

**NATIONAL RESERVE BANK  
OF TONGA**

**Monetary Policy Statement**  
February 2016

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Issued by: National Reserve Bank of Tonga  
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## List of abbreviations

AFI	Alliance for Financial Inclusion
AML/CFT	Anti-Money Laundering/Counter Terrorist Financing
AUD	Australian Dollar
COLA	Cost of Living Allowance
ECB	European Central Bank
ESA	Exchange Settlement Accounts
EXIM	Export-Import
FDEF	Fisheries Development and Export Fund
FEC	Foreign Exchange Control
FED	Foreign Exchange Dealers
GDP	Gross Domestic Product
GNP	Gross National Disposable
IDH	International Dateline Hotel
IMF	International Monetary Fund
JPY	Japanese Yen
LDS	Latter Day Saints
MAFFF	Ministry of Agriculture, Food, Forests & Fisheries
MPS	Monetary Policy Statement
NBFIs	Non-Bank Financial Institutions
NEER	Nominal Effective Exchange Rate
NPAT	Net Profit After Tax
NRBT	National Reserve Bank of Tonga
NZ	New Zealand
NZD	New Zealand Dollar
OET	Overseas Exchange Transactions
OPEC	Organization of the Petroleum Exporting Countries
PNG	Papua New Guinea
PG	Pacific Games
REER	Real Effective Exchange Rate
RFB	Retirement Fund Board
ROA	Return on Assets
ROE	Return on Equity
RSE	Regional Seasonal Employers
SMEs	Small to Medium Enterprises
TCT	Tupou College Toloa
TDB	Tonga Development Bank
TDoS	Tonga Department of Statistics
THS	Tonga High School
TOP	Tongan Pa'anga
US	United States
USD	United States Dollar
WEO	World Economic Outlook

## Overview

### Recent Development

The National Reserve Bank of Tonga's (NRBT) is tasked with the objectives to maintain internal and external monetary stability, promote financial stability and a sound and efficient financial system, and to conduct its activities in a manner that supports macroeconomic stability and promote economic growth by ensuring adequate level of foreign reserves and low and stable inflation are maintained. In the past six months to February 2016, these objectives were observed.

The economic growth prospects look promising. The NRBT projected strong growth for real gross domestic product (GDP) over the three consecutive financial years 2014/15 through to 2016/17. Growth is expected to be driven by the construction, trade and tourism sectors. The Department of Statistics has yet to release its official estimates for 2014/15 financial year. The NRBT estimated Tonga's economy to have grown strongly in 2014/15. Estimates were slightly revised upwards from the previously published projection in the August 2015 Monetary Policy Statement (MPS) due to new data received from the Ministry of Agriculture, Food, Forestry and Fisheries (MAFFF) for the fisheries sector. The NRBT expected the economy to have expanded by 3.3% in 2015/16, consistent with the International Monetary Fund (IMF) Article IV projection of 3.1% growth.

Inflationary pressures continued to ease in 2015 as annual deflation was recorded almost throughout the entire year. On an annual basis, February 2016 recorded a deflation of 0.3% compared with a deflation of 1.2% in February 2015 which is well below the NRBT's reference range of 6-8%.

The balance of overseas exchange transactions (OET), which is equivalent to the net change in the foreign reserves, deteriorated over the past six months to February 2016 to a surplus of \$17.6 million. This is 40.3% lower than the \$29.5 million surplus in the past six months to August 2015. This was due to a higher deficit in the current account at the end of the six months to February 2016, compared to a surplus in the past six months to

August 2015. This was a result of increasing import payments over the last six months.

The level of foreign reserves continued to rise and remained above 3-4 months of import cover bolstered by higher export proceeds, travel receipts, and remittances, as well as the receipt of foreign aid from donor partners including budgetary support for the government. In February 2016, foreign reserves reached another record high of \$328.5 million, sufficient to cover 9.3 months of imports, well above the NRBT's minimum range of 3-4 months.

The financial system remained sound over the 6 months to February 2016 as the banking system continued to be profitable and maintained strong capital and liquidity positions. Broad money increased to its highest record of \$456.5 million compared to \$424.2 million in August 2015. Banking system liquidity also grew by 6.4% to a new record high of \$177.9 million. Banks' weighted average interest rate spread continued to narrow in February 2016 to 5.84% from 5.98% in August 2015. Total bank lending rose over the 6 months to February 2016 by 7.1% to its highest level of \$331.9 million compared to a 4.2% growth in the 6 months to August 2015.

The banking system data showed the net credit to government fell by 3.0% over the six months to February 2016, compared to an increase of about 11.0% over the six months to August 2015.

### Outlook

The NRBT anticipates economic growth to slightly ease to 1.9% in 2016/17, which is still well above the average growth of 1.4% of the past ten years for Tonga. This follows after a period of strong growth in the previous years. Inflationary pressure is expected to remain low in the remaining months of 2015/16, and to record an annual deflation of 0.6% in June 2016 then increase to a peak of 3.8% annual inflation at the end of 2016.

The level of foreign reserves is expected to remain comfortably above the minimum range to June 2017. The deficit in the trade balance is expected to narrow with higher imports being fuelled by anticipated

higher export receipts and firmer lending outcomes. Remittances and travel receipts are expected to remain high due to upcoming festivities.

Credit growth is forecasted to continue and a growth of about 14.4% to be recorded at the end of the 2015/16 and 11% in 2016/17. This coincides with the IMF Article IV projection of 15.5% growth for 2015/16 and 10.8% for 2016/17. The NRBT's proposed policy measures that are currently being discussed with the banks, such as a target on banks' loans/deposit ratios to encourage further lending, should also support the anticipated continued growth in credit and broad money. At the same time, it is important for the structural reforms in different sectors as well as other impediments to lending such as the improvement to the land administrative system and the bankruptcy laws to improve the confidence of the banks to lend further in a prudent manner.

Net credit to the government is also expected to increase, coinciding with the higher liquidity within the banking system and broad money. However, this is also subject to the proposed expenditure in the financial year 2016/17 budget estimate, which is due

to be released in June 2016. NRBT will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

In light of recent developments and the outlook on the monetary policy targets, the current accommodative monetary policy stance is therefore considered appropriate in the medium term. However, as the 2016 IMF Article IV mission had recommended, the NRBT will remain vigilant and closely monitor early signs of vulnerabilities. At the same time, the NRBT is reviewing and imposing new policies to enhance its role in promoting macroeconomic and financial stability.



Sione Ngongo Kioa  
**Governor**

# 1. Global Developments

## World Growth

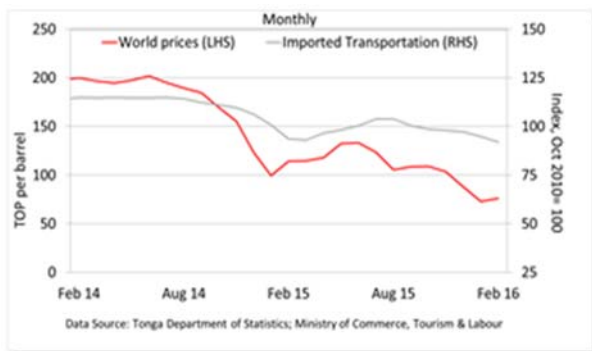
Global recovery has slowed owing to an increasing financial turbulence, falling commodity and asset prices and noticeable slowdown in trade. The IMF in its April 2016 World Economic Outlook (WEO) has downgraded its global growth projection to 3.2% in 2016 and 3.5% in 2017. This is relative to its October 2015 projection of 3.6% and 3.8% in 2016 and 2017 respectively. Growth in advanced economies is expected to remain modest and growth in emerging markets remained uneven and generally weaker, particularly for oil exporting countries. At the same time, downside risks to the global outlook have increased.

Monetary policy remains accommodative in advanced economies while fiscal policy was somewhat expansionary in some countries such as in the United States (US) and to some extent contractionary as in Japan. In December 2015, the U.S. Federal Reserve Bank raised policy rates above the zero lower bound for the first time since 2009 and may adjust in the future depending on data available. The European Central Bank (ECB) also announced further easing measures and a further reduction in all policy rates in March 2016. The Bank of Japan introduced a negative interest rates on marginal excess reserves in late January and the Central Bank of China cut the required reserve ratio.

## World Oil Prices

World oil prices averaged around US\$41.26/barrel in February 2016 compared to an average of US\$58.36/barrel in August 2015 and US\$70.40 per

Figure 1: World Oil Prices



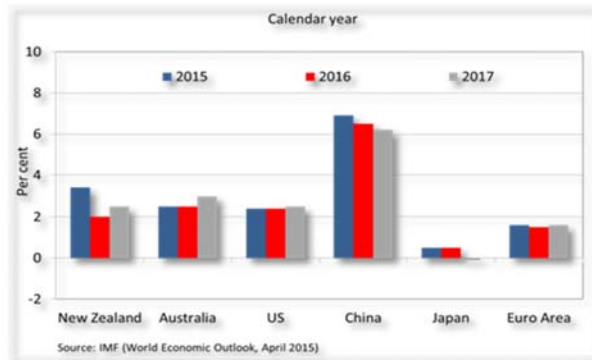
barrel a year ago. The declining oil price is due to strong supply from members of the Organization of the Petroleum Exporting Countries (OPEC) and Russia, and expectations of higher supply from the Islamic Republic of Iran. According to the IMF April 2016 WEO Update, the assumed average price of oil based on futures markets is US\$34.75/barrel in 2016 and US\$40.99/barrel in 2017 relative to US\$50.79/barrel in 2015.

