MONETARY POLICY STATEMENT

February 2023

National Reserve Bank of Tonga

Contents

Executive Summary

Tonga is rebounding from the double shock in 2022 but, several supply side constraints are hampering a faster recovery. To sustain the on-going recovery, prudent macroeconomic management and effective implementation of structural reforms will be critical.

Inflation grew steeper and higher in 2022 peaking at 14% in September before easing in the last quarter where domestic inflation surprised on the upside overtook imported inflation since August 2022. This has pushed up the cost of living expenses and quickly depletes purchasing power of both households and businesses.

The external and financial stability have been maintained and the Reserve Bank's principal objectives as laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, 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.

The MPS 2023 has revised the current accommodative policy and proposed monetary policy measures to manage a sharp resurgence in inflation over the next six months at the same time support targeted credit easing for vulnerable businesses and households to support economic recovery.

Monetary Policy Decision

Reserve Bank seeks to better control inflation through monetary policy

1. The Monetary Policy stance over the next six months will focus on reducing inflation in the short term, and at the same time continue targeted support for the vulnerable households and businesses. The level of foreign reserves at over 14.2 months of imports, excess liquidity of over $350 million, and banks' adequate capitalisation to date provide space to continue to support targeted measures.

2. The Reserve Bank Board stressed the importance of price stability in the near term as it moves to strengthen the monetary policy framework that can better control inflation, build the resilience of the financial sector, promote macroeconomic stability, and support growth recovery taking into account the following:

- Headline inflation reached a high of 14% in September 2022 but cooled down to 9.2% in 2022 last quarter whilst the underlying inflation remains persistent.
- Demand in the Tongan economy is on track for recovery with the HTHH volcanic eruption reconstruction underway, services sector rebound with increasing air arrivals allowed by the Governments successful management of the pandemic and support of post-eruption tsunami reconstruction.
- Semi-skilled labour market shortages to cater for both local and overseas seasonal demands are slowing down the economy putting pressure on wages and increasing inflation.
- Global food and petroleum price crises, supply chain constraints, domestic supply shortages and volatility in the global exchange rates of our trading partners are adding to inflation in Tonga.
- The main challenge for the Tongan economy in the medium term is to improve its growth potential, create local job opportunities for the young population and build resilience to global and natural hazards.

3. Monetary policy actions need to be augmented by targeted supply side policy actions to support increasing access to financing and avoid un-necessary slowdown in growth below potential.

Price Stability

4. Inflation in Tonga reached a high of 14% in the third quarter of 2022, the highest in the last 13 years since 2008. The year-on-year average increase in the overall Consumer Price Index (CPI) was 11.1% in October 2022 compared to 5.6% in 2021. Higher rise in prices immediately translates to a decline in each family's purchasing power with same income, therefore Tongans buy less in 2023 than in 2022. Family decisions to pay for weekly food, petroleum, electricity and other necessities become more difficult in 2023 if inflation is not reduced.

5. The Reserve Bank will use the following policy instruments:

I. The exchange rate policy will be geared towards cushioning the erosion of household and business purchasing power by:
   a. reducing the exchange rate spread offered by authorised agents: USD/TOP from 220 to 170 basis points, AUD/TOP at 300 basis points, and NZD/TOP at 350 basis points;
   b. linking the exchange rate policy to developments in energy prices; and
   c. encouraging competition and level playing field for all authorised foreign exchange dealers on foreign exchange trade, and lower costs to be passed on to customers.

II. Review the exchange rate basket to ensure the weights reflect current overseas transaction patterns and latest economic developments.

III. Increase the Statutory Reserve Deposit ratio from 10% to 15%.

IV. Remove the restriction on syndicated lending by banks to increase banks' capacity to finance larger scale projects, negotiated partnership products with shared risks.

V. Offer deposits to Government and the retirement funds to move their deposits from the banks to the NRBT.

VI. Government to consider measures to help contain inflation such as a reduction in consumption taxes and base costs subject to inflationary hikes for applied tax[1].

