

Economic Overview

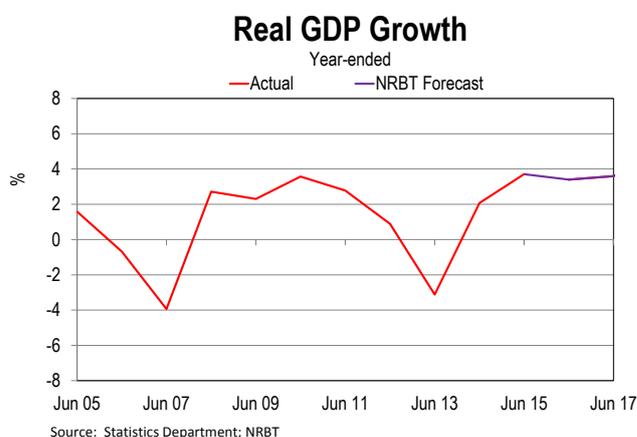
Overseas Economies

The International Monetary Fund (IMF) revised downwards its global economic growth forecast to 3.1% from 3.2%. This is due to the expected macroeconomic and political consequences of a sizeable increase in uncertainty of Britain leaving the European Union which is further expected to take a toll on confidence and investment thus affecting global financial markets. The U.S., China, Australia and New Zealand economies reportedly all experienced growth over the year ended June 2016 quarter. However GDP growth for U.S., Australia, New Zealand, and Japan are expected to slow down whilst China is expected to experience slight growth. Crude oil prices rose as a result of declines in excess oil supply.

Developments in the Domestic Economy

Domestically, real sector performances continued to support the National Reserve Bank of Tonga's (NRBT) estimated real GDP growth of 3.4% for 2015/16. This economic growth forecast, which is consistent with the IMF Article IV's projection of 3.1% growth, is supported by the rebound in the agricultural and marine sectors, and strong growth in the construction, trade, tourism and financial sectors.

Both the agricultural and marine exports have recovered during 2015/16. Total agricultural exports volume rose over the year by 379.8 tonnes (4.6%), attributed mainly to higher export volumes of squash, sweet potatoes, breadfruit and kava products. This outweighed a decline in the exports of taro, yam, coconut, watermelon, taro leaves and sandalwood. Squash exports increased the most by 1,568.7 tonnes (71.2%) followed by kava powder exports rising by 60.7 tonnes (29.7%) despite the current shortage in the supply of kava.



Higher exports of kava powder recorded in October 2015 was due to the re-opening of the market in Europe. In addition, the High Temperature Forced Air (HTFA) machine has resumed its operation at the airport thus also contributed to the rise in exports. Furthermore, the increase in the catch rate of tuna and snapper during the year contributed to a growth of marine export volumes by 723.7 metric tons (72.8%) in June 2016. The increase in the number of fishing vessels also supported the overall rise in marine exports. The continuous support from government through the Government Development Loans at Tonga Development Bank also supports the anticipated growth in the primary sector.



Local crops showcase during Agriculture Show 2016

Construction activities grew during the year with rises in individual housing loans and business loans for construction and manufacturing purposes, supporting a strong growth in the secondary sector.

The trade sector advanced over the year, supported by an increase in total number of containers registered by 1,389 registrations (16.4%). This reflected the events that occurred during the year, including the King's coronation, annual church conferences, reunions and the Tupou College Toloa 150th anniversary. Furthermore, the increasing number of imported second hand cars bought online from Japan contributed to the annual rise in vehicle registrations by 770 vehicles. The benefits of the fibre optic cable and the better internet connection facilitated the online purchasing and choice of vehicles. Fuel prices continued to decline over the year to June 2016 hence supporting the annual increase in vehicle registrations. The 5% increase in the Cost of Living Allowance (COLA) in the civil servants salaries in November 2015 also fueled strong consumer demand.

