Foreign Reserves Management: Tonga Context

Session 3: Managing Reserves in a Small Country
Speaker: Mr. Tatafu Moeaki, Governor of the National Reserve Bank of Tonga

2025 ASIAN REGIONAL FORUM
ON INVESTMENT MANAGEMENT
OF FOREIGN EXCHANGE RESERVES

Tonga Background

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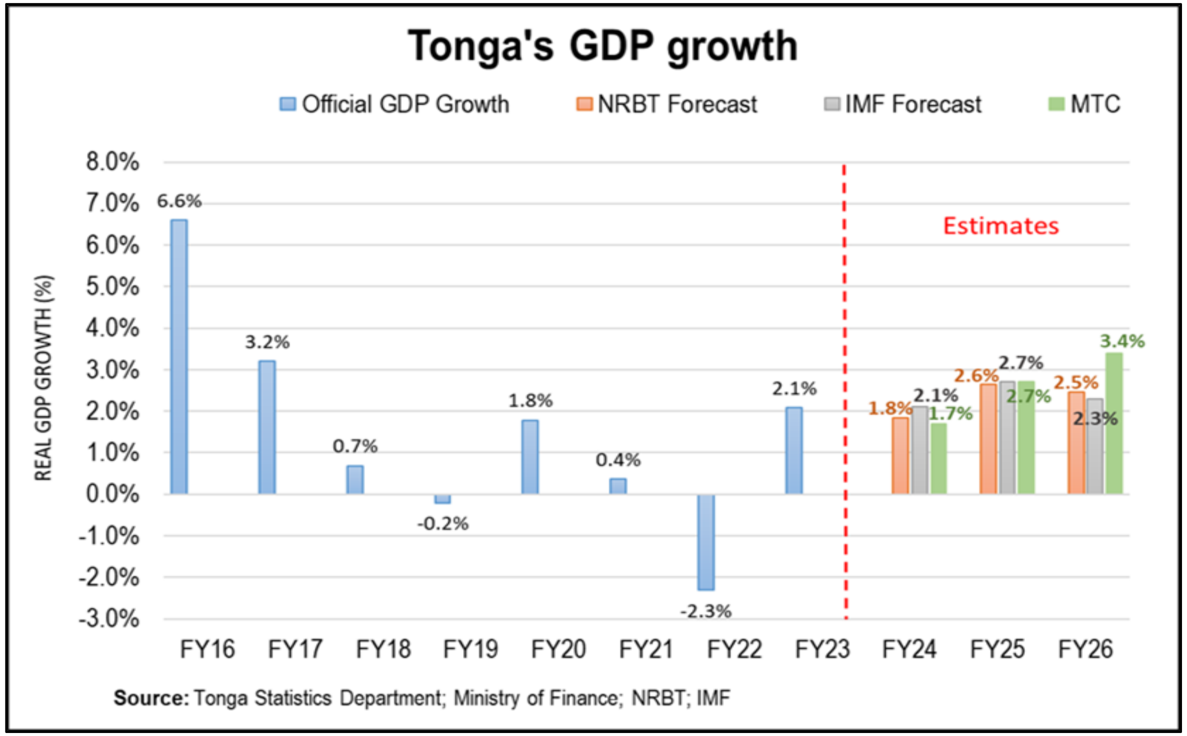
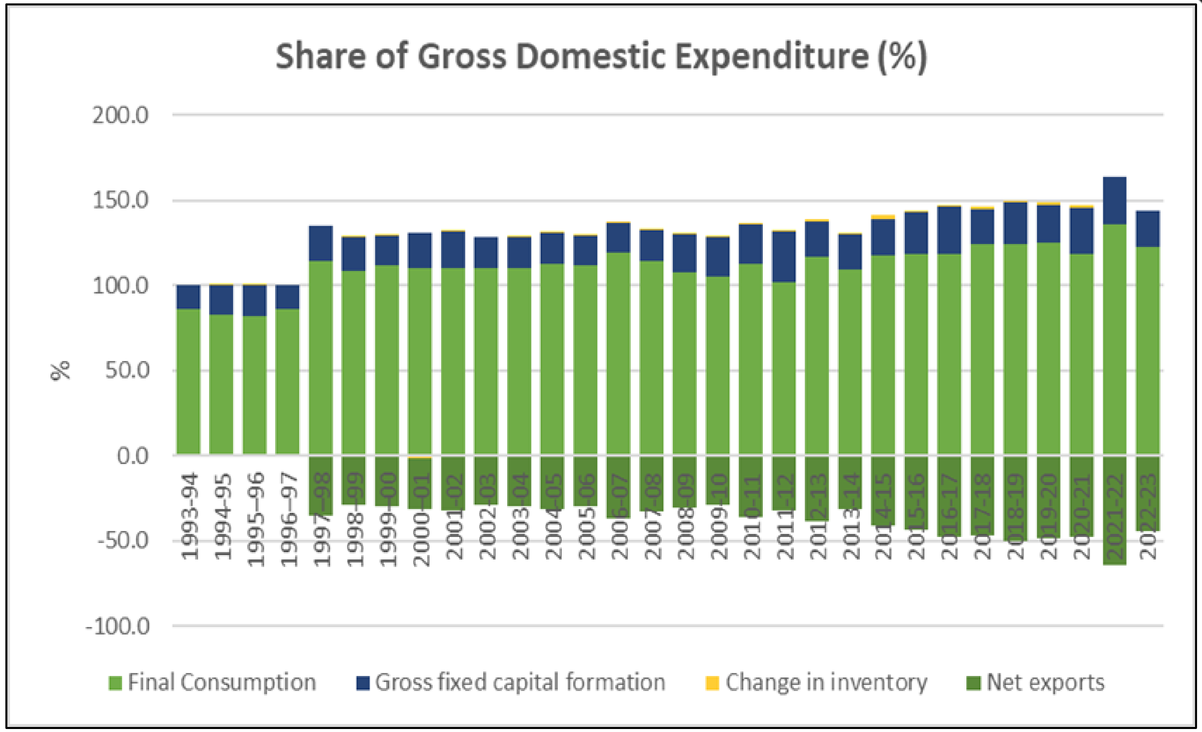