VII. Effective communication of future course and actions to reduce inflation in the next 6 months.

VIII. The Reserve Bank will support developing financial instruments to build medium-term growth through targeted credit easing for (i) vulnerable growth sectors identified with disproportionate access to finance: agriculture, tourism, manufacturing, housing construction, education, and (ii) energy efficient and climate resilience financing such as investments in renewable energy. Increased financial instruments to support credit easing in consultation with the Ministry of Finance of the Government of Tonga.

6. The Reserve Bank Board of Directors will review the monetary policy on a monthly basis and determine appropriate changes to the Kingdom's monetary policies[2].

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[1] For example hikes in freight for both air and shipping costs where included in the base costs for border taxes.

2 Key challenges outside the Reserve Bank's control are covered in Annex 1.

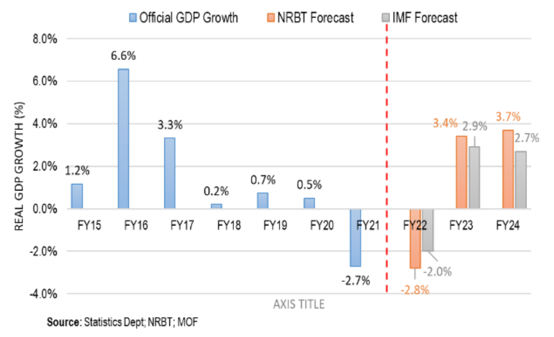
Annex

1. Annex 1 - **Economic and Financial Developments**

a. GDP Growth

Domestic economic activities were mostly muted during the first half of 2022 following the aftermath of the Hunga Tonga Hunga Ha'apai (HTHH) volcanic eruption and tsunami, and the extended national lockdowns from the Covid-19 outbreak. As a result, the Reserve Bank downgraded its growth estimate for FY2021-22 from -2.0% in the May 2022 Monetary Policy Statement (MPS), to -2.8%.

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



By October 2022, the economy showed signs of gradual recovery as restrictions were lifted, and the international border re-opens. This allows for the return of technical expertise required for the implementation of delayed infrastructure projects such as the Queen Salote Wharf upgrade, and Renewable Energy projects to name a few. Tourism activities have also resumed while the HTHH reconstruction projects are ongoing. The expansionary fiscal policy remains focused on economic recovery with a wider budget deficit of $22.9 million for FY2022-23. This includes allocations for the HTHH reconstructions and stimulus packages to support businesses and employees. Demand for labour is also rising both from the public administration, the private sector and seasonal employment to Australia and New Zealand, supporting employment and income. These positive developments have improved business confidence and boosted demand and consumption activities. Consequently, the Reserve Bank upgraded its GDP growth forecast for FY2022-23 from 3.1% (May 2022 MPS) to 3.4%, underpinned by the stronger growth anticipated for the tertiary and industry sectors. The recovery of the primary sector, however, is slower than previously anticipated due to the brief drought observed in the third quarter of 2022 affecting the agricultural sector.

All sector growths are estimated to pick up momentum by 2023 contributing to the stronger growth outlook of 3.7% in FY2023/24, despite the gloomier global prospects. The International Monetary Fund (IMF) in its World Economic Outlook (WEO) in October 2022, projected a steeper slowdown for the global economy from 6.0% in 2021, to 3.2% and 2.7% in 2022 and 2023, respectively. This largely stems from the spillover impacts of the war in Ukraine and the accelerated monetary policy tightening in response to the persistent inflationary pressure. Global inflation is expected to peak in the last quarter of 2022 as global supply-demand imbalances ease. Meanwhile, the Reserve Bank continues to closely monitor the developments in the global economy as any further deterioration can affect Tonga's recovery given our high dependence on foreign aid, external financing, remittances, and imported energy and food.