Likewise, the overall performance of the tourism industry in 2015/16 strengthened as expected by the Reserve Bank. In the year to June 2016, the total number of international arrivals increased by 13,785 passengers (14.2%). Air arrivals grew the most by 9,736 passengers (11.9%), followed by cruise ships arrivals rising by 4,022 visitors. The annual events and festivities during the year have contributed to this rise. Additionally, 14 cruise ships were recorded in 2015/16 compared to only 12 that ar-



Vava'u, Ha'apai and 'Eua Agricultural, Fisheries and Industrial Show 2016

rived in 2014/15. The introduction of the Air New Zealand Boeing 777 flights and the commencement of Fiji Airways direct flight from Fiji to Vava'u during the year also contributed to the increase.

Monetary Policy Formulation

Monetary policy actions

Over the year to June 2016, inflation remained low and foreign reserves were at a comfortable level well above the minimum range of 3-4 months of import cover; exchange rates were relatively stable and competitive; the financial system remained sound as it maintained strong capital and liquidity positions, weighted average interest rates narrowed; and the domestic economy grew strongly. Therefore the Reserve Bank maintained the current accommodative monetary policy stance.

The focus of the Reserve Bank's monetary policy actions was to consider measures to encourage the full utilization of the excess liquidity in the banking system for lending activities to support economic growth. However, as the 2016 IMF Article IV mission had recommended, the Reserve Bank will remain vigilant and will closely monitor early signs of vulnerabilities. The following policy actions are being taken by the Reserve Bank to enhance its role in promoting macroeconomic and financial stability:

- 1) Imposed a new requirement for banks to maintain a minimum loans/deposit ratio of 80% by December 2016, and progressively increase further. This is to encourage banks to utilize the excess liquidity in the banking system to lend and thereby support economic development.

- 2) Engaged technical assistance from the IMF to develop the domestic financial markets in order to be more market based, to improve the attractiveness of investments in local securities and also strengthen the monetary policy transmission mechanism. This includes considering interest rate as a new monetary policy tool.

- 3) Completed the amendment to the Foreign Exchange Control Act to improve the Reserve Bank's ability to protect the foreign reserves through the establishment of a framework for the return of proceeds of exports of goods and services rendered in Tonga, and requiring

residents' holdings overseas to be repatriated back to Tonga, and improvement to enforcement powers for the enforcement of exchange control requirements. The draft amendments are to be forwarded to the Minister of Finance for processing.

4) Completed the drafting of legislations for the supervision and regulation of microfinance institutions, money lenders, credit union. Other laws to be drafted are for the supervision of retirement funds, insurance companies, investment banks and capital markets. This would encourage improved access to finance but in a prudent way that would protect the interest of customers of the NBFIs.

5) Financial inclusion initiatives to support inclusive economic growth. This includes developing strategies and policies to improve access to financial services, by the population at large throughout Tonga, as well as supporting the development of Small to Medium Enterprises (SMEs) and their access to finance.

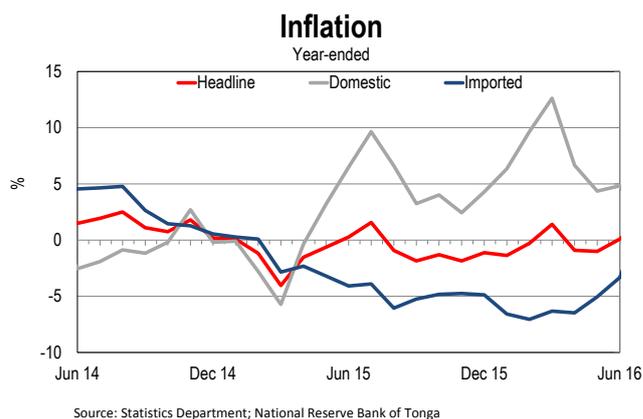
6) Amendment to the Financial Institutions Act to strengthen the controllership and receivership provisions and rename as the Banking Act as it focuses on bank supervision only.