## Advanced Economies

Economic growth in China is projected to slow to 6.5% in 2016 and 6.2% in 2017. The slowdown has been driven mainly by investment and exports after an extended period of very rapid growth. Given China's large share of global growth and investment, the slowdown in growth has caused both direct and indirect sizable global spillover effects through trade channels, affecting other countries exchange rates and asset markets. Economic growth in China, however, was slightly stronger than expected in the April 2016 WEO updates due to strong domestic consumption and robust growth in the services sector offsetting a decline in manufacturing activity. Inflation is expected to remain low around 1.8% in 2016 due to lower commodity prices, the appreciation of the Chinese renminbi and weaker domestic demand.

In the US, growth in economic activity fell to 1.4% in the December 2015 quarter as economic conditions weakened due to very weak exports and domestic demand as well as declining

Figure 2: Growth Projection in the Advanced Economies





non-residential investment including outside the energy sector. Despite signs of weakening growth, labour market indicators continued to improve. In particular, employment growth was very strong, labour force participation rebounded, and the unemployment rate continued its downward trend. Inflation is projected to rise from 0.1% in 2015 to 0.8% in 2016. The stronger US dollar and lower oil prices, however, exert downward pressure on prices.

In Japan, economic activity is expected to remain weak primarily reflecting a declining labour force. A growth of 0.5% is anticipated for 2016 and to worsen in 2017 to a negative growth of 0.1% reflecting the effects of a 2 percentage points increase in the consumption tax rate. The appreciation of the Japanese Yen together with weaker demand from emerging markets are projected to restrain activity during the first half of 2016. The negative interest rates on marginal excess reserve deposits adopted in February by the Bank of Japan is expected to support private demand. A deflation of 0.2% is expected in 2016 due to lower energy prices and the strengthening of the Japanese yen. In the medium term, inflation is projected to be between 1.0% to 1.5%.

Economic activity in the Euro zone is gradually recovering. The unemployment rate has continued its gradual decline and employment growth has

increased steadily. Headline inflation is forecasted to reach 0.9% in 2016 and to increase further to 1.2% in 2017.

The Australian economy is continuing to rebalance following the mining investment boom. Consistent with developments in the labour market, overall GDP growth is anticipated to remain at 2.5% in 2016 and to pick up in 2017 by 3.0%. The Australian dollar (AUD) has appreciated recently. The Australian labour market conditions have improved. Employment grew strongly and the unemployment rate is projected to fall from 6.1% in 2015 to 5.9% and 5.8% in 2016 and 2017 respectively. Wage growth in the final months of 2015 grew strongly. Inflation expectations remain low.

In New Zealand (NZ), GDP growth is projected to weaken in 2016 recording a growth of 2.0% and to pick up further in 2017 by 2.5%. Growth in housing price in Auckland declined in late 2015, possibly due to recent changes to taxation and the tightening of lending regulations to investors in Auckland. Dairy prices are around their lowest level in a decade and the prices of NZ's commodity exports have declined to below their decade average. With inflation remaining low and a moderation in the pace of employment growth, the Reserve Bank of NZ cut its policy rate by a cumulative 100 basis points over 2015. Inflation is expected to increase to 4.0% in 2016 and decline to 1.8% in 2017.

Table 1: World Data (Real GDP Growth, Inflation, and Unemployment)

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2015	2016 <sup>f</sup>	2017 <sup>f</sup>	2015	2016 <sup>f</sup>	2017 <sup>f</sup>	2015	2016 <sup>f</sup>	2017 <sup>f</sup>
World Growth	3.1	3.2	3.5						
New Zealand	3.4	2.0	2.5	0.3	1.5	1.9	5.8	5.9	5.8
Australia	2.5	2.5	3.0	1.5	2.1	2.4	6.1	5.9	5.8
United States	2.4	2.4	2.5	0.1	0.8	1.5	5.3	4.9	4.8
China	6.9	6.5	6.2	1.4	1.8	2.0	4.1	4.1	4.1
Japan	0.5	0.5	-0.1	0.8	-0.2	1.2	3.4	3.3	3.3
Euro Area	1.6	1.5	1.6	0.2	0.9	1.2	10.9	10.3	9.9

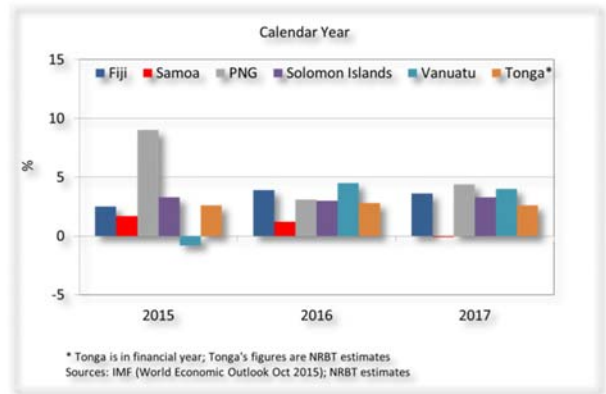
Note: f – forecast; \* for month of December

Source: IMF (World Economic Outlook, April 2016)

### South Pacific Economies

Most South Pacific economies have continued to show signs of recovery in 2016 and 2017, benefitting from the lower global oil prices. Growth in the South Pacific region is expected to remain generally moderate. While the global recovery is weakening, unemployment rates continue to decline helping the Pacific economies. Remittances and tourist inflows are expected to pick up in line with the improvement in economic conditions across the region. Growth in Papua New Guinea (PNG) and Fiji is expected to weaken due to the impact of lower commodity prices affecting PNG and the cyclone that hit Fiji in early 2016.

Figure 3: Growth Projections in the Pacific

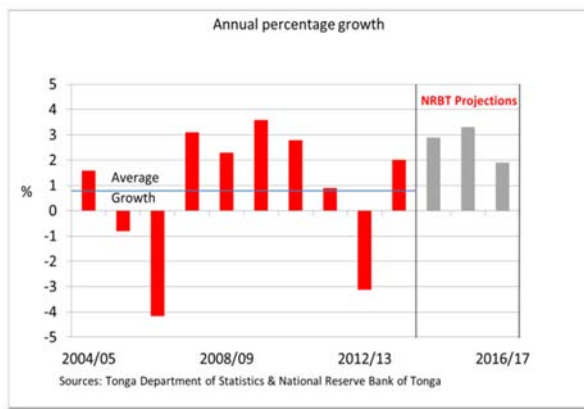


## 2. Tonga's Economic Growth

### Real GDP Growth

Domestic economic growth prospects look promising. The NRBT projects strong growth for real GDP over the three consecutive financial years, 2014/15 through to 2016/17. Growth is expected to be driven by the construction, trade and tourism sectors. TDoS has yet to release its official estimates for 2014/15 financial year. The NRBT estimates the economy to have grown strongly in 2014/15. Estimates were slightly revised upwards from the previously published projection in the August 2015 MPS due to new data received for the fisheries sector from MAFFF.

Figure 4: Real GDP Growth



In 2015/16, the NRBT expects the economy to have expanded by 3.3%, consistent with the IMF Article IV projection of 3.1% growth. The NRBT's forecast reflects the impacts of a rebound in the agricultural sector, strong growth from the fisheries sector as well as expected developments in the construction, trade and financial intermediation sectors. The upcoming Tupou College Toloa's 150<sup>th</sup> Anniversary, annual church conferences and family reunions held in Tonga in December 2015 support the expected growth in the trade sector.

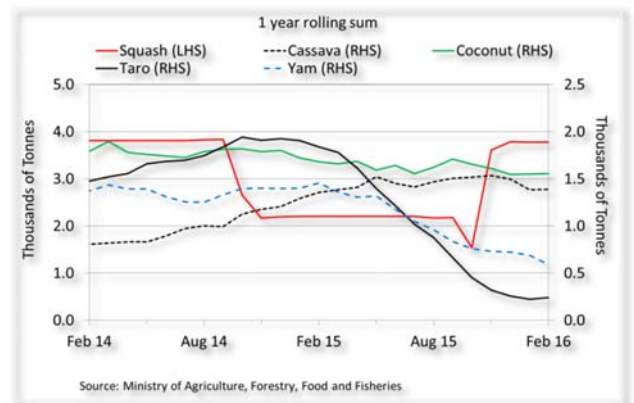
The NRBT anticipates economic growth to slightly ease to 1.9% in 2016/17, which is still well above the average growth of 1.4% of the past ten years for Tonga. This follows after a period of strong growth in the previous years due to one-off events that happened during 2015/16, including the King's

coronation and the Tupou College Toloa's (TCT) 150<sup>th</sup> anniversary which will take place before the end of 2015/16. Growth is expected to be driven by the agricultural, financial intermediation, construction, manufacturing and tourism sectors. The IMF Article IV indicated growth of around 2.5% – 3.0% over the medium term.

### Primary Production

The agricultural sector is expected to rebound in 2015/16 and to record a growth of 2.0% as the sector recovers from the drought and cyclone effects of the previous years. Weather conditions have been favourable resulting in a significant increase in the 2015 squash yields by 1,568.7 tonnes (71.2%) in the first eight months of 2015/16. Exports of sweet potatoes and kava products also rose by 30.1 tonnes (67.2%) and 78.2 tonnes (53.2%) respectively. In addition, the increase in the export of mulberry juice and green coconut further contributed to the agricultural sector growth.

Figure 5: Volumes of Major Agricultural Exports



Banking system data for the first eight months of 2015/16 revealed a \$1 million (18.7%) increase in the proceeds for the export of agricultural products to \$5.1 million. The strengthening of the US dollar (USD), Japanese Yen (JPY) and (AUD) against the Tongan Pa'anga (TOP) supports the higher receipts from the exports of squash and kava powder.