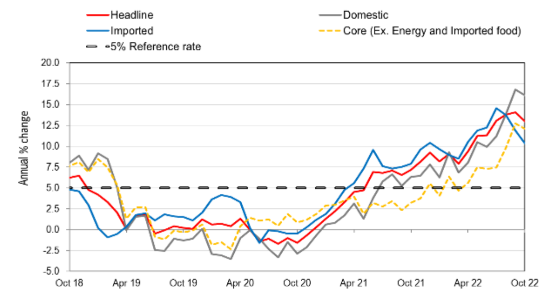
Natural disasters and climate change implications are key downside risks to the outlook. Additionally, the growing demand for the overseas labour mobility schemes competes with the rising domestic demand for labour as the economy recovers. The resulting resource and capacity constraints slows down sector growth, and reconstruction and recovery works are held back. Similarly, the persistent and broadening inflationary pressure may affect investment and consumption appetites, which could hinder short-term recovery and growth.

Considering the global slowdown and the significant downside risks to domestic growth, both fiscal and monetary policy will need to support vulnerable households and businesses with targeted resilience building in the near term until economic recovery is on a more firm path. Fiscal measures to cushion the prolonged adverse impact of the HTHH disaster and COVID-19 as well as ensure the timely implementation of development projects contribute to the high liquidity in the banking system while boosting economic activities, encouraging investment, and creating employment opportunities. Stimulus packages targeted at reviving vulnerable sectors of the economy such as agriculture, fisheries, and tourism are appropriate. More sustainable labour management strategies to manage the gaps in domestic demand and supply will also assist with the timely project implementation and growth recovery. Many of these projects also revolve around building resilience to external shocks and natural disasters, which will reduce future downside risks. The Reserve Bank from the monetary side will complement the fiscal measure by encouraging prudent lending to vulnerable sectors, support building our resilience with increasing import substitution, encourage export businesses, and renewable energy investments.

b. Inflation

Tonga's annual headline inflation has accelerated since the May 2022 MPS, peaking at 14.0% in September 2022 before easing slightly to 12.9% in October 2022. This is compared to an annual growth of 11.3% in May 2022, and 7.2% in October 2021. The increase over the year reflects higher prices for food and non-alcoholic beverages; alcoholic beverages, tobacco and kava; housing, water, electricity, gas and other fuel; and the transport expenditure groups. More specifically, the rising inflation was driven mostly by higher food and energy prices, which comprises more than half (56%) of the Consumer Price Index (CPI) basket. This means that for the average Tongan household, the strong rise in inflation feeds straight into higher cost of living throughout the year. Since there is no strong evidence of wage adjustments to compensate for the rising inflation, purchasing power and real income levels have quickly diminished.

Figure 2: Tonga's Inflation



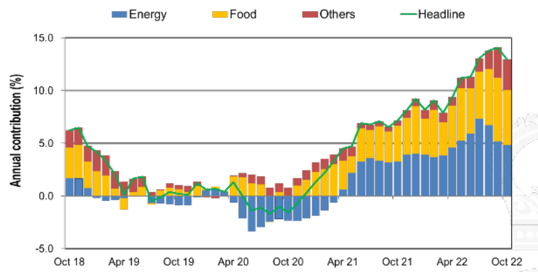
Sources: Tonga Statistics Department ; National Reserve Bank of Tonga.

Imported inflation grew over the year to October 2022 by 10.4%, contributing 5.9% to the headline. The increase was mostly driven by higher prices of imported fuel (23.5% increase), gas (13.2% increase), food and non-alcoholic beverages (5.2% increase). This reflects the ongoing disruptions to global supply chains from the war in Ukraine and the pandemic, pressuring global oil and commodity prices. At the same time, the prices of imported alcoholic beverages, tobacco, construction materials, household appliances and equipment, personal care items, transport services, clothing and footwear, also rose corresponding to higher imported inflation from our source import countries, in addition to the elevated freight costs. Tonga's major trading partner countries such as the United States, Australia, and New Zealand have been observing historically very high inflation, and they have been increasing interest rates consistently during the year in the effort to slow down demand, thus inflation. Consequently, the US dollar (USD) has strengthened considerably against the Tongan Pa'anga (TOP) contributing to higher imported inflation and import outflows. On a positive note, the rising pace of imported inflation has marginally slowed down since July 2022 and is expected to continue in line with the declining trend in global oil prices and freight rates.

