

Financial Markets Operation

Monetary Policy Formulation

The Reserve Bank's monetary policy target is to maintain adequate level of foreign reserves above 3-4 months of import cover and to promote low and stable inflation below 6% annually. Throughout the 2015/16 financial year, the level of foreign reserves remained above eight months of import cover and headline inflation remained low. The Reserve Bank's monetary policy therefore remained accommodative throughout the year.

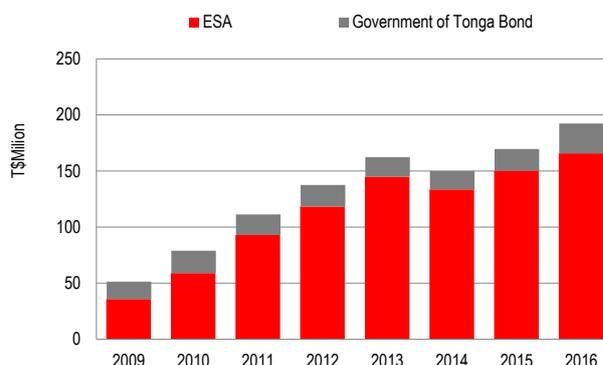
Domestic Market Operations

Given the Reserve Bank's accommodative monetary policy stance remained unchanged during the financial year 2015/16, the Reserve Bank did not issue any Reserve Bank notes. This was to continue leaving excess liquidity in the system to encourage banks to lend and support economic growth.

As of the 30 June 2016, the banking system liquidity stood at \$192.3 million, an increase from \$169.1 million at the end of June 2015. The banking system liquidity comprised mainly of \$165.7 million in the banks' Exchange Settlement Accounts (ESA) held with the Reserve Bank and \$26.6 million of Government of Tonga's Bonds held by the banks. The higher liquidity was in line with the higher foreign reserves and government bonds held by the banks.

Due to the excess liquidity in the banking system, there was no activity in the inter-bank market and similarly there were no applications for repurchase agreements during the year.

Banking System Liquidity



The Reserve Bank continued to publish financial information, such as weekly exchange rate comparisons across financial institutions, in its efforts to improve the public's understanding of financial indicators in order to make better financial decisions.

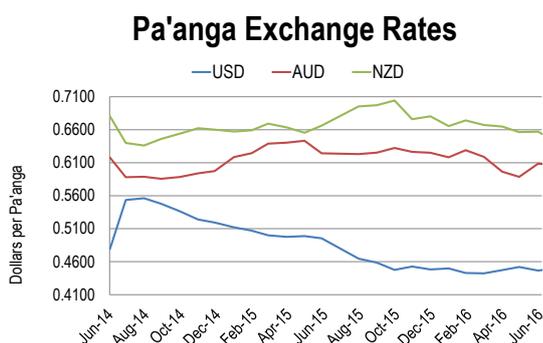
The Reserve Bank is also exploring other avenues and mechanisms in order to develop the domestic market operations in the near future to be more market oriented.

Foreign Exchange Operations

The Reserve Bank determines the rate at which the Tongan pa'anga is exchanged for foreign currencies on a daily basis by reference to a weighted basket of currencies of Tonga's major partners in foreign trade and foreign receipts and payments transactions. The exchange rates set on a daily basis generally form the basis of the commercial banks' publicly quoted foreign exchange dealing rates.

The Reserve Bank monitored the movement of the rate of exchange of the pa'anga against other currencies with a view to ensure that the country's balance of payments position and price stability are maintained at levels that are consistent with the achievement of macroeconomic stability.

The Tongan pa'anga fluctuated against the US dollar (USD) and the Australian dollar (AUD) in wider bands in 2015/16, compared to last year. This reflected the increased volatility in the USD and AUD during the year. Meanwhile, the volatility of the New Zealand dollar (NZD) was lower in 2015/16 compared to the previous year. This largely reflects the strengthening of the USD against all major currencies during the year and the AUD weakening at a relatively larger magnitude compared to the NZD due to relatively stronger economic prospects in New Zealand.



During the year, the Reserve Bank was a net purchaser in the spot foreign exchange markets. Foreign exchange purchases of T\$231.3 million exceeded sales of T\$167.7 million giving a total foreign exchange turnover for the year of T\$399 million. This is a decrease from T\$488.1 million last year. The Reserve Bank conducted foreign exchange operations for its customers, but especially the Government, and for its own account in a range of currencies.

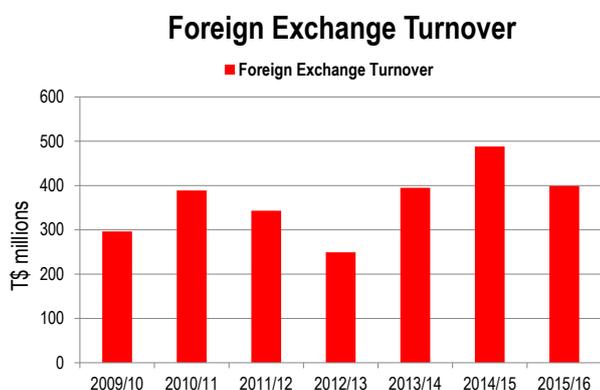
The management of the foreign reserves met the objectives of safety, liquidity and profitability. The currency composition of the foreign reserves was mainly in US dollars, Australian and the New Zealand dollars.