Both volumes for export and domestic production are anticipated to increase in 2016/17 supporting the expected 3.0% growth. The active Agricultural Growth Committee together with the continuous support of the MAFFF supports development in this sector. This includes the improvement of the existing infrastructures for farmers such as the packing house

Table 2: Real GDP Growth Forecast

	Official Jun-14	Jun-15 (Aug-15 MPS) %	Jun-15 (Revised) %	Jun-16 (Aug-15 MPS) %	Jun-16 (Revised) %	Jun-17 (Forecast) %
<b>GDP</b>	2.0	2.5	2.6	3.3	3.3	1.9
<b>Primary production</b>	3.1	-2.4	-1.7	2.1	2.3	2.9
Agriculture	4.7	-3.0	-3.0	2.0	2.0	3.0
Forestry	4.3	0.0	5.5	1.0	-2.0	3.0
Fishing	-5.9	1.0	5.0	3.0	5.0	2.0
<b>Secondary production</b>	1.3	5.5	5.3	5.4	5.3	2.6
Mining and quarrying	3.2	4.0	4.0	3.0	3.0	2.0
Manufacturing	0.0	3.0	3.0	3.0	3.0	3.0
Utilities	-1.2	5.0	4.0	3.5	3.5	1.0
Construction	3.4	8.0	8.0	8.0	8.0	3.0
<b>Tertiary production</b>	1.6	3.4	3.4	3.3	3.5	1.6
Trade	1.1	5.0	5.0	4.0	5.0	0.1
Hotels, restaurants	-0.4	5.0	5.0	5.0	4.0	2.0
Transport, communication	0.6	5.0	5.0	5.0	5.0	1.0
Financial intermediation	4.6	6.2	6.2	6.0	6.0	5.0
Real estate, business services	1.5	3.0	3.0	3.0	3.0	1.5
Public administration	0.4	2.0	2.0	2.0	2.0	1.0
Education	12.0	2.0	2.0	2.0	2.0	2.0
Health and social work	8.3	1.0	1.0	1.0	1.0	1.5
Recreational, cultural activities	1.4	1.5	1.5	2.0	2.0	2.0
Other community services	2.0	2.0	2.0	2.0	2.0	2.0
Ownership of dwellings	0.4	1.5	1.5	2.0	2.0	2.0
Other*	4.1	1.0	1.0	1.5	1.0	1.0

\* Includes taxes minus subsidies and imputed bank service charges

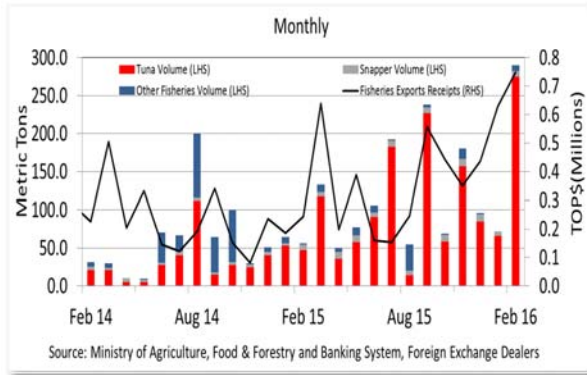
Source: Department of Statistics, NRBT

facilities, High Temperature Forced Air (HTFA) facility resuming operation, new market access request to China, introduction of new products to export such as chillies, eggplant & watermelon and the opening of a Kava export market in Europe. The government's continued assistance to the growers through the managed fund loan scheme at TDB also supports the anticipated positive growth in the coming years. Uncertainty in weather conditions poses the most serious risk to the outlook of the sector.

Strong performance in the fisheries sector drove the slight increase in the revised primary production

growth of 5.0% for 2015/16. A total of 25 fishing vessels were licensed in 2015 compared to 17 boats in 2014. According to data received from MAFFF, the total quantity of fisheries exports in the first half of 2015/16 up to February 2016 increased by 559.7 metric tons (89%) compared to the same period of 2014/15. This was mainly driven by a significant increase in tuna exports by 704 metric tons (194%) and a 28 metric tons (78.5%) rise in exports of snapper. The overseas exchange transactions (OET) data compiled by the NRBT, showed that proceeds from the export of fisheries and other marine products increased by \$1.5 million (50.8%) to \$4.5 million in the same period compared to a year ago.

Figure 6: Fishery Exports



MAFFF indicated plans for the expansion of the pearl industry and new markets available for seaweed exports in the coming year, which contributes to the expected 2.0% growth for the fisheries sector in 2016/17. This sector continues to benefit from the consumption tax and custom duty exemptions on oil and fishing gear, as well as the Fisheries Development and Export Fund (FDEF) initiatives by the government which is facilitated by the TDB. MAFFF is also negotiating with one of the donors for loan guarantee funds to increase the amount of loan funds available to a person or enterprise involved in fishing beyond its own collateral limits.

A substantial reduction in sandalwood exports by 7.9 tonnes (93.5%) in the first eight months of 2015/16 explained the revised negative growth of 2.0% in the forestry sector for 2015/16. The NRBT expects this sector to revert back to average growth of 3% in the years to come.

### Secondary Production

Strong growth in the construction sector drives the positive outlook for secondary production. Increases in individual housing loans and business loans for construction and manufacturing also support the expansion. The completion of major construction projects during 2015/16 supports growth. This includes the upgrade of the Fua'amotu International Airport in Tongatapu and Lupepau'u International Airport in Vava'u, Retirement Fund Board building, new buildings for the Ministry of Police, and the Adiloas building to name a few. The on-going constructions including the St. George Palace,

renovation of the International Dateline Hotel (IDH) by the Tanoa Group, LDS chapels, major upgrade and extension of Nuku'alofa's domestic wharf and various other construction projects are contributing to a strong positive growth in 2015/16 and 2016/17.

The developments in the construction sector are expected to have spillover effects on mining and quarrying activities, manufacturing, utilities sector and other sectors of the economy. Electricity consumption rose by 6.0% in the first half of 2015/16 to February 2016 coinciding with a 6.9% increase in electricity production and 1,328 more electricity consumers. Handicrafts also have the potential to further boost its growth in line with the expected growth in the tourism sector.

A number of both public and private construction projects are already in the pipeline, such as a new hospital for Niuaotupapu, preparations for the Pacific Games in 2019 and other projects will also help to boost activities in the sector.

### Tertiary Production

Partial indicators revealed strong consumption activities and signal a very strong growth in the trade sector in 2015/16. Eight months into 2015/16, imports of wholesale and retail goods were 2.1% higher supported by a 18.4% rise in container registrations. Vehicle registrations increased by 36.0% reflecting higher demand for imported second-hand vehicles from the Japanese market. The lower global oil prices continued to benefit the transportation sector and giving consumers more purchasing power. The major upgrade and extension of the Nuku'alofa wharf will contribute significantly in improving the safety and quality of domestic inter-island shipping. This is the fundamental means of transportation to and from the outer islands to the main island, which would further support economic activity.

Furthermore, bank's lending to households grew by 14.2% over the same period benefitting the trade sector. The 5% increase in the Cost of Living Allowance (COLA) in the civil servants' salaries also

Figure 7: Import Indicators

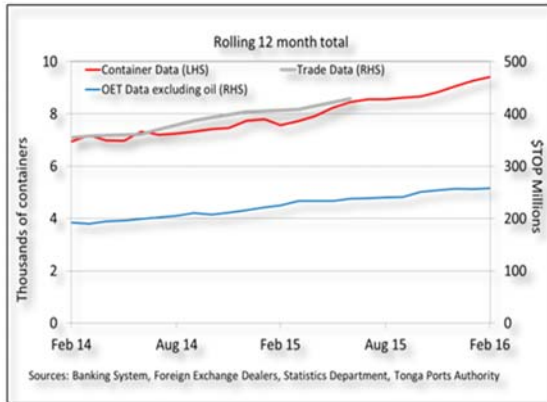
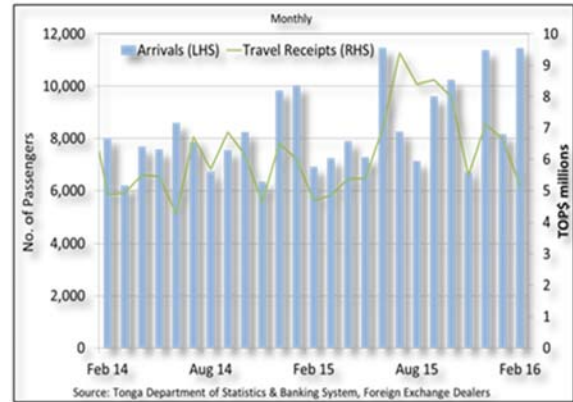


Figure 8: International Air Arrivals & Travel Receipts



drove strong consumer demand. On the outlook, scheduled events for this year such as the TCT 150<sup>th</sup> anniversary, 100<sup>th</sup> anniversary of the LDS and annual church conferences will lift growth in the trade sector. These events will also contribute to growth in the other sectors.

The performance of the tourism industry is expected to strengthen further with the completion of the multi-million upgrade of the Fua'amotu International Airport in Tongatapu and Lupepau'u International Airport in Vava'u. The successful completion of this project makes it possible for the first arrival in April 2016 of a Boeing 777 aircraft in Tongatapu and the introduction of direct flights by Fiji Airways from Nadi to Vava'u. Growth in the number of cruise ships arrivals, arrangements of Chinese group tours and plans to host international games domestically is expected to provide the added boost in the industry. Eight months into 2015/16, tourism earnings rose by \$11.5 million consistent with the 15.0% growth in visitor arrivals in the same period. The renovation of the IDH by the Tanoa Group is expected to boost the tourism industry in the years to come. However, the proposed increase in the passenger service charge

to help fund the 2019 Pacific Game (PG) poses a risk to the growth outlook for the sector.

Activities in the financial intermediation sector remains strong supported by higher credit growth during the first eight months of the financial year to February 2016. Increase in government transfers to the manage funds loan scheme facilitated by TDB also support the growing activities in this sector. The low interest rates and the ongoing competition among banks further contributed to growth. There is excess liquidity in the banking system which NRBT anticipates will support strong lending growth in the future.