Domestic inflation also rose sharply over the past six months to October 2022, and has outpaced imported inflation with an annual growth of 16.2%, contributing 7.0% to the headline. The main drivers behind the higher domestic prices were from local food (increased by 23.8%), and electricity (increased by 44.6%). Damages from the HTHH disaster and the adverse weather conditions continue to impact the domestic food supply including tobacco and kava, while the increasing prices of imported fuel pass through to electricity prices. Meanwhile, other CPI groups are also adjusting prices up due to the higher costs of raw materials, energy, and shipping such as domestic transport services, communication services, labour for housing maintenance, outpatient services, and takeaway food.

Core inflation (excluding energy and imported food) has trended closer to the headline over the six months to October, standing at 12.1% compared to 7.5% in May 2022, and 3.2% a year ago. The stronger growth in the domestic food prices is the main driver of higher core inflation, which underscores the vulnerability of the domestic food supply to natural disasters and climate change. It also affirms the broadening price pressures to non-energy and non-food items pushing the cost of living expenses higher.

Figure 3: **Sources of Inflation**



Source: Tonga Statistics Department, NRBT

In response to the persistent inflationary pressure, the Government issued temporary inflation subsidies on petroleum prices (July to mid-October 2022) and electricity tariffs (since July 2022) to alleviate the burden on households. The petroleum subsidy partially offset some of the rises in fuel prices, while the electricity subsidy was passed onto consumers based on their consumption levels. While noting that the sources of inflation are beyond its control, the Reserve Bank focused on closely managing the exchange rate basket against the unprecedented strengthening of the USD, while being mindful of the implications on foreign reserves.

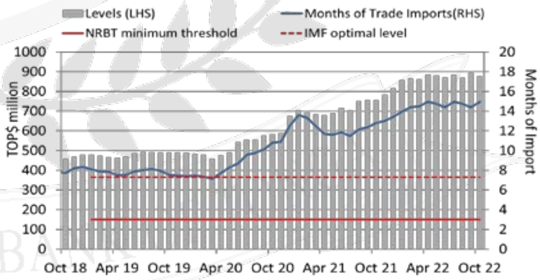
The Reserve Bank projects inflation to peak around the last quarter of 2022, before easing towards the 5% reference rate by mid-2023. Imported inflation is forecasted to continue slowing down as global oil and food price rises start to lose heat, and freight rates consistently decline. Global supply is slowly catching up with pent-up demand from the pandemic. At the same time, Central Banks remain focused on restoring price stability, which will flow through imports to Tonga's inflation. Domestic prices are also expected to soon ease as upcoming harvesting seasons will improve domestic food supply. The declining fuel prices are also expected to pass through to lower electricity prices in 2023. The lower imported inflation will also reduce business overheads on raw materials for domestic production and services.

Risks to the outlook, however, are tilted to the downside as high uncertainty remains on global developments such as the war in Ukraine, China's stringent Covid controls, and the Federal Reserve's tightening path. Natural disasters remain a threat to Tonga's food supply and domestic inflation. Wage adjustments to compensate for the higher cost of living amid increasingly competitive demand for labour from both domestic and overseas employers, may trigger second-round inflation effects.

