen Tonga's health systems for combating COVID-19. Additional assistance is also expected to mitigate the impacts of COVID-19 on the economy.
- Additional budget support from donor partners, and insurance claims for TC Harold.
- Expected receipt of Government grants and project funds for earmarked infrastructure projects such as the upgrade of the Queen Salote Wharf and the Fanga'uta Lagoon Bridge.

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

- Remittance receipts are expected to ease given the global impact of COVID-19 on our major remitting source countries, including our Tongan diaspora.
- The new seasonal workers that were about to leave for New Zealand and Australia on the RSE and SWP schemes can no longer do so due to the border lockdown.
- Tourism activities are now on a standstill affecting travel and other tourism receipts such as whale watching and accommodation.
- Scheduled repayment of external public debt to EXIM Bank of China.
- Fragile financial markets affecting returns on foreign investments and exchange rates.
- Volatile global commodity and oil prices.
- On-going trade tensions and political unrest in advanced economies.
- High uncertainty on the breath and depth of the global COVID-19 pandemic.
- High vulnerability to natural disasters and global shocks.

5. Promoting a Stable Financial System

The banking system remained sound in the six months to February 2020. This was reflected through strong capital positions, adequate profits, high liquidity, and low non-performing loans. Total banks' lending rose albeit at a slower pace further contributing to the loans to deposit ratio surfacing above the minimum 80% threshold. Weighted average interest rate spread narrowed, solely as a result of lower lending rates.

Money Supply

In the six months to February 2020, broad money fell to $590.1 million by $10.4 million (1.7%) from August 2019. This resulted mainly from a $16.0 million (3.1%) decrease in net foreign assets. More specifically, foreign reserves declined by $12.0 million (2.4%) during the past six months driven largely by more import payments as well as lower private transfer receipts. This had offset a $5.8 million (6.4%) rise in net domestic assets due to more lending extended to the private sector.

In the year to February 2020, broad money rose by $1.1 million (0.2%). This resulted from lower net domestic assets, specifically, more government deposits. Meanwhile, the higher net foreign assets coincided with an increase in foreign reserves which also contributed to the annual rise in broad money.

During the six months to February 2020, liquidity in the banking system (reserve money) fell by $13.4 million (4.3%) to $297.9 million. This was led by declines mainly in the currency in circulation and the commercial banks' Exchange Settlement Account (ESA) which declined respectively by $7.5 million (8.9%) and $5.0 million (3.0%). Furthermore, the Statutory Required Deposits (SRD) also declined by $0.8 million (1.4%). The lower ESA balance may have possibly been driven by higher public demand for cash to assist with normal obligations during the festive season.

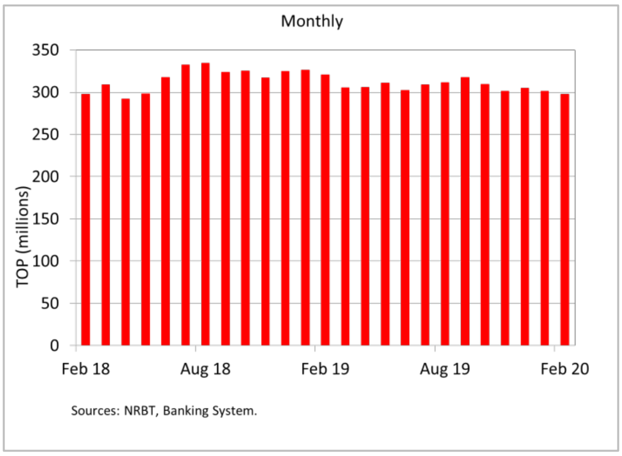
Annually, liquidity in the banking system declined further by $22.7 million (7.1%) as a result of the decline in ESA by $19.8 million (10.8%) and SRD by $2.5 million (4.2%). Currency in circulation also slightly declined further contributing to the yearly fall.

Table 4: Consolidated Balance Sheet of Depository Corporations

	Level			YoY Change	
	February 2019	August 2019	February 2020	February 2020	
	$TOPm	$TOPm	$TOPm	$TOPm	Per cent
Broad money liabilities	**589.0**	**600.5**	**590.1**	**1.1**	**0.2**
Currency in circulation	60.5	67.1	63.2	2.7	4.5
Demand deposits	217.4	209.0	210.3	-7.1	-3.3
Savings and term depos	311.1	324.4	316.6	5.5	1.8
equals					
Net foreign assets	**492.6**	**510.9**	**494.9**	**2.3**	**0.5**
plus					
Net domestic assets	**96.5**	**89.7**	**95.3**	**-1.2**	**-1.2**
Gross bank lending**	490.0	497.8	499.7	9.7	2.0
Public enterprises	58.3	65.0	61.7	3.4	5.7
Private Sector	429.3	429.5	435.6	6.3	1.5
Other financial corpor	2.3	3.3	2.4	0.0	1.3
Other***	-393.5	-408.1	-404.4	-10.9	2.8

* 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 19: Banking System Liquidity