### Unemployment

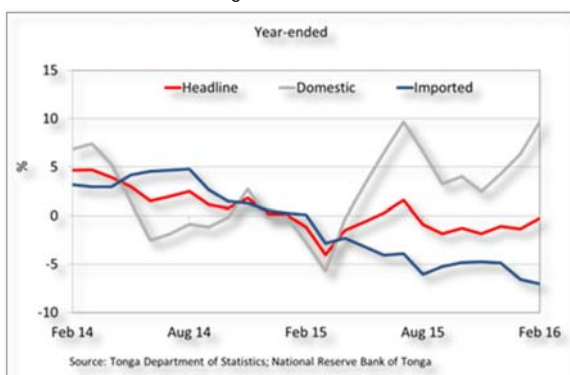
The unemployment rate remains at 6.5% as reported in the last MPS. According to the NRBT's survey of job advertisements, recruitment intentions were noted mainly in the public administration sector. Looking ahead, employment prospects remain positive in line with the economy's favorable growth outlook. NRBT will continue to investigate new avenues for the production of more timely and inclusive labour market data.

### 3. Promoting Low and Stable Inflation

#### Recent Developments

Inflationary pressures continued to ease in 2015 where only 3 months recorded annual positive inflation and annual deflation was noted in the remaining months. On an annual basis, February 2016 records a deflation of 0.3% compared with a deflation of 1.2% in February 2015. Key factors that have helped to drive down inflation include the declining imported food and oil prices more than offsetting a general increase in domestic prices. The year-on-year headline inflation is still well below the NRBT's reference range of 6-8%.

Figure 9: Inflation

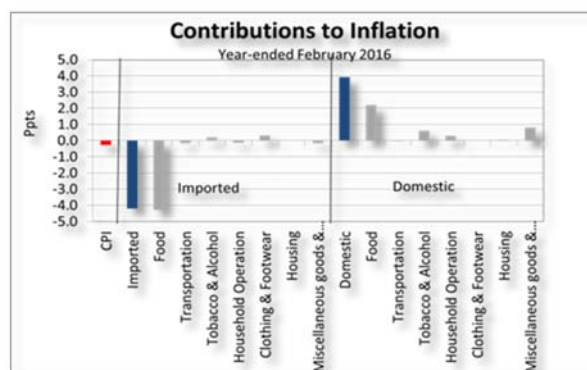


In February 2016, year-on-year imported prices recorded a deflation of 7.1%, marking 12 consecutive months of imported price deflation. This figure is the lowest level in history which was also significantly lower than the deflation of 2.8% seen in the same month a year earlier. Negative contributions from the food, transportation, and household operation categories were a drag on overall imported prices during the year.

Imported Food prices continued to decline since May 2015 to record the highest year-on-year fall of 13.8% in February 2016 due to a decline in prices for almost all food items particularly potatoes, onions, apples, mutton flaps, chicken pieces and flour. This partially reflects the flow-on effects of government incentives to exempt consumption tax and duties on healthy imported food including fruits and vegetables which was effective in July 2015 as well as the regulated

prices of imported chicken by the Competent Authority starting in November 2015. The Competent Authority also reduced the domestic fuel prices five times in the past 6 months likewise the Electricity Commission reduced the electricity tariff twice in the past 6 months, on account of falling global oil prices which coincides with the falling imported prices. Higher prices for tobacco and alcohol reflects government imposing additional import duty of 15% on imported beers, spirits, cigarettes and tobacco products.

Figure 10: Contributions to Inflation



The spike in the year-on-year domestic food prices from a deflation of 2.8% in February 2015 to a 9.7% rise in February 2016, largely reflects the significant increase in the price of Kava Tonga by 81.5%, and a 12.1% rise in food prices particularly for fruits and vegetables (24.6%) and meat, fish and poultry (9.6%). Lag effects of the drought and increased demand for domestic food items during the festivity season supported the increase in prices for food items such as talo futuna, talo tonga, cassava, early and late yams, lu, tomatoes, capsicum, ripe banana, watermelon, pineapple, pawpaw, brown and green coconuts, tuna fish, cockles and also stringed fish. Prices for stamps (air mail) also markedly increased by 206.6% over the year. Prices for household Furniture and textiles rose by 19.7%, reflecting increasing demand for these items, supported by the increase in construction activities.

Figure 11: Alternative Inflation Measures

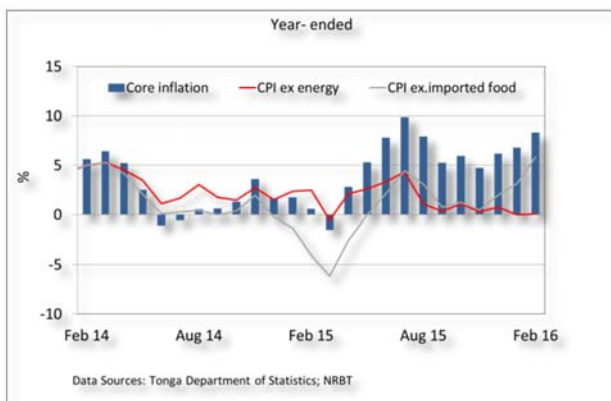
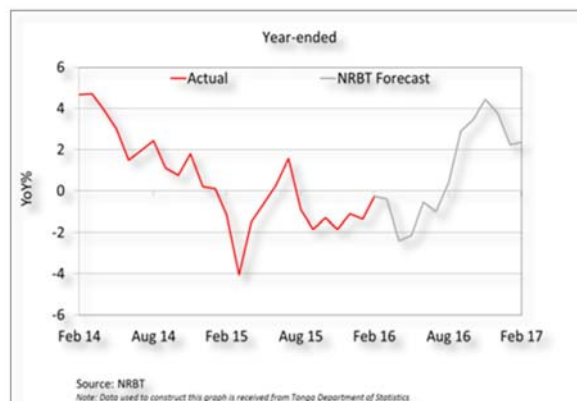


Figure 12: Headline Inflation Forecast



The annual core inflation rate (excluding energy and imported food) increased by 8.3% indicating the significant influence of global food and oil prices has on annual headline inflation. This is much higher than the 0.6% rise recorded in February 2015.

**Outlook**

Inflationary pressure is expected to remain low in the remaining months of 2015/16 and to record an annual

headline deflation of 0.6% in June 2016 then increase to a peak of 3.8% annual headline inflation at the end of 2016 as signs of world commodity prices picks up again before falling to 2.3% in February 2017. The IMF Article IV projected a 0.1% annual headline inflation rate for June 2017 in line with the IMF’s outlook on global commodity prices. Risks to this forecast would be developments in world oil and food prices for both domestic and imported inflation.



## 4. Maintaining Adequate Level of Foreign Reserves

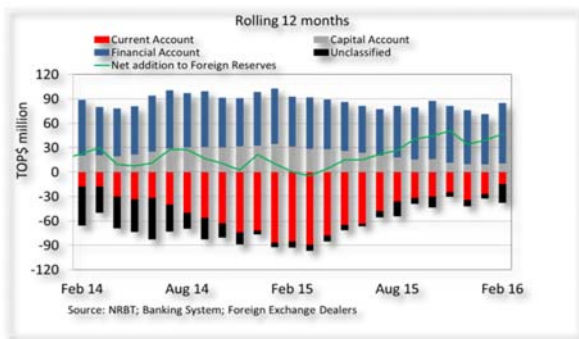
NRBT closely monitors external monetary position in its attempt to maintain an adequate level of foreign reserves above 3-4 months of imports cover. The following data and estimates of the balance of payments are based on the OET data collected by the NRBT from the banks and Foreign Exchange Dealers (FEDs).

### Balance of Overseas Exchange Transactions

The balance of OET, which is equivalent to the net change in the foreign reserves, deteriorated over the past six months to February 2016 to a surplus of \$17.6 million. This is 40.3% lower than the \$29.5 million surplus in the past six months to August 2015. This was due to a higher deficit in the current account at the end of the six months to February 2016, compared to a surplus in the past six months to August 2015.

However, the balance of OET over the year to February 2016 was a surplus of \$47.2 million compared to only \$0.2 million in February 2015. The higher surplus reflected a significant increase in the current account receipts over the year.

Figure 13: Balance of Overseas Exchange Transactions



### Current Account

The current account balance recorded a deficit of \$16.3 million over the six months to February 2016, in contrast to a surplus of \$1.7 million over the six months to August 2015. This was a result of increasing import payments over the last six months.

Over the year to February 2016, the current account balance recorded a deficit of \$14.7 million, significantly narrowing by \$70.8 million from the deficit reported in the previous year. This improved deficit stems from higher inflows from official and private transfers of \$47.3 million which more than offset the rise in merchandise trade balance of \$19.5 million. Services and income also recorded surpluses

of \$21.2 million and \$7.5 million respectively in the year ending February 2016, compared to deficits in the same period last year. This contributed to the lower deficit in the current account balance.

In the past six months to February 2016, import payments rose by 11.7% to \$161.1 million. Import payments for construction materials climbed by 47.7% over the past six months, indicating a more active construction industry, evident by the on-going construction projects in the main island of Tongatapu, including the opening of the RFB building. The rising level of housing loans would support more construction activity going forward. Import payments for motor vehicles also rose by 27.4% which is consistent with the 36.6% rise in motor vehicles registrations over the year. Oil import payments slightly rose by 2.0% over the past six months, reflecting the impact of the declining global oil prices during the year. On the other hand, import payments for wholesale and retail goods fell by 6.4% as demand slowed following months of strong demand due to the events such as the coronation festivities and church conferences.