In view of the competing challenges of reviving the weak economy and containing the elevated inflation, coordination between monetary and fiscal policies needs to be strengthened given the limited fiscal space and the weak monetary policy transmission. Targeted temporary inflation subsidies or tax exemptions on food and energy products should continue, to protect the most vulnerable groups from the rising cost of living. The Reserve Bank through its exchange rate policy will also influence domestic fuel prices, thus easing the pressure on businesses and households from high energy costs. The Government is encouraged to invest in a more stable energy system that can ensure price stability in the medium and long run. The Reserve Bank in parallel can play a role in facilitating favourable financing options for renewable energy projects and investments, which will, in turn, reinforce Tonga's overall economic resilience.

c. Foreign Reserves

Figure 4: **Gross Official Foreign Reserves**

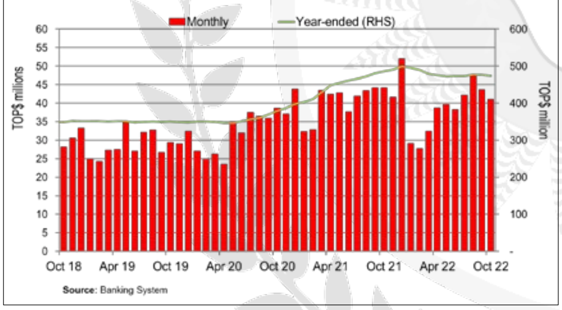


Source: Banking System; Statistics Department

Tonga's foreign reserves remain comfortable at $877.0 million by the end of October 2022, equivalent to 13.9 months of imports coverage. This is above the Reserve Bank's minimum threshold of 3 months, and the optimal level of 7.3 months projected by the IMF. Foreign reserves is 0.4% lower than it was in May 2022, as higher outflows for import and debt repayments, coupled with the declining remittances, outweighed the inflows from development partners for budget support and development projects.

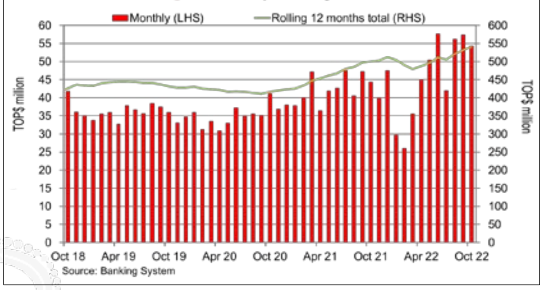
Compared to a year ago, foreign reserves have increased by 15.8% ($119.9 million). These were mostly inflows to the Government for budget support, donor funds for development projects, and external financing for the budget deficit. Private remittance receipts, however, declined over the year to October 2022 by 2.4% from the record high levels in the previous year. Additionally, the reopening of the border and the resumption of international travel diverts part of remittance receipts to travel receipts which have increased by 80.6% in the same period. Foreign exchange outflows also increased over the year to October 2022, on account of the rising import payments for goods (increased by 8.2%) and services (increased by 68.8%). This aligns with the pick-up in economic activities and the rising imported inflation. Offshore investments also rose due to lack of available domestic investment opportunities, and better yields in the overseas markets.

Figure 5: **Remittance Receipts**



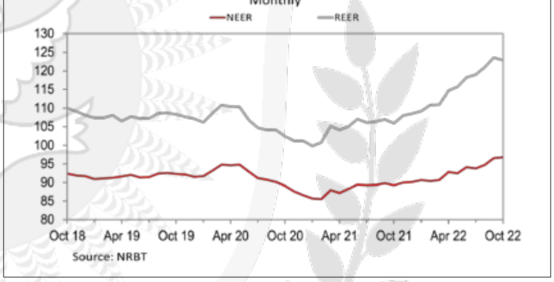
Foreign reserves is projected to still remain comfortable at around 11 months of imports cover by end of 2023, sustained by large inflows of donor funds for development projects in the near term. However, import outflows are projected to continue to increase in line with the domestic economic recovery and the relatively high imported inflation. Remittances is expected to return to pre-Covid levels, partially offset by the increase in travel receipts in line with the recovery in the tourism industry. Tonga is at high risk of debt distress as assessed by the IMF with around 87% of total public debt from external sources. Debt servicing is expected to increase substantially by 2023/24 as the principal repayment of the major EXIM loan commences (68% of external debt), putting pressure on foreign reserves in the short to medium term.