Monetary Policy Outcomes

Headline inflation remained relatively low during 2015/16. Annual headline inflation increased by 0.1% in June 2016 following two consecutive months of deflation. A 4.8% rise in domestic prices outweighed a 3.3% decline in imported prices. High domestic prices reflected the hike in kava-Tonga prices, which has now increased by 137% over the year to \$80 per kilo. In addition, domestic food prices rose by 1.3%, reflecting high demand due to the annual church conferences and the special events that were held in June 2016 particularly the celebration of the Tupou College Toloa 150th anniversary. However, the decline in imported prices was due to a fall in prices of imported meat, fruits and vegetables.

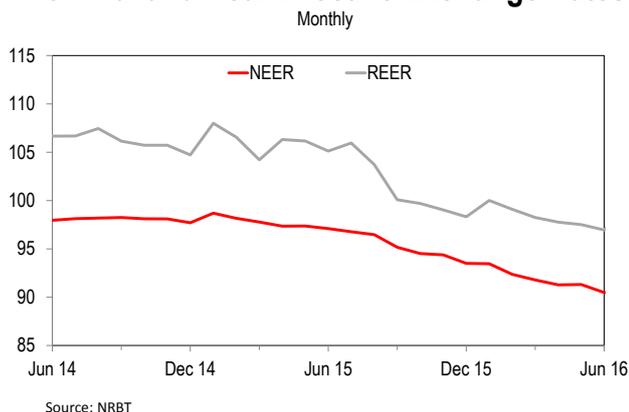
Over the year ended June 2016, total OET (Overseas Exchange Transactions) receipts rose by \$135.9 million (26.2%) to \$654.8 million driven by higher receipts of remittances, budgetary support, government grants, interbank transfers, travel and other services. Similarly,

total OET payments continued to rise by \$62.5 million (12.4%) to \$568.7 million which is attributed to higher import, services and transfer payments. The overall balance for the year ended June 2016, which is equivalent to the net change to foreign reserves, was a surplus of \$65.2 million, equivalent to USD\$29.3 million which is more than the IMF's projection of USD\$16 million. Compared to June 2015, the overall balance is now \$50 million higher than it was a year ago.



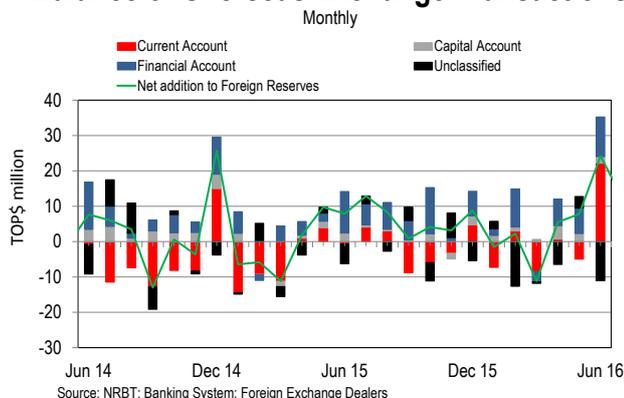
Agriculture have recovered during 2015/16.

Nominal and Real Effective Exchange Rates



Foreign reserves rose to \$354.9 million in June 2016, sufficient to cover 9.4 months of imports, well above the Reserve Bank's minimum range of 3 – 4 months. The level of foreign reserves at the end of June was equivalent to USD \$159.7 and is close to the IMF's projection of USD \$158.6 million by the end of 2015/16, but with lower months of import cover of 6.2 months. The foreign reserves press release is posted on to the website every month for the awareness of the public.

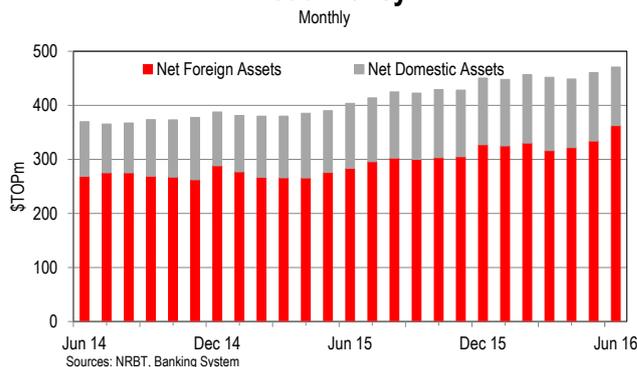
Balance of Overseas Exchange Transactions



The majority of Tonga's major trading currencies have strengthened against the Tonga Pa'anga over the year ended June 2016, namely the U.S. dollar, Australian dollar, New Zealand dollar, Fijian dollar and the Japanese Yen. As a result, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) depreciated over the year by 6.8% and 7.8% respectively. The lower REER indicates an improvement in Tonga's price competitiveness against that of its major trading partners.