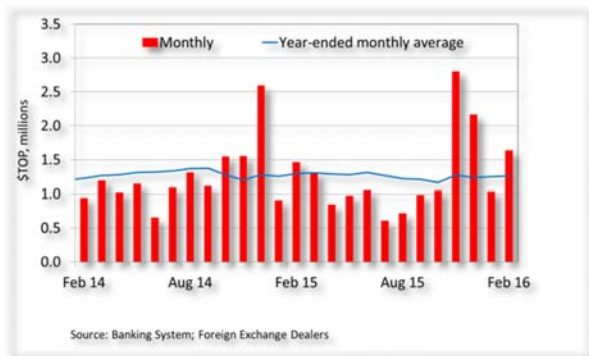
Figure 14: Import Payments



On an annual basis, import payments rose by 6.8% to \$305.3 million in February 2016 coinciding with the annual rise in container registrations of 24.3%. The rise in import payments was mainly attributed to the rise in import payments for wholesale and retail goods increasing by 8.5%, construction materials by 93.8%, and motor vehicles by 54.5%, offsetting the fall in oil import payments of 15.6%.

In the six months to February 2016, total export receipts rose by 76.1% to \$9.7 million when compared to the six months to August 2015. This was largely attributed to agricultural exports proceeds climbing by \$3.4 million (294.8%) during

Figure 15: Export Receipts



the squash harvesting season, supported by the 71.2% growth in tonnage of squash exports over the year ending February 2016. Fish and other marine exports proceeds also rose by \$1.0 million (35.7%).

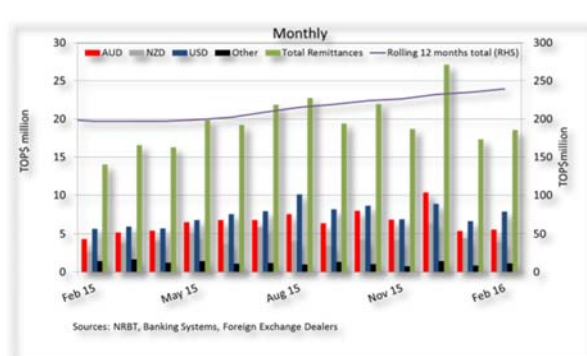
Year-on-year total export proceeds fell by \$0.1 million (0.4%) to \$15.2 million driven by a \$3.0 million (52.7%) drop in exports of other goods which more than offset the increase in agricultural exports of \$0.7 million (13.6%), and fish and other marine products by \$2.2 million (48.6%) over the year. The more favourable weather conditions this year aided the improvement in the proceeds from agricultural and fisheries products.

The turnaround in services receipts is largely owed to travel services receiving \$40.9 million over the six months to February 2016, a 1.4% increase compared to the past six months to August 2015. This aligned with the 8.3% rise in international air arrivals mainly due to the holiday season, christmas festivities, school reunions and church conferences. Over the year to February 2016, travel receipts increased by 20.7% to \$81.3 million, representing 61% of total service receipts.

Remittance rose by 5.6% to \$123.0 million over the six months to February 2016. This includes receipts from residents working in the Regional Seasonal Employers (RSE) scheme overseas, which totals to \$3.0 million over the 6 months to February 2016, compared to \$4.9 million in the 6 months prior. The strong USD and AUD supported the rise in remittances received as they both increased by 7.3% and 10.9% respectively.

In year ended terms, remittance have reached a new record high of \$239.4 million in the year ending February 2016 which was 22.5% higher than the previous year and representing 40.0% of total OET receipts. Receipts from RSE accounts for 3.3% (\$7.9 million) of the total remittance over the year. The

Figure 16: Remittances by Currency



2015 coronation celebrations, together with the church annual conferences and family reunions contributed to the higher inflow of remittance. Remittance received in USD hold the largest share of 38%, followed by the AUD with 35%, and the New Zealand dollar (NZD) with 22%. Positive growth in these economies and the weaker TOP contributed to the rise. According to the latest official measure of Gross National Disposable (GNP) income for 2014/15, remittance represents a 28% of overall GNP.

#### Capital Account

Capital receipts rose by 15.3% to around \$8.7 million over the past six months to February 2016. This was due to higher official and private capital receipts mainly for construction projects. Capital payments on the other hand declined over the same period by 33.2% to \$2.1 million driven by lower private capital payments. Therefore, the capital account balance recorded a surplus of \$6.6 million over the six months to February.

In year ended terms, the capital account balance was a surplus of \$11.0 million, 64.6% lower than over the year to February 2015. The lower surplus reflected a fall in private capital receipts due to lower receipts of private grants for investment projects and capital expenditures compared to the previous year.

#### Financial Account

Financial receipts rose by 12.8% to \$59.1 million over the past six months to February 2016 due to residents withdrawing funds from their accounts held overseas. Financial payments also rose by 12.5% over the same period to \$20.0 million due to the increase in residents transferring funds into their accounts held overseas. Thus, the financial account balance was a surplus of \$39.1 million over the six months to February 2016 compared to a surplus of \$34.7 million in the past 6 months to August 2015.

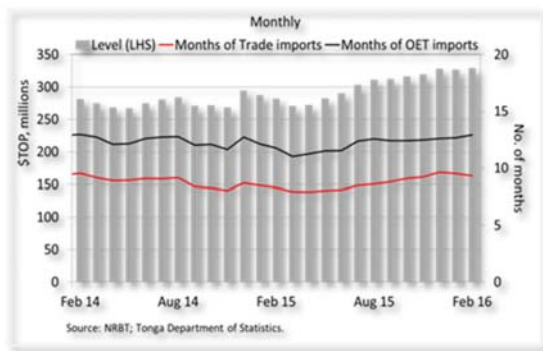
Over the year ended February 2016, the financial account balance was a surplus of \$73.8 million, which is 20.6% higher than over the year to February 2015, reflecting strong growth in other financial investments mostly in the form of interbank transfers with overseas correspondent banks.

The balance of unclassified transactions was an average outflow of \$1.9 million per month over the year ended February 2016, compared to \$0.6 million in the previous year. This was due to higher liabilities in the financial account balance from foreign exchange dealings between commercial banks and its overseas correspondent banks.

### Official Foreign Reserves

Gross official foreign reserves continued to rise as it reaches another record high of \$328.5 million in February 2016, compared to \$310.9 million in August 2015. This was sufficient to cover 9.3 months of imports, well above the NRBT's minimum range of 3-4 months. On year ended terms, gross official foreign reserves rose by \$47.2 million. The lower deficit in the current account balance, higher remittances, and receipt of foreign aid from donor partners including budgetary support for the government, contributed to the higher foreign reserves over the past year.

Figure 17: Gross Official Foreign Reserves



### Exchange Rates

The Nominal Effective Exchange Rate (NEER) fell by 4.2% over the six months to February 2016 as the TOP depreciated against currencies of its major trading partners except the British Pound. The lower headline inflation rate relative to that of our trading partners, combined with the lower NEER accounted for the 6.1% decline in the Real Effective Exchange Rate (REER). Over the year, both the NEER and the REER fell by 5.9% and 10.2% respectively. The continued weakening of the TOP against its major trading currencies over the year maintained price competitiveness against that of our trading partners.

### Outlook

The NRBT expects the level of foreign reserves to remain comfortably above the minimum range to June 2017. The forecast stems from a balance of key factors:

- The trade deficit is expected to narrow with higher imports being fuelled by firmer lending outcomes would be partially offset by anticipated higher export receipts.
- Remittance and travel receipts are expected to remain high due to upcoming festivities such as the 100<sup>th</sup> anniversary of the LDS church, TCT 150<sup>th</sup> anniversary and the annual church conferences.
- Government receipt of aid funds in the form of budget support and other assistance from donor partners are expected for the financial years 2015/16 and 2016/17.
- The IMF Article IV forecasted the foreign reserves to reach \$380 million at the end of June 2016 and \$398 million in June 2017. They also projected a current account surplus by the end of 2015/16 as remittance and services receipts are anticipated to increase, supported by a narrowing trade deficit.

Delays to the inflow of aid and budget support from development partners, combined with the pace of development in domestic economic activities may pose a risk to the foreign reserves outlook. The significant rise in external debt service to Export-Import (EXIM) Bank of China in financial year 2018/19 and preparations for the 2019 PG is also expected to put pressure on the level of foreign reserves.

Coping with natural disasters is a challenge as Tonga is one of the high-risk countries to natural disasters. This vulnerability presents a risk to agricultural, fisheries and tourism sectors which can greatly impact export and travel receipts.

The government is introducing a Foreign Exchange Levy to be effective before the end of 2015/16, to help with the funding of the upcoming PG in 2019. This levy is to be imposed on all foreign receipts and payments of the banks, foreign exchange dealers and the NRBT. This may also adversely impact the outlook on foreign reserves. Work is underway to amend the Foreign Exchange Control (FEC) Act to establish a framework for the return of the proceeds and earnings from exports of goods and services, such as tourism activities, that are being rendered from the country. This would support the NRBT's role of maintaining the foreign reserves.

## 5. Promoting a Stable Financial System

The financial system remained sound over the 6 months to February 2016 as the banking system continued to be profitable with strong liquidity and capital positions maintained. Total credit and deposits rose to record levels whilst the weighted average interest

rate narrowed to its lowest level over the 6 months to February 2016. Broad money and foreign reserves remained high, coinciding with the increase in banking system liquidity over the 6 months to February 2016.