Figure 6: **Import Payments**



Safeguarding foreign reserves remains the top priority for the Reserve Bank for maintaining external and internal stability. In consideration of the anticipated pressure on the foreign reserves identified above and the weak foreign investment and export proceeds inflows, prudent management of the foreign reserves, including adopting measures to prevent any further capital outflows if needed, will continue.

Figure 7: **Nominal and Real Effective Exchange Rates**
Monthly



Despite the continued strengthening of the USD against the TOP, the Nominal Effective Exchange Rate (NEER) continued to increase over the last six months to October 2022, by 4.6% indicating a general strengthening of the TOP against most of its major trading partner currencies, except for the USD. The ongoing strengthening of the USD from the Federal Reserve's monetary policy tightening have also contributed to the strengthening of the TOP against the AUD and NZD. This has benefitted importers from New Zealand and Australia, while USD denominated importers such as oil, are worse off. The Real Effective Exchange Rate (REER) also increased by 6.2% in the same period, underpinned by Tonga's higher inflation rates compared to that of its major trading partners. Similarly, both the NEER and REER increased over the year by 8.4% and 16.0%, respectively. This implies a loss in Tonga's trade competitiveness.

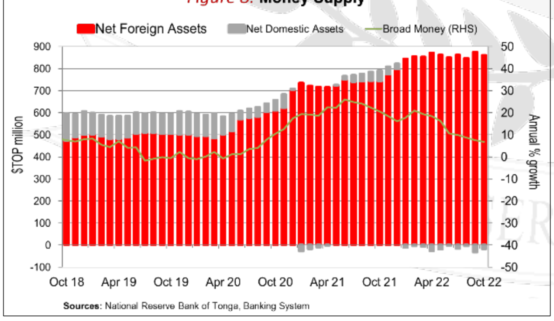
The Reserve Bank will review the exchange rate basket to ensure the weights continue to reflect the current overseas transaction patterns and the latest economic trends. The Reserve Bank will also review and set limits on the exchange rate spread for all authorised persons (banks and foreign exchange dealers) to help cushion the impact of the pressure on households and businesses' purchasing power, and contribute to reducing imported inflation.

d. Monetary Sector

The financial system remained sound during the review period, supported by the banks' strong capital position. While credit growth has started to pick up, excess liquidity remains high and the gradual widening of the weighted average interest rate spread resumes.

Money supply was recorded at $843.4 million in October 2022, 0.1% ($0.7 million) higher than in May 2022, and 6.8% ($53.7 million), higher than in October 2021. The high growth over the year was mostly from the built-up in foreign reserves. Liquidity (broad money) in the banking system, however, is 1.7% ($10.4 million) lower than it was in May 2022, on account of lower Currency in Circulation and Exchange Settlement Account (ESA) balances. Annually, liquidity rose by 12.9% ($69.0 million) reflecting large increases in the Commercial Bank's ESA. Statutory Reserve Deposits (SRD) and Currency in Circulation also increased, supporting the higher liquidity.