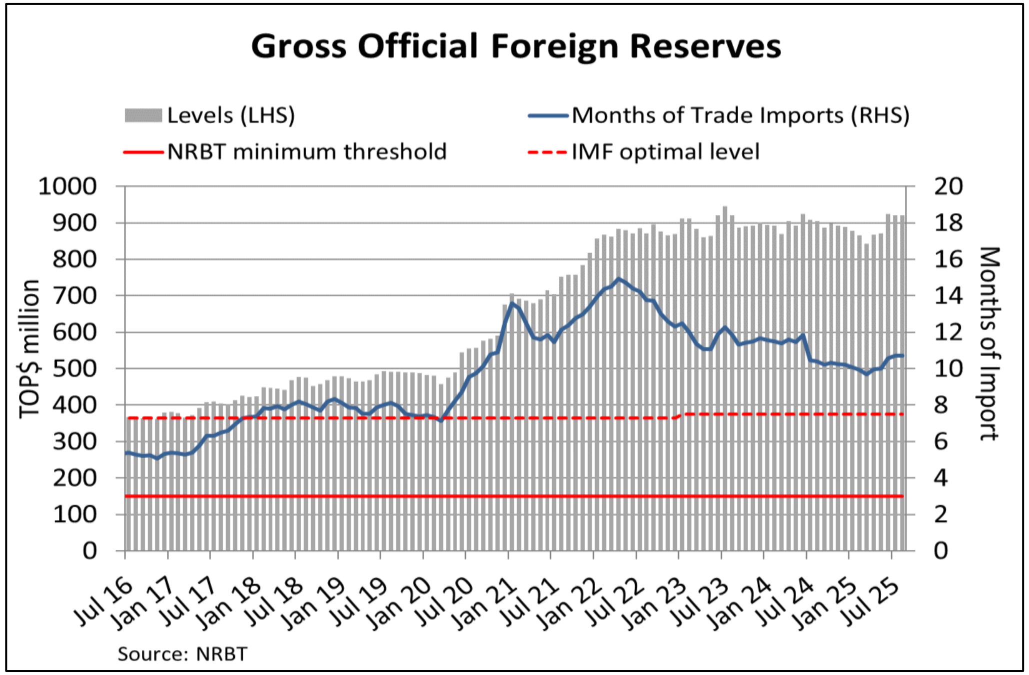
Source: Tonga Statistics Department; Ministry of Finance; NRBT; IMF