Table 3: Consolidated Balance Sheet of Depository Corporations Level

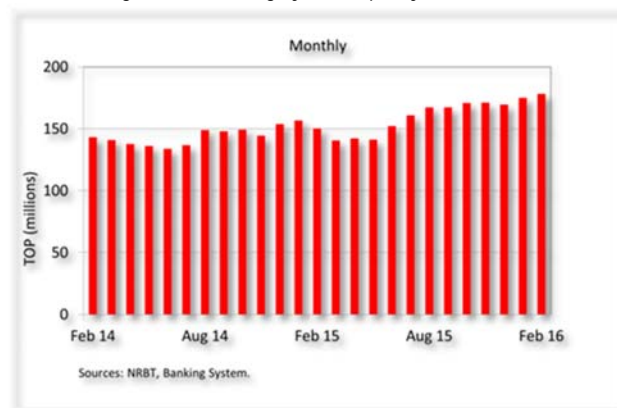
	Feb 16 \$TOPm	Aug 15 \$TOPm	Feb 15 \$TOPm	YoY change Feb 16 \$TOPm	%
<b>Broad money liabilities</b>	<b>456.5</b>	<b>424.2</b>	<b>379.7</b>	<b>76.8</b>	<b>20.2</b>
Currency in circulation	47.6	46.7	40.2	7.4	18.4
Demand deposits	182.3	158.6	137.1	45.2	33.0
Savings and Term deposits*	226.6	218.8	202.4	24.2	11.9
<i>equals</i>					
<b>Net foreign assets</b>	<b>330.3</b>	<b>302.4</b>	<b>266.7</b>	<b>63.6</b>	<b>23.8</b>
<i>plus</i>					
<b>Net domestic assets</b>	<b>126.2</b>	<b>122.4</b>	<b>113.3</b>	<b>13.2</b>	<b>11.6</b>
Gross bank lending**	340.5	318.5	305.6	35.0	11.4
Other***	-214.0	-196.1	-192.2	-21.8	11.3

### Money Supply

Broad money increased over the past 6 months to February 2016 to its highest record of \$456.5 million compared to \$424.2 million in August 2015. This stemmed from a 9.2% increase in net foreign assets and a 3.4% rise in net domestic assets. The increase in net foreign assets resulted from an increase in foreign reserves whilst the growth in lending contributed to the rise in net domestic assets. Broad money also increased over the year by 20.2%, underpinned by a 23.8% growth in net foreign assets and a 11.6% rise in net domestic assets. Currency in circulation also recorded a 18.4% growth over the year which is in line with the increase in broad money.

Banking system liquidity grew over the past 6 months to February 2016 by 6.4% to a new record high of \$177.9 million, compared to a 11.5% increase in the 6 months to August 2015. This was mainly due to the higher foreign reserves and an increase in banks' deposits. Banking system liquidity also increased by 18.7% over the year to February 2016, reflecting rises in foreign reserves and banks' deposits.

Figure 18: Banking system liquidity

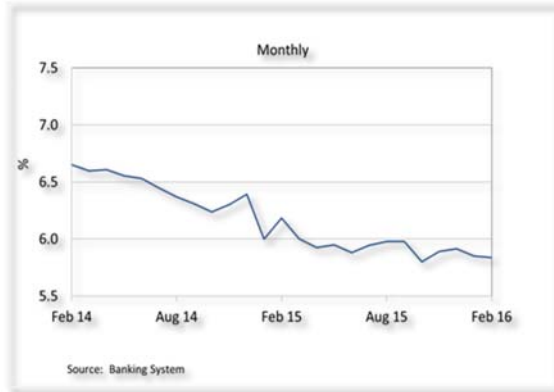


### Interest Rates

Banks' weighted average interest rate spread narrowed by 14.1 basis points to 5.84% in February 2016 from 5.98% in August 2015. This stemmed from a 23.2 basis points decline in weighted average lending rate to 8.03% which outweighed a 9.2 basis points decrease in weighted average deposit rate to 2.19%. Increased competition amongst banks and the high liquidity drove the weighted average lending rate lower whilst the rise in deposits

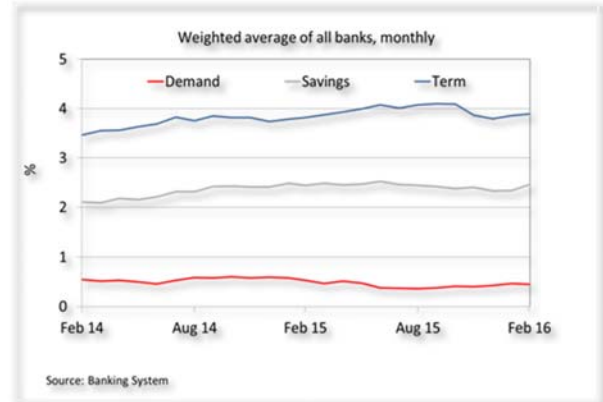
contributed to the decline in weighted average deposit rate. Over the year, banks' weighted average interest rate spread narrowed from 6.2%, reflecting the fall in the weighted average lending rate of 43.5 basis points which more than offset the decline in the weighted average deposit rate of 8.6 basis points.

Figure 19: Weighted Average Interest Rates Spread



on business loans decreased the most, owing mainly to banks offering competitive interest rates on loans to businesses, including public enterprises. Continued competition amongst banks and the government's low-interest rate managed funds will continue to support the current low lending rates.

Figure 20: Deposit Rates



Banks' weighted average interest rates on most of the key lending categories fell over the 6 months to February 2016, with the other personal loans interest rate decreasing the fastest followed by the housing loan interest rates. The decline in the weighted average lending rate on other personal loans supported a 5.7% increase in other personal loans over the same period. This would suggest stronger consumer confidence and support economic activity. Over the year, the weighted average interest rate on all bank loans fell by 43.5 basis points, reflecting declines in weighted average interest rates on all of the key lending categories. The weighted average lending rate

However, the weighted average deposit rate fell over the 6 months to February 2016, underpinned by a decline in the weighted average term deposit rate, offsetting an increase in both the weighted average demand and saving deposit rates. The weighted average term deposit rate fell due to the increase in term deposits at lower interest rates compared to the previous 6 months to August 2015. However, the increase in the weighted average demand deposit rate supported a 7.3% rise in total deposits over the 6 months to February 2016 to its highest level of \$429 million. This reflected increases mainly in businesses' demand deposits. An increase in

Table 4: Lending Rates

Weighted average of all banks

	Level as at			Change over 6 months to		Loan share	
	Feb 16 %p.a.	Aug 15 %p.a.	Feb 15 %	Feb 16 bps	Aug-15 bps	Feb 16 %	Aug-15 %
All	8.03	8.26	8.46	-23	-20	100	100
Housing	8.18	8.52	8.47	-34	5	38	35
Other personal	10.94	11.31	11.04	-37	27	17	18
Business*	7.17	7.38	7.77	-21	-39	26	26
Other	6.25	6.25	6.53	0	-28	19	20

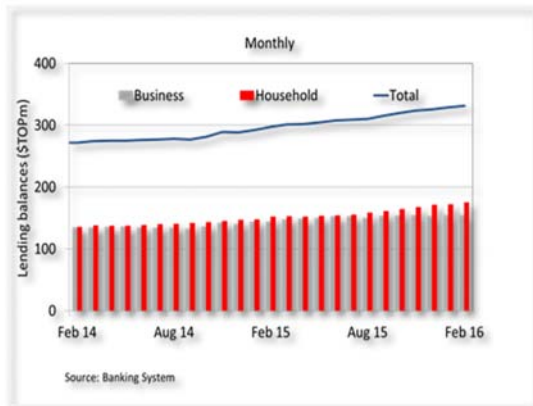
\*Included Statutory Non-financial Corporation and Other Financial Corporations

government deposits also contributed to the higher demand deposits reflecting the increase in revenue collected from tax. Over the year, the weighted average deposit rate fell by 9 basis points on the back of a decline in the weighted average demand deposit rate.

### Lending

Total bank lending rose over the 6 months to February 2016 by 7.1% to its highest level of \$331.9 million compared to a 4.2% growth in the 6 months to August 2015. More than half of the increase in total loans were for households coupled with growth in business loans, indicating growing economic activities. New loan commitments increased over the 6 months to February 2016 by 23.3% to \$12.9 million, compared to a 39.0% decline over the 6 months to August 2015. This was driven mainly by rises in new loan commitments to both households and businesses.

Figure 21: Bank's lending

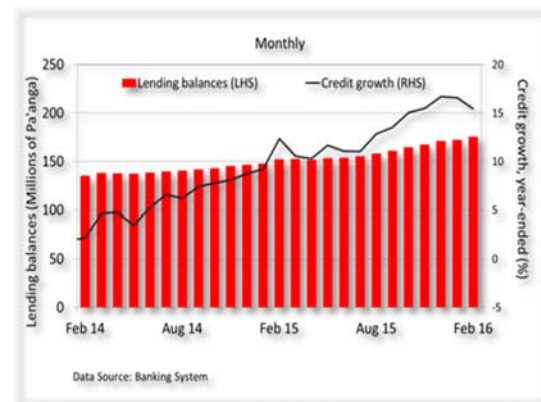


Annual total loans extended by banks increased by 11.6%, resulting from higher lending to households and businesses. This reflected a 24.8% growth in new loan commitments over the year, reflecting rises in household's loan commitments. Lending activities in the non-bank financial institutions also increased over the year by 14.7%, driven by an increase in lending to households.

Banks' lending to households recorded a growth of 10.8% to \$175.3 million over the 6 months to February 2016, compared to a 4.2% rise in the 6 months to August 2015. All household loan categories increased, with housing loans rising the fastest. This is in line

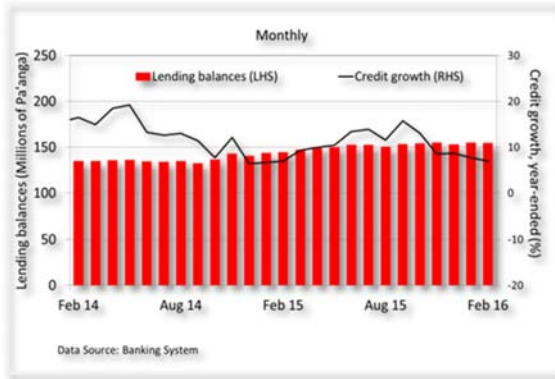
with a 30.4% rise in new household loan commitments to \$9.7 million, driven entirely by increases in new housing loans commitments. Ongoing competition particularly the housing loan campaigns and refinancing of housing loans amongst banks have contributed to the increase in housing loans. However, the increase in vehicles and other personal loans over the past 6 months reflected annual events and strong consumer demand which was also supported by a 5% rise in the COLA in the civil servants' salaries that was effective in November 2015. In year ended terms, total household lending increased by 15.4%, reflecting rises in all the household categories. This coincides with rises in import payments for construction materials and vehicles over the year. New household loan commitments also increased over the year by 20.7% on the back of higher housing loan commitments.