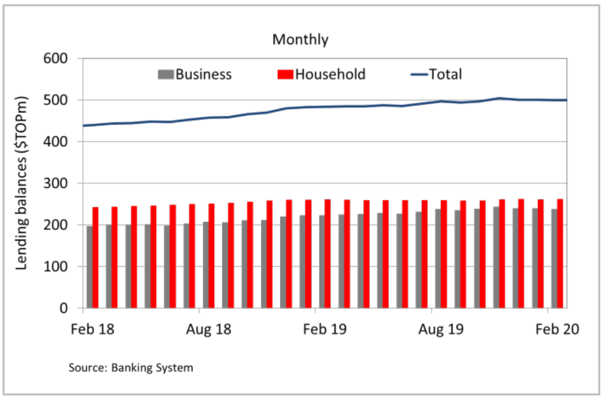


Lending

In the six months to February 2020, the total banks' lending (including Government Development Loans - GDL) increased by $3.2 million (0.6%) to $499.7 million from $496.5 million in August 2019 driven by both individual and business loans. GDL accounted for 1.8% of total loans in February 2020, compared to a 1.7% share in August 2019 and a 1.5% share in February 2019. Throughout the past six months, lending rose to a new high record of $504.3 million in November 2019.

During the past year to February 2020, the total banks' lending further increased by $16.0 million (3.3%). This is a slower annual movement compared to that reported in the August 2019 MPS of 8.6%.

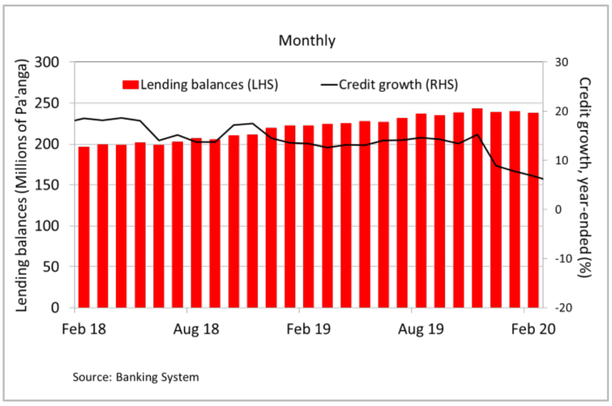
Figure 20: Bank's lending



In the past six months, lending to businesses increased by $0.7 million (6.9%). This was largely owing to higher lending for the professional & other services, agriculture, and tourism sectors. However, this was partially offset by a decline in lending to the wholesale & retail trade, public enterprises, and manufacturing sectors. Despite the slight increase in lending to the private sector in the past six months, this is still noted as a slowdown highlighting the possibility of sectors experiencing lower than expected growth.

In the year to February 2020, business loans grew by $15.2 million (6.9%). These were mostly lending to professional & other services, public enterprises, agriculture, and transport sectors. This is indicative of more economic activity throughout these sectors. The lower interest rate from the GDL scheme is also supportive of these sectors' developments.

Figure 21: Business Lending

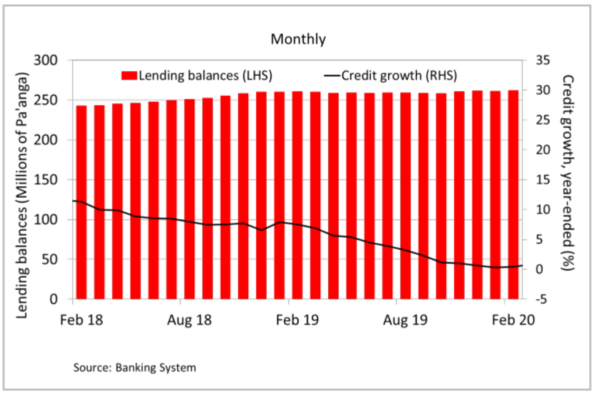


Furthermore, lending to households rose by $2.7 million (1.0%) over the six months to February 2020 to $261.9 million. This was due mainly to higher housing loans which increased by $2.4 million (1.2%). Other personal loans also increased contributing to the bi-annual growth by $0.4 million (0.7%). These rises were partially offset by lower vehicle loans.

In the year to February 2020, household lending rose by $1.1 million (0.4%). This was driven solely by housing loans which increased by $3.5 million (1.8%) offsetting the decline in both vehicles and other personal loans. Interestingly enough, this is the lowest rate of growth on an annual basis that household lending has ever recorded. This may be resulting in lower demand by households for lending.

The banks' new loan commitments fell over the six months to February 2020 by $8.0 million and over the year by $8.3 million indicating fewer prospective investments for the future.