The Reserve Bank's investment policy is to obtain the maximum income commensurate with safety, liquidity and the maintenance of overall value which continued to be a challenge, given the uncertainty and volatility in the global financial markets and continued low interest rates in the trading partner countries. The currency composition therefore deviated from the benchmark portfolio but remained within the Board approved limit, in order to maximize income and maintain the value of the foreign reserves. The currency composition exposes the Bank to exchange rate risk. However, the Reserve Bank continued to closely monitor the implications of the movements of the exchange rates on the value of the foreign reserves. Despite lower interest rates in the global markets and the general weakening of the NZD and AUD, the income on the investment of the foreign reserves increased by \$2.8 million compared with the previous year, which is in line with the significant increase in the level of foreign reserves of \$65.2 million.

Foreign Reserves Management

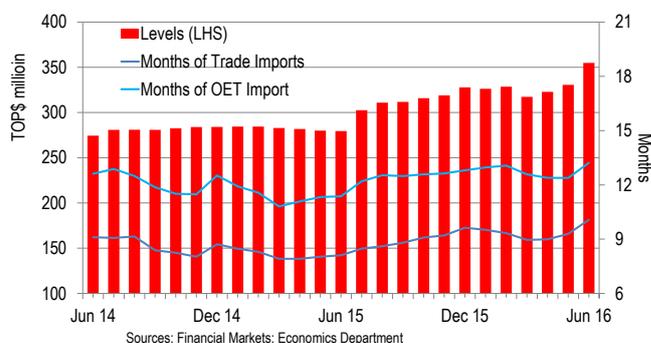
The Reserve Bank Portfolio

The gross official foreign reserves was maintained well above the benchmark of 3 to 4 months of imports. As at the end of June 2016 the level of foreign reserves peaked at a record high of T\$354.9 million, equivalent to 10.1 months of import cover compared to T\$289.7 million and 8.1 months of import as at 30 June 2015. The significant increase in the level of foreign reserves was attributed mainly to receipts of budget support for the Government. The foreign reserves ranged between 8.5 months and 10.1 months of import cover during the year.



Gross Official Foreign Reserves

Monthly



The Reserve Bank complied with all the Board approved risk parameters for the management of the foreign reserves during the year and ensured that investments were held with banks rated above the Board approved minimum “A” rating by international credit rating agencies.

Exchange Control Operations

During 2015/16, the Reserve Bank processed 824 exchange control applications for current payments of amounts above the delegated limit of \$100,000 and all capital payments as stipulated in the Exchange Control policy guidelines. The approved exchange control applications amounted to T\$198.3 million in 2015/16 (of which 12% were classified as capital transactions) compared to the 722 exchange control applications (11% capital transactions) processed in 2014/15 amounting to T\$212.3 million. The increase in the number of exchange control applications while the total amount of the applications decreased reflects the rising number of lower valued applications processed during the year. The exchange control unit achieved its target for a half day turnaround time for processing and approval of applications, provided that all the submitted documents do meet the requirements. The exchange control data on foreign currency payments by large importers were key inputs to the Reserve Bank’s foreign reserves forecast and monetary policy decisions.

The Reserve Bank also received 72 applications for the removal of cash, both Tongan pa’anga and foreign currency notes, totaling T\$10,000 and above across the border, of which all applications were approved and amounted to a total of T\$50.7 million. This is an increase from 47 applications totaling T\$35.6 million last year. This

increase is attributed to more applications for exports of cash by banks and foreign exchange dealers due to the more favorable exchange rates offered overseas. The exchange control unit also notified the Ministry of Revenues and Customs of all approved applications for exports of cash, two (2) days before the date of travel, with some exceptions due to late submission from banks and authorized restricted foreign exchange dealers.

Quarterly spot checks were conducted during the year to ensure banks and authorized restricted foreign exchange dealers were compliant with the exchange control guidelines. Meanwhile, internal monitoring of compliance is also carried out through other reports such as the Overseas exchange transactions, Foreign exchange transactions with value that is equivalent to T\$50,000 and above, Forward exchange contracts and the Foreign currency accounts. The annual review of the Exchange Control Policy Guidelines was completed during the year and came into effect on 1st July 2016. Press releases were posted on the website, and trainings with the banks and authorized restricted foreign exchange dealers were conducted to keep them informed of the any revisions to the exchange control guidelines and to also raise issues identified from the spot checks. The Reserve Bank still continued to issue the Gift list for those who have reached their annual delegated limit.

The review of the Foreign Exchange Control Act is in progress to be finalized in 2016/17. One of the main objectives of this review is to ensure that all foreign exchange due to Tonga such as exports proceeds are better captured. This would support the Reserve Bank’s role of protecting the foreign reserves. In addition, the Reserve Bank’s enforcement powers will be strengthened.