Figure 22: Household Lending



Banks' lending to businesses also increased over the 6 months to February 2016 by 2.7% to \$154.4 million. This resulted mainly from rises in lending extended to businesses mainly in the tourism, manufacturing, construction, trade and fishing sectors, indicating growing activities in these sectors. New business loan commitments also increased over the 6 months to February 2016 by 57.4% to \$3.2 million, mainly loan commitments to the manufacturing and trade sectors. Only 1.3% of the total loans were funded from the government's managed funds scheme as at the end of February 2016, decreasing from 1.4% in August 2015. The

Figure 23: Business Lending

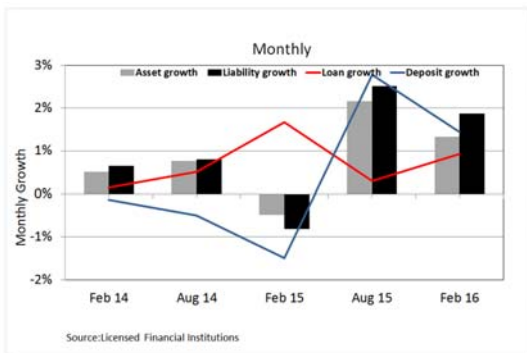


total funds allocated for the managed funds loan scheme was about \$13 million which was effective in August 2014 for a term of 6 years. Over the year, banks' loans to businesses also increased by 7.0%, reflecting rises mainly in lending to the manufacturing, construction, tourism, trade and agricultural sectors.

### Banking System Performance

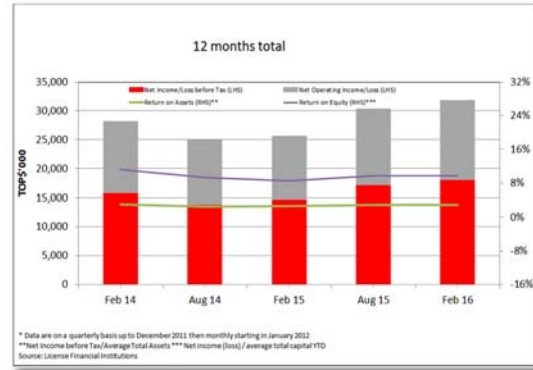
The banking system continued to remain sound during the six months to February 2016. The total assets of the banking system increased by 7.7% to \$667.8 million over the six months to February 2016 mainly due to growth in total loans and the higher exchange settlement accounts, which coincides with the higher deposits and liquidity. Similarly, total liabilities increased by 9% to \$524.3 million, due mainly to a 9% growth in total deposits over the past six months to February 2016.

Figure 24: Total Banking System Balance Sheet Development



The banking sector remained profitable. The Net Profit After Tax for the six months ended February 2016 was \$13.6 million, a slight decrease from \$13 million in August 2015, but

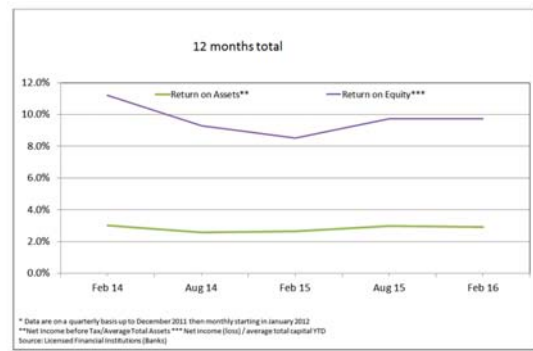
Figure 25: Total Banking System's Profitability



improved from \$10.9 million in February last year. This represented a Return on Assets (ROA) of 2.9%, which slightly fell from 3% in August 2015, but increased from 2.6% in February 2015. The Return on Equity (ROE) on the other hand remained relatively stable at 9.7% compared to August 2015, but rose from 8.5% in February 2015.

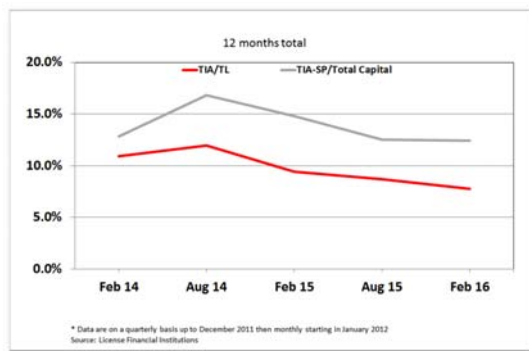
Over the six months, despite the slight increase in the non-interest income to 3.8% of average assets from 3.7% in August 2015, largely due to increase in income from foreign exchange, which was supported by the decline in non-interest expenses to 4.3% of average assets from 4.5% in August 2015 due mainly to lower outsourcing and management fee expenses, this was offset by an increase in provision expenses to 0.3% of average assets from 0.1% in August 2015 and a decline in net interest income to 3.5% of average assets from 3.6% in August 2015.

Figure 26: Total Banking System's ROE & ROA



The liquidity position of the banking system continued to remain comfortably above the minimum liquidity requirements during the six

Figure 27: Total Banking System Asset Quality Indicators



months to February 2016. Furthermore, the capital position of the banking system remained strong as healthy profits were recorded by the banks. The total risk-weighted capital ratio remained above the minimum ratio required by the NRBT of 15% at 43% at the end of February 2016, rising from 41.8% in August 2015 and 40.8% in February 2015.

The overall quality of the banks' assets (loan portfolio) still requires close monitoring over the six months to February 2016 even though there was some improvement to a more manageable level compared to previous years. Total non-performing loans decreased by 5% to \$25.7 million over the past six months to February 2016, representing 7.7% of total loans, improving from 8.7% six months ago. There are adequate provisions held against the non-performing loans. Most of the non-performing loans are business loans. Therefore, the decline in the level of non-performing loans indicates an improvement in the performance of private sector businesses and improved economic conditions.

#### Supervision of Non-Bank Financial Institutions (NBFIs)

Following the amendments to the NRBT and Financial Institutions Act in 2014 to extend the NRBT's mandate to include the supervision and oversight of all non-bank financial institutions, work is still in progress to develop separate legislations for all the NBFIs. In addition, the FEC Act which enables the NRBT to regulate foreign exchange dealers is being amended to strengthen the enforcement powers of the NRBT. Priority legislations are to

be processed in the 2016 parliamentary session, which includes the FEC (Amendment) Bill, Microfinance Bill, Money Lender Bill, and Credit Union Bill. Other legislations that are being drafted include the legislations for the supervision of retirement funds, insurance companies, investment firms, and the capital markets. Furthermore, the NRBT is developing a Consumer Protection policy pursuant to section 59B(2) of the NRBT (Amendment) Act 2014 to enhance the protection of financial consumers and thereby maintain confidence in the financial system. Work is also in progress to register and stock take all the NBFIs operating in Tonga while awaiting the approval of the legislations.

The financial system is affected by the banks' de-risking decisions which has resulted in the closing of some of the foreign exchange dealers' accounts and the difficulty in securing correspondent banks for some banks due to elevated money laundering & terrorist financing risks associated with foreign exchange dealers and the US banks tightening their standards on correspondent banks who trade in USD outside of the US. In recognition of the potential impact of these de-risking decisions on the cost and level of remittances and the economy as a whole, as well as encouraging illicit flows through more informal channels, the NRBT has worked together with the foreign exchange dealers to improve their Anti-Money Laundering/Counter Terrorist Financing (AML/CFT) compliance status and required that their agents overseas are being licensed by another competent authority, in order for the banks to retain their accounts. The banks in Tonga were willing to retain some of the accounts as a result, however, the issue now is the overseas agents' banks are continuing to close their accounts in NZ and Australia, due to pressure from their correspondent banks in larger countries such as the US and UK to follow suit. This is a real problem and a growing one both regional and globally therefore regional efforts have been put forward to the regulators in Australia and NZ as well as the AML/CFT standard setters to reconsider their tight standards on lower AML/CFT risk countries such as Tonga and other Pacific



Islands. To date, there has been no concrete solution from these efforts, however at the same time, the money transfer operators are being encouraged to develop alternative ways of transferring remittance such as online-based products. Positive development however has been seen as the smaller banks have been successful in their applications to open USD correspondent bank accounts in one of the Australian banks.

#### **Financial Inclusion Initiatives**

The NRBT is a member of the Alliance for Financial Inclusion (AFI) network in its efforts to promote financial inclusion in Tonga. Inclusive economic growth and improving access to financial services is crucial for poverty reduction and improving the people's standard of living. The NRBT intends to collaboratively develop a National Financial Inclusion Strategy to promote financial inclusion in Tonga. A Supply Side Survey was conducted to assess the availability of financial services to financial customers. In addition, a Demand Side Survey was conducted in February to March 2016 to identify the public's demand for financial services, and the outcome of this survey is still being finalised. The intention is to ensure that appropriate policies and products are being developed by the suppliers of financial services to meet the identified demand for financial services, which would improve the access to financial services and bring on-board those in the informal sector to the formal sector. The NRBT committed to the Maputo Accord 2015 during the AFI's Global Policy Forum meeting in September 2015 in order to develop and

improve the access of Small to Medium Enterprises (SMEs) to finance by 20% by 2020. The NRBT through its membership in the AFI has received assistance to promote the access of SMEs to finance and this project is in progress.