Figure 22: Household Lending



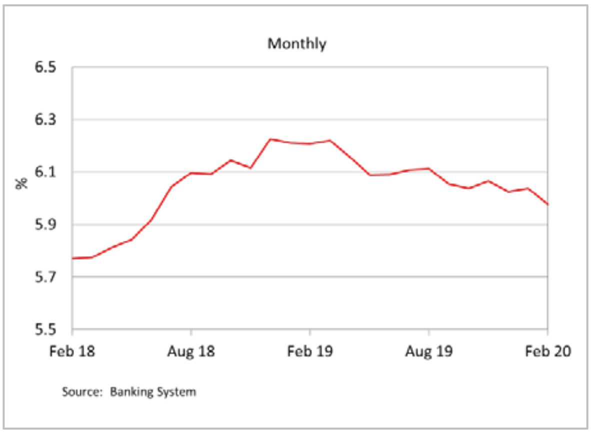
The banks' total loans to deposit ratio increased from 79.0% in August 2019 and 77.7% in February 2019 to 84.1% in February 2020. These movements were resulting in the rise in lending coupled with the decline in deposits. Despite the loans to deposit ratio being higher than the 80% minimum threshold as at the end of February 2020, excess liquidity remains in the banking system available for further lending.

The current COVID-19 outbreak poses a risk to financial stability through difficulties expected to be felt by both households and the private sector with regards to business operations and performances thus loan repayments.

Interest Rates

The banks' weighted average interest rate spread narrowed by 13.4 basis points to 5.98% over the six months to February 2020. This was driven by a 2.09 basis points decline in weighted average lending rates coupled with an increase in weighted average deposit rates by 11.32 basis points. The lower weighted average lending rate was largely driven by lower rates offered for households' vehicle, housing, and other personal loans. Meanwhile, lending rates to the private sector increased particularly for the utilities, trade, and construction sectors. The higher demand and term deposit rates drove the increase in weighted average deposit rates. This outweighed the lower saving deposit interest rates.

Figure 23: Weighted Average Interest Rates Spread



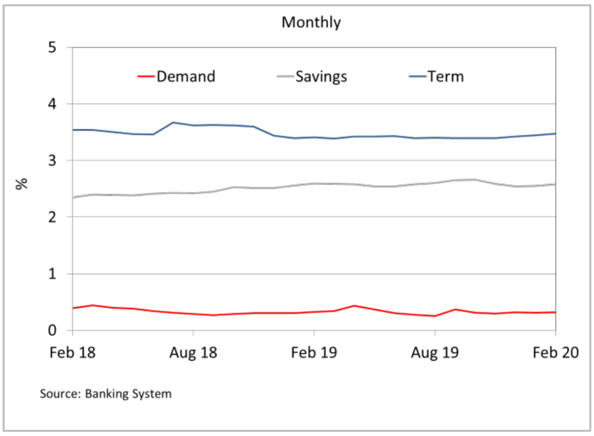
Annually, the weighted average interest rates spread narrowed further by 22.98 basis points as a result of a decline in the weighted average lending rates by 9.44 basis points whilst the weighted average deposit rates rose by 13.55 basis points. The term deposit rates increased outweighing the decline in savings and demand deposits rates. This largely coincided with lower volumes of demand deposits. The lower weighted average lending rates owes mostly to lower rates for all households' related loans particularly rates for housing and vehicle lending.

Table 5: Lending Rates
Weighted average of all banks

	Month ended			Change over 6 months to	Change over 12 months to	
	Feb 20 % p.a.	Aug 19 % p.a.	Feb 19 % p.a.	Feb 20 Bps	Feb 20 Bps	Loan Share %
Loans all	8.01	8.04	8.11	-6.23	-13.99	100
Housing	8.05	8.20	8.24	-14.26	-18.70	42
Other personal	11.27	11.43	11.45	-16.24	-17.73	11
Business*	7.84	7.69	7.83	15.12	1.69	30
Other	0.00	6.53	6.25	-6.53	-625.00	17

*Included Statutory Non-Financial Corporation and Other Financial Corporations
Sources: Banks; NRBT

Figure 24: Deposit Rates



Banking System Performance

The banking system remained sound during the six months to February 2020. Total assets slightly declined by 0.5% to $878.3 million over the six months from August 2019. The decline in asset growth reflected the decrease in Exchange Settlement Account by about $7 million (4.1%) followed by the decline in Time Balances due from Head Offices abroad of $5.7 million (29.9%). Furthermore, Cash Holdings fell by $2.9 million (13.3%) up to February 2020. This was partly offset by the increase in the Non-financial Assets and Loan and Advances by $5.3 million (10.2%) and $2.3 million (0.5%) respectively. This was followed by growth in Items in Transit of $1.4 million (25.5%). On the other hand, total liabilities declined in February 2020 by $15.7 million (2.2%) to $684.2 million. This was attributed mainly to the fall in deposits by $21.0 million (3.4%) driven by a decline in savings and demand deposits by $15.9 million (13.6%) and $11.4 million (4.4%). The decline was attributed to the lower deposits for the Government and Statutory Non-financial Corporations. Provisions for Loses also fell by $2.4 million (13.3%) over the six months from August 2019 as a result of a quarterly review of provisioning for one of the big banks. This offset rises in Other Liabilities and Accumulated Depreciation of $4.8 million (18.7%) and $1.7 million (8.8%) respectively.

The total banking system remained profitable over the year to February 2020. The Net Profit after Tax was $24.6 million which was lower than $20.0 million in August 2019 and the same period last year, which was at $21.6 million. The higher profitability was attributed mainly to lower loan loss provision expense falling by $4.3 million (71.8%). Furthermore, interest income also increased over the six months to February 2020 rising by $1 million (2.1%).