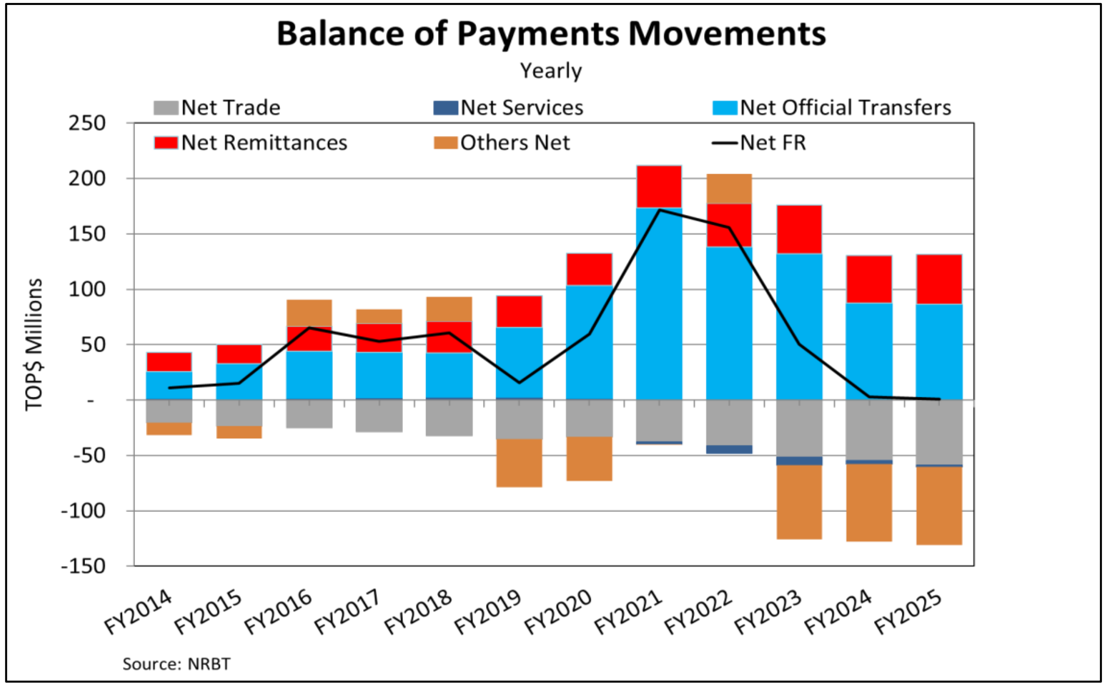


- Tonga's GDP USD$0.5 Billion/Population: 100,000
- Growth in the medium term at around 2%
- Long term growth at 1.2% below regional/global outlook.

- Tonga's vulnerability to external shocks/frequent natural hazards, high unit cost structures stemming from small market, heavy reliance on imports requires effective macro economic management.

Foreign reserves trend





- Foreign Reserves have been comfortable above optimal level at around 10 months of imports coverage
- The NRBT employs Foreign Exchange Control to protect the Foreign Reserves and the peg

- Foreign Reserves is highly vulnerable due to :
  - Heavy reliance on imports for consumption
  - Interest parity
- A drop in remittances and donor funds will have dire consequences on foreign reserves

Foreign Reserves Management

Mandate

NRBT Act Section 30(3)

" The Bank shall manage all official external reserves consistent with international best practices, and respecting safety, liquidity, and yield in that order of priority."

Approach

- External stability and protects the peg
- Large liquid holdings – exceed Tranches 1 & 2 limits
- Invest in fixed term deposits only with minimum A rating & BIS
- Currency distribution – USD, AUD, NZD only
- Actual holdings are close to benchmark holdings – minimize revaluation losses

Risk management framework

Safety risk parameters

i. Credit Risks – Invest with minimum A rated institutions and Instruments

ii. Counterparty Risks – Limits on counterparty exposure (individually and collectively – i.e. Commercial banks)

iii. Country Risks – Only G7 countries plus a few others

iv. Financial Instruments – limited to approved list (section 30(1) NRBT Act). No derivatives & equities

v. Market Risks – Foreign Currency Exposure limits and Maturity limit

Risk management framework (cont')

Liquidity risk parameters

- Liquidity Tranches
  i. Daily – Working Accounts
  ii. Short-term (<= 12 months) – Waterfall maturities ensuring adequacy.
  iii. Investment tranche (1-3 years)

Performance index

- Coverage ratio,
- Budget/benchmark: portfolio yield, investment income (interest, realized gains)

Challenges & Outlook

- Lack/limited diversification of investment instruments due to capacity constraints. Investing in bonds soon for more flexibility.
- Difficulties in establishing investment counterparties. Diversifying financial instruments can assist in risk-return trade-off considerations.
- Operational Risks – Small size: difficult to establish a Middle Office. Current practice relies on Segregation *btw* Front & Backoffice, supported by independent checks (IAD, and Risks & Compliance).
- Uncertainty in foreign reserves forecast, results in holding higher liquid tranches (Tranches 1 & 2) and fewer long-term investment (Tranche 3). Introducing bonds can add flexibility.
- Yield least priority to safety and liquidity but, main source of the Bank's income (solvency).
- ESG (Environment, social and governance) principles not incorporated in RMP, leaving a gap compared to evolving best practice.