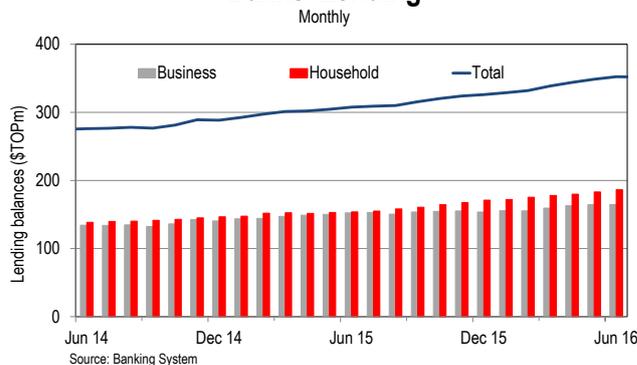
Over the year to June 2016, broad money increased by \$67.2 million (16.7%) underpinned by a significant rise in net foreign assets of \$79.3 million (28%) which outweighed a \$12.2 million (10.1%) decline in net domestic assets. This is the highest annual growth recorded for net foreign assets which is attributed mainly to the continued increase in foreign reserves. Banking system liquidity also rose over the year by \$31.1 million (13.8%) due mainly to a \$15.9 million (10.5%) rise in banks' deposits to the Reserve Bank vault.

Broad Money



In year ended terms, total bank lending rose to another record high of \$352.3 million in June 2016, increasing by \$44.7 million (14.5%) over the year ended June 2016. The increase in annual total bank lending slightly exceeded the Reserve Bank's forecast of 14.4% growth for 2015/16. Household loans remained as the main driver of the annual growth in credit. Lending activities in the non-bank financial institutions also increased over the year by \$15.2 million (14%) to \$124 million, reflecting rises in both household and business lending. Weighted average interest rate spread narrowed over the year by 27.1 basis points from 5.88%, due to declines in both the weighted average lending and deposit rates.

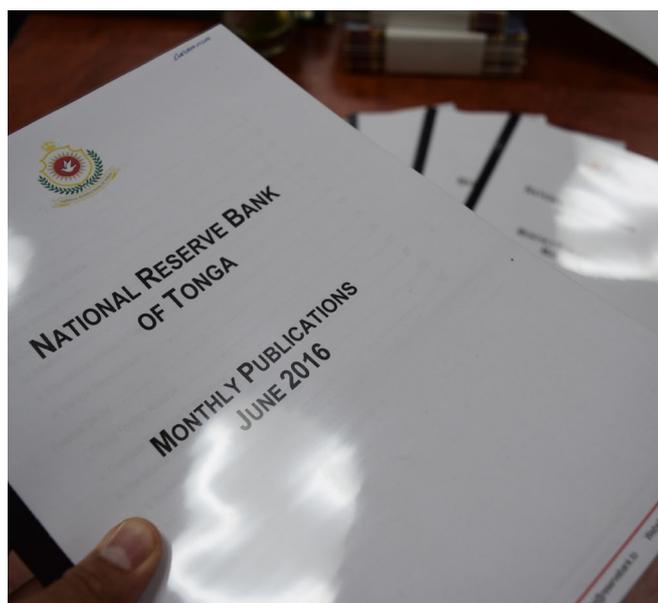
Banks' Lending



Net credit to government fell over the year by \$24.3 million due mainly to an increase in government deposits. This was due mainly to receipt of budgetary support and government grant funds during the year.



Governor's presentation during NRBT meeting with Parliamentarians



Economic monthly publications are sent to Privy Council and also posted to website