Figure 25: Total Banking System Balance Sheet Development

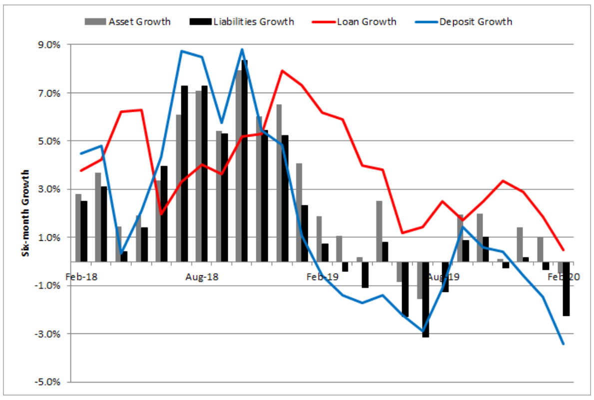
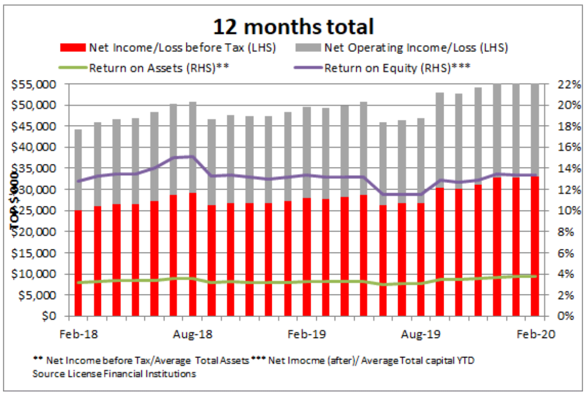


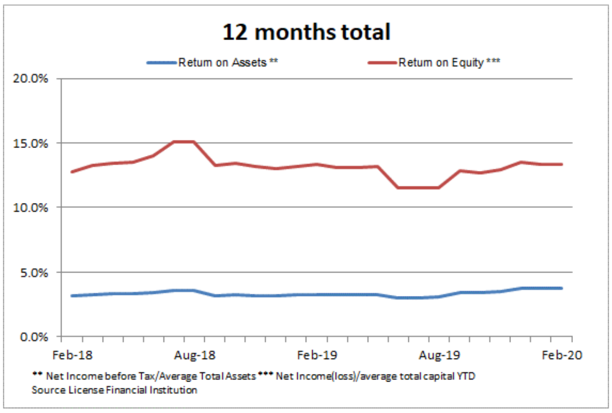
Figure 26: Total Banking System's Profitability



Return on Assets (ROA) and Return on Equity (ROE) increase over the past six months. ROA rose to 3.7% from 3.1% in August 2019. Similarly, ROE increased to 13.4% from 11.5% in August 2019 driven by higher profitability over the six months to February 2020. The banking system's capital position remained strong as the risk-weighted capital ratio was at 32.0% in February 2019 increasing from 30.1% in August 2019 which continued to remain well above the Reserve Bank's minimum requirement of 15%. The higher risk-weighted capital ratio reflected the decrease in capital as some banks continued to repatriate their retained earnings back to their head offices. The banks' net interest margin remained at 4.0% in February 2020, reflecting the proportionate increase in interest income while the cost of funds remained relatively stable.

The overall quality of the banks' assets weakened over the past six months to February 2020. Total non-performing loans rose to $15.6 million from $14.8 million, which represented only 3.2% of total loans compared to 3.0% in August 2019. Loan downgrades over the past six months from August 2019 to February 2020 period contributed to the weaker asset quality.

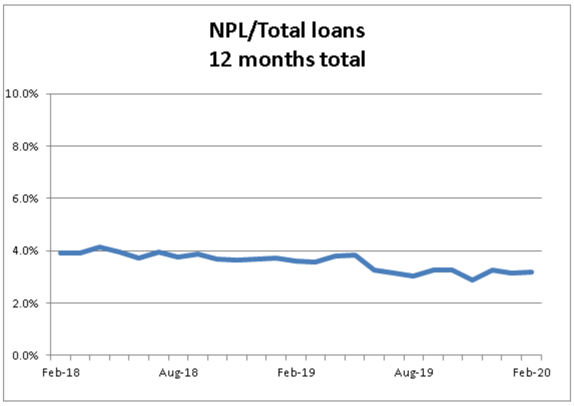
Figure 27: Total Banking System's ROE & ROA



The non-performing private individual loans rose to 75.9% ($12.0 million) of total non-performing loans, from 71.6% ($10.1 million) six months ago, and 61.0% ($10.7 million) around the same time last year. Non-performing private individual loans comprised mainly of housing loans which represent 57.4% of total non-performing loans increasing from 51.7% in August 2019, and 44.6% in February 2019.

Provisions against loan losses are sufficient however declining over the last six months from $17.6 million to $14.9 million in February 2020 due mainly to the ongoing quarterly review of the banks' provisions.