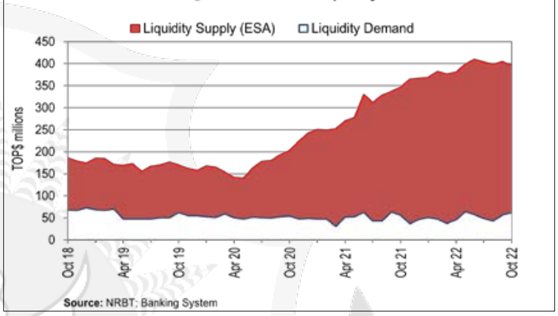
Figure 8: **Money Supply**



Sources: National Reserve Bank of Tonga, Banking System

The Reserve Bank estimates that there is excess liquidity of more than $350 million in the banking system, reflecting relatively stronger growth in liquidity supply compared to demand. Liquidity supply also includes Government funds earmarked for development projects. Against this background of excess liquidity, slow credit growth, and delayed project implementation, commercial banks are more inclined to price out any further deposit intakes to stem interest expenses. In this regard, the Reserve Bank is considering targeted mopping of the excess liquidity in the banking system by offering alternative domestic investment options to the Retirement Funds, whom are major market movers in the domestic financial system. In this regard, the excess liquidity will be retained domestically to support local investments, including climate change investments to build economic resilience.

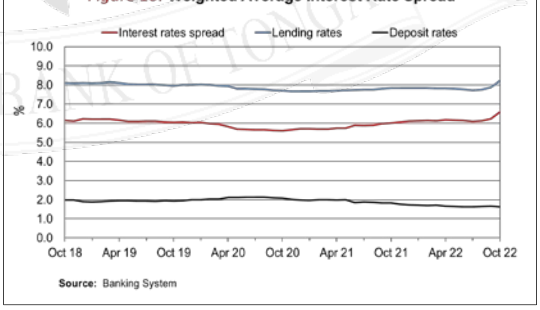
Figure 9: **Excess Liquidity**



Source: NRBT; Banking System

The weighted average interest rate spread widened over the year to October 2022 by 35.5 basis points to 6.6%. This was mostly driven by the increase in the weighted average lending rate by 36.4 basis points to 8.2%, coupled with the decline in the weighted average deposit rate by 20.6 basis points to 1.6%. The higher lending rates are mostly from higher business lending rates to the agriculture, distribution, tourism, and personal services sectors. Meanwhile, the liquidity built up in the banking system coupled with the lack of domestic investment options, continues to depress deposit rates.

Figure 10: **Weighted Average Interest Rate Spread**

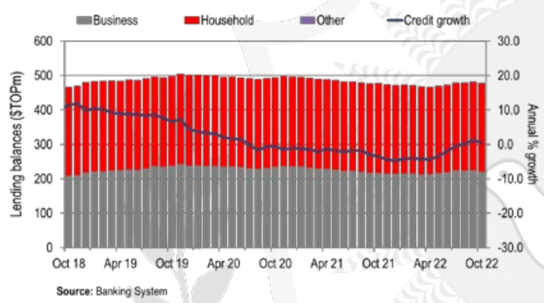


Source: Banking System

Credit growth is slowly easing out of negative territory, recording a positive annual growth of 0.4% in October 2022 compared to an annual growth of -3.4% in May

2022, and -3.5% in October 2021. Business lending rose 1.2% over the year, mostly from the distribution, construction, agriculture, and fisheries sectors. This coincides with the recovery works in these sectors from HTHH and Covid-19. The reopening of the international borders has also assisted in improving credit conditions. Household lending, however, fell by 1.1%. This was mostly from housing and other personal loans. Household indebtedness remains a barrier for household lending by the banks. Meanwhile, credit offered by non-bank institutions such as the Retirement Fund Board, South Pacific Business Development (SPBD), and Government on-lent increased by 8.1% over the year to October 2022 which are mostly lending to the informal sector and Medium, Small, and Micro Enterprises (MSMEs), and more recently to public enterprises.