#### **Outlook**

The NRBT is forecasting credit growth to continue and a growth of about 14.4% to be recorded at the end of the 2015/16 and 11% in 2016/17. This coincides with the IMF Article IV's projection of 15.5% growth for 2015-16 and 10.8% for 2016/17. The banks' prospects for credit growth remain positive and the NRBT's projection is supported by the continuous improvements in business confidence, improving economic conditions and annual events. Broad money is also projected to increase in June 2016 by 13% and 10% in June 2017, supported by the anticipated rise in lending and foreign reserves. This is consistent with the IMF Article IV's projection for broad money to rise by about 12% and 9% in June 2016 and 2017 respectively. The NRBT's proposed policy measures that are currently being discussed with the banks, such as a target on banks' loans/deposit ratios to encourage further lending, should also support the anticipated continued growth in credit and broad money. At the same time, it is important for the structural reforms in different sectors as well as other impediments to lending such as the improvement to the land administrative system and laws and bankruptcy laws, to improve the confidence of the banks to lend further in a prudent manner.

## 6. Fiscal Indicators

Banking system data shows the net credit to government fell by 3.0% over the six months to February 2016, compared to an increase of about 11.0% over the six months to August 2015. This was due to a 9.3% rise in government deposits reflecting higher government revenue collection during the past six months. Dividends received from Public Enterprises and the high customs and duty collection during the festive season contributed to the higher government revenue over the past 6 months. Additionally, the NRBT registered a \$7.7 million new government bond issued in January 2016 which led to the 24.5% rise in banks' bond holdings. Over the year to February 2016, net credit to government rose by 8.3% driven by a 0.6% increase in government deposits, reflecting the receipt of budgetary support and the new bond issued.

The 2015/16 government budget estimated the receipt of T\$28.4 million in budget support from development partners, however, none has been received to date. However, a delayed budgetary support of T\$8.72 million from the European Union (EU) that was budgeted for 2014/15, was received in September 2015. This contributes to the increase in foreign reserves in the past 6 months to February 2016.

Tonga remains at moderate risk of external debt distress, and its external debt continues to increase as a result of the 50% of the grants from World Bank and Asian Development Bank received during the year being deemed credit. The total public debt position for June 2016 is estimated to be 51% of GDP, of which 44.6% is external debt and 6.4% is domestic debt. External Debt service is projected to remain at over \$10 million for the next two fiscal years, and then increase significantly to \$26.0 million in 2018/19, reflecting the first principal repayment for the Nuku'alofa Central Business

District loans, followed by the commencement of principal repayment for the Road Project in 2019/20, both to EXIM Bank of China. This will put pressure on the level of foreign reserves. The EXIM Bank of China remained the main external debt creditor hence the Chinese renminbi has the highest share of the total external debt portfolio.

The government budget statement for 2015/16 showed new government bonds of T\$15 million to be issued during the year, where \$5 million is to support the managed fund loan scheme currently facilitated by the TDB, and T\$10 million to pay for the transfer value owed by the government to the RFB. This will contribute to higher liquidity in the banking system. At the end of February 2016, total government bonds of \$7 million have been issued in January 2016, and only \$5.1 million have been allotted. The remaining \$9.9 million as indicated by the Ministry of Finance are to be issued in April and June 2016.

Few of the initiatives set out by government in its budget statement for 2015/16 have been implemented, such as the expansion of the private sector initiatives (loan scheme managed by TDB) and amending the existing taxes (custom and excise) for specific goods. With the on-going campaign for a healthier Tonga, the government has imposed a zero percent rating of duty on healthy imported food, leading to the lower prices in imported fruits and vegetables. Likewise, the government has imposed an additional import duty of 15% on imported beers, spirits, cigarettes and tobacco products with the attempt to discourage its consumption. This is reflected in the higher prices for tobacco and alcohol index in February 2016. Ultimately these efforts should support lower non-communicable diseases and in turn lower government health spending in the long term. Part of the new bond issued in

January 2016, were transferred to TDB for the managed funds loan scheme. The remaining government bonds to be issued before the end of this fiscal year is also expected to be transferred to the managed funds loan scheme which would support economic activity in the private sector. The fisheries sector continued to benefit from tax exemption on imported oil and fishing gears.

Two other initiatives that are yet to be implemented include increasing the passenger service charge and the levy. This is to assist with the funding of the 2019 PG .

The government has indicated during the 2016 IMF Article IV mission that the funding of the PG will be a non-debt financing source. The two main venues that need construction works are the Teufaiva outdoor stadium and the Tonga High School (THS) sports complex. PNG with the assistance from NZ will finance the construction at the Teufaiva stadium while THS is to be funded from China. The construction work for the Teufaiva stadium is expected to commence in March 2016 until

September 2017, whilst the THS sports complex construction commences in October 2016 till July 2018. These construction activities support the NRBT's forecast for continuous strong growth in the construction sector in the years to come.

Going forward, it is anticipated that government receipts will increase in the near term from a rise in public debt due to the remaining new bonds to be issued before the end 2015/16 and the receipts of budget support This includes the budget support yet to be received in 2015/16 which supports the NRBT projection for foreign reserves to remain comfortably above the minimum range to June 2017.

Net credit to the government is also expected to increase, coinciding with the higher liquidity within the banking system and broad money. However, this is also subject to the proposed expenditure in the government's 2016/17 budget estimate, which is due to be released in June 2016. NRBT will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

## 7. Monetary Policy Stance

In the past six months to February 2016, inflation remained low and foreign reserves were at a comfortable level above the minimum range of 3-4 months of import cover; exchange rates were 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 NRBT maintained the current accommodative monetary policy stance.

The NRBT continues to project inflation to remain below the reference range of 6% to 8% and foreign reserves to remain above the 3-4 months of import cover. The banks' loans/deposit ratio remained below the NRBT's internal benchmark which indicates that there is excess liquidity in the banking system. However, as the 2016 IMF Article IV mission had recommended, the NRBT will remain vigilant and closely monitor early signs of vulnerabilities. Furthermore, the outlook is for the economy to grow strongly. The current accommodative monetary policy stance is therefore considered appropriate in the medium term. At the same time, the following policy actions are being taken by the NRBT to enhance its role in promoting macroeconomic and financial stability:

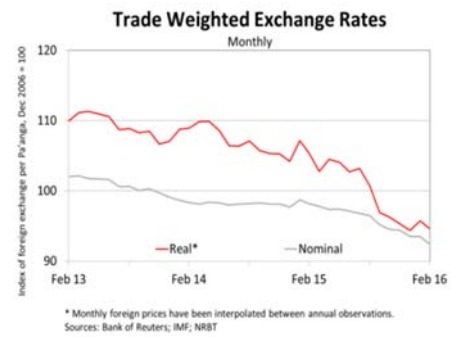
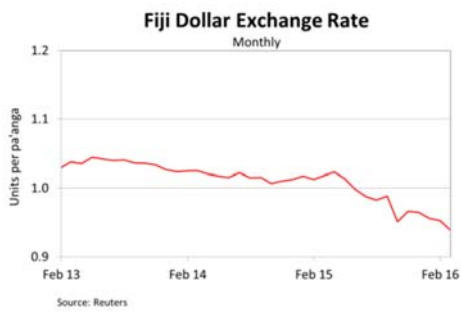
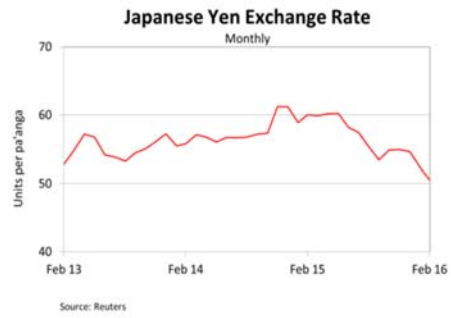
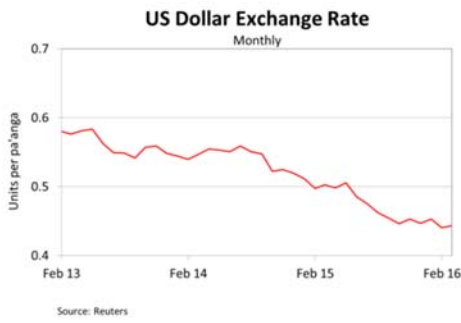
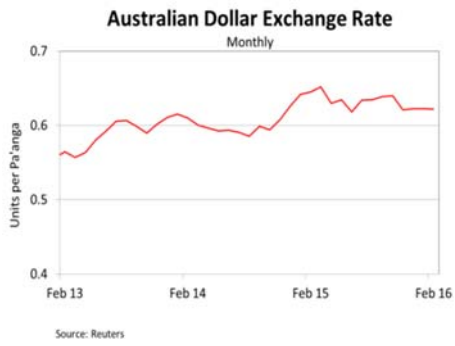
- 1) Consider measures to encourage the full utilization of the excess liquidity in the banking system for lending activities to support economic growth.
- 2) Explore alternative monetary policy tools and other macro-prudential tools to strengthen the transmission mechanism and ensure financial stability is maintained.
- 3) Amendment to the Foreign Exchange Control Act to improve the NRBT'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.

- 4) Develop separate legislations for the supervision and regulation of each type of non-bank financial institution (NBFIs) as well as the regulation of capital markets. This would encourage improved access to finance but in a prudent way that would protect the interest of customers of the NBFIs. This would include issuing a Consumer Protection Policy to protect the interests of the customers of all financial service providers.
- 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) Improvement to the credit environment to encourage lending by banks, including the regulation of the credit bureau to ensure it is effective in its function of providing the credit history of borrowers to enable the banks to lend to them.
- 7) Amendment to the Financial Institutions Act to strengthen the controllership and receivership provisions as it focuses on bank supervision only.
- 8) Develop the domestic financial markets in order to be more market based, to improve the attractiveness of investments in local securities.

The NRBT will closely monitor the country's economic and fiscal developments and financial conditions to maintain internal and external monetary stability, and promote a sound and efficient financial system in order 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 through 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.

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 58% 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 and sustainable economic development. Price stability also contributes to better economic performance. 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 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 depend 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 raise prosperity for Tonga.