Figure 28: Total Banking System Asset Quality Indicators



The Reserve Bank continued to monitor and manage the payment and settlement system to ensure it is functioning in an efficient, sound, and safe manner. Work is currently in progress on automating the current national payment system to improve the efficiency of the settlement of banks' transactions.

Supervision of Non-Bank Financial Institutions (NBFIs)

Given that promoting access to finance and protecting the interest of financial customers are priorities, the Reserve Bank continues to develop an adequate legal framework for regulating and supervising non-bank financial institutions, thus, fulfilling its objective of promoting a sound and efficient financial system as well as protecting financial consumers. The non-bank financial institutions play an essential role in driving inclusive economic growth, although it accounts for only a small portion, it may pose a risk to the overall financial system. However, 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 which the Reserve Bank has licensed twelve (12) foreign exchange dealers under the Foreign Exchange Control Act 2018. However, in September 2019 one (1) foreign exchange dealer has voluntarily surrendered its license certificate due to the difficulty in finding an efficient way of sending money from New Zealand to Tonga, which left us with a total of eleven (11) foreign exchange dealer. Since the banks started de-risking, the money transfer services industry in Tonga were directly affected in terms of preserving their overseas bank accounts. The Reserve Bank has considered possible solutions to assist local foreign exchange dealers in sustaining its business. This includes upgrading two license foreign exchange dealers from Type B (Inward remittance only) to license Type A (Inward and outward remittance) and one foreign exchange dealer license type B application is currently being processed to upgrade to license type A. This is to facilitate the flow of remittance but at the same time making sure that they still comply with all legal and regulatory requirements especially AML/CFT requirements. There is on-going interaction with authorized foreign exchange dealers such as technical meetings, quarterly spot checks, providing training and advisories on the importance of improving and strengthening their Anti-Money Laundering/ Counter-Terrorist Financing (AML/CFT) compliance status, in order for the banks to retain their accounts. Furthermore, the Reserve Bank constantly liaised and urged the banks to offer alternative products for de-risking, aiming to reduce the cost of remittances to Tonga.

As required under Section 3 of the Microfinance Act 2018, the Reserve Bank has granted a microfinance license to the South Pacific Business Development Microfinance Tonga Limited (SPBD) to conduct a microfinance business in Tonga effective on 24th February 2020. The SPBD Tonga is due to comply with the conditions of the license set by the Reserve Bank at all times in the exercise of its operations. This includes the continuance of submitting a monthly report to the Reserve Bank of Tonga to ensure that SPBD remains financially sound and will continue to operate in the future. The Reserve Bank will be undertaking quarterly spot checks as part of monitoring SPBD prudent performance, thus promoting confidence in using the financial system.

The preparation for the implementation of the Moneylenders Act 2018 is currently underway to be executed in the next financial year. To note the work that is still in progress with drafting the legislation for the supervision of insurance companies and retirement funds. At the same time, the Reserve Bank continues to collect monthly reports from the two (2) retirement funds, and quarterly monthly reports from the four (4) insurance companies. The collating of these reports would enhance the understanding of the NBFI's business and to monitor 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 bank assets as well as enhance access to loans.

Financial Inclusion Initiatives

Financial inclusion has become an important part of public policymaking in many countries which contributes to the mainstream of economic stability. The Reserve Bank continues to carry out its functions of promoting financial inclusion in Tonga through attaining its financial inclusion's key objectives, to enhance access to finance for Micro, Small and Medium Enterprises (MSMEs) and individuals as well as to promote reliable, sound and affordable digital financial services (DFS). These objectives supported the Reserve Bank's objectives of inclusive economic growth and macroeconomic stability.

Tonga's access to financial services slightly contracted over the year to December 2019, with a decline in the total banking system's number of financial access points by 42 (7%) compared to December 2018. This is mainly due to a decrease in the number of EFTPOS terminals and ATMs. This fall offsets the rise in the number of agents. BSP was the main contributor to the decline in the total access points mostly in the number of EFTPOS terminals, due to the closing down of some of the inactive merchants. However, the rise in the number of agents indicated that banks have broadened their financial services, and are less costly compared to establishing a bank branch.

Access points by constituency decreased over the year to December 2019, particularly for Tongatapu 1 and Tongatapu 2. However, Ha'apai 13 constituency showed a marked improvement in access points with an increase to 4 access points compared to no access points in December 2018. The extension of banks' access points (agent/in-store banking) to this remote constituency was the outcome of moral suasion by the Reserve Bank, and also a change in strategy by one bank to increase their footprint in remote and rural areas. Similarly, the number of Non-Banks access points declined due to a fall in the number of branches and agents, as some of the foreign exchange dealers closed down during the year due to the closure of branches' bank accounts overseas. In comparison to banks, the SPBD has more access points than MBf, TDB, and ANZ. SPBD village meeting centers offer simple products at low-cost compared to banks' access points.