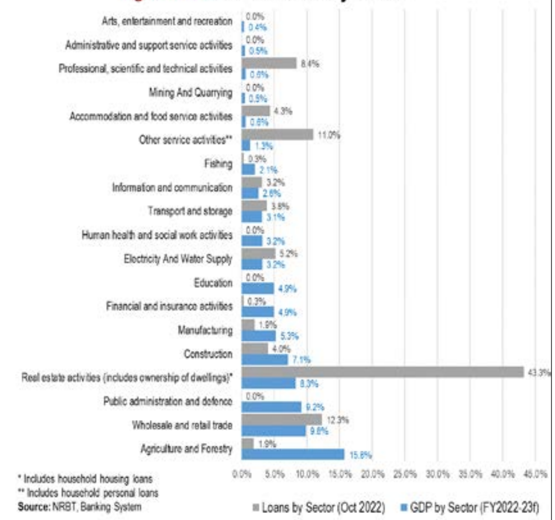
Figure 11: **Banks' Lending**



Non-performing loans are also steadily increasing, from 3.8% in October 2021, to 4.7% in May 2022, and is now at 6.5% of total loans in October 2022. The withdrawal of loan relief packages, coupled with the slow economic recovery impacting borrowers' repayment capacity have led to higher non-performing loans from both businesses and households.

Credit growth is expected to rebound by 9.1% over the year to September 2023. Stronger demand for credit is anticipated as the economy recovers, improving business confidence, and investment appetite, thereby creating more employment opportunities. The Government and Tonga Development Bank have reviewed the current Government Development Loan scheme in the effort to enhance the take up of these low-interest rate loans. Other commercial banks are also rolling out a number of loan campaigns which also supports the positive outlook. Major sectors of the economy such as agriculture, manufacturing, fishing, and construction, are under-served in terms of accessing bank financing, as reflected on Figure 12. The Reserve Bank is therefore exploring other means of facilitating loans to these sectors in order to support growth-enhancing efforts. Lending to MSMEs should also be encouraged given the significance of the informal sector in Tonga's economy.

Figure 12: **GDP vs Credit by Sector**



Banks remained profitable in the year to October 2022, although lower compared to the previous year. The return on equity was 8.6% (10.4% in May 2022 and 9.3% in October 2021), and the return on asset was 2.1% (2.5% in May 2022 and 2.4% October 2021). The deterioration of asset quality has triggered the increase of loan loss provisions, while interest income declined. Non-interest income, mostly from foreign exchange revaluations, however, increased. The anticipated positive credit growth will improve net interest income over the coming year, but at the same time, further deterioration in asset quality will continue to impact banks' profitability. Nonetheless, capital positions remain strong with the consolidated risk-weighted capital ratio at 33.1% in October 2022, more than double the minimum requirement of 15%.

e. Key Challenges

The Reserve Bank will continue to closely monitor global and domestic developments and cascading impact on its monetary policy, including the following factors beyond its control:

- Geographically isolated economy that is highly vulnerable to domestic and external shocks, global commodity price crisis, supply chain disruptions, global pandemic, natural hazards (cyclones, tsunami), as well as global financial market volatility impacting the Tongan pa'anga exchange rate.

- Narrow-based economy with limited human and financial resources, small domestic market and high costs of doing business and service delivery;
- Heavy reliance on inflows of remittances and external assistance to supplement domestic revenue;
- Data quality and limited data availability.

2. Annex 2 - Monetary Policy Objectives

The Reserve Bank's principal objectives as laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, 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.

Subject to subsections (1) and (2), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth. Safeguarding macroeconomic stability requires addressing the imbalances in key macroeconomic variables in a sustainable manner, such as the foreign reserves and current account deficit, inflation, fiscal deficit and debt levels, and risks to employment, economic growth, and financial stability. This warrants policy trade-offs that must be carefully weighed to ensure the imbalances are manageable.

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

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

In accordance with Section 50(A) of the National Reserve Bank of Tonga (Amendment) Act 2014; The Bank shall, at least every six months, publish a Monetary Policy Statement and submit a copy to the Minister. The Statement shall contain:

a. review of economic developments and the conduct of monetary policy in the period since the previous Statement;
b. a statement of how the Bank intends to conduct monetary policy over the coming six months to achieve its objectives specified under the Act; and
c. a statement of any other development outside its control, which are adversely affecting, or may adversely affect in future, the successful pursuit of the Bank's objectives under the Act.