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

Constituency	Jun-19					Jun-18				
	Total Access Points	No. of branches	No. of Agents	No. of EFTPOS	No. ATMs	Total Access Points	No. of branches	No. of Agents	No. of EFTPOS	No. ATMs
Tongatapu 1	**47**	0	2	43	2	**42**	0	1	39	2
Tongatapu 2	**309**	5	2	288	14	**305**	5	2	285	13
Tongatapu 3	**26**	0	0	25	1	**26**	0	0	25	1
Tongatapu 4	**30**	0	0	27	3	**29**	0	0	26	3
Tongatapu 5	**15**	0	1	14	0	**12**	0	1	11	0
Tongatapu 6	**8**	1	1	6	0	**8**	1	1	6	0
Tongatapu 7	**7**	0	0	7	0	**7**	0	0	7	0
Tongatapu 8	**35**	0	6	28	1	**32**	0	4	27	1
Tongatapu 9	**29**	2	5	21	1	**29**	2	5	21	1
Tongatapu 10	**6**	0	2	4	0	**4**	0	2	2	0
'Eua 11	**8**	2	1	4	1	**8**	2	1	4	1
Ha'apai 12	**17**	2	1	13	1	**18**	2	2	13	1
Ha'apai 13	**2**	0	1	1	0	**0**	0	0	0	0
Vava'u 14	**5**	0	1	4	0	**4**	0	1	3	0
Vava'u 15	**73**	4	2	63	4	**71**	4	2	62	3
Vava'u 16	**2**	0	0	2	0	**2**	0	0	2	0
Ongo Niuas 17	**2**	2	0	0	0	**2**	2	0	0	0
TOTAL	**621**	**18**	**25**	**550**	**28**	**599**	**18**	**22**	**533**	**26**
Source: Banks										

From the usage of financial services perspective, the total number of individual deposit accounts fell over the year, whereas the number of individual loan accounts increased. BSP and TDB contributed to the decline in the number of deposit accounts owing to a close down in the dormant customer accounts. The decline in the lending interest rates by BSP in October 2019 may have supported the rise in the number of loan accounts. The upward trend in the number of deposit accounts over the last 5 years may also indicate the bank's requirement to open a deposit account to facilitate receipts of remittances including RSE workers and drawdown of loans. TDB's Ave Pa'anga Pau may have also contributed to the upward trend on deposit accounts since its launch in 2017.

The current level of MSMEs in Tonga through the banking system indicated mixed outcomes as the MSMEs outstanding loans increased whilst the number of MSMEs fell over the year ended December 2019. In that regard, MSMEs outstanding loan rose by $1.4 million (6%) to T$23.3 million. This was mainly due to an increase in outstanding loans to agriculture, fishing, and manufacturing sector. The increase was predominantly driven by the Government Development Loan (GDL) scheme with an increase of $3.5 million, followed by Tonga Development Bank with an increase of T$1.6 million. The rise in GDL's loan was driven by an increase in agricultural sector loans of $2.1 million, fishing sector loans of $0.9 million, and manufacturing sector (women in development groups etc.) loan of T$0.4 million. The rise in GDL's outstanding loan reflected the release of GDL fund after it ceased in March 2019 until June 2019. Furthermore, the rise in the number of MSMEs for the agriculture and fishing sector contributed to the increase in the outstanding loan to these respective sectors.

However, the number of MSMEs that banks lend to, fell by 45 (2.3%) to 1,922 MSMEs owing to a significant decline in the number of MSMEs for other services, and the manufacturing sector which outweighs the increase in the number of MSMEs for the agriculture sector. Majority of the MSMEs are owned by males compared to female-owned MSMEs. The decline in the number of female-owned MSMEs was mainly evident in the other services and manufacturing sectors.

Most MSMEs who can gain access to finance in the banks are from the formal sectors where they are licensed in the Ministry of Trade and Economic Development. About 69% of the total number of formal MSMEs are male-owned MSMEs. On the other hand, female-owned MSMEs are the major driver of the informal sector by accessing finance through the GDL scheme under the manufacturing sector which is about 1% of the total number of MSMEs. This informal sector is mainly made up of Community Groups such as Vaimo'ui Group, Fiefia Group etc.

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 subdued annual credit growth of 0.2% in 2019/20 compared to annual growth of 9.2% in 2018/19. Although non-performing loans are expected to remain at low levels, standards on monitoring asset quality and prudent lending practices are to be maintained.

- Continue to closely monitor likely impacts of COVID-19 on the local businesses such as the tourism sector followed by other private businesses as it will affect their financial capability 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.
- Ongoing 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 confidence level of the banks 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) is stated in the loan agreement and 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 as well as 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 as well as 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 rate of growth in credit and nonperforming 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 further natural disaster for the first half of the year will have a financial impact on the country.

6. Fiscal Indicators

The fiscal position remained positive despite the uncertainties caused by the global pandemic COVID-19. Banking system data shows the net credit to Government increased by $7.2 million (3.9%) over the 6 months to February 2020, compared to a $7.5 million (4.1%) decline in the 6 months to August 2019. This was attributed to a $6.8 million (3.4%) decline in Government deposits due to principal repayment for the Nuku'alofa Central Business District Reconstruction Project in September 2019. In addition, the delay in budget support receipts that were scheduled to be received during these six months may have contributed to this lower level of deposits.

However, net credit to Government slightly decreased over the year by $0.2 million (0.1%), as a result of a $4.3 million (2.3%) rise in Government deposits. The receipt of some of the budgetary support, and grants from development partners, and better revenue collection during the financial year largely contributed to this increase in Government deposits.

The 2018/19 Government revised budget estimates expected the receipt of $43.5 million in budget support from development partners, whereby a total of $62.6 million was received before the end of June 2019. The extra amount received more than expected was due to deferred budget support. The 2019/20 Government Budget indicated a Government Finance Statistics (GFS) fiscal balance of $10.2 million of net lending. The total budget support estimated for 2019/20 is $34.4 million in which $46.4 million has been received to date. The excessive amount was driven by extra funds due to TC Harold and support for preparations for COVID-19.

The total public debt position for June 2020 is estimated to represent 44% of GDP, of which 39% is external debt and 5% is domestic debt. This is in line with one of the three fiscal targets in the Government of Tonga Fiscal Strategy for 2019/20, which is to maintain the external debt below 50% of GDP. The other two targets are to raise domestic revenue collections to at least 22% of GDP and to maintain the compensation of employees at no more than 53% of domestic revenues and to gradually decline to 50% over time.

The estimated total debt service for 2019/20 is to remain around $20 million, due to the commencement of the first principal repayment for the Tonga National Road Improvement Project loan due in March 2020 to EXIM Bank of China. The main repayment months for the loans to the EXIM Bank of China are September and March of every year. The EXIM Bank of China remains the main external debt creditor, hence the Chinese Renminbi has the highest share of the total external debt portfolio.

On the outlook, Government receipts are expected to rise in the near term due to the remaining budget support, additional funds for COVID-19 preparations and, recovery from TC Harold that is yet to be received for the year 2019/20. This would contribute to the Reserve Bank's projection for foreign reserves to remain at comfortable levels up to June 2020.

Net credit to the Government is also anticipated to decrease due to the expected inflow of Government budgetary support and Government grants receipts, as well as improved Government revenue collection. This will also be supported by new bonds of $15.0 million issued during the current financial year. However, this will be partially offset by the repayment of the Tonga National Road Improvement Project loan to EXIM Bank of China, and the projected expenditure in the Government's 2019/20 budget statement, released in June 2019. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

7. Monetary Policy Stance

Despite the recent global pandemic and natural disasters, the Reserve Bank's monetary policy stance remained accommodative during the past six months to February 2020. Inflation stayed below the 5% reference rate in the last six months, while foreign reserves continued to be at a comfortable level above the minimum of 3 months of import cover. Exchange rates were competitive, and the financial system remained sound supported by strong capital and liquidity position. The domestic economic indicators are reflective of the slowdown during this period aligning with the recently announced global recession by the IMF. Regardless, no sign of overheating was observed in the financial system as credit growth slowed. The banks' loans/deposit ratio surfaced above the minimum 80% loan to deposit threshold yet excess liquidity remains in the financial system.

The Reserve Bank's projection for Tonga's economy to contract in the current fiscal year remains, due to the negative impacts of COVID-19. However, the foreign reserves is still expected to remain at sufficient levels above the 3 months minimum threshold of import cover. Inflation is also expected to gradually increase yet remain below the 5% reference rate. The banking system is still sound supported by high liquidity.

- ✓ Given these latest developments, the Reserve Bank maintains its current accommodative monetary policy stance. This is to encourage banks to utilize the excess liquidity in the banking system to lend out and to support the economy from the impacts of COVID-19. Maintain the monetary policy rate at 0% (zero interest rate policy).

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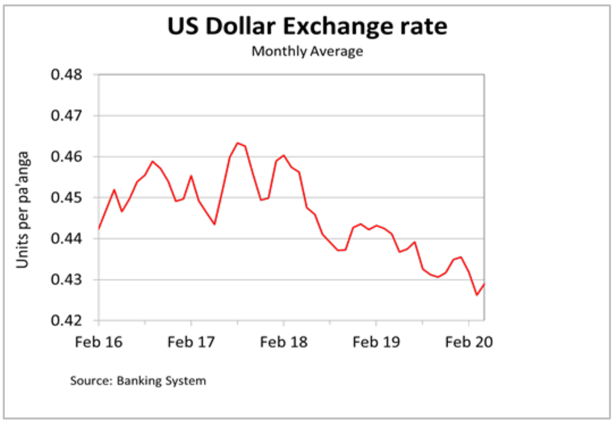
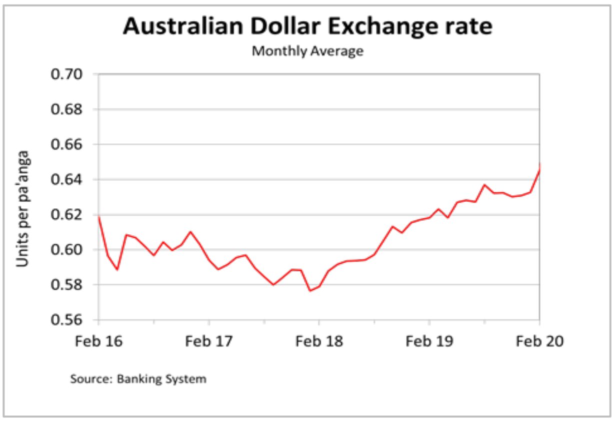
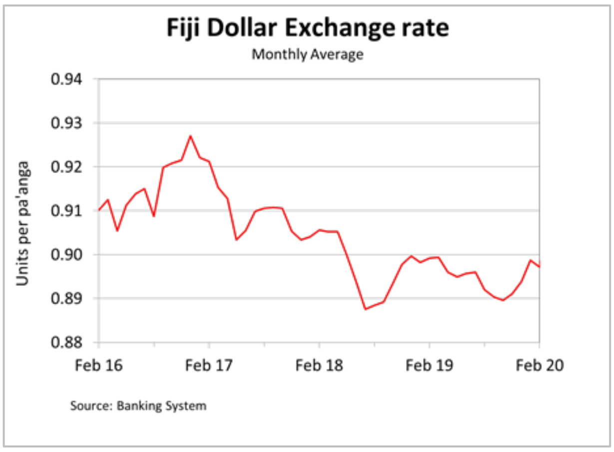
- ✓ Maintain the minimum loans/deposit ratio of 80%.
- ✓ Maintain the Statutory Reserve Deposit ratio at 10%.
- ✓ Maintain the inflation reference rate at 5%.
- ✓ Monitor the commercial banks' liquidity and adjust the SRD ratio if needed.
- ✓ Monitoring the commercial banks' capital reserves and adjust further when required.
- ✓ Ease the exchange control requirements when required.
- ✓ Continue to issue Government Bonds.
- ✓ Maintain clear channels of effective communications with the financial institutions for adequate preparedness.
- ✓ Continue to be transparent and raise awareness of its monetary policy decisions through press releases to the public.
- ✓ Closely monitor the impacts of the pandemic in the financial system for early detection of any signs of vulnerability.
- ✓ 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.

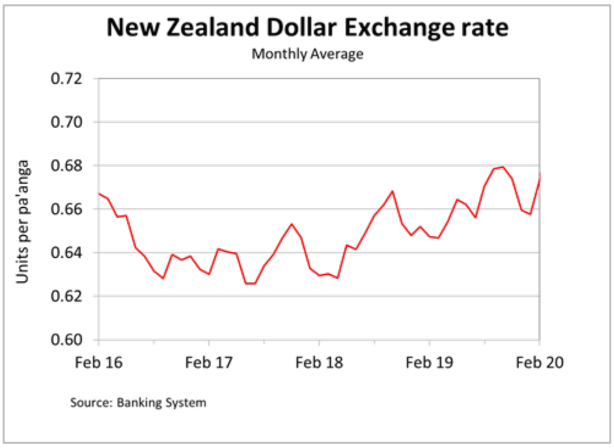
The Reserve Bank will remain vigilant and continue to closely monitor the on-going COVID-19 outbreak and other associated risks. The Reserve Bank will continue to closely monitor developments in the domestic and global economy, and update its monetary policy setting to maintain internal and external monetary stability and to promote a sound and efficient financial system to support macroeconomic stability and economic growth.

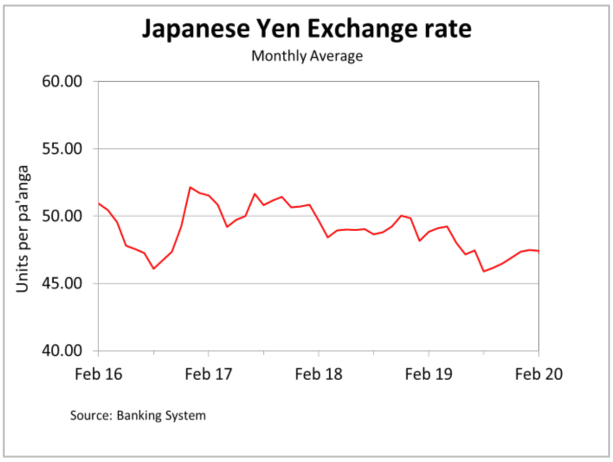
Appendix 1: Tongan Pa'anga Exchange Rates

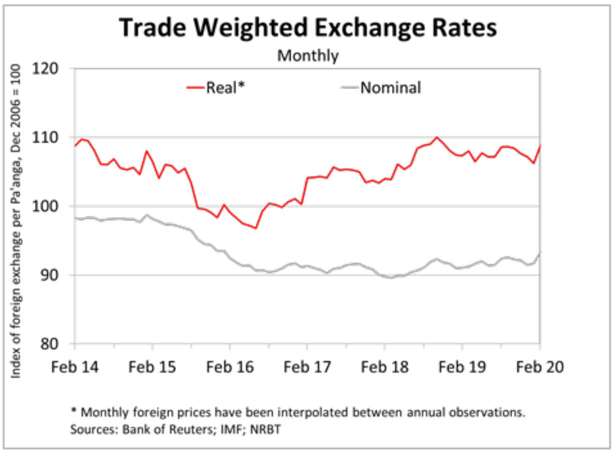












Appendix 2: Monetary Policy Objectives

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, 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.